2000 CAPITAL ACCOUNTS- ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

Under the general principle of § 704(b) and (c), an allocation of partnership's income, gain, loss, or deductions must have substantial economic effect, or be in accordance with the partners' interests in the partnership. (See PTM 1040)

When property is contributed to a partnership, the contributing partner must be allocated certain items of income, gain, loss and deductions attributable to the pre-contribution appreciation or depreciation. (See PTM 2100)

If the contributed property is distributed by the partnership to a non-contributing partner, the contributing partners may recognize certain gain or loss. (See PTM 2450)

If the contributing partner receives certain distributions from the partnership, he may have to recognize gain.

PTM 2100 General Principles
PTM 2200 Traditional Method
PTM 2300 Remedial Allocation Method

PTM 2500 Distribution of Contributed Property
PTM 2600 Seven-year Period
PTM 2900 Audit Issues and Techniques

2100 GENERAL PRINCIPLES

The purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution (built-in) gain or loss. To achieve that purpose, § 704(c) and the regulations thereunder provide the following: [Treas. Reg. § 1.704-3(a)(1)]

- A partnership's allocation of income, gain, loss, and deduction with respect to property contributed by a partner to the partnership must take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.
- The allocation must be based on a **reasonable** method that is consistent with the purpose of § 704(c). A reasonable allocation method must include the application of all of the rules of § 704(c) regulations (e.g., aggregation rules).
- Section 704(c) regulations provide three allocation methods that are generally reasonable: Traditional method, Traditional method with curative allocations, and

Remedial allocation method. Other methods may be reasonable in appropriate circumstances.

- An allocation method is not necessarily unreasonable merely because another method would result in a higher aggregate tax liability. However, in the absence of specific published guidance, an allocation method that distorts the basis of the contributed property or disregards the effects on the book capital accounts is not reasonable.

PTM 2110 Operating Rules
PTM 2120 Definition of § 704(c) Property
PTM 2130 Definitions of Built-in Gain and Built-in Loss
PTM 2140 Accounts Payable
PTM 2150 Other Provisions
PTM 2160 Revaluation and § 704(c) Principals
PTM 2170 Transfer of Partnership Interest
PTM 2180 Disposition of Property in Non-recognition Transaction

PTM 2181 Disposition in an Installment Sale
PTM 2190 Tiered Partnerships
PTM 2195 Anti-Abuse Rules

2110 Operating Rules

The allocation method applies on a property-by-property basis.

In determining if there is a disparity between the adjusted tax basis and the fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated.

A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purposes of § 704(c).

It may be unreasonable to use one method for appreciated property and another method for depreciated property.

It may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using the curative

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allocations for built-in gain property contributed by a partner with a low marginal tax rate. [Treas. Reg. § 1.704-3(a)(2)]

2120 Definitions of § 704(c) Property

A § 704(c) property is a property that at the time of contribution, its book value (i.e., fair market value) differs from the contributing partner's adjusted tax basis.

For purposes of IRC § 704(c), book value is determined as contemplated by § 1.704-1(b). Thus, book value is equal to fair market value (See PTM 1470) determined at the time of contribution and is subsequently adjusted for cost recovery (depreciation) and other events that affect the basis of the property.

For a partnership that maintains capital accounts in accordance with the capital account rules under § 1.704-1(b)(2)(iv) (See PTM 1400), the book value of property is initially the value used in determining the contributing partner's capital account under § 1.704-1(b)(2)(iv)(d) (regarding contributed property, see PTM 1420) and is appropriately adjusted thereafter (e.g., for book cost recovery under §§ 1.704-1(b)(2)(iv)(g)(3) and 1.704-3(d)(2) and other events that affect the basis of the property).

For a partnership that does not maintain capital accounts under the rules of § 1.704-1(b)(2)(iv), it must comply with §1.704-3(a)(3) by using a book capital account based on the same principle stated immediately above.

If the partnership has a termination under § 708(b)(1)(B)[8],
the property deemed to be contributed to the new partnership is not a § 704(c) property unless the property was already a § 704(c) property in the hands of the terminated partnership immediately prior to the termination. This provision applies to termination under § 708(b)(1)(B) occurring on or after May 9, 1997. However, for terminations that occurred on or after May 9, 1996, the provision may be applied provided that the partnership and its partners apply the provision in a consistent manner. [Treas. Reg. § 1.704-3(a)(3)(i)]

2130 Definitions of Built-in Gain and Built-in Loss

The built-in gain on § 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution.

[8] Commonly referred to as a "technical" termination.

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The built-in gain is thereafter reduced by the decreases in the difference between the property's book value and adjusted tax basis.

The built-in loss on § 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution.

The built-in loss is thereafter reduced by the decreases in the difference between the property's book value and adjusted tax basis. [Treas. Reg. § 1.704-3(a)(3)(ii)]

For definition of book value, see PTM 2120.

2140 Accounts Payable

If a partner using a cash receipts and disbursements accounting method contributes accounts payable and other accrued but unpaid items, these items are treated as § 704(c) property for purposes of applying the rules of § 704(c). [Treas. Reg. § 1.704-3(a)(4)]

2150 Other Provisions

The rules of IRC § 704(c) and the regulations thereunder apply to a contribution of property to the partnership only if the contribution is governed by § 721, taking into account other provisions of the code. Thus, if a transfer of property to a partnership is treated as a sale under § 707, the property is not a § 704(c) property. [Treas. Reg. § 1.704-3(a)(5)]

2160 Revaluation and § 704(c) Principles

- The principles of § 704(c) apply to allocations with respect to property for which its book value differs from its adjusted tax basis as a result of the partnership's revaluation (See PTM 1450) of its property under § 1.704-1(b)(2)(iv)(f) or § 1.704-1(b)(2)(iv)(s) (reverse § 704(c) allocations). [Treas. Reg. § 1.704-3(a)(6)]

- Partnerships are not required to use the same allocation method for reverse § 704(c) allocations as for contributed property, even if at the time of revaluation, the property is already subject to the § 704(c) regulations. Thus, if the partnership uses an allocation method for a contributed property, it can use another allocation method for such property after a revaluation. In addition, each time the partnership revalues its property, it may use a different allocation method, provided the method used is reasonable and consistent with the purposes of § 704(b) and (c). [Treas. Reg. § 1.704-3(a)(6)]

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- A partnership making adjustments under § 1.743-1(b) or § 1.751-1(a)(2) must account for built-in gain or loss under § 704(c) in accordance with the principles of the § 704(c) regulations. [Treas. Reg. § 1.704-3(a)(6)(ii)] Treas. Reg. § 1.743-1(b) relates to adjustments to basis of partnership property as a result of a transfer of an interest in the partnership. Treas. Reg. § 1.751-1(a)(2) relates to adjustments to IRC § 751 property (hot assets) due to a sale or exchange of an interest in the partnership.

2170 Transfer of Partnership Interest

If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. [Treas. Reg. § 1.704-3(a)(7)]

If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner. [Treas. Reg. § 1.704-3(a)(7)]

2180 Disposition of Property in Non-recognition Transaction

If a partnership disposes of § 704(c) property in a non-recognition transaction in which no gain or loss is recognized, the substituted basis property is treated as § 704(c) property with the same amount of built-in gain or loss as the § 704(c) property disposed of by the partnership. [Treas. Reg. § 1.704-3(a)(8)]

IRC § 7701(a)(42) defines “substituted basis property” as property which is transferred basis property, or exchanged basis property. Transferred basis property is property whose basis is determined by reference to the basis in the hands of the donor, grantor, or other transferor. Exchanged basis property is property whose basis is determined by reference to the basis of the property transferred.

If gain or loss is recognized in a non-recognition transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. [Treas. Reg. § 1.704-3(a)(8)(i)]

If a partnership transfers § 704(c) property together with other property to a corporation under § 351 (nontaxable transfer to a corporation controlled by transferor), in order to preserve the § 704(c) property’s built-in gain or loss, the basis in the stock received in exchange for § 704(c) property is determined as if each item of § 704(c) property had

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been the only property transferred to the corporation by the partnership. [Treas. Reg. § 1.704-3(a)(8)(i)]

2181 Disposition in an Installment Sale

If a partnership disposes of § 704(c) property in an installment sale as defined in § 453(b), the installment obligation received by the partnership is treated as the section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property. [Treas. Reg. § 1.704-3(a)(8)(ii)]

2190 Tiered Partnerships

If a partnership contributes § 704(c) property to another partnership (the lower-tier partnership), or if a partner who contributes § 704(c) property to a partnership contributes his partnership interest to another partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of the lower-tier partnership items with respect to that § 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. [Treas. Reg. § 1.704-3(a)(9)]

2195 Anti-Abuse Rules

An allocation method (or a combination of methods) is not reasonable if the contribution of property (or event that results in reverse § 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. [Treas. Reg. § 1.704-3(a)(10)] (See PTM 2210, Example (4))

2200 TRADITIONAL METHOD

Under the general principle of allocation under § 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Section 704(c) regulations provide three allocation methods that are generally reasonable: Traditional method, Traditional method with curative allocations (See PTM 2220), and Remedial allocation method (See PTM 2400).

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In general, the traditional method requires that the partnership's income, gain, loss, or deductions attributable to § 704(c) property must be allocated in a manner to avoid shifting the tax consequences of the built-in gain or loss. Under this rule:

- If the partnership sells § 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner.
- If the partnership sells a portion of, or an interest in, § 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner.
- If the § 704(c) property is subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items must take into account the built-in gain or loss on the property. For example, the tax allocation of cost recovery deductions with respect to § 704(c) property to non-contributing partners must, to the extent possible, equal the book allocations to those partners. There is a limitation to this requirement under the Ceiling Rules discussed at PTM 2210. [Treas. Reg. § 1.704-3(b)(1)]

PTM 2210 The "Ceiling Rule" Under Traditional Method
PTM 2220 Traditional Method with Curative Allocation
PTM 2230 Reasonable Curative Allocations

2210 The "Ceiling Rule" Under Traditional Method

The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. [Treas. Reg. § 1.704-3(b)(1)]

Example 1*: Terry and J.J form a partnership and agree that all partnership's items will be shared equally except that items attributable to § 704(c) property will be allocated under the traditional method. Terry contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. J.J. contributes $10,000 cash. Under § 1.704-3(a)(3)(ii)* (See PTM 2130*), Terry has a built-in gain of $6,000, the excess of book value over adjusted basis.*

The property is depreciated using the straight-line method over a 10-year recovery period. Thus, the annual tax depreciation on the property is $400 and the book depreciation is $1,000. If the adjusted tax basis of the property equaled its fair market value at the time of contribution (i.e., $10,000), J.J would have been entitled to a depreciation of $500 annually for both book and tax purposes (50% of total $1,000

depreciation). Under the "ceiling rule", the partnership can allocate only $400 of tax depreciation and the tax allocation must be allocated entirely to J.J.

Assuming during the first year, the partnership operating income equals its expenses (without depreciation), the book value of the property at the end of the first year is $9,000 and its adjusted tax basis is $3,600. The capital accounts of the partners are:

	Terry		***J.J.***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: Losses	*500*	*0*	*500*	*400*
End of year 1	*$9,500*	*$4,000*	*$ 9,500*	*$ 9,600*

Also, Terry's built-in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). [See Treas. Reg. § 1.704-3(b)(2), Ex. 1 (ii)]

***Example 2**: Assume the same facts as in Example 1 except the partnership sells the property at the beginning of year 2 for $9,000. The partnership realizes a taxable gain of $5,400 ($9,000, the amount realized less $3,600 adjusted tax basis). Under § 1.704-3(b)(1), the entire gain of $5,400 must be allocated to Terry because the property he contributed has that much built-in gain remaining. If the property is sold for less than $9,000, the gain will be less than $5,400 and has to be allocated entirely to Terry.*

Assume the partnership sells the property at the beginning of year 2 for $10,000, the partnership realizes a taxable gain of $6,400. Under § 1.704-3(b)(1), only $5,400 of the gain has to be allocated to Terry to account for his built-in gain.

The remaining $1,000 of the gain is allocated equally between Terry and J.J. in accordance with the partnership agreement. [See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(iii)]

***Example 3**: Assume the same facts as in Example 1 except that at the beginning of year 2, the partnership sells the property for $9,000 and allocates the entire $5,400 gain to Terry. Thereafter, the partnership liquidates and distributes its assets ($19,000) to Terry and J.J. in proportion to their **book** capital account balances. Their capital accounts are as follows:*

	Terry		***J.J.***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: Losses	*500*	*0*	*500*	*400*
End of year 1	*$9,500*	*$4,000*	*$ 9,500*	*$ 9,600*

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Add: Income in year 2	*0*	*5,400*	*0*	*0*
End of year 2	*$9,500*	*$9,400*	*$ 9,500*	*$ 9,600*

Terry and J.J each receive a distribution of $9,500 in proportion to their book capital account balances. Thus, Terry will recognize a capital gain of $100 ($9,500, the amount distributed to Terry, less $9,400, the adjusted tax basis in his interest). J.J. recognizes a capital loss of $100 (because his adjusted tax basis of $9,600 exceeds the distribution of $9,500). [See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(iv).]

*Observation**:** As illustrated by the above examples, the ceiling rule creates a disparity between J.J's tax and book capital accounts that will grow at the rate of $100 per year. This disparity will be locked in until J.J sells or retires his partnership interest. In effect, the ceiling rule causes a distortion by shifting a portion of Terry's built-in gain to J.J. When a ceiling rule shift of income is made with the purpose of substantially reducing the partners' aggregate tax liability, such allocation may be considered unreasonable under the § 704(c) anti-abuse rule.*

***Example 4**: (Unreasonable use of the traditional method)*

*Bob and Marion form a partnership and agree that all partnership items will be allocated equally between themselves except the items attributable to § 704(c) property will be allocated using the traditional method. Bob contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000. The equipment has only one year remaining on its cost recovery schedule although its remaining economic life is substantially longer. The equipment is a § 704(c) property and the built-in gain at the time of contribution is $9,000. Marion contributes $10,000 cash. Marion has a large unused net operating loss carryover, which will expire soon. Under § 1.704-1(b)(2)(iv)(g)(3) (*See PTM 1460*), the partnership must allocate the entire book depreciation to the partners in year 1. Thus, in the partnership's first year, there is a book depreciation of $10,000 and a tax depreciation of $1,000. At the beginning of year 2, the partnership sells the property for $10,000 and recognizes a gain of $10,000 (adjusted tax basis after the first year depreciation is zero).* If the allocations were respected, the capital accounts would be as follows:

	Bob		***Marion***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$1,000*	*$10,000*	*$10,000*
Depreciation in Yr.1	*(5,000)*	*0*	*($5,000)*	*($1,000)*
Sale in Yr. 2	*$5,000*	*$5,000*	*$ 5,000*	*$ 5,000*

End of year	*$10,000*	*$6,000*	*$10,000*	*$14,000*

The method used by the partnership is unreasonable for the following reasons:

- *At the beginning of year 2, both the book value and adjusted tax basis of the equipment are $0 (due to book and tax depreciation in year 1). Therefore, there is no remaining built-in gain ($0 book value less $0 tax basis). The gain of $10,000 is allocated equally to Bob and Marion. Thus, Marion is allocated $1,000 tax depreciation in year 1 and $5,000 gain in year 2, which results in a net gain of $4,000. The interaction of the partnership's one-year write-off of the entire book value of the equipment and the use of the traditional method result in a shift of $4,000 of the pre-contribution gain in the equipment to Marion.*
- *Under the anti-abuse rule (*See PTM 2195)*, the traditional method is not reasonable because it shifts a significant amount of taxable income to a partner with a low marginal tax rate (Marion has unused net operating loss carryover) and from a partner with a high marginal tax rate.*
- *Under these facts, if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated to Bob to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule stated above. [See Treas. Reg. § 1.704-3(b)(2), Ex. (2)(ii)]*
- *See Example 3 at* (PTM 2230) *for methods that could be used to correct the distortion caused by the ceiling rule.*

2220 Traditional Method with Curative Allocation

The interaction between the traditional method and the ceiling rule may cause distortions to the tax consequences in certain situations (See PTM 2210, Example 4). To correct such distortions, a partnership using the traditional method may make a reasonable curative allocation to reduce or eliminate disparities between book and tax items of noncontributing partners. [Treas. Reg. § 1.704-3(c)(1)]

A curative allocation is an allocation of the partnership's income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a non-contributing partner is allocated less tax depreciation than book depreciation with respect to an item of § 704(c) property, the partnership may make a curative allocation to that partner by allocating tax depreciation from another item of partnership property to make up the difference (although the corresponding book depreciation of that other item is still allocated to the contributing partner.) [Treas. Reg. § 1.704-3(c)(1)]

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A partnership's curative allocations may be limited to certain specific property even if the allocations of these items do not fully offset the effect of the ceiling rule. [Treas. Reg. § 1.704-3(c)(1)]

A partnership must be consistent in its application of curative allocations with respect to each item of § 704(c) property from year to year. [Treas. Reg. § 1.704-3(c)(2)]

2230 Reasonable Curative Allocations

The amount, the timing, and the type of curative allocations must be reasonable:

Amount: If a curative allocation exceeds the amount necessary to offset the effect of the ceiling rule (in the current year or prior years), the excess allocation is not reasonable. [Treas. Reg. § 1.704-3(c)(3)(i)]

Timing: The period of time over which the curative allocations are made is a factor in determining if the allocations are reasonable. Curative allocations may be made in the current year to offset the effect of the ceiling rule in prior years, provided that the current year curative allocations must be made over a reasonable period of time and are provided for under the partnership agreement. [Treas. Reg. § 1.704-3(c)(3)(ii)]

Type: To be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The expectation must exist at the time the § 704(c) property is contributed to the partnership and the allocations with respect to that property become part of the partnership agreement. If the partnership agreement is not sufficiently specific with regard to the manner in which allocations of the § 704(c) property are to be made, the expectation is to be tested at the time the allocations are actually made. [Treas. Reg. § 1.704-3(c)(3)(iii)]

Example 1*: Lisa and Paul form partnership LP, agreeing that they will share all partnership's items equally, except that allocations attributable to § 704(c) property will be made under the traditional method with curative allocations. Lisa contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The property has 10 years on its cost recovery schedule and is depreciable using the straight-line method. Paul contributes $10,000 cash, which was used to buy inventory for resale.*

In the first year, the revenue generated by the equipment equals its expenses, excluding the cost recovery deduction, which is $1,000 for book and $400 for tax. The inventory is sold during the year for $10,700, generating taxable income of $700. The partners

anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from the equipment. Under the traditional method, Lisa and Paul would each be allocated $350 of income from the inventory sale for book and tax purposes and $500 of book depreciation on the equipment. The tax depreciation would be allocated entirely to Paul, the noncontributing partner. Thus, at the end of the first year, Lisa's and Paul's book and tax capital accounts would be as follows:

	Lisa		***Paul***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: depreciation	*(500)*	*0*	*(500)*	*(400)*
Sales Income	*350*	*350*	*350*	*350*
End of year 1	*$ 9,850*	*$4,350*	*$ 9,850*	*$ 9,950*

Due to the ceiling rule (i.e., allocation of tax depreciation to Paul is limited to the total partnership depreciation during the year, which is $400), there is a $100 disparity between Paul's book and tax capital accounts. Under the curative allocation method, the partnership may allocate an additional $100 of income from the inventory sale to Lisa (the contributing partner) for tax purposes. As a result, Paul's income is reduced by $100 which has the same tax effect as an allocation of $100 of tax deduction to Paul. This curative allocation results in the following capital accounts:

	Lisa		***Paul***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: depreciation	*(500)*	*0*	*(500)*	*(400)*
Sales Income	*350*	*450*	*350*	*250*
End of year 1	*$9,850*	*$4,450*	*$9,850*	*$9,850*

The above curative allocation is reasonable because it "cures" the disparity in Paul's capital account caused by the ceiling rule. (Note that for book purposes, the sales income is allocated equally between Lisa and Paul). However, if the partnership allocates the entire $700 of sales income to Lisa, such allocation is unreasonable since the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule. [See Treas. Reg. § 1.704-3(c)(4), Ex. (1).]

***Example 2**: Joe and Elaine form a partnership, agreeing that they will share all partnership items equally, except that allocations attributable to § 704(c) property will be made under the traditional method with curative allocations, but only to the extent the partnership has sufficient tax depreciation. Joe contributes property J with an adjusted tax basis of $3,000 and a book value of $10,000. Elaine contributes property E with an*

adjusted tax basis of $6,000 and a book value of $10,000. Both property have 5 years remaining on their cost recovery life and are depreciable using the straight-line method. Since both property J and E have built-in gains of $7,000 and $4,000, respectively, they are § 704(c) property. Each property generates $500 of operating income. The book depreciation of each property for each of five years is $2,000. The tax depreciation for each of five years is $600 for property J and $1,200 for property E. Under the traditional method, the partnership items are allocated as follows:

	Joe		***Elaine***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$3,000*	*$10,000*	*$6,000*
Prop. J depreciation	*(1,000)*	*0*	*(1,000)*	*(600)*
Prop. E depreciation	*(1,000)*	*(1,000)*	*(1,000)*	*(200)*
Operating income	*500*	*500*	*500*	*500*
End of year 1	*$8,500*	*$2,500*	*$8,500*	*$5,700*

*Note that the allocation of tax depreciation on property E to Joe is to the extent of his share of book depreciation ($1,000) as required under the traditional method. (*See PTM 2200*). The tax allocation of the property J to Elaine is limited to $600 under the ceiling rule.*

Under the traditional method, Joe is allocated more tax depreciation deductions than Elaine, even though Elaine contributes property with a smaller disparity reflected on the partnership's book and tax capital accounts. The partnership may make curative allocations to Elaine of an additional $400 of tax deductions each year which reduces the disparity between Joe's and Elaine's book and tax capital accounts ratably each year.

	Joe		***Elaine***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$3,000*	*$10,000*	*$6,000*
Prop. J depreciation	*(1,000)*	*0*	*(1,000)*	*(600)*
Prop. E depreciation	*(1,000)*	*(600)*	*(1,000)*	*(600)*
Operating income	*500*	*500*	*500*	*500*
End of year 1	*$8,500*	*$2,900*	*$8,500*	*$5,300*

The above allocations are reasonable provided the allocations meet other requirements provided under § 704(c) regulations. [See Treas. Reg. § 1.704-3(c)(4), Ex. (2).]

***Example 3**: Read Example 4 at* PTM 2210*. The allocation under the traditional method in this example is unreasonable since it shifts the tax consequences of the built-in gain to the partner with a low marginal tax rate.*

Assume the partnership has sales income of $8,000 in the first year. Pursuant to the partnership agreement, the sales income is allocated equally between Bob and Marion. Their capital accounts are as follows:

	Bob		***Marion***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$1,000*	*$10,000*	*$10,000*
Less: depreciation	*(5,000)*	*0*	*(5,000)*	*(1,000)*
Sales Income	*4,000*	*4,000*	*4,000*	*4,000*
End of year 1	*$9,000*	*$5,000*	*$9,000*	*$13,000*

To correct the disparity caused by the ceiling rule, the partnership may allocate some of the sales income to Bob. If the partnership allocates the entire $8,000 of sales income to Bob in the first year, such curative allocation is not reasonable because it is done within a period of time significantly shorter than the economic life of the property. Thus, assuming the remaining economic life of the property is 10 years, the partnership, instead of allocating the entire additional $4,000 of sales income to Bob, may allocate 10 percent or $400 in the first year to Bob. This curative allocation is reasonable. [See Treas. Reg. § 1.704-3(c)(4), Ex. (3).]

2300 REMEDIAL ALLOCATION METHOD

To eliminate the distortion caused by the ceiling rule, a partnership may adopt the remedial allocation method by creating remedial items and allocating these items to the partners. [Treas. Reg. § 1.704-3(d)(1)]

Under the remedial allocation method, the partnership first determines the amount of book items (explained at PTM 2310) and the partners' distributive share of these items under § 704(b). [Treas. Reg. §1.704-3(d)(1)]

The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method (described at PTM 2200). If the ceiling rule (described at PTM 2210) causes the book allocation of an item to differ from the corresponding tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full

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amount of the difference and allocates it to the noncontributing partner. [Treas. Reg. § 1.704-3(d)(1)

The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner. [Treas. Reg. § 1.704-3(d)(1)]

See Example at PTM 2340

PTM 2310 Determining the Amount of Book Items
PTM 2320 Character of Remedial Allocations
PTM 2330 Effects of the Remedial Items
PTM 2340 Limitations on Remedial Allocation Method
PTM 2350 Exceptions and Special Rules

2310 Determining the Amount of Book Items

The determination of the amount of book items for the purpose of the remedial allocation method is done in the following manner: the book basis of the contributed property is divided into two portions. The portion equal to the adjusted tax basis in the property is depreciated in the same manner as the adjusted tax basis in the property is depreciated (i.e., generally over the remaining recovery period under § 168(i)(7) or other applicable sections.) The portion of the book basis in excess of the adjusted tax basis is recovered using any depreciation (or other cost recovery) period and method available to the partnership for newly purchased property. [Treas. Reg. § 1.704-3(d)(2)]

Note that the above determination of the amount of book item for the purpose of the remedial allocation method is different from the determination of book items for purposes of § 704(b) provided under § 1.704-1(b)(2)(iv)(g)(3)) (See PTM 1460)

2320 Character of Remedial Allocations

The character of the remedial allocations of income, gain, loss, or deductions to the noncontributing partner is determined with reference to the items limited by the ceiling rule. (see 2210 for ceiling rule) [Treas. Reg. § 1.704-3(d)(3)

The same principle applies to the offsetting remedial allocations.

Any partner level tax attributes are determined at the partner level.

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For example, if the ceiling-rule limited item is depreciation from property used in a rental activity, the remedial allocation to the non-contributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity.
Each partner then applies § 469 to the allocation at his level as appropriate. [Treas. Reg. § 1.704-3(d)(3)]

See Examples at PTM 2340

2330 Effect of the Remedial Items

Effect on Partnership: Remedial items do not affect the partnership's computation of its taxable income under § 703 and do not affect the partnership's adjusted tax basis in its property. [Treas. Reg. § 1.704-3(d)(4)(i)]

Effect on Partners: Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest. For example, if the remedial item is $500 of partnership taxable gain on sale of a partnership property allocated to partner A, the allocation affects A's tax liability in the year of allocation and his adjusted tax basis in the partnership interest. [Treas. Reg. § 1.704-3(d)(4)(ii)]

2340 Limitations on Remedial Allocation Method

Limitation on Taxpayer: in the absence of published guidance, the remedial allocation method is the only reasonable § 704(c) method allowing the creation of notional tax items. In other words, if a partnership uses another method to create a notional tax item, such method is unreasonable. [(Treas. Reg. § 1.704-3(d)(5)(i)]

Limitation on the Internal Revenue Service (IRS): In exercising its authority under § 1.704-3(a)(10) (Anti-abuse rules, see PTM 2195) to make adjustments if a partnership's allocation method is unreasonable, the IRS will not require a partnership to use the remedial method or any other method involving the creation of notional tax items. [Treas. Reg. § 1.704-3(d)(5)(ii)]

***Example**: Karen and Steve form a partnership and agree that each will be allocated a 50 percent share of all partnership items, except that items attributable to § 704(c) property will be allocated the remedial allocation method and that the straight-line method will be used to recover excess book basis. Karen contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The*

property has 10 years remaining on its economic life and 4 years remaining on its tax recovery period. Steve contributes $10,000 cash which is used by the partnership to purchase land. The partnership's operating income equals its operating expenses, except for depreciation deductions.

In years 1 through year 4, under the remedial allocation method, the book depreciation is computed as follows: the total book basis of $10,000 is divided into two portions. The portion equal to the adjusted tax basis of the property ($4,000) is depreciated over its remaining tax recovery period (i.e., 4 years).

Thus, the annual book depreciation for this portion is $1,000 ($4,000 ÷ 4). The book portion in excess of the adjusted tax basis (i.e., $6,000) is depreciated over its remaining economic life (10 years). Thus, the annual book depreciation for this portion is $600 ($6,000 ÷ 10). Therefore, from year 1 through year 4, total book depreciation is $1,600 ($1,000 + $600). Under the partnership agreement, Karen and Steve are each allocated 50 percent of the book allocation or $800. The tax depreciation of the property is $1,000 ($4,000 adjusted tax basis over 4 years). Thus, under the general requirement of § 704(c), Steve, the noncontributing partner, will be allocated tax depreciation equivalent to his share of the book depreciation ($800). The remaining $200 of tax depreciation is allocated to Karen, the contributing partner. No remedial allocation is made in the first 4 years because the ceiling rule does not cause a disparity between book and tax depreciation with regard to Steve. Their capital accounts at the end of year 4 are as follows:

	Karen		***Steve***	
	Book	*Tax*	*Book*	*Tax*
Initial Contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Depreciation	*(3,200)*	*(800)*	*(3,200)*	*(3,200)*
End of year 1	*$ 6,800*	*$3,200*	*$ 6,800*	*$ 6,800*

In each of years 5 through 10, the partnership has $600 of book depreciation (computed above) and no tax depreciation. Under the partnership agreement, Karen and Steve are each allocated $300. Thus, there is disparity in Steve's book and tax depreciation because he has $300 book depreciation but no tax depreciation under the ceiling rule. The partnership must make remedial allocation of $300 of tax depreciation deduction to Steve for each of the years from 5 through 10 and simultaneously make an offsetting remedial allocation of $300 taxable income to Karen for those years. The character of the $300 taxable income allocated to Karen must be the same as the income generated by the property. Their capital accounts at the end of year 5 are as follows:

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	Karen		***Steve***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: Depreciation	*(3,200)*	*(800)*	*(3,200)*	*(3,200)*
End of year 4	*$6,800*	*$3,200*	*$6,800*	*$6,800*
Year 5 depreciation	*(300)*	*0*	*(300)*	*0*
Remedial allocation	*0*	*300*	*0*	*(300)*
End of year 5	*$6,500*	*$3,500*	*$6,500*	*$6,500*
Years 6 - 10 depreciation	*(1,500)*	*0*	*(1,500)*	*0*
Years 6 - 10 Rem. Alloc.	*0*	*1,500*	*0*	*(1,500)*
End of Year 10	*$5,000*	*$5,000*	*$5,000*	*$5,000*

Under the remedial allocation method, the partners' book and tax capital accounts will be equal at the end of the economic life of the contributed property. [See Treas. Reg. § 1.704-3(d)(7), Ex. (1)].

For illustration of remedial allocation on sale of the property, see Treas. Reg. § 1.704-3(d)(7), Ex. (2).

For an illustration of a remedial allocation involving built-in gain property, sold for book and tax loss, see Treas. Reg. § 1.704-3(d)(7), Ex. (3).

2350 Exceptions and Special Rules

Small Disparity: if the difference between the fair market value and the adjusted tax basis of a contributed property is small, the partnership may:

- Use a reasonable § 704(c) method;
- Disregard the application of § 704(c) to the property; or
- Defer the application of § 704(c) to the property until the disposition of the property. [Treas. Reg. § 1.704-3(e)(1)(i)

Definition of small disparity: The disparity is less than 15 percent of the adjusted tax basis of all properties contributed by one partner in a taxable year, and the total gross disparity is less than $20,000. [Treas. Reg. § 1.704-3(e)(1)(ii)

Aggregation Rules: If contributed by one partner during the partnership taxable year, each of the following types of property may be aggregated for the purposes of making § 704(c) allocations:

- Depreciable property: All property, other than real property, that is included in the same general asset account of the contributing partner and the partnership under § 168.

- Zero Basis Property: All property, other than real property, with a basis equal to zero.

- Inventory: If the partnership does not use a specific method of accounting, each item of inventory, other than qualified financial assets (see statement below). [Treas. Reg. § 1.704-3(e)(2)

There are special aggregation rules for securities partnerships provided under § 1.704-3(e)(3) which are not discussed in this manual.

2500 DISTRIBUTION OF CONTRIBUTED PROPERTY

The Seven-year Recognition Rule: If a partnership distributes § 704(c) property to a partner **within 7 years** (See PTM 2600) from the date the property was contributed to the partnership, the contributing partner has to recognize gain or loss in an amount equal to the gain or loss that would have been allocated to such partner under § 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of distribution. [Treas. Reg. § 1.704-4(a)(1)]

The Five-year Recognition Period: If a property was contributed prior to June 9, 1997, the recognition period is five years. (See PTM 2510)

The above rule applies only to the extent the distribution by the partnership is a distribution to a partner acting in his capacity of a partner (i.e., a distribution within the meaning of § 731). [Treas. Reg. § 1.704-4(a)(2)]

For definition of § 704(c) property, see PTM 2120

Example 1*: On January 1, 2008, Phyllis, Ron, and Renee form a partnership. Phyllis contributes $10,000 cash and non-depreciable real property P with a fair market value of $10,000 and an adjusted tax basis of $6,000. Ron contributes $10,000 cash and non-depreciable real property R with a fair market value of $10,000 and an adjusted tax basis of $10,000. Renee contributes $20,000 cash. On December 31, 2013, Renee withdraws from the partnership, receiving property P and R in complete liquidation of her partnership interest. Since the distribution occurs within 7 years from the date the property was contributed (*See PTM 2510*), the distribution is*

treated as a sale of property P to Renee. Phyllis has to recognize a $4,000 gain (assuming the fair market value of the property at the time of distribution is also $10,000 and the adjusted tax basis remains at $6,000). Ron would not have to recognize any gain on the distribution of property R since property R was not § 704(c) property (i.e., there is no difference between fair market value and adjusted tax basis at the time of contribution). [Treas. Reg. § 1.704-4(a)(5) Ex. (1).]

Example 2: *On January 1, 2008, Phyllis, Ron, and Renee form a partnership. Phyllis contributes non-depreciable real property P1 with a fair market value of $10,000 and an adjusted tax basis of $6,000 and non-depreciable real property P2 with a fair market value and an adjusted tax basis of $10,000. Ron and Renee each contribute $20,000 cash. Since property P1 is a § 704(c) property, the partnership uses the remedial method of making § 704(c) allocation (*See PTM 2400*).*

On December 31, 2013, property P1 is distributed to Renee in a current distribution. At the time of distribution, the fair market value of the property is $7,000. Since the distribution occurs within a 7-year period, the distribution is treated as a sale that results in a built-in gain of $1,000 ($7,000 fair market value less $6,000 adjusted tax basis). All of this gain is allocated to Phyllis. The partnership also recognizes a book loss of $3,000 ($10,000 original fair market value less $7,000 current fair market value). The book loss of $3,000 is allocated equally to Phyllis, Ron and Renee. Since Ron and Renee (the non-contributing partners with regard to property P1) are allocated $2,000 of book loss, under the remedial method, they would also have to be allocated $2,000 of tax loss to match their share of book loss. As a result, an offsetting remedial allocation of $2,000 of tax gain must also be allocated to Phyllis. Phyllis will recognize $3,000 total gains ($1,000 of § 704(c) built-in gain and $2,000 of remedial gain) on the distribution of property P1 to Renee. [See Treas. Reg. § 1.704-4(a)(5), Ex. (3).]

PTM 2510 Effective Dates
PTM 2520 Fair Market Value

2510 Effective Dates

The **seven-year** rule applies to property contributed to a partnership **on or after June 9, 1997.** [Act § 1063(b)(1), PL 105-34, 8/5/97]
With respect to property contributed to a partnership before **October 4, 1989**, neither the five-year rule nor the seven-year rule of this section applies. [Treas. Reg. § 1.704-4(c)(1)] [§7642(b), PL 101-239, 12/19/89] Note: Before the amendment of § 704(c) by the Omnibus Budget Reconciliation Act of 1989 (1989 RRA), the contributing partner did not recognize any gain on distribution of the contributed property to other partners (§ 731(b). Thus, the contributing partner could defer taxation on the gain until disposition of his partnership interest. To prevent such lengthy deferral, § 704(c)(1)(B) was added

by the 1989 RRA (P.L. 101-239 § 7642(a)), effective with regard to property contributed to a partnership after October 3, 1989, in tax years after such date.

For distributions by a partnership to a partner before **January 9, 1995**, the seven-year rule of this section does **not** apply. [Treas. Reg. § 1.704-4(g)] (Note: Regulations under § 704(c)(1)(B) were issued in December 1995 (See T.D. 8642, 60 Fed. Reg. 66727 (12/26/95), effective with respect to distributions of property by a partnership to a partner on or after Jan. 9, 1995.) Although the federal law changed in 1997 to seven years, the regulations can still be used.

California Conformity:
Federal changed to the seven-year rule in 1997, for contributions made after 6/8/97. California conformed to those changes in August of 1998 (AB 2797, Ch. 322) when the specified date (§17024.5) was changed to incorporate the IRC as it read on 1/1/98 for taxable years beginning on or after 1/1/98. This means, for California purposes, the five-year rule remained in effect for contributions made until 12/31/97. Accordingly, there is a difference between California and federal for property contributed to partnerships from 6/5/97 until 12/31/97. If the partnership ends up distributing these properties after 5 years, but before 7 years, then the contributing partner will have to recognize gain for federal purposes, but not for California.

Summary:

- For property contributed before 10/4/89, no gain is recognized regardless of the date the property was distributed to the partner.
- Property that was contributed to the partnership after 10/4/89 and distributed to the partner on or after 1/9/95 is subject to the five-year rule. (Thus, if only one of the two conditions is met, no gain is recognized (e.g., property contributed after 10/4/89 but distributed before 1/9/95)).
- If property is contributed after 6/8/97 and distributed within seven years from the date of the contribution, then gain is recognized. (except as noted above for California's nonconformity).

2520 Fair Market Value

The fair market value of the distributed § 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. [Treas. Reg. § 1.704-4(a)(3)]

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The fair market value assigned by a partnership to the distributed § 704(c) property is regarded as correct, provided that the value reflects the arm's-length negotiation and the partners have sufficiently adverse interests. [Treas. Reg. § 1.704-4(a)(3)]

2600 SEVEN-YEAR PERIOD

The Seven-year period mentioned at PTM 2500 begins on and includes the date of contribution.

IRC § 708(b)(1)(B) termination:

- If a partnership terminates under § 708(b)(1)(B) (i.e., termination due to sale of 50 percent or more of total partnership interest), a new seven-year period with regard to built-in gain or loss **does not** begin for each partner (i.e., the seven-year period starting at the time the property is originally contributed by the partner to the partnership continues to run as if the new partnership were the terminated partnership. A subsequent distribution of the § 704(c) property by the new partnership to a partner is subject to the seven-year rule of this section to the same extent that a distribution by the terminated partnership would have been subject to the seven-year rule.) [Treas. Reg. § 1.704-4(c)(3)]

- The above rule applies to terminations under § 708(b)(1)(B) that occur on or after May 9, 1997. For terminations occurring on or after May 9, 1996, the above rule may apply if the partnership and its partners apply the rule to the terminations in a consistent manner. [Treas. Reg. § 1.704-4(c)(3)]

PTM 2610 Character of Gain or Loss
PTM 2620 Exceptions
PTM 2630 Complete Transfer to Another Partnership
PTM 2640 Incorporation of a Partnership
PTM 2650 Undivided Interests
PTM 2660 Like-Kind Exchange of Section 704(c) Property
PTM 2670 Transfer of Partnership Interest
PTM 2680 Basis Adjustments
PTM 2690 Anti-Abuse Rule

2610 Character of Gain or Loss

When a § 704(c) property is distributed within the 7-year period, the gain or loss recognized by the contributing partner has the same character as the gain or loss that

would have resulted if the distributed property has been sold by the partnership to the distribute partner at the time of the distribution. [Treas. Reg. § 1.704-4(b)(1)]

Example: *Dave contributes non-depreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000 for a 10 percent interest in the partnership. Linda contributes $90,000 cash for the remaining 90% interest. The partnership is formed on January 1, 2008. On December 31, 2013, the property is distributed to Linda in a current distribution. The property is going to be used in a trade or business of Linda.*

Dave will recognize a built-gain of $6,000 (assuming the fair market value of the property remains at $10,000). Since the property is not a capital asset in Linda's hands and she holds more than 50 percent interest in partnership capital and profits, the character of the gain on the sale of the property to Linda is ordinary income under §707(b)(2). Thus, the character of the $6,000 gain to be recognized by Dave is ordinary income. [See Treas. Reg. § 1.704-4(b)(2), Ex.]

2620 Exceptions

The seven-year recognition rule **does not** apply to property contributed to the partnership on or before October 3, 1989. [Treas. Reg. § 1.704-4(c)(1)] this isn't the right cite, uses different dates.

The seven-year recognition rule of this section **does not** apply in a liquidation if:

- the contributing partner receives an interest in the § 704(c) property contributed by that partner (and no other property); and
- the built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under the deemed-sale distribution of this section. [Treas. Reg. § 1.704-4(c)(2)]

Example*: In exchange for a 50 percent interest in a partnership, Patricia contributes non-depreciable real property P with a fair market value of $20,000 and an adjusted tax basis of $10,000 on January 1, 2008. (Thus, the built-in gain at the time of contribution is $10,000.) On December 31, 2013, the partnership liquidates. Patricia receives, in complete liquidation of her interest in the partnership, 75 percent interest in property P (the remaining 25 percent interest is distributed to the other partner). At the time of the liquidating distribution, property P has a fair market value of $40,000. Patricia's share in*

the built-in gain in property P at the time it is distributed to Patricia is $20,000 computed as follows:

Fair market value	*$40,000*
Percentage of interest	*.75*
Fair market value received	*$30,000*
Less: basis in the partnership interest (*)	*(10,000)*
Built-in gain on distribution	*$20,000*

(*) Patricia original basis in the partnership interest is $10,000, the carry-over basis in her contributed property. Assume, for simplicity, her basis remains the same from 1/1/08 through 12/31/13.

Since (1) property P is distributed back to Patricia and (2) the built-in gain at the time of distribution ($20,000) is greater than the built-in gain at the time property P is contributed ($10,000), Patricia does not have to recognize any gain on the distribution of a portion (25 percent) of property P to the other partner. [See Treas. Reg. § 1.704-4(c)(7), Ex.]

2630 Complete Transfer to Another Partnership

The seven-year recognition rule does not apply in the following situation:

Partnership A transfers all of its assets to Partnership B in an exchange governed by § 721 (non-recognition of gain or loss on contribution). Partnership A immediately liquidates and distributes its interest in partnership B to its partners. All of the transactions (the transfer of the assets from A to B, the liquidation of A, and following distribution) are parts of the same plan or arrangement.

A subsequent distribution of § 704(c) property by partnership B to a partner of B will trigger the application of the seven-year rule to the same extent that a distribution by partnership A would have been subject to the seven-year rule. [Treas. Reg. § 1.704-4(c)(4)]

A similar rule is provided under § 1.737-2(b) in the context of § 737.

2640 Incorporation of a Partnership

The seven-year recognition rule does not apply if:

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- the partnership is incorporated, and the incorporation occurs by any method except the method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation, and
- the partnership is immediately liquidated as part of the incorporation transaction. [Treas. Reg. § 1.704-4(c)(5)]

A similar rule is provided under § 1.737-2(c) in the context of § 737.

2650 Undivided Interests

The seven-year recognition rule does not apply to a distribution to the contributing partner of an undivided interest in the § 704(c) property to the extent it does not exceed the undivided interest originally contributed by such partner. [Treas. Reg. § 1.704-4(c)(6)]

A similar rule is provided under § 1.737-2(d)(4) in the context of § 737.

2660 Like-Kind Exchange of Section 704(c) Property

As discussed at (PTM 2180), property received by a partnership in exchange for § 704(c) property in a non-recognition transaction is treated as a § 704(c) property for the purposes of the seven-year rule. [Treas. Reg. § 1.704-4(d)(1)]

If a partnership distributes a § 704(c) property to a partner other than the contributing partner and like-kind property (within the meaning of § 1031) is distributed to the contributing partner no later than the earlier of:

- 180 days after the date of the distribution to the non-contributing partner, or
- the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the non-contributing partner,

the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under the seven-year recognition rule is reduced by the amount of the built-in gain or loss in the distributed like kind property that the contributing partner receives. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution. [Treas. Reg. § 1.704-4(d)(3)] See section § 1.707-3 for provisions treating the distribution of the like kind property to the contributing partner as a disguised sale in certain circumstances.

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***Example**: Susan, Lori, and Chris form a partnership on January 1, 2008. Susan and Lori each contribute $50,000 cash. Chris contributes non-depreciable property C with a fair market value of $50,000 and an adjusted tax basis of $20,000. The partnership purchases non-depreciable property X which is of a like-kind property to property C for $15,000.*

On December 31, 2013, property C is distributed to Susan in a current distribution. At the same time, property X is distributed to Chris in a current distribution. At the time of distribution, property X has a fair market value of $25,000. Assume the distribution of property X to Chris does not result in the recharacterization of Chris' contribution of property C as a disguised sale under § 1.707-3. The tax impact of the two distributions is as follows:

- *Distribution of property X to Chris: Chris' basis in the partnership interest is $20,000 (the carried-over basis in the contributed property, assuming, for simplicity, there is no change in his partnership basis since January 1, 2008 through December 31, 2013). Property X has an adjusted tax basis of $15,000 in the hands of the partnership. Under the general rule of § 732(a)(1), Chris' basis in property X is the lesser of his basis in the partnership interest or the adjusted tax basis of the property in the hands of the partnership. In this instance, his basis in property X is $15,000. Thus, Chris has $10,000 of built-in gain in property X ($25,000 fair market value less $15,000 adjusted tax basis). There is no gain to be recognized from the distribution of property X to Chris.*
- *Distribution of Property C to Susan: Property C has a built-in gain of $30,000 at the time Chris contributes it to the partnership. Assuming the property's fair market value is the same as when it is contributed (i.e., $50,000), Chris has to recognize a built-in gain of $30,000 under the seven-year recognition rule when the property is distributed to Susan. However, this gain is reduced by the built-in gain in property X in the hands of Chris ($10,000). Thus, Chris recognizes only $20,000 of gain on distribution of property C to Susan.*
- *Chris' basis in his partnership interest is as follows:*

Initial Basis (1/1/08)	*$20,000*
Less: distribution (property X)	*(15,000)*
Add: Gain recognized on distr. of property	*20,000*
Basis on 12/31/13	*$25,000*

2670 Transfer of Partnership Interest

If a contributing partner transfers all or a portion of his partnership interest, the transferee is treated as the contributing partner for purposes of the seven-year

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recognition rule to the extent of the share of the built-in gain or loss allocated to the transferee partner. [Treas. Reg. § 1.704-4(d)(2)]

2680 Basis Adjustments

Contributing Partner's Basis in Partnership Interest: The contributing partner's basis in his/her partnership interest is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under the seven year recognition rule. The increase or decrease is taken into account in determining:

- the contributing partner's adjusted tax basis under § 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property (except the like-kind property described in PTM 2660; see note above), and

    - the amount of the gain recognized by the contributing partner under § 731 or §737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of contributed property. [Treas. Reg. § 1.704-4(e)(1)]

Note: The above rule does not apply in a distribution of like-kind property. As in the Example at PTM 2660, Chris's basis is increased by the distribution of property C to Susan. However, this increase is not taken into account in computing his adjusted tax basis in the partnership interest for the purpose of determining the built-in gain of property X which is distributed to Chris.

Partnership's Basis in Partnership Property: The partnership's adjusted tax basis in the distributed § 704(c) property is increased or decreased immediately before the distribution by the amount of the gain or loss recognized by the contributing partner under the seven-year recognition rule. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under § 732. [Treas. Reg. § 1.704-4(e)(2)]

IRC § 754 Adjustments: The basis adjustments to partnership property mentioned in the above paragraph are not elective and must be made regardless of whether the partnership has an election in effect under § 754. [Treas. Reg. § 1.704-4(e)(3)]

Example*: Allen contributes property A to partnership ABC in exchange for an interest in the partnership. At the time of contribution, the property has a fair market value of $10,000 and an adjusted tax basis of $4,000. Four years later, property A is distributed to Brian, a partner of partnership ABC. Allen recognizes the built-in gain of $6,000 and*

his partnership basis is increased by the gain. The partnership's basis in property A immediately prior to the distribution is increased from $4,000 to $10,000. Thus, Brian's basis in distributed property A is the lesser of $10,000 or his adjusted tax basis in the partnership interest under § 732(a)(1). [See Treas. Reg. § 1.704-4(e)(4), Ex.]

2690 Anti-abuse Rule

- In general, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of § 704(c)(1)(B), the transaction may be recast for federal income tax purposes. [Treas. Reg. § 1.704-4(f)(1)]

- The purpose of § 704(c)(1)(B) is "to eliminate the inconsistent treatment of sales and distributions by a partnership and thereby prevent partners from circumventing the rule requiring pre-contribution gain or loss on contributed property to be allocated to the contributing partner by distributing the property to another partner." [PS-76-92; PS-51-93, 1995-1 CB 1001, 1002]

- The determination of whether a tax result is inconsistent with the purpose of §704(c)(1)(B) is determined based on all the facts and circumstances. [Treas. Reg. § 1.704-4(f)(1)] For illustration of the anti-abuse rule, see the Examples provided in § 1.704-4(f)(2).

2900 AUDIT ISSUES AND TECHNIQUES

This section discusses the potential audit issues and techniques regarding:

- Allocations of Partnership income or loss (PTM 1000)
- Allocations of Non-recourse Deductions (PTM 3000)
- Allocations with respect to Contributed Property (PTM 2000)

PTM 2910	Determination of a Partner's Share of Partnership Items
PTM 2920	Obligation to Restore Deficit Capital Accounts
PTM 2930	Liquidation Distribution requirements
PTM 2940	Partnership Agreement
PTM 2950	Partner's Interests in the Partnership
PTM 2960	Burden of Proof

2910 Determination of A Partner's Share of Partnership Items

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Issue: Determine if a partner's distributive share of each item of partnership income, gain, loss, deduction, and credit has substantial economic effect or is consistent with the partner's interest in the partnership.

Scoping Techniques:

- In general, the allocation of partnership items to a partner should be in proportion to his profit or loss sharing ratios, as reported on the schedule K-1 issued to such partner. This can be determined quickly by multiplying the profit or loss sharing ratios to the total partnership income or loss as reported on the schedule K. If the amount computed by the auditor appears substantially different from the amount reported on the schedule K-1 regarding each partnership separately reported item, the difference may be an indication of a special allocation.
- In some situations, the above quick check is impossible because the profit or loss sharing ratio is reported on the schedule K-1 as "various". However, the auditor may verify if the <u>same ratio</u> is used to allocate the items of income or loss to such partner (e.g., operating income on line 1, rental income on line 2 and 3, portfolio income on line 4, gain on line 6, and other gain on line 7 of the schedule K). If different ratios are used for allocation of different items or income or loss, the partner might have been specially allocated certain partnership items. In addition, the auditor may request the partnership return filed for another taxable year and compare the allocation ratios of one year to the other with regard to each partner. If the ratios appear to have changed substantially from one year to the other, the auditor may want to examine the issue.
- In other situations, the partnership schedule K may show net operating income but the schedule K-1 issued to the partners may show losses. For instance, line 1 of schedule K may show the partnership's total operating income of $10 but line 1 of the schedule K-1 issued to partner A shows an operating loss of $4 while line 1 of the schedule K issued to partner B shows an operating income of $14. Although the net amount on line 1 of all the schedules K-1 matches the amount on the schedule K ($14 - 4 = $10), each partner does not appear to have a proportionate share of such income.
- An allocation may be in accordance with a partner's interest in a partnership but may not be respected for lack of substantial economic effect. Until a partnership agreement is obtained, it is unrealistic to determine the economic effect of an allocation. However, if the schedule K-1 issued to a partner shows a negative capital account balance caused by an allocation of the partnership loss in the current taxable year <u>and</u> there is no indication of the partner's share of partnership liabilities (shown on Section E of the schedule K-1), the auditor should verify if such allocation is valid and deductible by the partner (under the provisions of §§ 704(b), 705, 465, and 469.) The partner's individual return

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should be requested to determine the effect of the allocation and how such partner deducts the loss.

Information and Documents to be Requested:

The following list is not inclusive. It is important the auditor tailor his information request to the particular items or issues identified on the return.

- Copies of the partnership agreement and all amendments from inception to the audit tax year, including all side agreements among and between partners.
- Schedule computing each partner's capital account from inception to the current year. (It should be noted that although a partnership is not required to maintain its partners' basis in their partnership interests, it is required to maintain the partners' capital accounts pursuant to § 704(b).) If the partners' book basis capital accounts are different from the tax basis capital accounts, the auditor may want to request the tax basis capital account schedule as well.
- Explanation of the items (that appear to have been specially) allocated to certain partners and documentary evidence supporting that the allocations have substantial economic effect.

Based on the response from the taxpayers, the auditor may request other additional relevant and reasonable information or documents. Since part of the substantial economic effect tests involves the tax effect of the allocation at the partners' level, the auditor may want to obtain copies of the partners' individual returns from in house or from the partners.

Law Application:

- The allocation rules are discussed in PTM 1000. In general, an allocation is respected if it has substantial economic effect or is in accordance with the partner's interest in the partnership.
- The substantial economic effect consists of the economic effect tests and the substantiality test.
- For issues involving partner's interest in the partnership, see PTM 2950.

The Economic Effect: To test the economic effect of an allocation, the auditor should verify the following:

- Does the partnership agreement provide that the partners' capital accounts have to be maintained according to § 704(b) Regulations? Does the partnership actually maintain the partners' capital accounts? Ask the partnership for the

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schedule computing the partners' capital accounts. See PTM 1400 for the maintenance rules.

- Does the partnership agreement provide that distributions in liquidation of the partnership should be made in accordance with the partners' positive capital account balance? See PTM 1160 for discussion of the law. See PTM 2930 for discussion of audit issues.

- Does the partnership agreement require all partners to restore the deficit balances in their capital accounts? See PTM 1130 for discussion of the law. See PTM 2920 for discussion of audit issues.

- If the partnership agreement contains only the first two requirements but not the deficit capital account restoration obligation, does it meet the requirements under the Alternative economic effect test? See PTM 1140 for discussion of the law.

- If the partnership agreement does not contain any of the above requirements, does it meet the requirements under the economic effect equivalence test? See PTM 1180.

The above economic effect requirements have been applied in various court cases [See, e.g., *Interhotel Company, LTD.*, TC Memo 1997-449.] The final test (question # 5) is referred to by some tax authors as the "dumb but lucky" rule that may be significant only in the simplest of situations. [See McKee et al, para 10.02[1]; 3 ed. 1997]

The Substantiality Test: If an allocation meets the above economic effect tests, it must also meet the substantiality test. See PTM 1200 for discussion of the law. The auditor needs to request the partner’s returns to determine if there is a shifting in tax consequences due to the allocation.

2920 Obligation to Restore Deficit Capital Accounts

The requirements to restore the deficit capital accounts are discussed at PTM 1130. It appears that this requirement has to be expressly stated in the partnership agreement in order to establish the "economic risk of loss".

Based on case law, this is the area where a number of issues have been identified.

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- If the partnership agreement is silent regarding the restoration obligation, can a similar provision under the state law satisfy such requirement? An argument raised by the taxpayer is that even though the partnership agreement does not contain the requirement to restore a deficit capital account, he is obligated to restore it under state or local law (e.g., under the Uniform Partnership Act). In *Hogan*, the taxpayer argued that under Pennsylvania law, general partners are obligated to restore any deficits in their capital accounts at liquidation. The Tax Court noted that the state law cited by the taxpayer did not have any express provision for restoration of the deficit capital accounts. In addition, the state law should only be used "for guidance as an interpretative aid and that the partnership agreement was the controlling factor."[9] Taxpayers are advised not to rely on state law to satisfy this requirement because the definition of "capital accounts" for state law purposes may not coincide with the tax capital account definition of the
Regulations-1[10]
Joseph M. Hogan, 59 TCM 870 (1990). See also *Goldfine v. Commissioner*, 80 TC 843 (1983).

- Is the guarantee of a partnership liability tantamount to "economic risk of loss"? A taxpayer claimed that his guarantee of a mortgage held by a bank provided him with the economic risk of loss. The Tax Court disagreed with the taxpayer's position, stating that (1) the creditors could look to the securing property itself for satisfaction of the liability; and (2) if that did not satisfy the liability, the taxpayer is only one of five co-guarantors; there is no assurance that he, rather than someone else, would be called upon to pay off the mortgage; (3) the debtors were not insolvent during any of the years at issue, and (4) the key issue is whether the taxpayer "had an obligation to restore the negative capital account balance on liquidation, not whether (the taxpayer) ultimately may pay the mortgage.
PNRC Limited Partnership, TC Memo 1993-335.

- Does the lack of an express deficit restoration requirement invalidate a special allocation in all situations? No, provided that the partners' capital accounts are always positive. In fact, the economic risk of loss becomes an "issue" only if an allocation renders the partners' capital accounts negative (i.e., are the partners required to restore the deficit balances?). However, there is an exception to this rule, as discussed at PTM 2930.
Jack D. McGuffey, TC Memo. 1989-267. See also *Fink v. Commissioner*, TC Memo. 1984-669; *Dibble v. Commissioner*, TC Memo. 1984-589.

[9] Id. See also Park Cities Corp. v. Byrd, 534 SW2d 668 (Tex. 1976)
[10] See Mckee et al., 11.02[2][a], Footnote 53; 4th ed. 2007

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- The existence of a "qualified income offset" provision in the partnership agreement (i.e., future profits will be allocated to offset the previous loss which reduces the capital account negative) is **not** a substitute for the restoration requirement in the partnership agreement. In *Sam J. Vecchio*, the partnership agreement did not require the partners to restore their deficit capital account balances but required that such partner's share of subsequent profits be applied to restore the deficit account. The Tax Court ruled that the allocation does not have substantial economic effect because the "qualified income offset" provision in the partnership agreement did not "redefine his share of such profits, allocate a greater share of the profits to such partner, or require a partner to contribute additional funds to the partnership to restore the deficit amount." Note that the holding of this case is for the purpose of determining if a special allocation of a partnership loss is valid given the above requirements in the partnership agreement. In situations wherein a special allocation of losses has economic effect (because the partner is required to restore his deficit capital account), the partnership is allowed to specially allocate gain to such partner in later years to offset the prior deductions which created the negative balance. *Sam J. Vecchio*, 103 TC 170, 1994.

- Note that the requirement for the partners to restore their deficit capital accounts under § 704(b) is for the purpose of validating partnership allocations. When the partnership liquidates and the partners with deficit capital accounts do not restore their deficit balance, the partners may realize capital gain under the operation of other sections. In general, a partner's "negative capital account" indicates the inclusion of partnership liabilities in a partner's partnership basis. When his interest in the partnership is liquidated and he does not restore the deficit balance through contributions or personal assumptions of the partnership liabilities, the relief of such liabilities constitutes a deemed cash distribution under § 752. If the deemed distribution exceeds the partner's basis in the partnership interest, the partner realizes gain under § 731 and generally the gain is treated as capital gain from the sale of his partnership interest. *Gene and Donna Young*, 94-SBE-017, December 14, 1994. Gain from a deemed cash distribution can be ordinary if the partnership holds hot assets (i.e. disproportionate distributions).

2930 Liquidating Distribution Requirements

In order for a partnership allocation to have substantial economic effect, the partnership agreement must contain the requirement that distributions in liquidation of the partnership must be made pursuant to the partners' positive capital account balances (See PTM 1120). If the liquidating distribution is not made on the basis of the partners' positive capital accounts, an allocation may not be valid.

As stated at PTM 2920, the absence of a requirement to restore the deficit capital accounts may not invalidate a special allocation if the allocation does not render the

capital account negative. However, if the partnership agreement does not require that liquidating distributions must be made pursuant to the capital account balances, an allocation may be disallowed even if it does not cause a negative balance in the partners' capital accounts. In *McDuffey*, the taxpayer argued that she should be specially allocated the partnership loss up to $35,600, the balance of her capital account. The Tax Court determined that the allocation did not have substantial economic effect because (1) the taxpayer was not required to restore her deficit balance and (2) regardless of her capital account balance, she would be distributed proceeds from the sale of the property in proportion to her percentage of ownership of the partnership. Thus, even though the specially allocated loss may not reduce a partner's capital account to zero, such allocation does not have economic effect because it does not affect the dollar amount she would receive upon liquidation, as stated by the Court: "While the (taxpayer) would receive a disproportionate share of the partnership's tax loss, she would not suffer any corresponding reduction in the dollars that she would receive upon liquidation."
Jack D. McGuffey, TC Memo. 1989-267. See also *Allison v. United States*, 701 F.2d at 939.

2940 Partnership Agreement

For discussion of the law, see PTM 1170, PTM 1650.

When requesting a partnership agreement, the auditor should request the original agreement and all subsequent modifications or arrangements among and between partners.

An amendment of a partnership agreement must be agreed upon by all partners pursuant to § 761(c). If there is no evidence showing that all partners are aware of and agree with the amendment, such amendment may not be valid. [*Sam J. Vecchio*, 103 TC 170, 1994]

Interactions with local law: The partnership agreement includes any provisions of federal, state, or local law that governs the affairs of the partnership. However, as noted at PTM 1180, the requirement to restore a deficit capital account must be provided for in the partnership agreement and state law should not be relied on to satisfy the requirement.
Girgis v. Commissioner, TC Memo. 1987-556; *Sellers v. Commissioner*, TC Memo. 1977-70.

Oral Partnership Agreement: A partnership agreement can be oral (§ 1.7611(c)). In the case of an oral partnership agreement, the auditor should consider all of the facts

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and circumstances surrounding the formation and operation of the partnership in determining the sharing ratios.
Reed v. Commissioner, TC Memo. 1978-58; *Ryza v. Commissioner*, TC Memo. 1977-64.
In *Hogan*, the partners claimed that the partnership agreement expressly provided for the deficit restoration obligation, although the partnership had no written partnership agreement. However, the Court determined that the allocation had no economic effect because during their testimony, the three partners were unable to recall "having specially agreed upon what would occur if a partner's interest was to be allocated, if the partnership itself was liquidated, or what effect the death of a partner would have on the partnership." *Joseph M. Hogan*, 59 TCM 870 (1990).

In particular, the auditor should:

- request the taxpayer to state in writing the partners' (oral) agreement regarding a certain item or requirement;
- verify such statement with other partners.
- scrutinize a transaction, as requested under the law, if the partners are related parties.

Transfer of Partnership Interest: See PTM 1500 for law discussion. When a partner disposes of less than his entire interest, the determination of both transferor's and transferee's distributive share of partnership items must be made pursuant to §706(d) and the regulations promulgated thereunder. Such determination cannot be altered by a modification of a partnership agreement, such as to retroactively allocate partnership losses to new partners. [*Rodman v. Commissioner*, 542 F.2d 845, [38 AFTR 2d 76-5840](2d Cir. 1976)]

2950 Partners' Interests in the Partnership

The determination rules are discussed at PTM 1600, PTM 1610, and PTM 1620[11] In *PNRC Limited Partnership*, TC Memo 1993-335, the Tax Court suggested another method by comparing the manner in which distributions and contributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the taxable year at issue to the manner in which distributions and contributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the prior taxable year.

[11] See also Interhotel Company, LTD., TC Memo 1997-449, for discussion and application of these laws.

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In addition, an allocation can be deemed in accordance with the partners' interests in the partnership. The rules are discussed in PTM 2000 and 3000, relating to contributions of property and nonrecourse deductions, respectively. When partnership items are specially allocated among the partners, the auditor needs to consider the application of the special rules contained in Treas. Reg. § 1.704-2 and 1.704-3 to determine whether such special allocation should be respected.

For example, when cost recovery deductions are specially allocated to certain partners, the auditor should first determine whether the deductions are attributable to nonrecourse liabilities ("nonrecourse deduction" PTM 3070) If so, the auditor should examine the partnership agreement for provisions including the "economic effect" requirements (PTM 1120) and "minimum gain chargeback" requirement (PTM 3150), which are required under §1.704-2. The auditor should also consider whether the special allocation is "reasonably consistent" with the allocations of some other significant partnership items. When property secured the nonrecourse liability is disposed of, gain may also be specially allocated to the partners due to the allocation of the nonrecourse deductions in prior years.

When a partner contributes property with build-in gain or loss to a partnership, the partnership is required to specially allocate items with respect to the contributed property in accordance with § 1.704-3. The rules also apply to a revaluation of partnership assets. In examining the issue, the auditor should request basis and value of the property contributed or revalued as well as depreciation and amortization schedules in order to determine whether the special allocation is valid. The auditor may have to check prior year returns of the partnership and the partners to see if the special allocation is reasonable.

An examination of partnership allocations can sometimes be time consuming due to the potential amount of documents to be reviewed. Therefore, it is important that the auditor determines in advance the materiality of the issue and the estimated time to resolve the issue. Partners' individual returns should be requested to determine the effect of the allocation and a potential reallocation. The auditor needs to exercise judgment to limit or expand the scope of his examination based on the facts and circumstances.

2960 Burden of Proof

If the auditor identifies partnership items which (1) are not allocated in accordance with the partners' interests in the partnership, or (2) are allocated in accordance with the partners' interests in the partnership but cause a deficit in the partners' capital accounts, he should request the taxpayer to explain the allocation and provide supporting

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authority. The burden of proof is on the taxpayer to show that a partnership allocation has substantial economic effect. [*Sam J. Vecchio*, 103 TC 170, 1994.]

The taxpayer is required to prove the substantial economic effect of not only the "special allocations" but also of all partnership allocations. [*Joseph M. Hogan*, 59 TCM 870 (1990).]

The substantial economic effect is determined on a year-to-year basis [12]. Prior acceptance of allocation by agent does not preclude the government to treat the item differently in later years. [*Interhotel Company*, LTD., TC Memo 1997-449.]

[12] Sam J Vecchio, supra.