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Sect. 704(c): Contributions to Partnerships and LLCs

Navigating Unsettled Issues, Complex Rules and Allocation Method Elections

WEDNESDAY, MAY 1, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Sect. 704(c): Contributions to Partnerships and LLCs

May 1, 2013

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Today's Program

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Jeff Helm, Ernst & Young

INTRODUCTION TO 704(c)

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Section 704(c)

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Purpose of §704(b)

- Ensures that the allocation of partnership income corresponds to the economic arrangement of the partners
- Deals with “book” allocations, rather than tax allocations
  - Incorporates elements of fair market value

Purpose of §704(c)

- Causes the allocation of taxable income to take into account the variation between the basis of contributed property and its fair market value at contribution
  - Prevents the shifting of precontribution built-in gains/losses between partners

The basics

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General rules: §704(c) allocations

- Section 704(c) property – contributed property with difference between §704(b) book basis (FMV) and adjusted tax basis of property on the contribution date
  - This difference is the contributed property's built-in gain ("BIG") or loss ("BIL")
  - This difference creates a §704(c) layer on the property
    - A §704(c) layer representing contributed BIG/BIL is called a "forward" §704(c) layer
    - BIG/BIL upon a revaluation of partnership property is called a "reverse" §704(c) layer
- Result – partnership is required to allocate tax items of income, gain, loss or deduction related to built-in gain or loss to the contributing partner

General rules: §704(c) allocations (cont.)

- Section 704(c) is applied on a property-by-property basis
- *De minimis* rule for small disparities between FMV and basis
- Certain properties can be aggregated
  - Depreciable property by general asset accounts (other than real property)
  - Zero-basis property
  - Inventory items
  - Special aggregation rules for securities partnerships

General rules: §704(c) allocations (cont.)

- Treas. Reg. §1.704-3 provides three reasonable methods for making §704(c) allocations:
  - Traditional allocation method
  - Traditional method with curative allocations
  - Remedial allocation method
- Can use a different method for each item of §704(c) property, but the method and combination of methods must be reasonable
- Step-in-the-shoes rule: when a partner transfers its interest, the share of §704(c) proportionate to the interest transferred must be allocated to the transferee partner (see Treas. Reg. §1.703-3(a)(7))

General rules: §704(c) allocations (cont.)

- **Anti-abuse rule** – An allocation method (or combination of methods) is not considered reasonable if the contribution of property 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
- Final §704(c) regulations issued 9 June 2010 would require tax liabilities of both the partners in a partnership and direct and indirect owners of such partners to be taken into account for purposes of applying the §704(c) anti-abuse rule

Traditional method: Allocation of income, gain, loss and deduction

- An amount of tax income, gain, loss or deduction is allocated among all non-contributing partners based on their shares of these items in the partnership agreement
- Contributing partner is allocated remaining tax income, gain, loss or deduction to the extent of built-in gain or loss

Treas. Reg. §1.704-3(b)

Traditional method

1. Allocate contributed property §704(b) book items to all partners (contributing and noncontributing) per the partnership agreement
2. Allocate contributed property tax items first to noncontributing partners in an amount equal to their book allocations (to extent possible)
3. Allocate remaining contributed property tax items to the contributing partners (to extent possible)

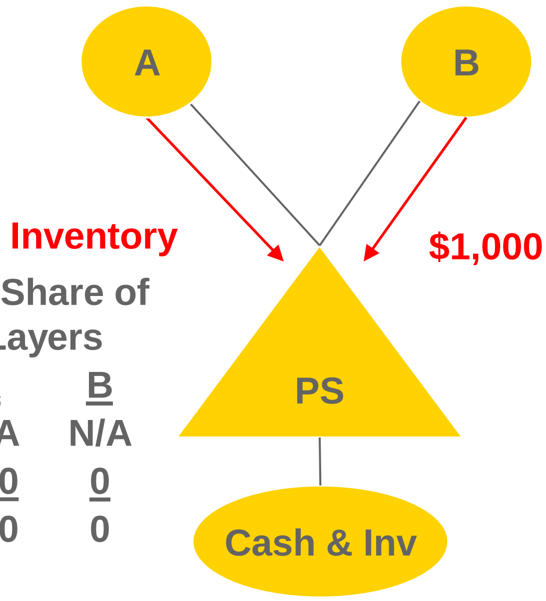
Traditional method: Allocation of income or gain

- Noncontributing partners are allocated the same amount of tax income or gain (to the extent possible) as their shares of these §704(b) book items, per partnership agreement
- Contributing partner is allocated the remaining amount of tax income or gain

Traditional method: Income or gain example

- A and B are equal partners in partnership PS. A contributed inventory (FMV=$1,000, A/B=$700) and B contributed $1,000 cash. Later, the partnership sells the inventory for $1,100.
- How is the gain on the sale of inventory allocated?

Example 1



	Book	Tax
Cash	1,000	1,000
Inventory	1,000	700
	2,000	1,700
A	1,000	700
B	1,000	1,000
	2,000	1,700

Inventory			Ptr %s of Layers		Ptr Share of Layers	
	Book	Tax	A	B	A	B
Base	700	700	N/A	N/A	N/A	N/A
Forward	300	0	100%	0%	300	0
Total	1,000	700			300	0

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Traditional method: Income or gain example (cont.)

- Calculate tax and book gain at the partnership level

	Book	Tax
Amt Real	1,100	1,100
Basis	1,000	700
Gain/Loss	100	400

- Allocate book gain

	A (C)	B (NC)
Book Gain	50	50

- Allocate tax gain to noncontributor (B)

	A (C)	B (NC)
Book Gain	50	50
Tax Gain-Non-Contrib		50

- Allocate remaining tax gain to contributor (A)

	A (C)	B (NC)
Book Gain	50	50
Tax Gain-Non-Contrib		50
Tax Gain-Contrib	350	

Traditional method: Income or gain example (cont.)

- Resulting balance sheet

	Book	Tax
Cash	2,100	2,100
Inventory	0	0
	2,100	2,100
A	1,050	1,050
B	1,050	1,050
	2,100	2,100

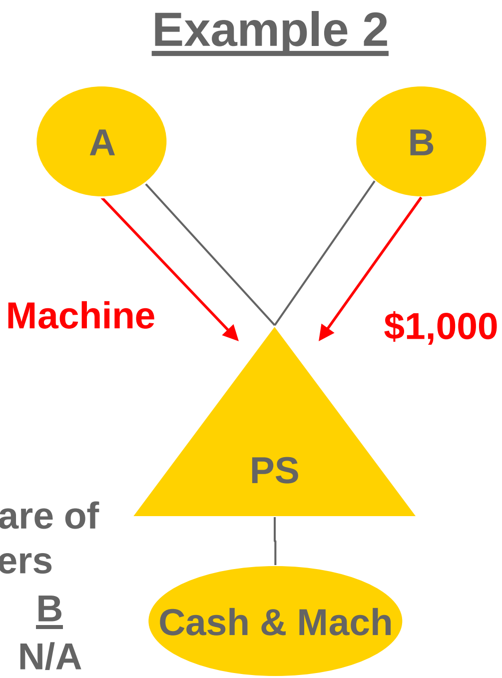
- The §704(c) allocations have eliminated the differences in both A and B's book and tax capital accounts

Traditional method: Allocation of depreciation

- Both §704(b) book and tax depreciation must be calculated
  - Book depreciation is based on §704(b) book basis
    - Book depreciation = tax depreciation / tax basis * book basis
  - Tax depreciation is based on tax basis (calculated "normally" and not impacted by §704(c) considerations)
- Noncontributing partners are allocated the same amount of tax depreciation as their shares of the §704(b) book depreciation, per the partnership agreement
- The contributing partner is allocated the remaining amount of tax depreciation

Traditional method: Allocation of depreciation example

- A and B are equal partners in partnership PS. A contributed a machine (FMV=$1,000, A/B=$700) and B contributed $1,000 cash. Assume that depreciation for tax purposes is $100 per year.
- How is the depreciation allocated? If the machine was sold after one year for $1,000, how would the gain be allocated?



	Book	Tax
Cash	1,000	1,000
Machine	1,000	700
	2,000	1,700
A	1,000	700
B	1,000	1,000
	2,000	1,700

Machine			Ptr %s of Layers		Ptr Share of Layers	
	Book	Tax	A	B	A	B
Base	700	700	N/A	N/A	N/A	N/A
Forward	300	0	100%	0%	300	0
Total	1,000	700			300	0

Traditional method: Allocation of depreciation example – depreciation

- Calculate tax and book depreciation
  - Book depreciation = tax depreciation (100) / tax basis (700) * book basis (1,000) = 143
- Allocate book depreciation

	A (C)	B (NC)
Book Depr	**71**	**71**

- Allocate tax depreciation to noncontributor (B)

	A (C)	B (NC)
Book Depr	**71**	**71**
Tax Depr-Non-Contrib		**71**

- Allocate remaining tax depreciation to contributor (A)

	A (C)	B (NC)
Book Depr	**71**	**71**
Tax Depr-Non-Contrib		**71**
Tax Depr-Contrib	**29**	

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Traditional method: Allocation of depreciation example – gain

- Calculate tax and book gain

	Book	Tax
Amt Real	1,000	1,000
Basis	857 *	600
Gain	143	400

* Orig book basis (1,000) less Yr 1 depr (143)

- Allocate book gain

	A (C)	B (NC)
Book Gain	71.5	71.5

- Allocate tax gain to noncontributor (B)

	A (C)	B (NC)
Book Gain	71.5	71.5
Tax Gain-Non-Contrib		71.5

- Allocate remaining tax gain to contributor (A)

	A (C)	B (NC)
Book Gain	71.5	71.5
Tax Gain-Non-Contrib		71.5
Tax Gain-Contrib	328.5	

Traditional method: Ceiling rule problem

- One problem with the traditional method of §704(c) allocations is the ceiling rule limitation
- For tax purposes, the partnership cannot allocate more income, gain, loss or deduction than it actually realized or incurred
- The ceiling rule limitation applies when a disparity exists between §704(b) book and available tax allocations to the noncontributing partners

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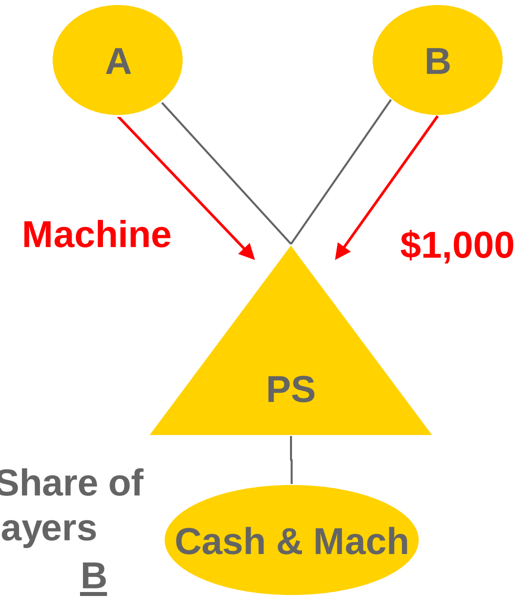
Traditional method: Ceiling rule example

- A and B are equal partners in partnership PS. A contributed a machine (FMV=$1,000, A/B=$100) and B contributed $1,000 cash. Assume that the asset has one year remaining in its useful life (Yr 1 tax depreciation = $100).
- How is the depreciation allocated?

Example 3



	Book	Tax
Cash	1,000	1,000
Machine	1,000	100
	2,000	1,100
A	1,000	100
B	1,000	1,000
	2,000	1,700

Machine			Ptr %s of Layers		Ptr Share of Layers	
	Book	Tax	A	B	A	B
Base	100	100	N/A	N/A	N/A	N/A
Forward	900	0	100%	0%	900	0
Total	1,000	100			900	0

Traditional method: Ceiling rule example (cont.)

- Calculate tax and book depreciation
  - Tax depreciation (100) / tax basis (100) * book basis (1,000) = 1,000
- Allocate book depreciation

	A (C)	B (NC)
Book Depr	**500**	**500**

- Allocate tax depreciation to noncontributor (B)

	A (C)	B (NC)
Book Depr	**500**	**500**
Tax Depr-Non-Contrib		**500?**

- Even though B should be entitled to $500 of tax depreciation, there is only $100 of tax depreciation to allocate. B's allocation is "ceiling-limited," and as such, B will only receive $100 of tax depreciation

	A (C)	B (NC)
Book Depr	**500**	**500**
Tax Depr-Non-Contrib		**100**
Tax Depr-Contrib	**0**	

Traditional method: Ceiling rule example (cont.)

- Resulting balance sheet

	Book	Tax
Cash	1,000	1,000
Machine	0	0
	1,000	1,000
A	500	100
B	500	900
	1,000	1,000

- Due to the ceiling limit, a disparity between each partner's book and tax capital accounts has been "locked-in" until such partner disposes of its partnership interest
- The §704(c) asset has been fully depreciated, and §704(c) no longer applies to any future disposition of such asset
  - No way to "fix" this disparity

Traditional method with curative allocations

- Used to correct distortions created by ceiling rule
- Allocates other partnership tax items of income, gain, deduction or loss to reduce or eliminate the distortion
- Attempts to make noncontributing partners whole
- Curative allocations:
  - Must be reasonable
  - Must be of same character (such as same tax attributes)
  - Made for tax purposes only, not §704(b) book purposes

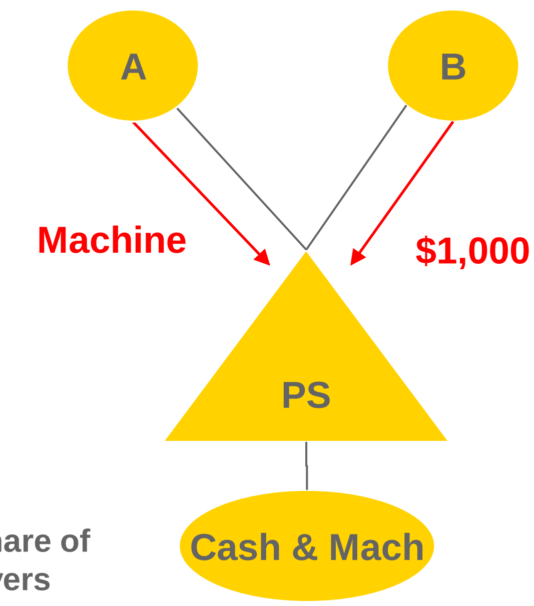
Treas. Reg. §1.704-3(c)

Traditional method with curative allocations

- If the partnership does not have sufficient items of a like character available to cure ceiling limits, then it may make curative allocations of less than the full amount necessary to cure
  - In limited situations, curative allocations may be made in subsequent years
- Curative allocations do not affect book capital accounts
  - Allows partnership to make tax allocations that have no economic consequences so as to reverse ceiling distortions

Traditional method with curative allocations example

Example 4



- A and B are equal partners in partnership PS. A contributed a machine (FMV=$1,000, A/B=$100) and B contributed $1,000 cash. Assume that the asset has one year remaining in its useful life (Yr 1 tax depreciation = $100). AB uses traditional with curative and has $1,000 of other deductions of like character and $2,000 of gross income.
- How is the depreciation allocated?

	Book	Tax
Cash	1,000	1,000
Machine	1,000	100
	2,000	1,100
A	1,000	100
B	1,000	1,000
	2,000	1,100

Machine

	Book	Tax	Ptr %s of Layers A	Ptr %s of Layers B	Ptr Share of Layers A	Ptr Share of Layers B
Base	100	100	N/A	N/A	N/A	N/A
Forward	900	0	100%	0%	900	0
Total	1,000	100			900	0

Traditional method with curative allocations example (cont.)

- Calculate tax and book depreciation
  - Tax depreciation (100) / tax basis (100) * book basis (1,000) = 1,000
- Allocate book depreciation

	A (C)	B (NC)
Book Depr	**500**	**500**

- Allocate tax depreciation

	A (C)	B (NC)
Book Depr	**500**	**500**
Tax Depr-Non-Contrib		**100**
Tax Depr-Contrib	**0**	

- Allocate other items (book = tax)

	A	B
Gross Income	**1,000**	**1,000**
Other Deductions	**500**	**500**

Traditional method with curative allocations example (cont.)

- Calculate curative allocations needed

	A (C)	B (NC)
Book Depr	500	500
Tax Depr-Non-Contrib		100
Tax Depr-Contrib	0	
Curative Needed (Realloc of Other Ded)	(400)	400
Total Tax Allocation	(400)	500

- Total allocation

	Book		Tax	
	A (C)	B (NC)	A (C)	B (NC)
Gross Income	1,000	1,000	1,000	1,000
Depreciation	(500)	(500)	0	(100)
Other Deductions	(500)	(500)	(100)	(900)
Total Tax Allocation	0	0	900	0

- Other deductions are reallocated to take into account the depreciation ceiling limit

Traditional method with curative allocations example (cont.)

- Resulting balance sheet

	Book	Tax
Cash	2,000	2,000
Machine	0	0
	2,000	2,000
A	1,000	1,000
B	1,000	1,000
	2,000	2,000

- The use of traditional with curative eliminates the capital account differences seen in Example 3
- Remember that the partnership *must* have sufficient available items to cure any ceiling limit
  - If sufficient items are not available, the ceiling limit will continue to create distortions in the partners' capital accounts

Remedial allocation method

- Used to correct distortions created by ceiling rule
- Curative method allocates only actual partnership tax items; remedial method allows partnership to create tax items for allocations
  - Advantage: no need for partnership to have actual tax items of a specific character to make allocation
  - Has the effect of lengthening the recovery period as compared to curative or traditional method
- **Created** tax items are allocated to noncontributing partners, with offsetting **created** tax items allocated to contributing partner

Treas. Reg. §1.704-3(d)

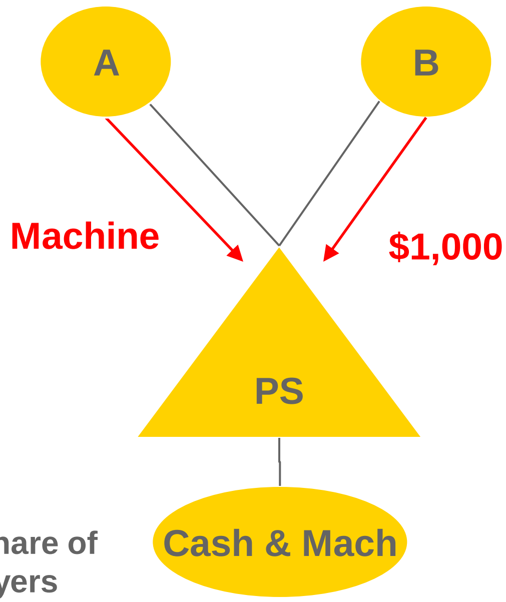
Remedial allocation method: depreciation

- Section 704(b) book basis of asset is split into two components:
  - Amount of §704(b) book basis equal to tax basis is recovered over remaining tax-recovery period
  - Excess of §704(b) book basis over tax basis is treated as new asset and depreciated over applicable tax-recovery period

Remedial allocation method example

- A and B are equal partners in partnership PS. A contributed a machine (FMV=$1,000, A/B=$100) and B contributed $1,000 cash. Assume that the asset has one year remaining in its useful life (Yr 1 tax depreciation = $100), but would be depreciated straight-line over 2 years if it was newly purchased. AB uses the remedial method.
- How is the depreciation allocated?

Example 5



	Book	Tax
Cash	1,000	1,000
Machine	1,000	100
	2,000	1,100
A	1,000	100
B	1,000	1,000
	2,000	1,100

Machine	Book	Tax	Ptr %s of Layers A	Ptr %s of Layers B	Ptr Share of Layers A	Ptr Share of Layers B
Base	100	100	N/A	N/A	N/A	N/A
Forward	900	0	100%	0%	900	0
Total	1,000	100			900	0

Remedial allocation method example (cont.)

- Calculate tax and book depreciation

	Yr 1 Book	Yr 1 Tax	Yr 2 Book	Yr 2 Tax
Base	100	100	0	0
Forward	450	0	450	0
Total	550	100	450	0

- Allocate book and tax depreciation

	Yr 1 A (C)	Yr 1 B (NC)	Yr 2 A (C)	Yr 2 B (NC)
Book Depr	275	275	225	225
Tax Depr-Non-Contrib		100		0
Tax Depr-Contrib	0		0	

- Make remedial allocations

	Yr 1 A (C)	Yr 1 B (NC)	Yr 2 A (C)	Yr 2 B (NC)
Book Depr	275	275	225	225
Tax Depr-Non-Contrib		100		0
Tax Depr-Contrib	0		0	
Remedial Allocation	(175)	175	(225)	225
Total Tax Allocation	(175)	275	(225)	225

Remedial allocation method example (cont.)

- Resulting balance sheet

	Book	Tax
Cash	1,000	1,000
Machine	0	0
	1,000	1,000
A	500	500
B	500	500
	1,000	1,000

- The use of the remedial method eliminates the capital account differences seen in Example 3
- Because PS can create notional items to correct for any ceiling limits, there is no potential for such limitations
  - Remedial is a “sure thing” vs. traditional with curative

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Telma Nadvorny, Ernst & Young

REVALUATIONS

Revaluations

- Generally, §704(b) book basis of partnership property *may* be revalued when partners' interests in the partnership change
- Revaluations serve to "lock-in" any unrealized gains/losses in partners' book capital accounts
- Revaluations also prevent capital shifts
  - If capital accounts are not adjusted to reflect the FMV of partnership property when an interest in the partnership is acquired or relinquished (via a contribution or distribution), and thus the principles of §704(c) are not applied to determine the partners' distributive shares for tax purposes, <u>other potential tax consequences may occur</u>
- Result in reverse §704(c) allocations

Requirements for revaluations – When?

- Partnership agreement *may* provide for a revaluation of partnership property if adjustments are made for a substantial non-tax business purpose (emphasis added) (Treas. Reg. §1.704-1(b)(2)(iv)(f)*(5)(i)-(iv)*):
  - In connection with a contribution of money or other property,
  - In connection with the liquidation of the partnership or a distribution of money or property to a partner as consideration for an interest in the partnership,
  - In connection with the grant of an interest in the partnership as consideration for the provision of services, or
  - Under generally accepted industry accounting practices for investment-type partnerships.

Requirements for revaluations – How?

- To meet the requirements of the §704(b) regulations, capital account adjustments based on a revaluation must meet the following (Treas. Reg. §1.704-1(b)(2)(iv)*(f)(1)-(4)*):
  - Adjustments are based on the fair market value of partnership property
  - Adjustments reflect the manner in which the unrealized income, gain, loss, or deduction in such property would be allocated amongst the partners upon a taxable disposition of such property
  - Partnership agreement must require that capital accounts take into account items of depreciation, depletion, amortization, and gain or loss as computed for book purposes with respect to such property
  - Partnership agreement must require that partners' distributive shares of tax depreciation, depletion, amortization, and gain or loss be determined so as to take into account the variation between the adjusted tax basis and book value of such property under §704(c)
- Revaluations are generally optional, not required

Requirements for revaluations – What?

- Simply, a revaluation locks in book gains/losses as if the partnership was liquidated immediately prior to the revaluation event
  - All partners who would be allocated such unrealized book gains/losses becoming “contributing” partners with respect to the revaluation layer

Contributions to partnerships – potential capital shift if no revaluation

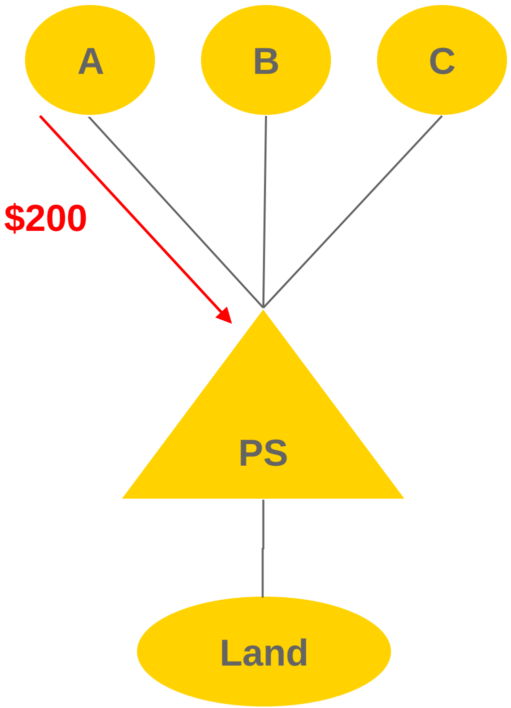
- A, B, and C form PS by contributing $50, $25, and $25, respectively. They agree to share all items of income or loss 50% (A), 25% (B), and 25% (C). PS purchases Land for $100.

PS initial balance sheet

	Assets			Equity	
	Book	Tax		Book	Tax
Land	100	100	A	50	50
			B	25	25
	___	___	C	25	25
	100	100		100	100

- A decides to invest additional capital of $200 and contributes it to PS. At such time, the Land's value was $200. A increases its ownership in PS from 50% to 75%. Each of B and C's ownership is diluted from 25% to 12.5%.

Example 6



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Contributions to operating partnerships – potential capital shift if no revaluation (cont.)

- If PS does not revalue its capital, capital accounts will only change to reflect the contribution by A.
- If PS revalues its capital, the Land will be "booked-up" by $100. This book-up will be allocated $50 to A and $25 each to B and C, in accordance with their sharing ratios immediately before the contribution by A.

Balance Sheets After Contribution

No Revaluation

	Assets Book	Assets Tax		Equity Book	Equity Tax
Land	100	100	A	250	250
Cash	200	200	B	25	25
			C	25	25
	300	300		300	300

Revaluation

	Assets Book	Assets Tax		Equity Book	Equity Tax
Land	200	100	A	300	250
Cash	200	200	B	50	25
			C	50	25
	400	300		400	300

Contributions to operating partnerships – potential capital shift if no revaluation (cont.)

- How will the gain be allocated if Land is sold 10 years later for the same value (*i.e.*, $200)?
- If no revaluation:
  - PS will have $100 book gain ($200 amount realized-$100 book basis), allocated 75% to A, 12.5% to B, and 12.5% to C. Allocations of tax gain would follow the book gain allocation.
  - The failure to revalue would shift aggregate gain of $25 from B and C to A. Even though A is a 75% partner, it would be entitled to 81.25% of PS's capital.
- If revaluation:
  - PS would have no additional book gain to allocate (*i.e.*, all book gain would have been locked-in through the revaluation) and PS would allocate the $100 tax gain in the same manner as it allocated the previous book gain (*i.e.*, in accordance with 704(c) principles).

Balance sheets after sale

No revaluation

Assets	Book	Tax	Equity	Book	Tax
Land	0	0	A	325	325
Cash	400	400	B	37.5	37.5
			C	37.5	37.5
	400	400		400	400

Revaluation

Assets	Book	Tax	Equity	Book	Tax
Land	0	0	A	300	300
Cash	400	400	B	50	50
			C	50	50
	400	400		400	400

How to calculate a revaluation and its effects

- Three-step process:
  1. Calculate revaluation gain or loss for each property
  2. Allocate each property's revaluation gain or loss to partners and update capital accounts
  3. Calculate §704(c) effects of revaluation for each property

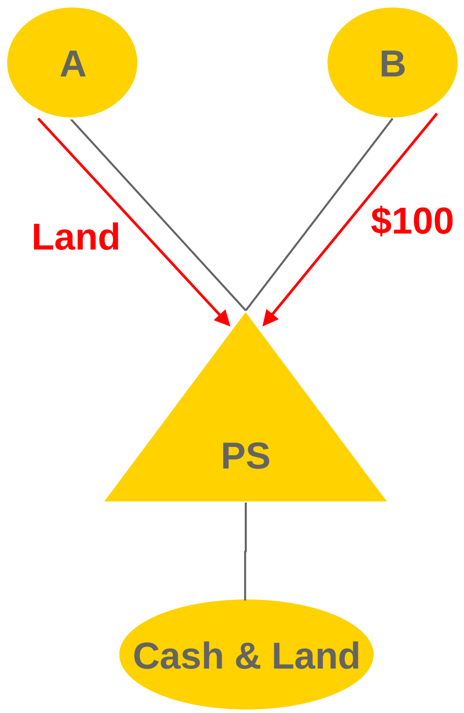
Calculation of a revaluation 1) Calculate and 2) Allocate revaluation gain

- Revaluation gain/loss on each property is equal to the property's FMV less its prior book value
- Allocate revaluation gain/loss to partners
  - Allocation of revaluation gain/loss is based on sharing arrangements, as defined in the partnership agreement *and as in effect prior to the event causing the revaluation*
  - Depending upon the agreement, there may be different sharing ratios for each property
- Update capital accounts and property §704(c) layers
  - Each partner's capital account is increased by its share of revaluation gain, and decreased by its share of revaluation loss (Treas. Reg. §1.704-1(b)(2)(iv)*(b)*)

Calculation of a revaluation example

- A and B are equal partners in partnership PS. A contributed Land with a value of $100 and a basis of $50 and B contributes $100 cash.

Example 7



	Book Basis	Tax Basis
Cash	**100**	**100**
Land	**100**	**50**
	200	**150**
Liabilities	**0**	**0**
A (CP)	**100**	**50**
B (N/C P)	**100**	**100**
	200	**150**

Land

	Book	Tax	Partner Share of Layers: A	Partner Share of Layers: B
Base	**50**	**50**	**N/A**	**N/A**
Forward	**50**	**0**	**50**	**0**
Total	**100**	**50**	**50**	**0**

- A, as the contributing partner, bears the full share of the Land's 704(c) pre-contribution built-in gain.

Calculation of a revaluation example (cont.)

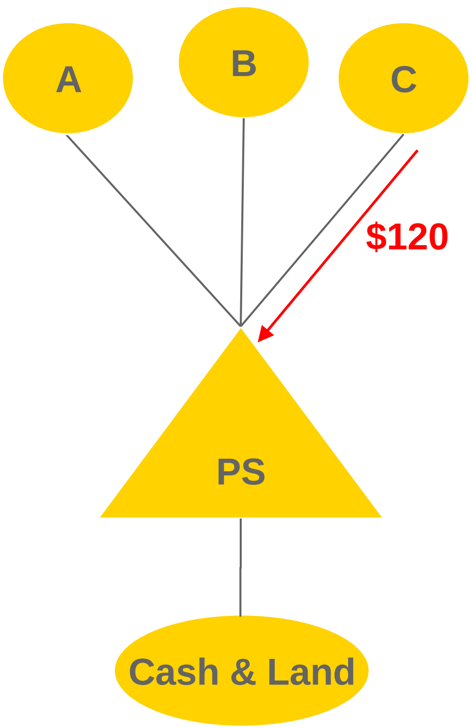
- When Land is worth $140, C contributes $120 cash for a 1/3 interest. The partnership revalues its capital.

FMV	**140**
Book Basis	**100**
Revaluation	**40**

	Sharing %	Reval Share
A	**50%**	**20**
B	**50%**	**20**
Total		**40**

	Book	Tax	Partner Share of Layers A	Partner Share of Layers B
Base	**50**	**50**	**N/A**	**N/A**
Forward	**50**	**0**	**50**	**0**
Reverse	**40**	**0**	**20**	**20**
Total	**140**	**50**	**70**	**20**

Example 7 (cont.)



Calculation of a revaluation example (cont.)

- A and B's book capital accounts are increased by the amount of the revaluation (note that there is **no** impact on tax basis).
- C has book basis equal to its tax basis due to its cash contribution.
  - C did not share in the revaluation because C was not a partner when the Land appreciated and, thus, was not entitled to share in any of such appreciation.

Resulting balance sheet

	Book Basis	Tax Basis
Cash	220	220
Land	140	50
	360	270
Liabilities	0	0
A (CP, RP)	120	50
B (RP)	120	100
C (N/C P)	120	120
	360	270

Opposite sign revaluations

- How should §704(c) layers resulting from *opposite sign revaluations* be taken into account?
- Treas. Reg. §1.704-3(a)(6) makes clear that separate layers of built-in gain are established upon revaluations of built-in gain property since they increase the built-in gain in such property, and separate layers of built-in loss are established upon same sign revaluations of built-in loss property (same sign revaluations)
- However, it is not clear whether opposite sign revaluations (*i.e.,* book-downs of built-in gain property):
  - Merely reduce the prior built-in gain layers under a netting approach, or
  - Establish a separate and independent "negative" layer (much like a "contra asset") under a layering approach that itself is subject to separate elections, methods and allocations

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MIXING BOWL RULES AND OTHER MATTERS

Statutory Backstopping of Section 704(c)

- There are two potential ways to avoid Section 704(c)'s application that were addressed by statute. These are the potential "mixing bowl" transactions:
  - Property subject to the Section 704(c) allocation is distributed to someone other than the contributing partner. [Section 704(c)(1)(B)]
  - Property, other than the property subject to the Section 704(c) allocation, is distributed to the contributing partner. [Section 737]

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Statutory Backstopping of Section 704(c)

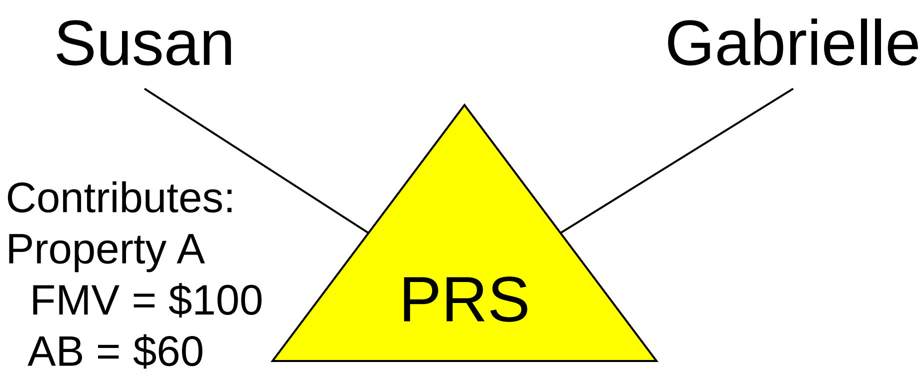
- Section 704(c)(1)(B)
  - Contributing partner must recognize gain or loss if the property contributed is distributed to another partner within 7 years of the contribution.
  - The amount of the gain or loss recognized is the amount that would have been allocated to the contributing partner under Section 704(c) if the property had been sold by the partnership on the date of distribution for its fair market value.
  - The character of the gain or loss is as if the property had been sold by the partnership to the distributee partner.

Statutory Backstopping of Section 704(c)

- Section 704(c)(1)(B)
  - Consistent basis adjustments are made to the basis of the contributing partner in the partnership and the distributed property to reflect any gain or loss recognized.
  - The gain or loss is recognized only by the contributing partner, not by the partnership or the other partners.
  - There are a number of exceptions to this gain or loss recognition provision, including:
    - Certain transactions in which the built-in gain or loss is preserved.
    - Incorporation transactions if the partnership is liquidated.
    - Pre-effective date contributions (10/3/1989).

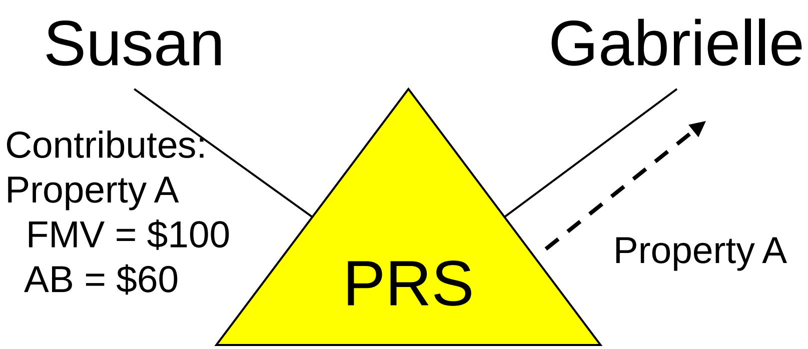
Statutory Backstopping of Section 704(c) Section 704(c)(1)(B): Example

- Susan contributed Property A, Section 704(c) property, to PRS.



Statutory Backstopping of Section 704(c) Section 704(c)(1)(B): Example (Cont.)

- Susan contributed Property A, Section 704(c) property, to PRS.



- If Property A is distributed by PRS to another partner within seven years of the date of contribution, Susan recognizes Section 704(c) gain or loss under Section 704(c)(1)(B) as if such property were sold for its FMV at the time of distribution.
- Susan would recognize a $40 gain, presuming FMV has not declined.
- Sect. 704(c)(1)(B) does not trigger reverse-Section 704(c) gain or loss.
- Exceptions:
  - Property A can be distributed back to Susan.
  - Like-kind property exception

Statutory Backstopping of Section 704(c)

- Section 737
  - In the case of a distribution to a contributing partner of other property, the partner shall recognize gain (not loss) equal to the lesser of:
    - The value of the distributed property over the partner's basis in the partnership interest before the distribution less cash distributed (not below zero), or
    - The net pre-contribution gain of the partner.
  - The Section 737 gain is in addition to any gain recognized on the distribution under Section 731.

Statutory Backstopping of Section 704(c)

- Section 737
  - The character of the Section 737 gain is a proportionate share of the net precontribution gain.
  - Net precontribution gain is the net gain which would be recognized under Section 704(c)(1)(B) if there was a distribution to another partner of any property contributed by the contributing partner within 7 years of the distribution and still held by the partnership at the time of distribution.

Statutory Backstopping of Section 704(c)

- Appropriate basis adjustments are made to the basis of the partner in the partnership and to the adjusted basis of the partnership in the contributed property to reflect the recognition of gain under Section 737.
- Exceptions:
  - Distributions of previously contributed property to the contributor.
  - The extent to which Section 751's hot asset rule applies.

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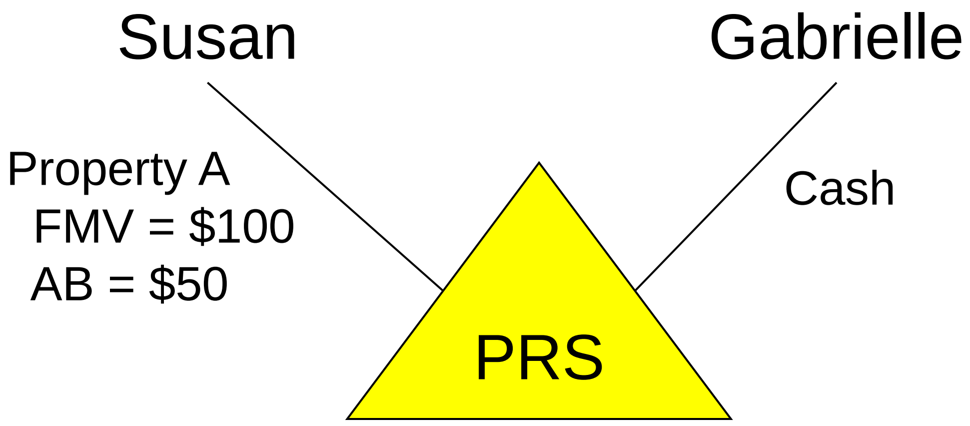
Statutory Backstopping of Section 704(c) Section 737: Example

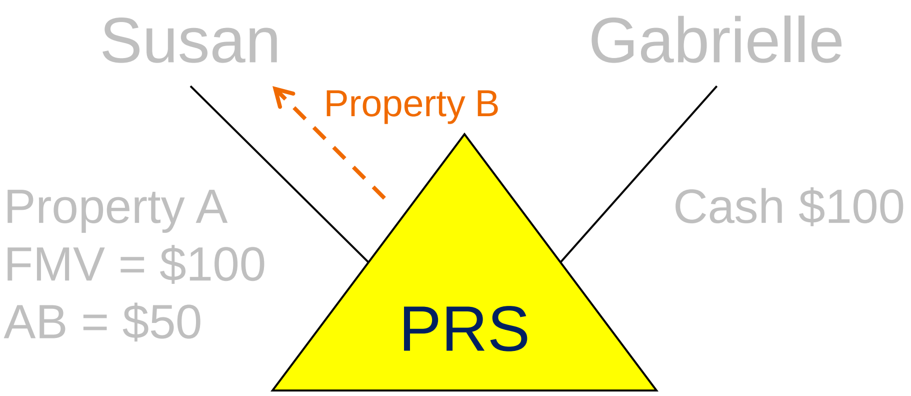
- Susan contributed Property A, Section 704(c) property, to PRS on 1/1/2008.



Property B (acquired by PRS for $80)

Statutory Backstopping of Section 704(c) Section 737 Example (Cont.)

- Susan contributed Property A, Sect. 704(c) property, to PRS on 1/1/2008.
- PRS distributes Property B to Susan on 1/1/2013.



Property A
Property B (acquired by PRS for $80, **FMV $80 on distribution**)

- Susan recognizes gain under Sect. 737.
- Gain triggered is equal to the lesser of Susan's:
  - Net pre-contribution gain ($50), or
  - Excess distribution (FMV of the distributed property – Susan's outside basis = $80 – $50 = $30).
- Exceptions:
  - Any property Susan contributed to PRS can be distributed to her.
  - Sect. 751(b)

Section 704(c) in Partnership Mergers & Divisions

- Notice 2009-70
  - The Treasury Department invited comments regarding the proper application of Section 704(c) in the context of partnership mergers and division.
  - Areas raised within the Notice included:
    - Tiered Partnerships
    - Multiple Layers of forward and reverse of Section 704(c) gain and loss
    - International Issues

Section 704(c) in Partnership Mergers & Divisions

- Notice 2009-70
  - Numerous groups provided comments and raised a variety of concerns.
  - No guidance has yet been provided by the IRS on these issues.
  - As a practical result, there is substantial flexibility as to how to apply the rules but little agreement as to the reliability of any selected methodology.

Final Section 704(c) Anti-Abuse Regulation

- An allocation method (or combination of methods) is unreasonable if the allocation, either in a direct or reverse section 704(c) context, results in a shifting of the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value (PV) of the partners' (or members') aggregate tax liability.
- The final regulations amended the anti-abuse rule to provide that the tax effect of an allocation method (or combination of methods) on both direct and indirect partners must be considered.

Final Section 704(c) Anti-Abuse Regulation

- Indirect Partners
  - An indirect partner is any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership, and any consolidated group of which the partner in the partnership is a member per Treas. Reg. § 1.1502-1(h).
  - A CFC shareholder is treated as an indirect partner only for allocation of items that: (1) enter into the computation of a U.S. shareholder's inclusion for the CFC; (2) enter into any person's income attributable to a U.S. shareholder's inclusion under section 951(a); or (3) would enter into these computation if the items were allocated to the CFC.

Final Section 704(c) Anti-Abuse Regulation

- The final regulations also provide that the principles of section 704(c), together with the allocation method only apply to contributions of property to the partnership.
- In determining if a purported contribution of property to a partnership should be recast to avoid results that are inconsistent with subchapter K, one factor that is relevant is the use of the remedial method in which allocations of remedial items of income, gain, loss or deduction are made to one partner and allocations of offsetting remedial items are made to a related partner.

Q&A

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