

Special Allocations of Partnership gains, losses and deductions under recent Treasury Department regulations

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I. INCOME SHIFTING ISSUE

Because our income tax system uses progressive tax rates, the IRS has long been concerned with taxpayers shifting income from one taxpayer to another to get the benefit of lower rates. Contributing property to a partnership could result in income shifting if the adjusted basis is not equal to the fair market value of the property.

Example

Moe has land with an adjusted basis of \$10,000 and a fair market value of \$100,000. Moe contributes this property to the Three Stooges partnership. Larry and Curly contribute \$100,000 cash each to become the other two-thirds partners. The partnership sells the property the next day. The partnership has a gain of \$90,000. Moe is allocated 1/3 or \$30,000 and Larry and Curly are allocated \$30,000 each and must pay tax on that \$30,000 each. This is the tax equivalent to Moe poking the other stooges in the eyes, because if Moe had sold the land himself, he would have had to pay tax on the entire \$90,000 gain. Note that Larry and Curly may agree to this if they have expiring net operating losses, and are being helpful by reducing Moe's taxes without increasing theirs.

The appreciation in property is called built-in gain. There may also be built-in loss.

To prevent shifting built-in gain or loss to other partners, Congress amended Internal Revenue Code § 704(c) in 1984¹. The relevant passage, as further amended in 1989², now reads:

Under regulations prescribed by the Secretary—
(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution³...

On December 21, 1993, the Treasury Department issued Temporary (§ 1.704-3T) and Final Regulations (§ 1.704-3) regarding the § 704(c) rules, with the final revision issued on December 27, 1994.⁴

Under Code § 704(c), the contributing partner retains the burdens and benefits of the built-in gain or loss associated with the property. If a partner contributes property to the partnership and if the property's adjusted basis is not equal to its fair market value, then any reasonable method can be used to allocate built-in gain or loss to the contributing partner.

The regulations describe three methods that will be deemed acceptable. This list is inclusive, not exclusive.⁵

1. "Traditional" method,⁶ *i.e.*, the method used in Treas. Reg. § 1.704-1(c) prior to the issuance of the current regulations⁷,
2. Traditional method with curative allocations,⁸
3. Remedial allocation method.⁹

The allocations are done on a property by property basis; the partners and partnership cannot aggregate built-in gains with built-in losses.¹⁰ But there are exceptions to this nonaggregation rule. Aggregation is permitted in the following situations:

1. Depreciable property (other than real property) included in the same general asset account;

2. Zero basis property;
3. Current inventory;
4. Other property permitted by the Internal Revenue Service, as published in the Internal Revenue Bulletin or in a private letter ruling;
5. There are special aggregation rules for securities partnerships (discussed below).¹¹

The partnership may use different methods of allocating the built-in gain or loss for different properties, as long as the use of the different methods is reasonable. The regulations state that using one method for built-in gain property and a different method for built-in loss property is not reasonable.¹²

The method used is deemed unreasonable if contribution and allocation are made with a view to shifting tax consequences of built-in gains or losses among partners so that it substantially reduces the present value of the partners' aggregate tax liabilities.¹³

II. TRADITIONAL METHOD

If a partnership disposes of property with built-in gain or loss in a taxable transaction (e.g., not a like-kind exchange), the gain or loss recognized is allocated first to the contributing partner to the extent of built-in gain or loss, and the excess gain or loss is allocated to all the partners according to their usual ratios for gain or loss.

Example

Laurel and Hardy each are 50% partners in a piano moving business. Laurel contributed land with adjusted basis of \$40,000 and fair market value of \$80,000 (built-in

gain of \$40,000). Hardy contributed \$80,000 cash. The partnership sold the property one year later for \$90,000, less partnership adjusted basis \$40,000 = \$50,000 gain. The built-in gain is \$40,000, leaving \$10,000 of partnership gain. All the built-in gain is allocated to Laurel, and the \$10,000 partnership gain is allocated \$5,000 to Laurel and \$5,000 to Hardy.

Suppose the property was sold one year later for \$70,000. The gain on the sale is \$30,000, which is less than the built-in gain of \$40,000. Note that is *not* permissible under the regulations for Laurel to receive \$40,000 of gain on the sale for \$70,000, and for Hardy to receive \$10,000 of loss. While this still nets out to \$30,000 for the partnership as a whole, the regulations take the position that the built-in gain allocation cannot create a paper loss for the non-contributing partner.¹⁴

Depreciation, amortization or depletion under traditional method

Since depreciation, amortization or depletion reduces adjusted basis (Code § 1016) and since adjusted basis helps to determine gain or loss, the regulations say that all § 704(c) special allocations must apply to depreciation, amortization or depletion just as they apply to calculation of gain or loss.¹⁵

The regulations set forth the following method for allocating depreciation, amortization and depletion among the partners:

1. Determine the deduction for depreciation, amortization or depletion based upon the property's fair market value (rather than basis) at the time of contribution; call this amount the book value of the deduction.

2. Allocate the book value of the deduction of each partner according to the partner's usual share of expenses.

3. The non-contributing partners receive a deduction for depreciation, amortization or depletion equal to their share of book value of the deduction.

4. The amount allocated to the non-contributing partners cannot exceed the allowable depreciation, amortization or depletion deduction for the partnership, based upon the property's adjusted basis.

5. Add up the amounts allocated for depreciation, amortization or depletion to the non-contributing partners. Compare this total to the partnership's allowable deduction (computed with regard to actual basis, not fair market value) for the property. The excess of allowable deduction over the amount allocated to the non-contributing partners is the deduction allocable to the contributing partner.

Example

Jack and Rochester are equal partners in the Thrifty partnership. Jack contributed depreciable property to the partnership for which the depreciation allowable for tax purposes is \$1,000 and the depreciation allowable for book purposes is \$1,200.

Rochester is allocated the lesser of the tax depreciation or one-half of the book depreciation, or \$600, and Jack is allocated the tax depreciation (\$1,000) less Rochester's allocation (\$600) = \$400.

The method described above may cause distortions that can be cured using the second method, discussed below.

III. TRADITIONAL METHOD WITH CURATIVE ALLOCATIONS

Suppose the book deduction for depreciation, amortization or depletion allocated to the non-contributing partner is less than the tax deduction allowable to the partnership. Then, the tax deduction allocated to the non-contributing partner is less than book deduction (and no deduction remains to be allocated to the contributing partner.) This is sometimes called the “ceiling rule.”

Example

Abbott and Costello are equal partners in the Third Base partnership. Costello contributed depreciable property to the partnership for which the depreciation allowable for tax purposes is \$500 and the depreciation allowable for book purposes is \$1,200. Under the Traditional Method, Abbott is allocated the lesser of one-half of the book depreciation or the tax depreciation (\$500) and Costello is allocated the tax depreciation (\$500) less the amount of depreciation allocated to Abbott (\$500) = zero (\$0-).

Under the traditional method with curative allocations, the partnership may make a “curative allocation” of tax depreciation from the other partnership property to the non-contributing partner. The curative allocations must be reasonable.

The curative allocations cannot exceed the amount necessary to offset the effect of the ceiling rule.

At the time of the property’s contribution, and when the allocation becomes part of the partnership agreement, the partners must expect that the allocation will affect each partner’s tax liability the same way the ceiling rule affects each partner’s tax liability. For example, if the ceiling rule affected capital gain as opposed to ordinary income, then the curative allocation must also affect capital gain as opposed to ordinary income.¹⁶

Example

If the ceiling rule limits depreciation, it is reasonable to specially allocate depreciation from other property, but not reasonable to specially allocate dividends or capital gain income.

The partnership agreement may limit curative allocations to one or more items; the curative allocations may be less than required to fully offset the ceiling rule, but may not be more.

The curative allocations may be reasonable to offset a prior year ceiling rule effect if the allocations are over a reasonable period of time (e.g., the property's useful life) and the partnership agreement in effect for the year of contribution provides for such allocations.¹⁷

Normally, gain from property cannot be allocated to offset depreciation, because one is § 1231 gain and the other is an ordinary deduction, but there is an exception. Gain from property may be specially allocated to compensate for unallowable book depreciation (due to the ceiling rule) from the same property if:

1. the ceiling rule offset has not been completely cured, and
2. the partnership agreement in effect for year of contribution specifically provides for this.¹⁸

IV. REMEDIAL ALLOCATION METHOD

If the ceiling rule causes disparity between book allocation and tax allocation, then the partnership may make a "remedial allocation" of income, gain, loss or deduction to the non-

contributing partner equal to the full amount of the disparity, and simultaneously make an offsetting allocation of deduction, loss, gain or income to the contributing partner.¹⁹

The remedial allocation must conform to the method set out in the temporary regulations in order to be reasonable.

1. Remedial allocations may not exceed the disparity caused by the ceiling rule for that tax year.
2. Book basis in excess of tax basis is recovered using the recovery period and depreciation method for property newly purchased at the time of contribution.
3. It must have the same effect on tax liability as the item limited by the ceiling rule (i.e., ordinary or capital gain or loss).²⁰

Example

George and Gracie form a partnership; they are equal partners. George contributes cash and Gracie contributes ten year property depreciated using the straight line method (ignore the mid-year convention of Code § 168(d) for simplicity's sake). Gracie's contributed property has a basis of \$4,000 at the time of contribution, a fair market value of \$10,000 and four years left on the recovery period. Again for simplicity, assume that partnership income equals all expenses except for depreciation.

A partnership must use the contributing partner's depreciation method and recovery period for contributed property. The tax depreciation is \$1,000 per year for four years. For book purposes, the basis is divided between tax basis, \$4,000 depreciable at the rate of \$1,000 per year, and an excess book basis of \$6,000.

The excess book basis is depreciable--for book purposes--over the same ten year straight line method that the tax basis uses (the partnership may actually use any recovery period and depreciation method authorized by the Code for this type of property; here, assume that the ten year straight line method is permissible and selected by the partnership for purposes of the remedial allocation method). But unlike the tax basis, which has only four years left, the excess book basis is depreciable as if the property were newly purchased, i.e., over ten years. Thus the excess book basis is depreciated \$6,000 over ten years or \$600 per year.

Therefore, the book depreciation is \$1,600 per year for the first four years and \$600 per year for the next six years. The book depreciation is allocated according to the partner's shares, or 50% each. For years 1-4, George is allocated \$800 (one-half the book depreciation) and Gracie is allocated the balance of tax depreciation or \$200. For years 5-10, since the tax depreciation is zero, both George and Gracie are allocated zero depreciation.

The ceiling rule limits George's depreciation deduction in years 5-10 to zero, which is a \$300 disparity per year between book and tax depreciation. Gracie's depreciation deduction is zero by the allocation rules, so the ceiling rule does not affect her. Thus the partnership must take remedial allocations in years 5-10 of \$300 per year to George of depreciation deductions and an offsetting \$300 per year to Gracie of income.²¹

V. SECURITIES PARTNERSHIPS

Securities partnerships must revalue their securities under Reg. § 1.704-1(b)(2)(iv)(f) every year. This may create disparities between book value and tax basis. Because of the

number of partnership assets involved, it may be impractical for a securities partnership to use the item by item allocations mandated by the Regulations. Thus, the Regulations permit securities partnerships to aggregate all gains and separately aggregate all losses from securities and similar investments when making allocations.²²

VI. *DE MINIMUS* RULE

For small disparities, a partnership may disregard the regulations regarding allocating depreciation deductions. The partnership is still required to specially allocate gain or loss on disposition of an asset.

Small (*de minimus*) disparities are defined as:

1. Fair market value of all property contributed by a partner in a tax year differs from the aggregate basis of the properties by no more than 15%, and
2. The disparity between fair market value and aggregate basis is no more than \$20,000.²³

VII. CONCLUSION

The new regulations are a comprehensive effort by the IRS to resolve the issues under § 704(c). All partnerships should obtain independent appraisals of contributed property to determine the built-in gain or loss if any, and should have the partnership agreement reflect one of the methods described herein for specially allocating the § 704(c) gains, losses and deductions.

¹ P.L. 98-369, § 71(a) (1984)

² P.L. 101-239 § 7642(a) (1989).

³ Code §704(c)(1)(A).

⁴ T.D. 8500, 8501 (12/21/93), TD 8585 (12/27/94)

⁵ Preamble to T.D. 8500.

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- ⁶ Treas. Reg. § 1.704-3(b).
- ⁷ Preamble to Prop. Regs. Fed. Regs. Vol. 57, No. 248A, p. 61345 (12/24/92)
- ⁸ Treas. Reg. 1.704-3(c).
- ⁹ Treas. Reg. § 1.704-3(d).
- ¹⁰ Treas. Reg. § 1.704-3(a)(2).
- ¹¹ Treas. Reg. § 1.704-3(e)(2), Reg. § 1.704-3(e)(3).
- ¹² Treas. Reg. § 1.704-3(a)(2).
- ¹³ Treas. Reg. § 1.704-3(a)(10).
- ¹⁴ Treas. Reg. § 1.704-3(b)(1); §1.704-3(b)(2) Example (1)(iii).
- ¹⁵ Treas. Reg. § 1.704-3(b)(2) Example (1)(ii).
- ¹⁶ Treas. Reg. § 1.704-3(c)(3).
- ¹⁷ Treas. Reg. § 1.704-3(c)(3)(ii).
- ¹⁸ Treas. Reg. § 1.704-3(c)(3)(iii)(B).
- ¹⁹ Treas. Reg. § 1.704-3(d)(1).
- ²⁰ Treas. Reg. § 1.704-3(d).
- ²¹ Treas. Reg. § 1.704-3(d)(5), Example 1.
- ²² Preamble to T.D. 8501; Treas. Reg. § 1.704-3(e)(3)(i).
- ²³ Treas. Reg. § 1.704-3(e)(1).