Is it Time to Remediate Section 704(c)?

## Introduction

The stated policy goal of § 704(c) is to prevent partners from “shifting” tax consequences among themselves. Shifting is generally understood to mean the recognition of income, gain, loss, or deduction by a person other than the person to whom the item economically accrued. For example if a shareholder contributes property with a value of $100 and a basis of $40 to an S corporation in exchange for a 20 percent interest in the corporation, and the corporation subsequently sells the property for $100, the contributor will recognize $12 of gain and the other $48 will be recognized by the other shareholder(s). $48 of gain will have been “shifted” to the noncontributing shareholder(s).

The goal of anti-shifting has been operationalized in a specific way: when a disparity between tax basis and book basis exists, a partnership must, to the greatest extent possible,[[1]](#footnote-1) allocate non-contributing partners tax equal to book. The implicit theory behind this methodology is that if non-contributing partners are allocated tax equal to book, nothing has been shifted to them, and the contributing partner has borne the benefit or burden of any inherent disparity.[[2]](#footnote-2)

It is worthwhile to ask, as an initial matter, *why* shifting tax consequences is restricted within partnerships. The most obvious answer is fiscal. If taxpayers are permitted to shift income, gain, loss, or deduction, they will take the opportunity to shift income and gain to non-taxable or low bracket taxpayers, and loss and deduction to those who pay full tax.[[3]](#footnote-3) The JCT report that accompanied the 1984 changes to § 704(c) makes this concern explicit,[[4]](#footnote-4) as does the structure of the anti-abuse rule, which asks whether contributions and allocations are made with a view to reducing the present value of the partners’ tax liability. Outside of § 704(c), however, particularly in the assignment of income doctrine, the tax system shows discomfort with the shifting of tax burdens regardless of the tax profiles of the taxpayers involved.[[5]](#footnote-5)

Anti-shifting is not the only policy goal served by § 704(c). As an integral part of subchapter K, § 704(c) serves the goal of flexibility, most notably in the current regulations embrace of *any* reasonable method for dealing with book/tax disparities. The value of this flexibility has recently come into question, with lawmakers asking whether it provides taxpayers with inappropriate opportunities to avoid or delay paying tax.

The history of § 704(c) tells a consistent story of ever-increasing restriction – including in the rules formally outside of § 704(c) – on the ability of taxpayers to shift tax attributes among themselves, particularly where doing so will reduce the aggregate tax liability of partners.

The regulations contain a curious limitation on the ability of a partnership (or the IRS) to allocate tax items to the noncontributing partner: outside of a very narrow set of circumstances, the partnership can only use tax items that it actually recognizes.[[6]](#footnote-6) This limitation has been a feature of § 704(c) since long before there was a Code section of that name. It is in tension with the stated goals of § 704(c). Its persistence has a great deal to do with the particular history of § 704(c).

We summarize that history and attempt to discern policy lessons from it immediately below. Then, we consider whether a contemporary proposal for the mandatory elimination of shifting for all partnerships – bringing the policy story full circle – is worth the cost to flexibility and other policy goals. Finally, we explore other possible modifications to the basic § 704(c) scheme, and discuss several crucial (and a few not so crucial) improvements to the mechanical functioning of the current system that would promote both good tax administration and the policies underlying § 704(c).

## History and Development of Section 704(c)

Section 704(c)(1)(A),[[7]](#footnote-7) added to the Code in its current form in 1984, provides that “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 contribution.”[[8]](#footnote-8) The regulations provide that “[t]he purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss.” This purpose, however, has not always been evident in Congress’s approach to property that is contributed to partnerships.

The need for a provision like § 704(c) arises from the fact that (1) a partner that contributes property to a partnership recognizes neither gain nor loss, (2) the partnership takes a carryover basis in the property contributed, and (3) income, gain, loss and deduction from the property will be recognized by the partnership and allocated to the partners. Although all three seem foundational to Subchapter K, none was inevitable. Carryover basis has been a feature of the Code since 1934,[[9]](#footnote-9) and was reflected in administrative practice well before,[[10]](#footnote-10) though prior to codification neither the courts nor taxpayers agreed.[[11]](#footnote-11) In fact, both the Board of Tax Appeals and the Second Circuit held that a partnership takes a fair market value basis in contributed property, with the Second Circuit intimating that built-in gain would remain untaxed until the liquidation of the partnership[[12]](#footnote-12) – even in cases where the property is sold by the partnership in the interim![[13]](#footnote-13) Nonrecognition for partnership contributions took longer to solidify, being at first unnecessary because of the Service’s somewhat tortured view that partnership contributions were generally open transactions and thus no realization occurs on property contributions.[[14]](#footnote-14) The sharing of income, gain, loss, and deduction from contributed property is perhaps the most foundational of the three, but early thinking on the subject explored keeping pre-contributions “basis derivative”[[15]](#footnote-15) items outside the partnership, at least in some cases.[[16]](#footnote-16)

Against this somewhat unsettled background, the question of what to do when a partner contributed either appreciated or depreciated property was largely determined by the partnership agreement, or left to the partners to decide *ad hoc*. Under the 1939 Code, regulations provided the following rules:

1. Gain or loss on disposition must be prorated according to the gain or loss ratios for the disposition of partnership assets.
2. For depreciation and depletion with respect to built-in gain property, partners were permitted but not required to adhere to the partnership agreement’s for sharing gains or losses affecting partnership capital, and
3. For depreciation and depletion with respect to built-in loss property, partners were required to adhere to the partnership agreement’s for sharing gains or losses affecting partnership capital.[[17]](#footnote-17)

During this same timeframe, however, a thoughtful and detailed (even if not entirely coherent) 1932 General Counsel Memorandum[[18]](#footnote-18) adopted a different approach: a deferred sale, reasoning that a contribution where the partnership used different values for the capital account and tax basis of an asset represented an agreement that the unrealized gain or loss was attributable to the contributing partner alone. The contributing partner would recognize gain or loss with respect to the contributed property as the partnership recovered its basis in the property, with full recognition if the partnership sold the property.

The GCM’s conception of partnership contributions was unusually reliant on an entity concept of partnerships, in stark contrast to the received wisdom of its time. In particular, it limited the items that could be recognized by the partners to the items available to the partnership itself (the first articulation of the “ceiling rule,” though not by that name). The GCM viewed partnership contributions as open transactions – a view that it was seemingly forced to adopt, given the absence of a statutory nonrecognition provision. [Maybe deferred sale was a direct reaction to the open transaction theory?] This Memorandum was contrary to the regulations, and apparently not followed in practice by either taxpayers or the IRS,[[19]](#footnote-19) but was not formally revoked until 1950. It nevertheless contains the seeds out of which the modern conception of § 704(c) grew.

### The First ALI Report

The pre-1954 status quo was clearly unstable. The American Law Institute produced a detailed report describing several possible schemes for dealing with contributed property. The first question was whether and, if so, to what extent gain or loss should be recognized upon contribution. The ALI considered a range of possibilities for full or partial recognition regimes. The possibility of immediate taxation opened up other questions, of course: how much gain should be taxable, and under what theory? Under an entity theory, each partner would be viewed as receiving a partnership interest in exchange for his contribution of property, which could be (1) fully taxable, or (2) a nonrecognition transaction, as under then-current law. Under an aggregate theory, on the other hand, the partners would be viewed as exchanging portions of each property among themselves, triggering gain or loss only to the extent property of non-like kind changed hands.[[20]](#footnote-20) The aggregate construct could itself give rise to varying amounts of gain or loss recognition, either to the extent the properties so-exchanged were of like kind, or to the extent that any particular partner was viewed as gaining an interest in cash (effectively treating all non-cash property as of like kind).

The ALI report ultimately advocated sticking with the current law construct for partnership contributions – a general nonrecognition rule. The authors reasoned that any rule requiring gain recognition would discourage new business enterprise, and would require answering the question of whether to recognize losses.

Once the ALI decided to embrace nonrecognition, it naturally embraced carryover basis for contributed property (and transferred basis for the partner’s partnership interest), setting up the fundamental question of § 704(c): what is a partner’s distributive share of income, gain, loss, and deduction when the basis of contributed property differs from its value. The ALI draft discussed four possibilities, using a familiar example. A contributes $100 of cash and B contributes property with a value of $100 and a basis of $20 to an equal partnership (depreciable over ten years straight line).

#### The Credited Value or Deferred Sale Approach

Under the “credited value” or deferred sale approach, B would be allocated the first $80 of gain on the sale of the property. The character of the gain would depend on the character of the property sold. Any remaining gain would be allocated according to the partnership agreement. For depreciable property, the non-contributing partner would be allocated depreciation equal to what he would have been allocated if the property had fair market value basis, or $5 per year. The contributing partner would be entitled to depreciation calculated based on the property’s actual basis, or $1 per year. Because the aggregate depreciation to the partners is greater than that which would have been allowed had the property not been contributed to a partnership, however, the contributing partner B would have been required to pick up an additional $4 of income or gain each year (the difference between the total depreciation of $6 allowable to the partners and the $2 that would have been allowable based on the actual tax basis of the asset). The ALI draft assumed that depreciable business assets would generally give rise to capital gain, so the $4 would likely be capital.[[21]](#footnote-21) This method is notable because it does not limit itself to the items recognized by the partnership – $4 of A’s depreciation deduction and B’s $4 of gain were simply pulled out of thin air (or, perhaps more charitably, B was required to recognize some of the gain held outside the partnership, and this recognition simultaneously gave rise to basis that could be recovered by A). This articulation thus represents a rejection of the ceiling rule.[[22]](#footnote-22)

The credited value approach was rejected for its “extreme complexity.”[[23]](#footnote-23) While noting that it is “inherently equitable,” the ALI recoiled at the complexity of partnerships needing to keep two sets of tax bases for each contributed property. It also hesitated to recommend an approach that would require annual recognition of gain even when no property is sold. The ALI discussion also worried that if the partnership sold the contributed property for less than its value on contribution, the contributor could have more tax gain than proceeds from the sale – if the partnership sold the property for only $80, the contributor would have $80 of gain and $10 of loss, but would only be entitled to $40 of proceeds. The ALI discussion reports that many of those involved in the discussion found these results “as objectionable as imposing a tax at the time of contribution.” Thus the “credited value” or deferred sale approach was rejected.

#### The Entity Approach

The next approach considered by the ALI was dubbed the “entity approach.” The description of the entity approach reads like a description of the current law’s approach to many aspects of partnership (and corporate) taxation – the partnership is regarded as an entity separate from the partners, and a partnership interest is viewed as a separate capital asset with its own basis (a basis that may differ from the partner’s share of inside basis). Contributions to the partnership would not result in recognition, and the partnership would take assets with carryover basis. Outside basis would equal the basis of property contributed.[[24]](#footnote-24) This approach differs from current law for partnerships, however, in that the partnership simply calculates its income, gain, loss, and deduction, and allocates those items to the partners according to the partnership agreement – no adjustments within the partnership are made to account for disparities between value and basis upon contribution. In the example above, if the partnership sold the $20 basis property for $120, the $100 gain would allocated equally. This approach is described as relatively simple, but the ALI acknowledged that it was unfair to the cash or high-basis property contributing partner and unduly advantageous to a partner who contributes low basis property. The ALI reasons that simplicity may be worth the unfairness, as partners will be able to bargain at the formation of the partnership, taking the tax unfairness into account. Furthermore, the unfairness will be unwound when the partners sell their interests or liquidate the partnership. The ALI also views large value/basis disparities as relatively uncommon, and so did not view addressing them as an urgent priority. In addition to unfairness, however, the ALI sees four basic issues with the entity approach: (1) sale or liquidation is a somewhat arbitrary time to true up the tax advantages or disadvantages of the partners, (2) it is possible that partners may not be able to use a large capital loss under any applicable capital loss limitation provisions, (3) the uncertainty inherent in predicting future tax rates will make it difficult for partners to bargain effectively to offset any tax unfairness, and (4) partners will be obliged to track both their outside basis and their share of inside basis, a burden that is likely to be “troublesome and unexpected.”[[25]](#footnote-25) Nevertheless, this approach was not rejected outright.

#### The Aggregate Approach – Transference of Basis

The next approach contemplated by the ALI is called transference of basis under an aggregate approach. Under this approach, a contribution would be viewed as an exchange of undivided interests in the property contributed, but basis would stay with the property. Consider the example discussed above, but instead of contributing $100 of cash, A contributes Whiteacre, with a value and basis of $100 (B contributes property with a value of $100 and a basis of $20). Under this approach, A would take half of the property contributed by B with a basis of $10, and A would take half of Whiteacre with a basis of $50. This approach, which sounds outrageous to modern ears, is acknowledged to result in a permanent shift of basis – if the property contributed by B is sold for $120, each partner would be allocated $50 of the gain. There is no true up on sale or liquidation. The ALI viewed this approach as being somewhat less fair than the entity approach, but as having the benefit of simplicity in that there would be no need to track separate inside and outside bases. The partners would have more certainty in bargaining upfront, as the tax benefits and detriments to each partner would be relatively clear from the outset. The ALI felt that partners would be better able to deal with an immediate, permanent shift in basis rather than one that is resolved only at an uncertain future date, as would be necessary in the entity approach. Because these benefits were viewed as outweighing the potential unfairness in unusual cases of low-basis property, the ALI recommended that it be adopted for most partnerships. The ALI was clearly aware of the possibility of using this simple framework as a means of tax avoidance, but it said “[w]here the intent is merely to shift a gain, courts would be able to determine whether a partnership was set up for no legitimate business reason but rather for tax saving purposes.”[[26]](#footnote-26)

#### Undivided Interests

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The ALI also describes a rule that would apply to cases where partners who own undivided interests in property contribute the property to a partnership in which their partnership interests are identical to their relative shares of the property. In such cases, the property would not be subject to the general rule and would, in effect, be treated as not contributed to the partnership at all. This rule would take pressure off cases where it is not clear whether a partnership exists at all.

#### Transference of Basis with Election to use Entity or Deferred Sale Approach

Although the ALI believed that the majority of partnerships would prefer the general rule recommended, it also countenanced allowing partnerships to elect into either of the other approaches described. The ALI approach allowed simplicity for any partnership that desired it, but maintained the flexibility of partners to choose more complicated methods for dealing with value/basis disparities. ALI viewed this as the appropriate balance to strike: “[s]ince this aspect of the tax treatment of contributed property relates essentially to the relationship between the partners, rather than to an issue between the Treasury and the partners, the paramount consideration should be a set of rules permitting sufficient flexibility in consumating [sic] partnership arrangements.”[[27]](#footnote-27)

### The 1954 Code

In 1954, Congress weighed in for the first time. A draft bill passed by the House aimed to simplify the provisions applicable to partnerships. It contained a single mandatory rule (with an exception for tax avoidance ploys): items with respect to contributed property were to be allocated in the same manner as other items of the same type, i.e., the same as items with respect to property the partnership purchased.[[28]](#footnote-28) This general rule appears to be the one that ALI advocated as its default rule,[[29]](#footnote-29) but without any elective alternatives. Thus, partners would not have been permitted to take account of the fact that contributed property had built in gain or loss. If tax avoidance motivated the allocation, or if the agreement contained no particular provision applicable to the item, then the items would be allocated according to bottom line income.[[30]](#footnote-30)

As is usually the case, simplicity quickly gave way to more pressing concerns, and the Senate drafted a bill that converted the House’s pro rata rule to a general pro rata rule with two exceptions (and ultimately became the 1954 Code’s § 704(c)).[[31]](#footnote-31) The first exception (enacted as § 704(c)(2)) was permissive, rather than mandatory: partners were allowed to agree in the partnership agreement to take into account the variation between contributed property’s basis and its fair market value at the time of contribution. The Senate reasoned that the difference between basis and fair market value represented a postponed gain or loss to the contributing partner, which would be realized when the partnership disposed of the property (either directly, as in a sale, or by amortization). The Senate report gave an example of how partners might “take into account” built in gains and losses in an example that became the basis for the traditional method and contained an articulation of what would eventually be called the “ceiling rule.”[[32]](#footnote-32) Interestingly, this example closely resembles the reasoning and conclusions of G.C.M. 10092, which had been revoked just four year prior. The language also appears sufficiently capacious to allow for either of the ALI’s suggested alternatives, so partnerships had flexibility in how they could “take into account” variations between basis and value.

The second exception in the Senate’s bill was narrow, applying in a narrow set of facts and only if the partnership agreement did not provide otherwise. It appears to have originated in the ALI report. It became § 704(c)(3) and provided as follows: “(3) Undivided interests. If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.”[[33]](#footnote-33) This provision was designed to protect partners who did not realize that their joint business activity gave rise to a tax partnership, but it applied to partners who contributed property to a juridical entity as well. If the partners subsequently agreed to change how they shared partnership capital or profits, the Senate report indicated that partners would then be required to elect a new method that complied with either the general rule or the first exception.

Commentators at the time of enactment dismissed this provision as both excessively complex and of limited use.[[34]](#footnote-34) However, it is notable in that it clearly permits one partner to have a gain and another to have a loss on the same transaction. Consider a case in which a building worth $200 that is co-owned equally by two individuals, C, who has held the building for many years and has a $40 basis in her interest, and D, who recently inherited his portion and has a $100 fair market value basis. If the joint activities of the owners rises to the level of a partnership (or if the owners decide to contribute the building to a 50/50 partnership), § 704(c)(3) would apply. If the partnership subsequently sold the building at a time when it had declined in value to $180, C would have a $50 gain and D would have a $10 loss. It is irrelevant that the partnership would not have a loss to allocate to D – there was no ceiling rule in § 704(c)(3).

Commentators also recognized the opportunities presented by the newly-enacted rules, pointing out that the general rule would be advantageous for high-bracket taxpayers who owned appreciated property to partner with lower-bracket individuals.[[35]](#footnote-35)

Between 1955 and 1984, the statutory language remained the same. Section 704(b), as in effect between 1954 and 1976, also arguably permitted allocations that would mitigate the distortions caused by the general rule of § 704(c)(1).[[36]](#footnote-36) Section 704(b) was modified in 1976 to require that allocations have “substantial economic effect,” however. Since allocations of tax-only items could not have substantial economic effect, any corrective allocations (i.e. those that departed from the partnership’s general sharing scheme) came to rely exclusively on § 704(c)(2).[[37]](#footnote-37)

Section 704(c)(3), which observers initially dismissed as having limited relevance, gained utility in an unexpected context. At the time, §§ 167(c)(2) and 167(j)(4) provided accelerated depreciation for the original user of purchased property. Property contributed to a partnership was not generally eligible for this benefit, on the theory that the partnership was not the original user. Practitioners at the time noted that the language of § 704(c)(3)[[38]](#footnote-38) provided an argument that property that is depreciable under that section would be eligible to continue using accelerated depreciation despite its contribution to a partnership.[[39]](#footnote-39)

In 1956, Treasury issued final regulations under § 704(c).[[40]](#footnote-40) The regulations provided illustrations of how partners could choose to take into account the variation between contributed property’s basis and its fair market value at the time of contribution under § 704(c)(2). The regulations were quite flexible, permitting partners to take into account the entire variation, or just a portion.[[41]](#footnote-41) Flexibility was not unlimited, however, and the regulations incorporated the “ceiling rule,” which read: “the total depreciation, depletion, or gain or loss allocated to the partners is limited to a “ceiling” which cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it.”[[42]](#footnote-42) This rule meant that the distortions caused by the general rule of § 704(c)(1) could occur even for partnerships that elected to use § 704(c)(2). This possibility was illustrated by an example showing a method that resembles the current “traditional method” in which the non-contributing partner is allocated all of the partnership’s tax depreciation, but less that he would have been allocated had the contributed property had full fair market value basis.

### Second ALI Report

In 1982,[[43]](#footnote-43) the ALI reconvened to draft recommendations for the pending revisions to Subchapter K. It produced a detailed report, but the recommendations for § 704(c) were disappointingly inconclusive. The 1984 ALI Report considered a single proposal for the reform of § 704(c) – a deferred sale or credited value system similar to the one that the 1954 ALI Report had rejected.[[44]](#footnote-44) The 1984 ALI Report rejected it too, but for completely different reasons. The deferred sale method was rejected primarily on the grounds that it would require assigning a fair market value to partnership property, both when originally contributed and when new partners are admitted. These valuation difficulties were viewed as too severe compared with the burden of extra complexity and the modest (though candidly acknowledged) value to be gained by preventing the shifting of tax consequences among partners. Interestingly, the ALI did recommend a deferred sale approach for one class of assets – marketable securities.[[45]](#footnote-45) With no valuation issues to worry about, the ALI had not trouble recommending the adoption of a rule to prevent the shifting of gain or loss with respect to marketable securities. It did not, however, recommend such a rule for cases where marketable securities are revalued, noting that such a rule would require valuing all of a partnership’s property, raising the same concerns that prompted the ALI to decline to recommend a general rule against shifting tax consequences.

### The 1984 Code

In 1984, Congress took up the question of what to do about § 704(c). The JCT report that accompanied the Deficit Reduction Act of 1984 indicated that while Congress still believed that taxpayers should be able to pool their resources in a partnership without triggering taxable gain or loss, it also believed that special rules were necessary to prevent “artificial shifting of tax consequences between partners with respect to pre-contribution gain or loss.”[[46]](#footnote-46) JCT noted that Congress was particularly concerned about partners in difference tax positions, for example, tax-exempt partners, partners in low brackets, and partners with expiring net operating loss carryovers. Congress was also aware that gain or loss could effectively be shifted in cases where cash was contributed to a partnership that held property worth more than its tax basis; Congress believed, however, that such cases may have been effectively dealt with by then-proposed Reg. § 1.704-1(b)(4)(i) (allocations where there is a disparity between tax and book capital accounts).[[47]](#footnote-47)

Section 704(c) was ultimately overhauled, taking on its modern form. After amendment, it provided in relevant part “[u]nder regulations prescribed by the Secretary, income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among 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 contribution.” This language represented a significant change, taking what had been an elective method and making it mandatory for all partnerships and all contributions made after its enactment. Section 704(c)(3) (contributions of undivided interests) was deleted without commentary. The language was proposed by the House and adopted unchanged by the Senate.[[48]](#footnote-48) Congress made it clear that, pending the issuance of revised regulations, it expected that any taxpayer that complied with the until-then elective rules of § 704(c)(2) would be in compliance with the new mandatory rule. Congress also specified that, although the statutory language provided the Secretary with the authority to require items of *income*, gain, loss and deduction to be shared so as to take account of the variation between value and basis, it did not intend for Treasury to require the use of operating income and loss to eliminate such disparities. The reference to income[[49]](#footnote-49) was address certain situations where a cash-method taxpayer contributes accounts receivable or similar property to a cash-method partnership. Congress made it clear, however, that it was generally granting the Treasury significant leeway to adopt new and novel rules.[[50]](#footnote-50) Treasury would take eight years considering how to exercise this broad authority.

[Discuss legislative history instructions]

In the meantime, in 1985, final regulations were promulgated under § 704(b). The proposed regulations had provided that, as a general rule, contributed property would be reflected in the partners capital accounts at its tax basis. Commentor had criticized this rule, and the final regulations required that property be reflected at its fair market value.[[51]](#footnote-51) These final regulations tied § 704(b) allocations and § 704(c) allocations together: § 704(c) allocations became derivative of § 704(b) allocations. The Regulations provided “[a]lthough section 704(b) does not directly determine the partners’ distributive shares of tax items governed by section 704(c), the partners’ distributive shares of tax items are determined under section 704(c) with reference to the partners’ distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph.” Thus, in general, the economic consequences to the partners would be unaffected by the fact that the tax basis of contributed property differs from its market value, provided the partnership complies with the capital account maintenance rules.

In 1989 and 1992, Congress further restricted partners’ ability to shift pre-contribution gain by making certain distributions of property by enacting §§ 704(c)(1)(B) and 737.

In 1992, Treasury proposed regulations implementing the changes to § 704(c) (now § 704(c)(1)(A)) that had taken place in 1984.[[52]](#footnote-52) The proposed regulations were an “attempt to provide guidance that is consistent with the intent of Congress in enacting the amendments to section 704(c) and that is relatively simple for taxpayers to comply with and for the Internal Revenue Service to administer.”[[53]](#footnote-53) The proposed regulations provided that taxpayers could use “any reasonable method” for “making allocations so that the contributing partner receives the tax burdens and benefits of any precontribution gain (built-in gain) and precontribution loss (built-in loss).” The proposed regulations described three generally reasonable methods: the traditional method, the traditional method with curative allocations, and the deferred sale method, but emphasized that other methods may be reasonable as well.

The traditional method described in the proposed regulations was the same as the elective method described in the 1956 regulations, including the ceiling rule. Each noncontributing partner’s share of the income, gain, loss, and deduction with respect to the contributed property should be the same for both book and tax purposes. Consequently, § 704(c) can be applied by allocating the tax items relating to the property to the noncontributing partners so that each is allocated tax items equal to his book items. In other words, under the traditional method for dealing with book/tax disparities, “tax follows book” for noncontributing partners. After the noncontributing partners are allocated their shares of each tax item relating to the contributed property, the balance of each tax item is allocated to the contributing partner (subject, or course, to the ceiling rule).

The tradition method, and § 704(c) more generally, does not allocate partnership basis among partners: it simply allocates annual tax deductions according to how the partners share book deductions. This means that, for example, a 100 percent book depreciation allocation to the contributing partner would draw with it 100 percent of the tax depreciation – the noncontributing partners do not share in the partnership’s tax basis, and such an arrangement would not trigger the ceiling rule, even for zero basis property. The traditional method is per se reasonable for a partnership with no ceiling rule limitations.

The traditional method with curative allocations permitted partners to use other tax items of the partnership to “cure” distortions caused by the ceiling rule. Curative allocations must be reasonable, not exceeding the effect of the ceiling rule, and having the same effect on the partners as the item limited by the ceiling rule. The proposed regulations also permitted partnerships to make curative allocation in the year following a year where the ceiling rule applied.

Most interestingly, the proposed regulations permitted the use of a deferred sale method. Under this method, a contribution of property to a partnership would be treated as a sale of the property to the partnership, with gain or loss on the sale deferred. The partnership would take fair market value basis, a portion of which would be carryover basis, and a portion of which would be treated in the same manner as basis attributable to newly acquired property. The contributing partner’s basis in his partnership interest would, however, not reflect the additional basis, setting up an inside-outside basis disparity. The deferred gain or loss would be triggered (in whole or in part) by (1) recovery of basis by the partnership, (2) disposition of the asset (including distribution to a non-contributing partner), (3) distribution of the asset back to the contributing partner, to the extent the value of cash and other property distributed exceeds the basis of the partner’s interest in the partnership, (4) disposition (other than by reason of death) or a reduction of the partner’s interest in the partnership. If the partnership disposed of the property in a nonrecognition transaction (such as a § 1031 exchange), the replacement property would be treated as deferred sale property. If the partner disposed of his interest in the partnership in a nonrecognition transaction (such as a § 721 or § 351 contribution), then the transferee partner would generally step in the shoes of the contributor. Aside from contributions to controlled partnerships (in which the contributor partnership would essentially be treated as continuing to hold the deferred sale property), there was no nonrecognition rule for contributions of deferred sale property to a lower-tier partnership or corporation: such transactions triggered gain or loss in full.

The character, source, and other attributes of gain or loss recognized by the contributing partner would be determined as if the property had been sold to the partnership at the time of contribution. The regulations also provided a stacking rule whereby ordinary income (such as recapture) is recognized first.

The proposed regulations said that “[t]he principles of the proposed regulations also apply to allocations that reflect differences between book value and adjusted tax basis created when a partnership chooses to revalue partnership property pursuant to §1.704-1(b)(2)(iv)(*f*) (reverse section 704(c) allocations).” The proposed regulations did not provide any detail regarding the interaction of the deferred sale method and reverse § 704(c) allocations.

The regulations would be subject to a general anti-abuse rule that provided that “[a]n allocation method is not reasonable if the contribution of property *and* the allocation of tax items are made with a view to reducing substantially the partners’ aggregate overall tax liability without substantially affecting the amounts to which each partner is economically entitled on the partnership’s books,” and provided the Service with the authority to make adjustments necessary to result in a reasonable method. The use of a conjunctive test is significant – if a taxpayer can show that the contribution of property was not made with a view to reducing aggregate tax liability, then the fact that the allocation method was made with such a view is irrelevant. This sense is reinforced by another provision of the anti-abuse rule: a method is not unreasonable merely because it results in lower aggregate tax liability.

Around this time there was a flurry of transactions that made use of the ceiling rule to shift income to foreign persons not subject to US tax. The most famous of the litigated cases was Castle Harbour,[[54]](#footnote-54) where the contributions were made just months before the proposed regulations became final.[[55]](#footnote-55)

The 1992 proposed regulations were finalized in 1993,[[56]](#footnote-56) with some notable changes. Most significantly, the deferred sale method was dropped as a “reasonable method,” and companion temporary regulations[[57]](#footnote-57) were issued that outlined the remedial method, described in the preamble as “the revised deferred sale method.” The original deferred sale method was declared presumptively unreasonable, as were all other methods (other than the remedial method) in which a partnership (1) increases or decreases the basis of partnership property, or (2) creates items that do not reflect book items. In response to comments that were concerned about the Service using the anti-abuse rule to force taxpayers to use the deferred sale or remedial method, the temporary regulations provided that the Service could not require the use of the remedial method.

It appears that the deferred sale method was abandoned because of concerns about the difficulty of deciding when and if gain or loss should be triggered in a variety of common transactions.[[58]](#footnote-58) Particularly in cases where the deferred sale property was subsequently transferred in a nonrecognition transaction, the drafters of the regulations faced the question of whether to permit nonrecognition under the deferred sale method (which could result in difficult or impossible tracking of the subsequent life of the property), or to immediately trigger gain or loss (which would be unduly harsh in some cases and unduly advantageous in others). The proposed regulations had made an attempt at delineating which cases deserved what treatment,[[59]](#footnote-59) but it is not difficult to see why the attempt to craft more detailed workable rules caused the drafters to give up.

The preamble to the final regulations discussed two methods that, although not specifically listed as reasonable methods, could be reasonable in appropriate circumstances: the “undivided interest method” of repealed § 704(c)(3) and “keep your own,” in which each partner benefits from the basis of the property that it contributed and the basis of property that the partnership purchases using cash that it contributed.[[60]](#footnote-60) Both of these methods were left out of the final regulations because they were viewed as having limited applicability.

The final regulations made several other changes, including clarifying that the anti-abuse rule uses a present value concept for determining whether the partners’ aggregate tax liability has been reduced. The same-tax effect limitation within traditional method with curative allocations was also clarified: at the time the allocation becomes part of the partnership agreement, the partners cannot expect for the curative allocation to have a different effect than the ceiling-limited rule item would have had (other than curing depreciation using gain on sale). The traditional method with curative allocations was also limited to same-year curative allocations, unlike the proposed regulations, which had permitted “make-up” allocations in the following year.

The temporary regulations released at the same time as the 1993 final regulations contained a new, previously unheard of method for taking into account the disparity between the basis and value of contributed property: the remedial allocation method. Under this method, the fiction of a sale is abandoned and the partnership it permitted to simply invent notional, tax-only items to cure distortions created by the ceiling rule. The remedial method is all or nothing – if a partnership uses the remedial method for a particular property, all non-contributing partners are allocated tax items equal to book for that property (at least with respect to each layer of gain or loss). The contributing partner is allocated equal and offsetting items of the same character. The partnership’s book basis in contributed (or revalued) property is recovered under the rules of the § 704(c) Regulations instead of the § 704(b) Regulations. An amount of book basis equal to the property's tax basis is recovered in the same manner as the adjusted tax basis of the property. Any excess is recovered using any applicable recovery period and method available to the partnership for newly purchased property (of the same type as the contributed property) placed in service at the time of contribution. In most cases, this second component of the book calculation will be stretched out beyond the first component, creating book depreciation deductions in “out years,” for which there are no actual tax depreciation deductions, thus giving rise to ceiling rule disparities. The mere fact that the use of the traditional method may not have caused a ceiling rule disparity is not a bar to the adoption of the remedial allocation method; as long as the adoption of this latter method itself creates a ceiling rule problem, it is a permissible method.[[61]](#footnote-61) The temporary regulations’ preamble described the remedial method as “less complex” than the deferred sale method; despite the complexity in calculating the allocations themselves, the remedial method had the salutary effect of focusing the analysis on the disparity between the noncontributing partners’ allocation of book and tax items rather than the more nebulous question of whether a sale should be treated as occurring. The remedial method also maintains inside/outside basis parity, unlike the deferred sale method in which the partnership’s basis is adjusted to fair market value but the contributor’s is not.

The remedial method also asks a different question when characterizing any gain or loss that is recognized. Instead of asking whether gain or loss would be capital or ordinary upon a sale of the property to the partnership, remedial allocations to contributor “have the same tax attributes as the tax item limited by the ceiling rule.” In effect, this means that remedial allocations are always net zero for the partnership as a whole, but at the cost of (generally) converting what would have been capital gain into ordinary income.

The temporary regulations were finalized the next year,[[62]](#footnote-62) with relatively few changes. Commentators suggested that the remedial method should be treated as a safe harbor, or that it should form the baseline against which the general anti-abuse rule is measured.[[63]](#footnote-63) These comments were rejected, as Treasury and the IRS believed that remedial allocations could themselves be abusive, and that the remedial method was merely an elective method for taking value/basis disparities into account.

The final regulations clarified several points about how remedial items work, including a statement that since remedial allocations by definition net to zero, they do not affect the partnership’s computation of it income under § 703 or the partnership’s basis in its assets. The preamble to the final regulations also contains an interesting discussion of whether partnerships that revalue their assets are permitted to aggregate or “net” positive and negative layers that result from revaluations with the layers attributable to contributed property. The preamble indicated that Treasury and the IRS believed that “this type of aggregation could lead to substantial distortions” in the timing or character of income recognition, and so it was not specifically permitted in the regulations. The regulations allow the IRS to permit such aggregation in letter rulings or published guidance.

### Post 1993 Era

The § 704(c) regulations remained in substantially the same state from 1993 until the present day, with relatively few notable modifications. In 2008, Treasury proposed a clarification to the anti-abuse rule in response to a JCT report on the Enron scandal.[[64]](#footnote-64) The clarification, which was finalized in 2010, provided that, in applying the anti-abuse rule, a partnership must consider the effect of an allocation method (or combination of methods) on indirect partners as well as direct partners.[[65]](#footnote-65) However, outside of § 704(c)(1)(A), Congress, Treasury, and the IRS have been building defenses against what they view as inappropriate transactions that result in shifting of income, gain, loss, and deduction.

In 1997, Congress enacted § 721(c),[[66]](#footnote-66) which provides that “[t] he Secretary may provide by regulations that subsection (a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person.” This section turns off nonrecognition for contributions of property to partnerships where such gain will be shifted to foreign persons. It would take until 2015 for the Treasury to exercise its authority under this section.

In 2004, Congress enacted § 704(c)(1)(C), which effectively removed losses from the ambit of § 704(c)(1)(A). Under § 704(c)(1)(C), losses are only for the account of the contributing partner. The partnership is treated as having fair market value basis in the property. Although the statute is not specific, it could be read to adopt something resembling the full deferred sale approach for loss property. Section 704(c)(1)(C) is beyond the scope of this article, but it raises numerous interpretive issues, many of which are addressed by regulations proposed in 2014.[[67]](#footnote-67)

In 2015, Notice 2015-54[[68]](#footnote-68) was issued under § 721(c). The Notice (and regulations[[69]](#footnote-69) that followed shortly thereafter) called off nonrecognition under § 721(a) for certain related-party transactions in which US persons contributed appreciated property to partnerships with related foreign persons. The target transactions made use of the traditional method and the traditional method with curative allocations on gain to shift built-in gain to related foreign persons not subject to US tax. The regulations adopt a general rule of upfront recognition, but permit an exception where the partnership elects the remedial method (among a host of other requirements). These rules significantly reduced opportunities for shifting income and gain from US persons to their foreign, non-taxable affiliates.

## Policy of Section 704(c): Does it matter whether partners are in the same tax bracket?

Having reviewed the history and development of § 704(c), it is not so difficult to discern the overarching policy goal of current § 704(c). The regulations say it clearly: “[t]he purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss.”[[70]](#footnote-70) But the prevention of shifting tax consequences is clearly not the only policy goal – otherwise, something resembling the remedial or deferred sale method would already be mandatory. In 1954, the overarching goal was flexibility for partners and encouraging the pooling of resources. Even though that flexibility has been steadily pared back both inside § 704(c) and in related rules such as 737 and 721(c), it remains in the regulations’ blessing of *any* reasonable method for addressing book/tax disparities. Throughout this history, the ceiling rule has taken precedence over the policy of anti-shifting.

Section 704(c) serves other policy goals as well – its operation does not create or exacerbate inside/outside basis disparities. It is part of the system that limits deferral to the earlier of the property’s sale or the partner’s exit from the partnership (in contrast to the 1930s *Walbridge* and *Archbald* cases, which would have allowed deferral until the liquidation of the partnership, even if property were sold prior). Its application can also approximate the after-tax economic results that a person would experience if he or she held contributed property outside of a partnership, preserving neutrality in the selection of business form. Current § 704(c) also promotes some degree of neutrality as between counterparties with different tax profiles.[[71]](#footnote-71) Highly informal surveys of practitioners reveal that § 704(c) works well in practice

Section 704(c) implicates deferral in a subtle way. The § 704(c) methods that restrict shifting also limit deferral for the contributing partner, but only to the extent that noncontributing partners receive deductions. To the extent that the contributing partner is a noncontributing partner with respect to other assets, the loss of deferral on her contribution will be offset by additional depreciation on the other partners’ contributed property. Restricting shifting thus does not reduce deferral overall.

One way to think about policy choices within § 704(c) is a scale with considerable flexibility with respect to shifting on one side (a state of affairs that existed under pre-1954 law) and mandatory recognition (i.e., the repeal of § 721(a)) on the other side.[[72]](#footnote-72) The history of § 704(c) to date has represented a steady march away from flexibility towards restriction. Congress and the administration have also made significant changes outside of § 704(c)[[73]](#footnote-73) that tend to prohibit or impede efforts to shift tax consequences in a way that saves significant tax, particularly for transactions involving related parties.

All of this adds up to a state of affairs is one in which (1) deferral is generally permitted for property contributed to a partnership, except to the extent that noncontributing partners get cost recovery with respect to the property, (2) some shifting is generally tolerated where it occurs between taxpayers who are in the same tax bracket, (3) where partners are not in the same tax bracket, shifting is generally restricted unless the anti-abuse rule does not apply. The anti-abuse rule is quite broad, but it is clear that it doesn’t apply even to tax saving shifts where, for example, the partnership elects the traditional method with curative allocations and lacks the items necessary for cure ceiling rule issues, or where a partnership can show that either the contributions or the allocations giving rise to the shifts were not made “with a view” to shifting.

It is against this backdrop that we consider a proposed next step in the evolution of § 704(c).

## Wyden Proposals

In 2021, Senator Ron Wyden released a discussion draft (the “Wyden Discussion Draft”)[[74]](#footnote-74) outlining proposals to reform Subchapter K. It contained two notable proposals that implicate § 704(c): (1) making remedial allocations mandatory for all § 704(c) allocations, including revaluations, and (2) making revaluations themselves mandatory. The Wyden Discussion Draft notes that the historical policy of § 704(c) is to allow flexibility in accounting for precontribution gains, and that the current rules tolerate some shifting. The Wyden Discussion Draft concludes that this flexibility is “no longer sustainable.”[[75]](#footnote-75) The general discussion of the impetus behind the proposals cites several concerns with the current rules, all of which likely apply to § 704(c). Excessive complexity is the primary concern. According to Senator Wyden, the current complexity of subchapter K allows sophisticated taxpayers to avoid tax, while other taxpayers struggle to understand the rules. It also makes it difficult for the IRS to effectively enforce the rules that do exist. Flexibility (or “optionality”) also comes under fire for allowing “investors and corporations to pick and choose when to pay tax.”[[76]](#footnote-76) Finally, the Wyden Discussion Draft asserts that “[t]he original policy intent of Subchapter K—to provide significant flexibility to taxpayers in arranging business affairs through partnerships—has been, and continues to be, at odds with the Internal Revenue Service’s (IRS) need to administer the IRC.”

These two proposals in the Wyden Discussion Draft arguably further the policy goals just described, at least within the realm of § 704(c). Requiring remedial allocations for all § 704(c) accounts would relieve the Service of the need to ask whether a partnership’s selection of § 704(c) method (or combination of methods) is reasonable. This may be the most important benefits of the Wyden proposal, as the somewhat muddled reasonableness standard (as discussed in Part [ ]) is confusing and difficult to apply even for sophisticated practitioners.[[77]](#footnote-77)

Requiring revaluations also obviates the question, ominously posed in the § 704(b) regulations,[[78]](#footnote-78) of what happens under § 704(c) principles when a partnership opts not to revalue its property. The use of remedials for all § 704(c) layers would, assuming that the separate layer approach discuss in Part H.1. is mandated, eliminate many of the issues around reverse § 704(c) allocations. Mandating remedials and revaluations increases complexity in some respects, however, most notably in proliferation of § 704(c) layers. Also, as noted by the drafters of the 1993 regulations, remedial allocations can themselves be abusive.[[79]](#footnote-79) If remedials were mandatory, the IRS presumably would not have the ability to argue that they are abusive.

Mandating remedial allocations can also have the effect of making a taxpayer worse off by contributing an appreciated asset to a partnership when compared with simply owning the asset directly. This happens because the tax life of virtually all assets (and thus the period over which remedial income is picked up) is significantly shorter than economic life.[[80]](#footnote-80) However, this effect generally only appears when the other partners contribute property with a longer (or no) recovery period.

The zero-sum nature of remedial allocations also means that mandating remedial allocations is unlikely to be a significant source of revenue. The unofficial revenue estimate on the Wyden Discussion draft as a whole is $172 billion over ten years. This estimate is not broken out by section, so it is difficult to assess whether the § 704(c) proposals are “worth” the additional revenue that the would raise. Given that remedial allocations by definition net to zero, it is difficult to imagine. Mandating remedial allocations would materially reduce the flexibility of the partnership form for all partnerships, even the vast majority that are neutral from the perspective of the fisc; policymakers should balance the benefits of flexibility against the likely modest revenue raise.

The Wyden proposals also, when taken together, raise a constitutional issue. Suppose the AB partnership holds property with a value of $100 and a basis and § 704(b) book value of $0. The partnership developed the property itself. C contributes $100 for a 50 percent interest, and the partnership revalues the property, creating a § 704(c) layer of $100 with respect to the property, allocated to A and B. If this § 704(c) layer is subject to the remedial method, A and B will recognize remedial income over time, even if there is no realized income or gain in the partnership. The Sixteenth Amendment, as interpreted in *Moore v. United States*,[[81]](#footnote-81) left open the question of whether Congress is permitted to impose unapportioned tax in the absence of realized income.[[82]](#footnote-82) Perhaps viewing the transaction on a pure aggregate basis would permit the imposition of tax – A and B would be viewed as selling a portion of their appreciated business to C for cash. Or perhaps one could certainly argue that the remedial allocations do not create net income and thus should be allowed – C’s depreciation deductions obviously precisely offset A’s and B’s income allocations – but from the perspective of A and B, the remedial allocations arguably represent tax liability in the absence of accession to wealth.

## Discussion of Possible Changes to Basic § 704(c) Scheme

Even if the Wyden proposal is not enacted, Congress or Treasury may wish to reconsider the overall § 704(c) scheme. The Wyden proposal shows discomfort with shifting generally, regardless of whether tax savings are achieved. In our view, this discomfort is misplaced, and shifting should only be viewed as problematic when it results in substantial tax savings. Thus, a better approach would be to narrowly target the relatively few remaining scenarios in which tax-saving shifting is still permitted. Congress could achieve this by disavowing the ceiling rule, particularly for “forward” § 704(c) amounts. This approach preserves flexibility for the vast majority of cases where the fisc is not harmed and allows the IRS to effectively target the rarer cases where taxpayers take advantage of the ceiling rule in order to reduce their net tax.

### Changes to the Anti-abuse Rule

The heart of the § 704(c) regulations is the anti-abuse rule. It reads, in full:

An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 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. For purposes of this paragraph (a)(10), all references to the partners shall include both direct and indirect partners.[[83]](#footnote-83)

Elsewhere in the regulations, however, a more comforting statement appears: “[a]n allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability.”[[84]](#footnote-84) Elsewhere still, however, taxpayers are cautioned that “[i]t may be unreasonable to use one method for appreciated property and another method for depreciated property. Similarly, 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 curative allocations for built-in gain property contributed by a partner with a low marginal tax rate.”[[85]](#footnote-85) It is thus difficult to discern precisely when a method (or combination of methods) will run afoul of the anti abuse rule, other than to say that if a method does not result in material net tax savings (i.e., if all partners have identical tax profiles) then it should be fine.

In order to attempt to understand the regulations’ usage of “reasonable,” it is informative to read these rules in conjunction with the examples in the regulations. The examples where a method is found to be unreasonable are those in which either a ceiling rule shift or its unwinding occur on a timeline that is significantly shorter than the economic life of the property to which it corresponds.[[86]](#footnote-86) It can thus be argued that either a ceiling rule shift or the use of curative (and presumably remedial) allocation is generally reasonable as long as it occurs over something resembling the economic life of the property.[[87]](#footnote-87) Even this theory, however, does not account for the regulations’ caution against using one method for appreciated property and another for loss property.

The regulations contain an inherent tension: their avowed purpose is the prevention of shifting of tax consequences, but they contain a rule that is certain to result in such shifting. The drafters of the anti-abuse rule faced a difficult task: they no doubt felt bound by the ceiling rule,[[88]](#footnote-88) which after all is a creation of the statutory scheme (though nowhere articulated in the statute itself).[[89]](#footnote-89) They did not feel they had the authority to discard it. But distortions and shifting opportunities within § 704(c) are the direct result of the ceiling rule. Thus the drafters evidently did not feel that they could flatly prohibit shifting outright where the ceiling rule applies. Instead, they acknowledged that some shifting is bound to take place, and attempted to limit it to limit the extent to which the ceiling rule can be used in ways that significantly and artificially (because of the vagaries of tax recovery lives) harm the fisc. The result is the somewhat confused “reasonable” standard in the anti-abuse rule. The regulations cannot say that all tax-saving shifting is prohibited, but also did not want to invite the transactions that would be possible if the ceiling rule were sacrosanct.

### Repeal the Ceiling Rule?

The ceiling rule is a creation of the § 704(c) statutory and regulatory scheme, so it can be repealed, in whole or in part, like any other rule. The discussion above in Part [ ] relating to the constitutionality of requiring the remedial method is relevant to the question of whether the ceiling rule is a mere creature of the tax law or whether it has more fundamental significance. For forward § 704(c) amounts, however, there should be no constitutional impediment to its repeal. Below, we consider what an optimal § 704(c) scheme would look like in the a world where Treasury and the IRS were not bound by the ceiling rule (as well as other changes).

As a general matter, we believe that the regulations’ blessing of any reasonable method to represent a sound starting point. In most transactions involving § 704(c), the partners are in the same or similar tax brackets and for those cases we believe that the question of whether and when to correct ceiling rule distortions is a matter of concern only to the partners; by definition the fisc does not have a stake. For other transactions, the IRS should have the ability to require the use of the remedial method or curative allocations to prevent shifting that would otherwise be caused by the ceiling rule.[[90]](#footnote-90) If Congress explicitly authorized Treasury and the IRS to override the ceiling rule in appropriate cases, Treasury could revise the regulations to rid them of the tension that currently muddles the policy principles of § 704(c).

### The Traditional Method

The traditional method can and does cause permanent shifts among partners, in direct contravention of the stated policy goal of § 704(c). These shifts are cause by the ceiling rule. It is thus reasonable to ask whether it should be permitted at all. The traditional method is a curious holdover from the 1954 Code, under which it was the only explicitly permitted method for taking into account disparities between value and basis of contributed property. When taking account of such disparities became mandatory in 1984, it was natural to permit partnerships to continue to use the traditional method, particularly in the period prior to the promulgation of regulations. When regulations were eventually issued, Treasury and the IRS may not have felt that they had the authority to outlaw the only method that had been blessed by Congress and used for several decades, despite its shortcomings. This feeling was supported by the legislative history. They may also have thought that in many routine cases where partners had the same or similar tax profiles, the traditional method is a perfectly good way to address book/tax disparities.

If the ceiling rule is softened as discussed above, Treasury and the IRS will face the question of whether to prohibit the traditional method altogether. We do not believe this is wise.

The traditional method has the benefit of being by far the simplest of the three officially sanctioned methods, and in the majority of cases its use is entirely benign. The anti-abuse rule does a (reasonably) good job of policing nefarious use of the traditional method while allowing it in cases where the fisc is indifferent. An anti-abuse rule that is modified as suggested in Part E.1 and E.2 would do an even better job. For property with a longer economic life than tax life (i.e., most property), the traditional method can mitigate the accelerated income pickup caused by curative or remedial allocations. The changes suggested to the anti-abuse rule would strengthen the IRS’s ability to police the unreasonable use of the traditional method so that its use it reserved for cases where it is benign.

### Cure with Operating Income

The regulations provide that, if the IRS determines that the method chosen by a partnership is not “reasonable,” it may require the partnership to adopt a reasonable method. There is an argument, based on the 1984 legislative history discussed above,[[91]](#footnote-91) that the IRS is not permitted to require partnerships to cure ceiling rule limitations using operating income from property. The IRS does not appear to believe that it is so limited,[[92]](#footnote-92) but if Congress wants to consider restricting § 704(c) in a way that is less drastic than the Wyden proposals, it should consider making it clear that the legislative history does not restrict the IRS in this way.

### Remedials

Even if a taxpayer choses a method that is not reasonable, the IRS is not permitted to require the adoption of the remedial method or any other method that involves the creation of notional tax items.[[93]](#footnote-93) Similar to the suggestion above, if Congress wishes to restrict the ability of partners to reduce taxes by shifting income amongst themselves, it could permit the IRS to require the use of remedials (including the extended book recovery rule) where other methods would result in significant tax savings. This is the most straightforward consequence of freeing the Treasury and IRS of the ceiling rule. Allowing the IRS to require the use of remedials on reverse § 704(c) amounts would, however, raise the same constitutional issues discussed above.

## Reasonable Methods: Should Other Reasonable Methods be Explicitly Permitted?

### Total Flexibility

If flexibility is still viewed as an important policy objective, Congress could allow complete flexibility without imperiling the fisc by allowing (or requiring) contributing partners or their partnerships to enter into something akin to a gain recognition agreement. If the partners are all in the same tax bracket, this calculation would be easy – gain could be calculated by multiplying the entire built-in gain by the partners’ marginal tax rate, payable over the tax life of the property. A final payment would be made on the sale of the property, calculated by multiplying the gain by the partners’ tax rate. The property could then be treated as having fair market value basis and allocations made under the normal rules, or if even more flexibility was desired, tax allocations could be completely divorced from economic allocations and partners could allocate deductions according to any agreement. There are several obvious issues with this approach. The first is that it would create inside/outside basis disparities, unless corrective allocations were made. Subchapter K has well understood methods for addressing these types of disparities (most notably §§ 734(b) and 743(b)), so this may be a surmountable obstacle. A more troublesome issue is that taxpayers do not always remain in the same tax bracket year to year, and even those that do may have tax liability that would be affected by tax allocations in a way that does not neatly correspond to the “income or gain multiplied by tax rate” formula. For example, AMT calculations or the application of various international provisions might be affected.

[More]

### Deferred Sale

The remedial method has now been available for use for over 30 years, and it is reasonable to ask whether it has generally proven superior to the deferred sale method that it replaced. In 1998, Laura E. Cunningham and Noel B. Cunningham advocated for replacing the “any reasonable method” rubric of current law with a mandatory application of the deferred sale method.[[94]](#footnote-94) They argued that it was generally simpler than current law, and would allow for simplification of other aspects of Subchapter K, most notably disguised sales and mixing bowl transactions. They argued that by adopting the deferred sale method, §§ 707(a)(2)(B), 704(c)(1)(B), and 737 could all be repealed. The primary driver of simplification appears to be that that partnership’s tax and book accounting would always be identical, though this equality requires that the deferred sale method would be mandatory for reverse § 704(c) amounts as well, as acknowledged by the authors.[[95]](#footnote-95) The deferred sale method also has the benefit preventing character conversion – though Cunningham and Cunningham do not mention it as such. Cunningham and Cunningham compare the outcomes of a variety of ordinary partnership transactions under the deferred sale method and current law and conclude that the deferred sale method is superior for disguised sales and mixing bowls (current law more complicated; wrong amount of gain recognized in some instances), depreciable property (no ceiling rule shifts, less complicated than remedials), worse for incorporations, and generally the same for formation transactions, the death of a partner, admissions or redemptions of partners, and § 1031 exchanges. Their discussion makes it clear that adopting mandatory remedial allocations, as in the Wyden proposal, would reach results that are broadly similar to the deferred sale method for most types of transactions, other than character conversion on cost recovery.

[More]

For the reasons discussed above, we believe that a blanket requirement of any one method is not the right way to go. Although the deferred sale method has its attractions, particularly in that it prevents character conversion and is free of the ceiling rule limitation, the drafters of the 1992 regulations rejected it for a reason. The attendant complexities, such as its operation when contributed property is subsequently contributed to a lower tier entity, are at least as severe as those faced under the remedial method, which has the benefit of being a known quantity. The anti-character conversion feature of the deferred sale method could be incorporated into the remedial method to the extent desired, such as by allowing taxpayers to elect capital gain or loss in certain cases where the person on the other side of the remedial allocation is unrelated.

### Keep Your Own

The proposed regulations that implemented the 1984 changes to § 704(c) discuss the “keep your own” method as one that is potentially reasonable. As currently used, “keep your own” is not properly thought of as a method of allocation under § 704(c) – it is a § 704(b) technique whereby 100 percent of *book* depreciation is allocated to the contributing partner. This allocation technique results in no allocation to any noncontributing partner, so § 704(c) never comes into play. The noncontributing partner is by definition allocated tax ($0) equal to book ($0). Thus, assuming that the 100 percent book allocation is respected under § 704(b) and the regulations thereunder, there is no further analysis under § 704(c).

The preamble to the proposed regulations, however, discusses “keep your own” as a § 704(c) method that is potentially reasonable – and one can certainly imagine a § 704(c) method in which book allocations are shared, but the contributing partner is allocated all of the available tax depreciation. It would resemble former § 704(c)(2) that applied to contributions of undivided interests in property and would not suffer from ceiling rule limitations. In some situations, this allocation scheme may result in allocations that are more reasonable – or at least result in less net shifting – than the traditional method.

Consider the following example: A contributes depreciable property with a value of $100 and a basis of $30, and B contributes depreciable property with a value of $100 and a basis $0 to the equal AB partnership. Under the traditional method, the entire benefit of A’s contributed basis would be enjoyed by B unless and until the property were sold and A would simply be out of luck. A could reasonably complain about this state of affairs, but B may have reasons why he does not want to use the remedial or curative methods. Of course A and B can negotiate the economics of their deal to reflect A's unfair tax burden, or A can refuse to agree to the traditional method. But such negotiations are often imperfect. Assuming that A and B have similar tax profiles, it seems reasonable for them to select “keep your own” as a § 704(c) method for all properties in these circumstances and let A benefit from the tax basis that she brought to the partnership without requiring the use of curative or remedial allocations. This result may be justifiable under the current regulations,[[96]](#footnote-96) but adding an example to this effect would be helpful and clarifying.

## Reverse Section 704(c)

When a partnership revalues its asset under Reg. § 1.704-1(b)(2)(iv)(*f*), the principles of § 704(c) apply to treat the existing partners are contributing the existing assets to a new partnership, and any difference between the tax basis and book value of the assets is treated for many[[97]](#footnote-97) purposes as built in gain or loss, allocable to the partners who are viewed as contributing the property.

In simple, pro rata partnerships without liabilities, it is easy to determine which of the original partners should be viewed as contributing which property – each partner can be viewed as contributing its pro rata share of each property. If liabilities are involved, it appears reasonable to treat each partner as contributing its share of the assets subject to its share of liabilities as determined under § 752. If the original partnership’s allocations are not pro rata – if, for example, there are special allocations of depreciation, or the allocations have changed over the life of the partnership – then things are more complicated, particularly when liabilities are involved.[[98]](#footnote-98) If there are multiple liabilities encumbering a single property, the regulations allow partnerships to use “any reasonable method” for divide the liability among the properties.[[99]](#footnote-99) A method is not reasonable, however, if it allocates to any property an amount of the liability that, taking into account other liabilities allocated to the property, exceeds the fair market value of the property at the time when the liability is incurred.

### Separate Layers versus Netting

The question of how to deal with the many “layers” that may or may not be created by successive bookups and bookdowns has vexed practitioners and the government more than any other issue within § 704(c). It is clear that the partnership may choose a different method not only for forward and reverse layers for each property, but for each newly-created layer as well.[[100]](#footnote-100) It is not clear whether, for example, an asset contributed with built-in gain that subsequently loses value should be viewed as having a separate positive layer and negative layer (the separate layer approach), or whether the positive layer should be reduced by the decline in value (the netting approach).[[101]](#footnote-101)

Under the current regulations, there is an argument that netting is required – Reg. § 1.704-3(a)(3)(ii) provides: “[t]he built-in gain on section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain *is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis*.” Regulations proposed in 2007[[102]](#footnote-102) would explicitly require netting of § 704(c) layers. In 2009, the IRS requested comments on a plethora of questions related to netting, including tiered partnership structures, mergers, divisions, and international issues.[[103]](#footnote-103) Regulations proposed in 2014[[104]](#footnote-104) would prohibit netting.

Netting has a tendency to cause shifting of tax consequences among partners, and many have argued[[105]](#footnote-105) that keeping separate layers should at least be permitted under current law.[[106]](#footnote-106)

For a demonstration of how netting can cause shifting of tax consequences, consider the following example. A contributes land with a basis of $40 and a value of $100, and B contributes $100 cash to the equal AB partnership. A has a positive $60 layer with respect to the land. At a time when the land has declined in value to $80, C contributes $90 for an equal 1/3rd interest in the partnership. The question is whether A’s positive $60 layer with respect to the land is now $40 (netting approach), or whether a new negative layer is created, with $(10) for A and $(10) for B (separate layer approach). If A’s layer is simply reduced, then A will have been able to shift some of the gain inherent in the land, even if the partnership uses the remedial method for *all* § 704(c) allocations. This tendency towards shifting is amplified with each successive revaluation, in clear violation of the stated purpose of the § 704(c) regulations.

The permission granted by the regulations to use different methods for different layers implicitly rejects a netting approach. Consider a partnership that elected to use the traditional method for forward layers and the remedial method for reverse layers. If the forward layer is positive, and the reverse layer is negative (or vice versa), then netting would simply reduce the amount of gain or loss in the forward layer, and the partnership’s election of the remedial method for the reverse layer would be ineffective. For the AB partnership, B may have demanded the use of the remedial method, and netting would deprive B of the $10 remedial loss with respect to the decline in value between the formation of the partnership and the admission of C as a partner.

Section 704(c) purists will recoil at the shifting inherent in the netting approach. But netting does have the significant benefit of resulting in (somewhat) manageable § 704(c) accounts, with one net positive or negative value per property per partner. Separate layers can result in each partner having dozens or hundreds of entries per property, some positive and some negative. There may be additional arguments to require netting as well. Consider the example above, but assume that the land declined in value to $40 instead (i.e., its value is now equal to its tax basis). Under netting, A’s § 704(c) account would simply go away. A could argue that this is entirely appropriate and indeed required, as the land is arguably no longer a § 704(c) asset.[[107]](#footnote-107) The separate layer theory also raises difficult collateral questions (some of which are also raised by netting): (1) can tax basis be assigned to any layer, or must it be assigned solely to the forward layer, (2) does each new layer start a new holding period and depreciation schedule,[[108]](#footnote-108) (3) should any ceiling limitations within a layer be allocated proportionately among the partners to whom that layer is attributable, or can partners choose to disproportionately inflict ceiling rule limitations amongst themselves? Despite these and many other questions, keeping separate layers is the correct approach from a policy perspective, and it should be explicitly permitted at the very least, and probably required.[[109]](#footnote-109) [If the Wyden proposal is adopted, it should be required.]

### Disparity Offset Method

Practitioner have devised ways to replicate the outcome of keeping separate layers without the endless spreadsheets that would be required to maintain them.[[110]](#footnote-110) These simplified approaches work if each layer uses the same allocation method, which limits their utility somewhat. Nevertheless, these approaches are reasonable methods in a wide variety of circumstances and future guidance should consider explicitly blessing them as reasonable.

### Allow partners to exchange reverse section 704(c) amounts resulting from a distribution (see preamble to proposed section 751(b) regulations)

### Should liabilities be revalued in a similar manner?

When interest rates changes, and when borrowers become more or less creditworthy, the fair market value of liabilities can change. Thus, disparities between the value and book basis of liabilities can arise, and have the same economic implications as disparities between value and book basis of property. Section 704(c) on its face, however, applies only to “property,” a category that does not ordinarily include liabilities. Nor do the regulations extend § 704(c) treatment to liabilities. Nevertheless, some partnerships track the fair market value of their liabilities in the same manner as assets, revaluing them when a revaluation is called for under Reg. § 1.704-1(b)(2)(iv)(*f*) and the partnership agreement and allocating the resulting items under § 704(c) principles. Doing so gets the “right” result under § 704(c) principles in that changes in the value of liabilities will be taxed to the partners who bear the economic effect of such changes. Thus the IRS should not object to partnership agreements that bring liabilities within the § 704(c) rubric. The question remains, however, whether Congress (or the administration) should require § 704(c) tracking of liabilities. Doing so would add material complexity to an already complicated area. And because changes in the value of liabilities are generally harder to predict than changes to the value of many types of assets, taxpayers are unlikely to attempt to engineer transactions that cause shifts. Thus, although theoretical purity would require § 704(c) tracking of liabilities, requiring it should not be a priority.

## How does Section 263A Interact with Section 704(c)?

Section 263A requires taxpayers, including partnerships, to capitalize a wide variety of costs into the basis of property such as inventory.[[111]](#footnote-111) Cost recovery, such as depreciation and amortization, is included in the universe of costs that must be capitalized. For example, suppose a taxpayer produces widgets for sale to customers using a widget-making machine. If the machine depreciates for tax purposes at $10 per year and produces five widgets, then the basis of each widget is increased by its $2 share of the machine’s depreciation. Thus, § 263A can affect the timing of cost recovery. If all of the widgets in the example are sold in the year they are produced, then the timing of basis recovery is the same as that of a non-263A taxpayer. But if the taxpayer has widgets on hand at the end of the year, it is entitled to proportionately less of the benefit of cost recovery.

It is not hard to see where the apparent conflict between § 263A and § 704(c) arises. Where § 263A applies, there is an argument that, after the application of § 263A, the partnership does not have items of cost recovery to allocate. Alternatively, one could argue that items with respect to § 704(c) property should not be subject to § 263A, giving precedence to the anti-shifting policy of § 704(c). A better view, however, is that both can apply in relative harmony if each inventory item sold is treated as the sale of a portion of the § 704(c) property (or properties) capitalized into its basis.[[112]](#footnote-112) This approach produces reasonable results that respect both the timing principles of § 263A and the principles of § 704(c). This approach is frequently used in practice, despite its lack of supportive authority. It would be a worthwhile exercise to bless its use either administratively or by statute.

## Section 704(c) and Tiered Partnerships

* Reg. § 1.704-3(a)(9) amendment to allow UTPs to treat LTP items as basis derivative items so that ceiling rule problems at UTP can be cured/remediated. Extend special rule for § 721(c) partnerships to all partnerships.

The regulations under § 704(c) contain two special rules applicable to tiered partnership structures. Regulations § 1.704-3(a)(8) applies when an upper-tier partnership (UTP) contributes § 704(c) property to a lower-tier partnership (LTP). It requires the UTP to treat the interest in the LTP as § 704(c) property with the same amount of built-in gain or loss as the contributed property and to use the same method under § 704(c) with respect to the LTP interest that is employed with respect to the contributed property. Regulations § 1.704-3(a)(9) applies when a UTP receives a contribution of either (1) § 704(c) property that is subsequently contributed to an LTP or (2) an LTP interest that already holds § 704(c) property. It requires the UTP to allocate its distributive share of items attributable to the LTP’s § 704(c) property “in a manner” that takes into account the contributing partner’s remaining built in gain or loss. It relies on the “*q* rule” of Reg. § 1.704-1(b)(2)(iv)(*q*) (adjustments where guidance is lacking) to support the allocation. It does not adopt an approach of treating the UTP as owning a portion of the § 704(c) property held by the LTP. Lower tier partnerships are required to report their § 704(c) items in a way that enables the UTP to apply these rules.

[Add example]

As has been recognized for many years,[[113]](#footnote-113) Reg. § 1.704-3(a)(9) goes only part way to carrying out the purposes of § 704(c). Because Reg. § 1.704-3(a)(9) merely requires the allocation of its distributive share of the LTP’s *in a manner* that takes into account remaining built-in gain or loss, and because it relies on the “*q* rule” for validity, there is a strong argument that it does not treat the items coming up from the LTP as basis derivative[[114]](#footnote-114) items that are subject to § 704(c). Thus none of the machinery of § 704(c), such as the availability of any reasonable method to cure book/tax disparities and the anti-abuse rule, is available to UTP to allow (or require) it to cure ceiling rule issues. As a result, shifting of tax consequences can occur at the UTP even when the § 704(c) property has enough basis to allocate the noncontributing UTP partner(s) tax equal to book in a world where the property is not contributed to the LTP.

[Paragraph on market practice where this comes up]

The technical shortcomings of Reg. § 1.704-3(a)(9) are not due to any inherent tension between the policy goals of § 704(c) and other policy priorities. It is not clear why the drafters of the regulations declined to simply treat items allocated by the LTP as basis derivative items susceptible to the full suite of § 704(c) tools.[[115]](#footnote-115) Amending Reg. § 1.704-3(a)(9) to do so would promote § 704(c) principles without obvious downsides and should be considered an administrative priority.

## How does § 704(c) apply to oil and gas property?

Partnerships hold oil and gas property in a unique manner for tax purposes.[[116]](#footnote-116) Even though a partnership owns an oil or gas property and recognizes income from its operation, it does not have tax basis in the property. Section 613A(c)(7)(D), enacted in 1975, sets in place a special system in which basis is held by the partners outside the partnership. Because different rules for cost recovery apply depending on the characteristics of the partner, each partner must separately compute depletion and gain or loss for a partnership oil or gas property. Section 613A(c)(7)(D) is clear that § 704(c) applies in in determining the partner’s shares of the tax basis of a partnership oil and gas property. The regulations clarify that the partnership must allocate to its partners the amount realized from the disposition of an oil or gas property.[[117]](#footnote-117) Thus, under § 613A(c)(7)(D), a partnership is required to allocate both basis and amount realized with respect to dispositions of oil and gas properties to its partners.

To state the obvious, § 704(c) typically does not operate to allocate the tax basis of partnership properties among the partners. Furthermore, the § 704(c) that existed in 1975 was different than the one that is in effect today, particularly with respect to the remedial and curative methods for addressing ceiling rule issues. Thus, there are many basic technical issues that arise when attempting to apply modern § 704(c) concepts to oil and gas partnerships, few of which are addressed by any authority. Given the substantial uncertainty in this area, it would be a worthwhile use of scarce administrative resources, and would further the policy goals of § 704(c), to provide updated regulatory guidance on the interaction between § 704(c) and § 613A(c)(7)(D).

The basic unanswered questions are summarized below, and include:

(1) How does § 613A(c)(7)(D) require basis in contributed property to be allocated?

(2) Can the curative of remedial methods be used to with respect to depletion, given that it is computed solely at the partner level?

(3) If the curative and remedial methods can operate on depletion, how are those methods applied? In particular, do they apply as an upfront allocation of basis to the noncontriuting partners, or are they applied to remediate or cure differences in book allocations and tax deductions as such differences arise?

### How is Basis Allocated?

It is clear from the statute and regulations that the tax basis of the property is allocated among the partners in a manner that gives effect to the principles of section 704(c).[[118]](#footnote-118) Given the relatively clear principles of § 704(c), then, § 613A(c)(7)(D) is best read as requiring the contributing partner to forgo tax basis in favor of the noncontributing partners to the maximum extent possible so that the noncontributing partners have cost recovery deductions equal to their book cost recovery. Because a partnership does not have tax deductions with respect to oil or gas depletion, the only mechanism by which to give the noncontributing partners a priority for tax deductions is to disproportionately allocate tax basis on contribution of the property. For example, if A contributes oil and gas property with a tax basis of $20 and a value of $100, and B contributes $100 of cash to the equal AB partnership, all $20 of tax basis with respect to the contributed property is allocated to B. If the partnership elects to use the traditional method (and if such method is reasonable in the circumstances), then the analysis ends here. As is clear from the example, however, the traditional method would allow A to shift $30 of built in gain to B, raising the question of whether the AB partnership is required, or even permitted, to use any further method under § 704(c) to address the shift.

### Can the Curative and Remedial Allocation Section be Applied to Depletion?

There is a reasonable argument that § 704(c) cannot have further application once it has effected the initial allocation of basis among the partners. After all, both the curative and remedial methods operate on the disparity between book and tax *allocations*, and a partnership that holds oil and gas property won’t have any allocations at all with respect to such property, so by definition no disparity can arise. Ending the analysis here would make some sense, given that the traditional method was the only specifically-blessed method for accounting for disparities between basis and value in 1975. Furthermore, the curative and remedial methods operate to address shifts caused by the ceiling rule, and the ceiling rule as it is normally conceived cannot apply where there are neither book nor tax allocations. The regulations under § 704(b) at least attempt to apply the principles of § 704(c) to depletable property.[[119]](#footnote-119) And there are strong policy reasons to allow or require partnerships to use the curative or remedial methods. Given the strong anti-shifting principles of § 704(c), then, it appears eminently reasonable for a partnership to adopt a method that mimics either the curative or remedial method to address shifts caused by the basis allocation described above.[[120]](#footnote-120)

### How do the Curative and Remedial Allocation Methods Work Mechanically?

Once partners conclude that § 704(c) permits the use of either the curative or remedial methods for depletable property, several more complex issues arise. Penick and Huffman[[121]](#footnote-121) suggest two possible methodologies for applying these method, either of which could be the basis for a helpful and clarifying guidance project. In the first method, the § 704(c) principles operate solely to allocate basis outside the partnership. In the second, § 704(c) works first to allocate basis and then to allocate deductions. Both methodologies produce sensible results for both the operation and the sale of oil and gas property by a partnership.

In the first methodology, both the curative and remedial methods would first allocate the tax basis of contributed property using traditional principles. Under the application of the curative method, the partnership would shift basis from other partnership oil and gas property and allocate that basis to the noncontributing partner, to the detriment of the contributor. Under the remedial method, instead of reallocating existing basis in other partnership oil and gas property, the partnership would allocate notional basis to the noncontributor, and notional *negative* basis to the contributor. The negative basis would have the effect of causing the contributor to recognize taxable income equal to the depletion attributable to the notional basis allocated to the noncontributing partner.

The second methodology is significantly more complicated, and its details are beyond the scope of this paper. Nevertheless, experience has shown that both methodologies can be applied in a variety of circumstances, including relatively complex transactions. If Congress, Treasury, or the IRS are interested in improving tax administration and promoting § 704(c) principles, a regulatory project incorporating either methodology (or allowing taxpayers to choose between them) would be well worth the time and effort.

## Other Recommendations

### Clarify the last sentence of Treas. Reg. § 1.704-3(a)(8)(i)

The last sentence of Treas. Reg. § 1.704-3(a)(8)(i) provides:

If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership.

This sentence is, to put it mildly, cryptic. The stated purpose of the rule – to preserve each item’s built-in gain – suggests a plausible reading that each item of contributed property is assigned some number of issued shares, with their basis calculated solely with reference to the § 704(c) property. As a result, a partnership would take back distinct lots of shares with different bases. As plausible as this reading is, it is not the only conceivable interpretation. An example added to the regulations would be illuminating and helpful.

### Clarify how Treas. Reg. sec. 1.704-3(a)(7) works in various circumstances, e.g., sale of a portion of an interest that tracks a section 704(c) asset.

### Make it clear that partners can have negative amounts in the tier 2 allocation of nonrecourse liabilities in cases where they would be allocated remedial loss.

As a very general matter, each partner is allocated (under “tier 2” of the § 752 regulations) a share of nonrecourse liabilities equal to the gain that would be allocable to him or her under § 704(c) (and reverse § 704(c) principles) in the event that the property was sold in exchange solely for satisfaction of the liability. The regulations under § 752 for the allocation of nonrecourse liabilities[[122]](#footnote-122) were finalized prior to the promulgation of the current § 704(c) regulations and, unsurprisingly, do not account for either the curative or the remedial methods. Revenue Ruling 95-41[[123]](#footnote-123) addresses some of the questions raised by the application of these methods to the allocation of nonrecourse liabilities, but many questions remain unanswered. Revenue Ruling 95-41 shows how, for nondepreciable property, § 704(c) can allocate additional gain to the contributing partner when the property is sold and confirms that, at least for gain allocated under the remedial method, this gain draws with it additional share of the nonrecourse liability. The ruling does not use the same rule for curative allocations, however, as the gain needed for such allocations is not certain to be available when the property is sold.

The ruling does not address the common situation where book depreciation of property reduces the book value below the amount of the liability, creating “minimum gain” that is allocated under “tier 1” rather than “tier 2.” As discussed in McKee et al.,[[124]](#footnote-124) blindly applying the § 752 regulations in these situations may lead one to conclude that once depreciation “moves” a portion of the gain (and thus the liability) from tier 2 to tier 1, there is no more gain available for allocation in tier 2. This interpretation is not consistent with how gain would actually be allocated in the event that the property were sold – § 704(c) can still apply to give allocate some partners gain and some partners loss, even if the net amount allocated in the § 704(c) tier is zero. As suggested by McKee et al., the regulations can arguably be read to allow for negative or loss allocations in tier 2, which would produce rational results in all cases. This interpretation should be explicitly incorporated into the regulations.

### Add a rule for cases where § 704(c) property on the remedial method is subject to a § 734(b) adjustment. See ¶ 11.04[3][d], n. 455

### Make it clear that Reg. § 1.704-1(b)(2)(iv)(g)(3) is not violated when you use the remedial method.

Our final suggestion is the least important. Regulations § 1.704-1(b)(2)(iv)(g)(3) requires the entire book basis of property to be recovered at the same rate that tax basis is recovered. The remedial method, however, requires a portion of the book basis of property on the remedial method to be recovered using an alternate schedule. This contradiction should be resolved by clarifying that Regulations § 1.704-1(b)(2)(iv)(g)(3) is not violated when a partnership uses the alternate recovery schedule required by the remedial method.

## Conclusion

1. Much of the history of § 704(c) reflects the expansion of what is “possible” in the realm of allocating noncontributing partners tax items equal to book items. [↑](#footnote-ref-1)
2. The regulations explicitly disavow the conclusion that parity of non-contributing partners’ book and tax allocations means that no shifting has taken place, cautioning that even the remedial method is subject to the anti-abuse rule. This tension is discussed in greater detail below. [↑](#footnote-ref-2)
3. These concerns are vividly illustrated in R. Donald Turlington, Section 704(c) and Partnership Book-Tax Disparities: The Ceiling Rule and the Art of Tax Avoidance, 46 Inst. On Fed. Tax’n 26 (1988). Despite the cheeky subtitle, Turlington’s article advocates for the repeal of the ceiling rule in the then-forthcoming regulations under the modern version of § 704(c). See the transactions at issue in TIFD III-E v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004), rev’d, 459 F3d 220 (2d Cir. 2006) (“Castle Harbour”); Chemtech Royalty Associates, L.P. v. United States, 766 F3d 453 (5th Cir. 2014). [↑](#footnote-ref-3)
4. Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p 212 (December 31, 1984). [↑](#footnote-ref-4)
5. See, e.g., Lucas v. Earl, 281 US 111 (1930), in which a husband and wife agreed that any income earned by either of them belonged to both of them equally. The husband earned substantial salary and fees from practicing law, and reported half of this income, with his wife reporting the other half, on the theory that their agreement effected an anticipatory assignment of income. There was no discussion of whether the agreement was motivated by tax avoidance or the spouses’ relative tax brackets (although the wife owned substantial property when the agreement was entered into, it does not appear that she earned any income for the year at issue). The Supreme Court reversed the decision of the Ninth Circuit and held that all of the income was taxable to the husband as the person who earned it, saying “we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.” Lucas v. Earl, 281 US 111, 115 (1930). Section 482, which polices shifting of tax consequences among related persons, permits the IRS to reallocate income or other items if “necessary in order to prevent evasion of taxes *or* clearly to reflect … income.” (Emphasis added) [↑](#footnote-ref-5)
6. The so-called “ceiling rule” provides that “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.” Thus, neither the IRS nor taxpayers have the unfettered ability to allocate items in a way that fully prevents shifting. [↑](#footnote-ref-6)
7. Although § 704(c) contains three subsections, only the first sub-sub section of the first sub-section will be discussed herein. As a result, references to § 704(c) should be read to refer to § 704(c)(1)(A) only. [↑](#footnote-ref-7)
8. Section 704(c)(1)(A). [↑](#footnote-ref-8)
9. Internal Revenue Act of 1934, § 113(a)(13) [↑](#footnote-ref-9)
10. G.C.M. 10092 CB XI-1 (1932) (revoked by G.C.M. 26379, 1950-1 C.B. 58 (1950)). [↑](#footnote-ref-10)
11. See Helvering v. Walbridge, 70 F. 2d 683 (2d Cir. 1934), *aff’g* Walbridge v. Comm’r, 27 B.T.A. 837 (holding that while neither the partner nor the partnership recognized gain on the contribution of an appreciated asset, the partnership was nevertheless entitled to a fair market value basis). See also Helvering v. Archbald, 70 F.2d 720 (2d. Cir. 1934). [↑](#footnote-ref-11)
12. Taxpayers naturally took advantage of this state of affairs. In Chisholm v. Commission, 70 F.2d 14 (1935) rev’g 29 B.T.A. 1334 (1934) the taxpayer was one of five shareholders in an engineering company. The shareholders gave an unrelated person an option to purchase the stock of the company. About a month later, the shareholders contributed their stock to a new partnership, taking the position that the partnership took a fair market value basis in the stock. There was no dispute about the value of the stock, because two days after the contribution, the partnership sold the stock to the optionholder. Neither the partnership nor the partners reported any gain, with the Second Circuit (Judge Learned Hand, who just a few years prior had written the decision in Gregory v. Helvering) agreeing with the taxpayer. [↑](#footnote-ref-12)
13. Helvering v. Walbridge, 70 F. 2d 683 (2d Cir. 1934). Commentators viewed Section 113(a)(13) of the 1934 Code as a direct response to the Board of Tax Appeals decisions in *Walbridge* and *Archbald*; the Second Circuit affirmations were released just four days after Section 113(a)(13) became law. See Valentine Brookes, The Strange Nature of the Partnership Under the Income Tax Law, 5 Tax L. Rev. 35, n. 31 (1949). [↑](#footnote-ref-13)
14. G.C.M. 10092, CB XI-1 (1932), at p. 114-115 (revoked by G.C.M. 26379, 1950-1 C.B. 58 (1950)). Prior to 1954, the Code contained a provision that increased the basis of contributed property by the amount of gain recognized on contribution. See § 113(a)(13) of the 1939 Code. Commentators noted that “since gain or loss is not recognized on the transfer of property by a partner to a partnership, this particular provision appears academic.” Joyce Stanley and Richard Kilcullen, The Federal Income Tax: A Guide to the Law, p. 189 (The Tax Club Press 1948). [↑](#footnote-ref-14)
15. Amounts computed by reference to the book and tax basis of a contributed property, i.e., book and tax gain, loss and amortization, depreciation or other cost recovery. See G.C.M. 10092, CB XI-1 (1932), (revoked by G.C.M. 26379, 1950-1 C.B. 58 (1950)), which viewed pre-contribution gain as remaining outside the partnership. [↑](#footnote-ref-15)
16. 1954 ALI Report, G.C.M. 10092, CB XI-1 (1932), (revoked by G.C.M. 26379, 1950-1 C.B. 58 (1950)); 1954’s § 704(c)(3) also represents a strategy of keeping some items outside of a partnership. [↑](#footnote-ref-16)
17. [Cite] [↑](#footnote-ref-17)
18. G.C.M. 10092, CB XI-1 (1932), at p. 114 (revoked by G.C.M. 26379, 1950-1 C.B. 58 (1950)). [↑](#footnote-ref-18)
19. See Laura E. Cunningham and Noel B. Cunningham, Simplifying Subchapter K: The Deferred Sale Method, 51 SMU L. Rev. 1, n. 16 (1998); J. Paul Jackson et al., A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners, American Law Institute Draft, 9 Tax. Law Rev. 109, 120 (1954). [↑](#footnote-ref-19)
20. Presumably the administration of such a system would involve something resembling the dreaded § 751(b) exchange tables. [↑](#footnote-ref-20)
21. The ALI Discussion notes that this is the approach adopted in GCM 10092. [↑](#footnote-ref-21)
22. There is, however, no discussion of the theory behind allowing partners to allocate items not recognized by the partnership. [↑](#footnote-ref-22)
23. ALI discussion, p. 122. [↑](#footnote-ref-23)
24. It is not clear from the Discussion whether the features just described would also be true in the deferred sale approach. [↑](#footnote-ref-24)
25. ALI Report, p. 127. [↑](#footnote-ref-25)
26. ALI Draft, p. 130. The ALI also said that in cases where a person became a partner in a partnership but made not contribution of property, know-how, or special ability, then if he were entitled to some portion of the partnership’s assets on liquidation, such partner would nevertheless be entitled to basis but the other partner(s) would be subject to gift tax, as the transaction would not represent an arm’s length bargain. [↑](#footnote-ref-26)
27. ALI Draft, p. 133. [↑](#footnote-ref-27)
28. [Cite] [↑](#footnote-ref-28)
29. NTD: check that this is true. [↑](#footnote-ref-29)
30. See the detailed discussion of this history in Charles W. Davis, Partners and Partnerships: Determination of Tax Liability Under the 1954 Code, Taxes – The Tax Magazine, 969-972 (Dec. 1954). [↑](#footnote-ref-30)
31. Section 704(c)(1) read: “General rule. In determining a partner's distributive share of items described in section 702(a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.” [↑](#footnote-ref-31)
32. See S. Rep. No. 1622, 83d Cong., 2d Sess. 381 (1954) (“since the partnership is allowed only $40 per year (10 percent of $400), no more than this amount may be allocated to B.”) [↑](#footnote-ref-32)
33. Code § 704(c)(3) (as in effect 1955-1984). [↑](#footnote-ref-33)
34. Charles W. Davis, Partners and Partnerships: Determination of Tax Liability Under the 1954 Code, Taxes – The Tax Magazine, 971-972 (Dec. 1954). [↑](#footnote-ref-34)
35. Id. [↑](#footnote-ref-35)
36. It was also thought that § 704(b) could support what we now think of as reverse § 704(c) allocations. See MNW First edition ¶ 10.08[1], n. 114 (1977). [↑](#footnote-ref-36)
37. First edition ¶ 10.08[2], n. 118. [↑](#footnote-ref-37)
38. As well as the language of the regulations at the time, which provided that “depreciation… shall be determined in the same manner as though such undivided interests continued to be held by the partners outside the partnership.” Reg. § 1.704-1(c)(3)(i) (as in effect at the time). [↑](#footnote-ref-38)
39. MNW First edition, ¶ 10.09[3] (1977). [↑](#footnote-ref-39)
40. TD 6175 (May 23, 1956). These regulations were part of a massive package of regulations implementing Subchapter K. [↑](#footnote-ref-40)
41. See Reg. § 1.704-1(c)(2)(i) (as in effect in 1956). [↑](#footnote-ref-41)
42. Reg. § 1.704-1(c)(2) (as in effect in 1956). [↑](#footnote-ref-42)
43. The report was drafted in 1982 but everyone speaks of it as the 1984 ALI Report and this piece will do the same. [↑](#footnote-ref-43)
44. 1984 ALI Report, Part G, p. 127. The 1984 ALI report considered an approach whereby the entire property is deemed sold, rather than just a portion as the 1954 ALI Report had contemplated. The difference between these two approaches is explored in Laura E. Cunningham and Noel B. Cunningham, Simplifying Subchapter K: The Deferred Sale Method, 51 SMU L. Rev. 1, 13-14 (1998). [↑](#footnote-ref-44)
45. 1984 ALI Report, Proposal G.a., p. 140. [↑](#footnote-ref-45)
46. Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p 212 (December 31, 1984). [↑](#footnote-ref-46)
47. Id. [↑](#footnote-ref-47)
48. Conference Report to Accompany H.R. 4170 (June 23, 1984). [↑](#footnote-ref-48)
49. A notable change from the prior statutory language. [↑](#footnote-ref-49)
50. Conference Report to Accompany H.R. 4170, 857 (June 23, 1984). [↑](#footnote-ref-50)
51. TD 8065. The proposed regulations had permitted contributed property to be reflected at fair market value only if certain conditions were met. [↑](#footnote-ref-51)
52. 57 Fed. Reg. 61,353 (Dec. 24, 1992). [↑](#footnote-ref-52)
53. Preamble to proposed regulations, 57 Fed. Reg. 61,345 (Dec. 24, 1992). [↑](#footnote-ref-53)
54. TIFD III-E v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004), rev’d, 459 F3d 220 (2d Cir. 2006) (“Castle Harbour”); Chemtech Royalty Associates, L.P. v. United States, 766 F3d 453 (5th Cir. 2014). [↑](#footnote-ref-54)
55. In Castle Harbour, the § 704(c) method chosen was the traditional method with curative allocations only on sale. The District Court noted that the tax benefits of the transactions arose from the application of the ceiling rule but notes that the IRS did not challenge the application of § 704(c), likely because the contribution was made shortly before the effective date of the final regulations. (“The rules governing the allocation of, among other things, depreciation deductions in situations where the book value of a contributed asset is greater than its tax basis are set forth in I.R.C. § 704(c) and its attendant regulations. In part, the application of that section's “ceiling rule” leads to the tax savings at issue here. The government, however, does not allege that the mechanics of section 704(c) allocation were improperly applied in this case, so there is no need to examine them.”) The Second Circuit’s opinion, which overturned the trial court’s decision, also declines to address § 704(c) and contains the following inexplicable footnote: “The so-called Ceiling Rule, derived from I.R.C. § 704(c), which has since been repealed, was the statutory provision upon which the partnership relied to justify its allocations.” [↑](#footnote-ref-55)
56. TD 8500 (Dec. 22, 1993). [↑](#footnote-ref-56)
57. TD 8501 (Dec. 22, 1993). [↑](#footnote-ref-57)
58. See McKee, Nelson, Whitmire & Brodie, Federal Taxation of Partnerships & Partners, 11.04[3][d] (Thomson Reuters Tax/Accounting, 5th Ed. 2024). [↑](#footnote-ref-58)
59. See Prop. Reg. §§ 1.704-3(d)(2)(i), 1.704-3(d)(2)(iii) (1992), 1993-1 CB 857, 864. [↑](#footnote-ref-59)
60. As described in the preamble, if the property is sold, any remaining built-in gain is allocated to the contributing partner and any excess gain is allocated according to the partnership agreement. [↑](#footnote-ref-60)
61. Reg. § 1.704-3(d)(2). See McKee, Nelson, Whitmire & Brodie, Federal Taxation of Partnerships & Partners, 11.04[3][d] (Thomson Reuters Tax/Accounting, 5th Ed. 2024). [↑](#footnote-ref-61)
62. TD 8585 (Dec. 27, 1994). [↑](#footnote-ref-62)
63. I.e., in determining whether allocations have the effect of substantially reducing the present value of the partners’ tax liability, the “reduction” would be calculated by comparing the actual tax liability to what it would have been under the remedial method. [↑](#footnote-ref-63)
64. REG–100798–06, 73 Fed. Reg. 28,765 (May 19, 2008). [↑](#footnote-ref-64)
65. TD 9485 (June 9, 2010). [↑](#footnote-ref-65)
66. P.L. 105-34, Sec. 1131(c)(3) (1997). [↑](#footnote-ref-66)
67. REG-144468-05, 79 Fed. Reg. 3041 (Jan. 15, 2014). [↑](#footnote-ref-67)
68. CITE [↑](#footnote-ref-68)
69. See Reg. § 1.721(c)-1 through -7. [↑](#footnote-ref-69)
70. Reg. § 1.704-3(a)(1). [↑](#footnote-ref-70)
71. In other words, a high-bracket taxpayer will not necessarily face different tax results if he chooses to partner with a low- or zero- bracket taxpayer, outside of a the relatively extreme cases caught by the anti-abuse rule. See, e.g., Reg. §§ 1.704-3(b)(2) Example 2; -3(c)(4) Example 3. [↑](#footnote-ref-71)
72. This latter approach is advocated in Philip F. Postlewaite, Thomas E. Dutton & Kurt R. Magette, A Critique of the ALI's Federal Income Tax Project--Subchapter K: Proposals on the Taxation of Partners, 75 GEO. L. J. 423, 470 (December 1986). The article advocates the same treatment for contributions to existing partnerships as well – upon a contribution in exchange for a partnership by a new or existing partner, the old partnership would recognize gain or loss in full. The article notes that upfront recognition would deter partnership formation, but notes that there are ways that partners could avoid upfront recognition – for example by leasing property to a partnership instead of contributing it, or selling the property on a deferred basis. While these strategies may work for initial contributions of property, it is harder to see how they would allow partners to avoid gain recognition when a new partner is admitted. This proposal suffers from the same constitutional issues discussed in Part [ ], below. [↑](#footnote-ref-72)
73. For example, § 737, the regulations under § 721(c), and the recent “basis shifting” guidance. [↑](#footnote-ref-73)
74. “WYDEN UNVEILS PROPOSAL TO CLOSE LOOPHOLES ALLOWING WEALTHY INVESTORS, MEGA-CORPORATIONS TO USE PARTNERSHIPS TO AVOID PAYING TAX”. [↑](#footnote-ref-74)
75. Wyden Discussion Draft, p. 5. [↑](#footnote-ref-75)
76. Wyden Discussion Draft, p. 1. [↑](#footnote-ref-76)
77. As discussed in greater detail below, our proposal to relax the ceiling rule would allow Treasury and the IRS to rewrite the anti-abuse rule in a clearer and less confusing way, which itself could reduce the technical burden on the IRS when it needs to determine whether a selected § 704(c) method is reasonable. By eliminating the tension between the ceiling rule and the anti-shifting policy of § 704(c), a new anti-abuse rule could be simpler for both taxpayers and the IRS to apply. [↑](#footnote-ref-77)
78. “If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property.” Reg. § 1.704-1(b)(2)(iv)(f)(5) (flush language). [↑](#footnote-ref-78)
79. [Discussion on Enron Condor transaction.] [↑](#footnote-ref-79)
80. Consider the following example (which assumes a discount rate of around 8.78 percent): Z owns an asset with a tax basis of $40, a fair market value of $100, a 10 year tax life (assume the asset is newly placed in service and no first year conventions apply), amortizable straight line over 10 years, and an economic life of 25 year (assume that the asset produces $10 per year over those 25 years, with a terminal value of $0. Z is subject to a 40% tax rate. If Z operates the business itself, it will incur $2.40 of tax in each of years 1-10 and $4 of tax in each of years 11 through 25, with a net present value of around $30. Z is considering partnering with Y, which would contribute $100 to be used to purchase land for the equal YZ partnership. If Z makes this contribution, it will pay $4.40 (including $2 of remedial income) of tax in each of years 1-10, and $4 per year afterwards, with a net present value of around $43. If Y contributes an asset with the same depreciation schedule as Z, however, then mandatory remedials get the exact same result as operating the asset directly because depreciation deductions from Y’s contributed asset (regardless of its basis in Y’s hands) offset the effect of remedials. [↑](#footnote-ref-80)
81. CITE (2024). [↑](#footnote-ref-81)
82. There is also arguably an issue of whether mandatory remedials on “forward” § 704(c) would be permissible. As discussed in Part [ ], above, the early theory of partnerships did not settle the question of whether a contribution to a partnership constitutes a realization event. Given the evolution of the treatment of partnerships in the last century, however, it seems likely that a court would find realization and thus allow Congress to mandate remedial allocations on forward layers. [↑](#footnote-ref-82)
83. Treas. Reg. § 1.704-3(a)(10). [↑](#footnote-ref-83)
84. Treas. Reg. § 1.704-3(a)(1). [↑](#footnote-ref-84)
85. Treas. Reg. § 1.704-3(a)(2). [↑](#footnote-ref-85)
86. See Laura Cunningham, Use and Abuse of Section 704(c), 3 Fl. Tax Rev. 94, 115 (1996). [↑](#footnote-ref-86)
87. Id. [↑](#footnote-ref-87)
88. Laura Cunningham reports that the drafters of the regulations indeed felt that they were so bound. Id. at [ ]. Whether this is true is an interesting question. The ceiling rule on its face does not suggest anything resembling a ceiling rule. But, in examples in the legislative history to both the original elective method for accounting for book/tax disparities, and the current statutory provision, Congress applied the ceiling rule without elaborating on why. The ceiling rule also has both theoretical and practical appeal. It is a theoretically pure application of the entity theory of partnerships. Since the partnership does not have items available to allocate, there is an argument that these items do not exist. From a practical perspective, Treasury may have been leery of untethering partnership allocations from the items actually recognized by the partnership. This concern is evident in the regulations explicit prohibition on notional items outside of the remedial method. [↑](#footnote-ref-88)
89. Taxpayers are also bound by the ceiling rule, unless they elect the remedial method. [↑](#footnote-ref-89)
90. The IRS has given some indication that it believes that it can override the effects of the ceiling rule by invoking § 482 to allocate the “excess” income back to the contributing partner. FSA 199936007 (May 25, 1999). This interpretation is not consistent with the delicately crafted § 704(c) regulations. [↑](#footnote-ref-90)
91. HR Rep. No. 861, 98th Cong., 2d Sess. 856 (1984) (“The conferees do not intend for the Treasury to require such variation to be eliminated by allocations of operating income and loss attributable to the contributed property.”) It is not clear whether this language means that Congress didn’t want to force Treasury to require variations to be cured with operating income, or whether it wanted to prohibit Treasury from doing so. [↑](#footnote-ref-91)
92. See LAFA 20204201 (April 22, 2020), (revealed by the New York Times to concern Bristol Myers, Jesse Drucker, An Accidental Disclosure Exposes a $1 Billion Tax Fight With Bristol Myers, New York Times (April 1, 2021)). The Bristol Myers transaction involved a related foreign person and the partnership agreement limited curative allocations in a variety of ways: curative allocations would be made only on sale, be limited to the amount of gain tax gain recognized on such sale, and would be further limited to the cumulative book depreciation to the non-contributing partner that was not matched by tax depreciation. The LAFA concludes that the use of the traditional method with limited curative allocations on sale is not reasonable that that the IRS is permitted to apply the anti-abuse rule to require that the taxpayer use a reasonable method. The transaction at issue would have been subject to the regulations under § 721(c) (or Notice 2015-54) had those rules been in effect at the time. [↑](#footnote-ref-92)
93. Reg. § 1.704-3(d)(5)(ii). [↑](#footnote-ref-93)
94. Laura E. Cunningham and Noel B. Cunningham, Simplifying Subchapter K: The Deferred Sale Method, 51 SMU L. Rev. 1, n. 16 (1998) [↑](#footnote-ref-94)
95. Mandatory application of the deferred sale method to reverse § 704(c) amounts would raise the constitutional issues discussed in Part [ ]. [↑](#footnote-ref-95)
96. It may run afoul of the general requirement that § 704(c) allocations be made in a way that prevents shifting *on a property by property basis*, since there is more of a shift than is necessary with respect to A’s property when it is considered on a standalone basis. Perhaps one could argue that this method fails to “take into account” the variation between tax and book basis with respect to A’s contributed property, and that it should fail to even qualify as a § 704(c) method for that reason. It also may be that although the combination of methods is reasonable, the method is not reasonable when applied solely to A’s property and should be prohibited. [↑](#footnote-ref-96)
97. Not §§ 704(c)(1)(B), 737, … [others]. [↑](#footnote-ref-97)
98. See B. Rubin & A. Macintosh, Exploring the Outer Limited of the 704(c) Partnership Built-In Gain Rule, 89 J. Tax’n 177 (1998) for a four step method that reaches sensible results. At a high level, this method involves (1) determining each partner’s share of liabilities under § 752 prior to the bookup, (2) determining the aggregate gross value of the assets each partner is deemed to contribute by adding the liabilities calculated in step one to the partner’s positive capital account after the bookup, (3) applying the regulations under § 743(b) to determine each partner’s share of inside basis, and (4) allocating the aggregate value and basis deemed contributed by each partner among the partnership’s assets. Within the final step there are several possible ways to make the calculation, each of which may be reasonable in different scenarios. [↑](#footnote-ref-98)
99. Reg. § 1.752-3(b). For a discussion of two methods that may be reasonable, see B. Rubin & A. Macintosh, “Exploring the Outer Limits of the 704(c) Partnership Built-In Gain Rule (Part 2), 89 J. Tax’n 228 (1998). Although this article was published prior to the promulgation of the “reasonable method” rule of the regulations, the approaches described therein are consistent with the limitations described in the regulations. [↑](#footnote-ref-99)
100. Reg. § 1.704-3(a)(6)(i), which provides “[p]artnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c) and paragraph (a) of this section. In addition, partnerships are not required to use the same allocation method for reverse section 704(c) allocations each time the partnership revalues its property.” [↑](#footnote-ref-100)
101. For a detailed exploration of the problem, see Hortenstine, Nadvorny & Helm, “Multi-Layered Partnership Assets; Divergent Results Under the Separate Layer and Single Asset Methods of Allocating Gain, Loss and Depreciation Under Section 704(c),” PLI Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (2014); Roger F. Pillow and Glenn E. Dance, Notice 2009-70: A Focus on Complex Section 704(c) Netting vs. Layering Issues, Journal of Taxation 336 (Dec. 2009). [↑](#footnote-ref-101)
102. Prop. Reg. § 1.704-4(c)(4)(ii)(F) Example 3 (2007). [↑](#footnote-ref-102)
103. Notice 2009-70, 2009-34 IRB 255 (Aug. 12, 2009). The New York State Bar Association produced a detailed and thoughtful response to the questions posed by Notice 2009-70, recommending, among other things, that netting should be prohibited for most partnerships, partnerships should be afforded flexibility in how they allocate tax items among layers, tiered partnerships should be treated as an aggregate when maintaining § 704(c) layers, and the treatment of § 704(c) layers in partnership mergers and divisions should be conformed as nearly as possible to the treatment of tiered partnerships. New York State Bar Association, Report on Notice 2009-70 (J

     an. 22, 2010). [↑](#footnote-ref-103)
104. Prop. Reg. § 1.704-3(a)(6)(i) (2014). [↑](#footnote-ref-104)
105. See Lay, Sloan, and Sutton, 723 T.M. III.A.2.a, Publicly Traded Partnerships, (1st ed., last visited October 2, 2024); B. Rubin & A. Macintosh, Exploring the Outer Limited of the 704(c) Partnership Built-In Gain Rule (Part 3), 89 J. Tax’n 271 (1998). [↑](#footnote-ref-105)
106. Netting also raises difficult questions of how, precisely, one should net various layers. Suppose a partnership has three gain layers and one loss layer with respect to a property. Each layer is shared by the partners in a different ratio. Which gain layer should be “netted” by the loss layer first? The earliest in time? Latest in time? All of the layers on a pro rata basis? [↑](#footnote-ref-106)
107. Reg. § 1.704-3(a)(3)(i) (“Property contributed to a partnership is section 704(c) property if at the time of contribution its book value differs from the contributing partner’s adjusted tax basis.”) [↑](#footnote-ref-107)
108. One would think not, as there does not appear to be any benefit of doing so. [↑](#footnote-ref-108)
109. Keeping separate layers may have an undesirable side-effect when property with a positive forward layer and negative reverse layers is distributed and § 704(c)(1)(B) applies. It appears that the positive layer would be triggered and the negative layers would not be tax effected, which seems unduly harsh. If future guidance requires the keeping of separate layers (or alternative methods that have the same effect), then it should address these questions. [↑](#footnote-ref-109)
110. Elizabeth Amoni and John G. Schmalz “Section 704(c): The Disparity Offset Method Provides Answers to Difficult Questions,” 114 Journal of Taxation 223 (Apr. 2011). [↑](#footnote-ref-110)
111. The definition of inventory for this purpose is very broad, and includes, among many other things, the electrons generated by a power plant. CITE PLRs. [↑](#footnote-ref-111)
112. See Gary R. Huffman, 704(c) Meets 263A : Contributions of Depreciable Property to Partnerships, 98 J. Tax’n 149 (Mar. 2003). [↑](#footnote-ref-112)
113. Gary R. Huffman and Barksdale Hortenstine, Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships, 86 Tax Mag. 179 (2008). [↑](#footnote-ref-113)
114. Amounts computed by reference to the book and tax basis of a contributed property, i.e., book and tax gain, loss and amortization, depreciation or other cost recovery. [↑](#footnote-ref-114)
115. The legislative history provides that items similar to true § 704(c) items could be treated in the same way, which seems like ample authority treat LTP items as basis derivative. See H.R. Rep. No. 861, 98th Cong. 2d. Sess. 856. [↑](#footnote-ref-115)
116. For a detailed history and analysis of these unusual rules, see Barksdale Penick and Gary Huffman, THE TAXATION OF OIL AND GAS PARTNERSHIPS, [ ] Tax Notes 1405 (Sept. 19, 2005) (hereinafter Penick and Huffman), from which much of this section is derived. [↑](#footnote-ref-116)
117. Reg. § 1.613A-3(e)(6)(iii). [↑](#footnote-ref-117)
118. Section 613A(c)(7)(D); Reg. § 1.613A-3(e)(5); Reg. § 1.704-1(b)(4)(v). [↑](#footnote-ref-118)
119. See Reg. § 1.704-1(b)(2)(iv)(k). [↑](#footnote-ref-119)
120. Although shifting is generally caused by the ceiling rule, the ceiling rule as it is traditionally understood does not really apply. The ceiling rule refers to the limitation on allocable items to those that would be available to the partnership itself. In an oil and gas, partnership, the partnership does not have items to allocate in any case, so the “ceiling rule” is better understood as limiting the partners to what they would collectively be entitled to in the absence of a special rule. [↑](#footnote-ref-120)
121. Penick and Huffman at 1426. [↑](#footnote-ref-121)
122. Reg. § 1.752-3(a)(2). [↑](#footnote-ref-122)
123. Rev. Rul. 95-41, 1995-1 CB 132. [↑](#footnote-ref-123)
124. McKee, Nelson, Whitmire & Brodie, Federal Taxation of Partnerships & Partners, ¶ 8.03[3][a] (Thomson Reuters Tax/Accounting, 5th Ed. 2024), which includes an example of this phenomenon. [↑](#footnote-ref-124)