

PARTNERSHIP ALLOCATIONS

ALLOCATIONS OF PROPERTY WITH BUILT-IN GAIN UNDER SECTION 704(C)

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Due to the fact that the Code and Regulations permit partnerships to choose the best method of allocation for their partnership, many partners and advisors may have difficulty in knowing which allocation method works best for their partnership's financial situation. This article discusses (1) the allocation of deductions (specifically focusing on depreciation deductions) by describing the relevant portions of subchapter K of the Code that deal with contribution of property, (2) the ceiling rule, and (3) the ways partners can mitigate the tax effects of the difference in the fair market value and the tax basis in the con-

tributed property through different permitted allocation methods.

Introduction

For tax purposes, business entities¹ are often classified as partnerships due to lower overall tax rates, flexibility of ownership, and ease of operation. Generally, partnerships do not pay income tax as the tax "passes through" the entity and subjects the partners of the partnership to income tax liability.² Tax³ on partnership income comes from the income, gain, loss, and deductions from the partnership operations, either from the normal course of the partnership's business, such as the sale of inventory or the performance of services, or the sale of the partnership property. This type of tax liability often arises when a partnership realizes deferred gain. For example, if a partnership buys an office building for \$1,000,000 and later sells the same building for \$1,500,000, the \$500,000 difference would be taxed as a gain from partnership property. During the period that the fair market value of the building has increased but before the building is sold, the gain is characterized as deferred. The resulting tax liability from the gain is split between the partners in accordance with their partnership agreement or, if the agreement is silent, then it will be split in proportion to each individual partner's equity interest.⁴

However, the amount of gain allocated to each partner could be distributed differently if a partner (or multiple partners) contributes prop-

erty to the partnership in exchange for their equity interest in the partnership. Further complicating the allocation is if property is depreciable and has been depreciated, or if the property has increased in value since it was acquired by the now-contributing partner, which leads to built-in gain.

This article will discuss (1) the allocation of deductions (specifically focusing on depreciation deductions) by describing the relevant portions of subchapter K of the Internal Revenue Code (the "Code") that deal with contribution of property, (2) the ceiling rule, and (3) the ways partners can mitigate the tax effects of the difference in the fair market value⁵ and the tax basis in the contributed property through different allocation methods permitted under the Code and the Treasury Regulations (the "Regs").

Contributions of Property Under Section 721

Under Section 721 of the Code, neither the partnership nor its partners recognize gain upon contribution of property to the partnership in exchange for an interest in the partnership. This means that if an individual, other partnership, corporation, etc., contributes property in exchange for equity in the partnership, generally, the contribution will be received by the partnership tax-free and there will not be any tax for the contributing partner.

There are many examples of property that are eligible for a tax-free contribution under Section 721, such as cash, tangible property, accounts receivable, and some rights or assets created by the contributing

¹ While this article uses the word "partnership" throughout, it is referring to any business that is classified as a partnership for tax purposes, such as LLCs, LLPs, and unincorporated general partnerships.

² In addition to elective pass-through entity taxes, some states and localities impose taxes

on entities that are pass-through for federal or state purposes, such as NYC's unincorporated business tax.

³ While there are many kinds of taxes, this article will only focus on income taxes.

⁴ For the purpose of this article, we will assume that all partners split income, loss, and

tax liability in proportion with the partners' interest in the partnership.

⁵ At the time of contribution, the book basis is equal to the fair market value, and therefore in this context they are synonymous. See, e.g., Treas. Regs. 1.704-3(a)(3)(ii) and 1.721(c)-7(b)(1).

partner. The nonrecognition treatment under Section 721 is intended to be extremely broad, similar to Section 351 of the Code, but without the additional control requirements imposed by Section 368(c) of the Code. The tax exemption from Section 721 does not apply to property exchanged for partnership equity if any of the following conditions are met: (1) the partner contributes property subject to a liability and the liability exceeds the basis of the contributed property;⁶ (2) the contribution is actually a disguised sale;⁷ or (3) the partnership is treated as an investment company for tax purposes.⁸

Depreciation. Depreciation is an economic concept that reflects the decline in an asset's value over the asset's useful life due to ordinary wear and tear of the asset, passage of time, change in capacity, or other physical or environmental factors. Depreciation occurs for the entirety of the asset's useful life and only ends when the underlying asset is worth zero. Depreciation deductions are permitted by the Code to grant partners allowances to recover the money invested in an asset. By making a deduction for depreciation, companies can lower the tax basis of an asset concurrently with the decline of the asset's actual value.⁹

There are several ways to calculate an asset's depreciation, commonly referred to as methods or systems, but for the purpose of this article, we will assume that assets are all depreciated using the straight-line method to simplify the

examples. Straight-line depreciation allows owners to allocate the depreciation cost of an asset over the asset's useful life evenly and incorporates the asset's salvage value, or the amount the asset is expected to be worth or sold for at the end of its useful life, into the annual cost of depreciation.

Depreciation example. Imagine a company purchases a machine for \$1,000,000. The machine has a useful life of 10 years and an expected salvage value of \$700,000. In order for the company to properly allocate depreciation, the machine's total depreciable amount must first be calculated. The machine's total depreciation amount is \$300,000.¹⁰ Next, the company will distribute the depreciation amount evenly over the machine's useful life. Ultimately, this company would deduct \$30,000 of depreciation for each of the 10 years of the machine's useful life.

Allocation of Depreciation Under Section 704

Generally, Section 704 of the Code and the Regs thereunder provide the rules to determine a partner's distributive share, stating that a partner's distributive share is determined by the partnership agreement or, if the agreement is silent, it is allocated in proportion to each partner's interest in the partnership. This rule applies to contributed property which has a tax basis equal to its fair market value; where the contributed property's tax basis and fair market value are not equal, a

separate rule governs the partners' distributive shares.

Section 704(c) provides, in relevant part, depreciation must be allocated in a manner that allocates the maximum amount of depreciation to the non-contributing partner as a mechanism to minimize the built-in gain between partners. An asset with built-in gain is any asset which has a fair market value greater than its tax basis, whether due to appreciation in value or if the asset was depreciated or amortized.¹¹ A partnership or its partners may choose to allocate in any way, provided that both of the following elements are met: (1) the partnership consistently uses a single reasonable method for each individual item of contributed property and (2) the overall combination of methods is reasonable. While the Code allows for any reasonable method(s) of allocation, the three methods explicitly identified by the Code are traditional, traditional with curative allocations, and remedial. Any other method, while not forbidden, would likely be viewed by the Internal Revenue Service ("IRS") as potentially unreasonable, as its use would suggest that it was being used to shift items of gain or loss between partners.

Allocations generally: the traditional method. The traditional method of allocation allocates built-in loss or gain to the contributing partner over the underlying property's useful life. It follows five simple steps.

⁶ I.R.C. Section 731. This is a common issue when property has appreciated significantly and has significant depreciation, particularly when accelerated depreciation was taken or property is contributed into a partnership that will renovate the property.

⁷ I.R.C. Section 707(a)(2)(B). This is outside of the scope of this article.

⁸ I.R.C. Section 721(b). This is outside of the scope of this article.

⁹ It must be noted that forms of accelerated depreciation, such as Modified Accelerated Cost Recovery System or bonus depreciation, are significant departures from the slower and more ratable economic depreciation that actually occurs to the assets of a business or investments.

¹⁰ The fair market value (\$1,000,000) less the salvage value (\$700,000). Much of the time, an asset's salvage value is zero or extremely minimal.

¹¹ This article will only discuss depreciation, but amortization of intangible assets will occur in the same manner.

- Step 1: Calculate tax allocations (using tax basis at the time of contribution).

- Step 2: Calculate book allocations (using the fair market value at the time of contribution).

- Step 3: Allocate book amounts according to the partnership agreement.

- Step 4: Allocate tax amounts to the noncontributing partner(s), up to their share of the book amount.

- Step 5: Allocate residual tax amounts, if any, to the contributing partner.

Example 1. To illustrate via example, Alma and Barry formed ACME Partnership. Barry contributed \$500 cash for 50% interest in ACME. Alma contributed a printer with a fair market value (and therefore book basis) of \$500 but a tax basis of \$300 for the same equity interest. The printer realizes depreciation under the straight-line method and has a useful life of 14 years with 10 years remaining.¹²

- Step 1: Calculate tax allocation: $\$300 / 10 \text{ years} = \30 per year.

- Step 2: Calculate book allocation: $\$500 / 10 \text{ years} = \50 per year.

- Steps 3 through 5 are demonstrated in Exhibit 1.

Barry's total tax allocation is limited to his fair market value contribution due to the ceiling rule.

The traditional method and the ceiling rule. The ceiling rule limits a non-contributing partner's total tax depreciation allocation to the amount of that partner's book allocation, which can cause a distortion between a non-contributing partner's tax depreciation allocation and their

book allocation due to the limited amount of tax depreciation that can be allocated.

Example 2. To demonstrate this distortion, assume all facts are the same from Example 1, except the printer has a tax basis of \$200 rather than \$300. We start by simply following the traditional method's five steps.

- Step 1: Calculate tax allocation: $\$200 / 10 \text{ years} = \20 per year.

- Step 2: Calculate book allocation: $\$500 / 10 \text{ years} = \50 per year.

- Steps 3 through 5 are demonstrated in Exhibit 2.

Here, you can clearly see a \$5 distortion between Barry's book value and tax value. Practically, that \$5 distortion means Barry is incurring an economic loss on the actual book value of the printer without receiving a similar deduction for tax purposes. To remedy issues caused by the ceiling rule, the Code provides two other methods of allocation, the traditional method with curative allocations and the remedial method.

The traditional method with curative allocations. The traditional method with curative allocations allows partnerships to offset the difference between property's book and tax depreciation by reallocating items of partnership gain, which is a "cure" to the ceiling rule.

Example 3. All the facts are the same as Example 2, except now ACME generated \$10 of ordinary income during the same tax year. Going through the steps provides the following.

- Step 1: Calculate tax allocation: $\$200 / 10 \text{ years} = \20 per year.

- Step 2: Calculate book allocation: $\$500 / 10 \text{ years} = \50 per year.

- Steps 3 through 5 are demonstrated in Exhibit 3.

By allocating – for tax purposes only – the entire \$10 of ordinary income to Alma, the effect is the same as allocating the full \$25 of depreciation to Barry. When making curative allocations under Section 704(c), the curative allocations must be reasonable. Under Treas. Reg. 1.704-3, the reasonability of a curative allocation depends on the allocation amount, timing, and type.

For a curative allocation to be reasonable, the amount of the curative allocation cannot exceed the minimum amount required to offset the distortion caused by the ceiling rule. A curative allocation that exceeds the minimum amount required to offset the effect of the ceiling rule for the appropriate taxable year will always be unreasonable and therefore will lack substantial economic effect. Thus, such curative allocation will be reallocated to each partner's interest in the partnership.

Generally, curative allocations will be reasonable if they are made for the current taxable year. However, curative allocations may be made for the prior taxable year, if such allocations are made over a reasonable period of time, such as the property's economic or useful life, and are provided for under the partnership agreement in effect for the year of contribution of the underlying property.

For curative allocations to have their intended effect, the partnership must have sufficient revenue¹³ to cover the disparity between the property's book and tax values. If the partnership has insufficient reve-

¹² Yes, we are aware that this is an extremely long useful life for a printer, particularly one worth \$500.

¹³ Curative allocations are of revenue and not net income. For the vast majority of busi-

nesses, they are sufficient to eliminate the problem caused by the ceiling rule.

nue, this method has the same ceiling rule issue as the traditional method, and the partnership should consider using the remedial method of allocation.

The remedial method. The remedial method is similar to the traditional method with curative allocations in that it allows partners to cure a ceiling rule distortion by modifying allocations of gross income. However, the key difference between the two is that the traditional method with curative allocations uses the partnership's actual revenue to mitigate the ceiling rule, while the remedial method essentially creates phantom revenue. Phantom revenue is a notional item of income or deduction made up by the partnership to act as gain or loss to permit the use of the full depreciation amount.

Remedial allocations may only be made to partners' tax basis for property, not their book basis because the revenue used to offset the capital accounts is notional, and their only role is to eliminate disparities between book and tax allocations, which, again, is best explained with an example.

Example 4. Recall the facts of Example 2. The only difference is that the partnership is using the remedial method to allocate.

- Step 1: Calculate tax allocation: $\$200 / 10 \text{ years} = \20 per year .
- Step 2: Calculate book allocation – in this scenario, the book allocation will be based off the depreciation of the built-in gain of the property as opposed to its fair market value. The built-in gain is $\$500 - \$200 = \$300$. The book allocation is therefore: $\$300 / 14 \text{ years} = \22 per year (technically it is $\$21.43 \text{ per}$

year but we are rounding up for convenience).

- Step 3: Allocate book amount according to their ownership percentages, equally in our case.
- Step 4: Allocate the tax amount to the non-contributing partner up to his book amount.
- Step 5: Cure any distortion between the non-contributing partner's book and tax amounts by creating a phantom asset which is equally offset by the contributing partner's tax amount.

By using the remedial method to allocate \$1 of phantom revenue to Alma (and create a \$1 phantom expense for Barry) each year, the partnership cures what would have been a \$1 distortion between Barry's tax basis and book basis. In the remedial method, tax allocations will always be available to match book allocations to a noncontributing partner(s) because the partnership is permitted to create phantom revenue.

Alma, Barry, and ACME all end up with nearly the same final amounts in Example 4 as in Example 3. Often, partnerships will achieve the same result by using either the traditional method with curative allocations or the remedial method. There is no difference between the two methods when the partnership has sufficient revenue to cure the ceiling rule problem.

Conclusion

Due to the fact that the Code and Regs permit partnerships to choose the best method of allocation for their partnership, many partners and advisors may have difficulty in knowing which allocation method works best for their partnership's fi-

nancial situation. Partners' ability to apply a combination of the methods also complicates the decision of which method or methods are best.

The traditional method tends to be favored by partners who contributed depreciable or amortizable property with built-in gain because that partner will not have extra allocations of revenue. The traditional method with curative allocations requires sufficient revenue to fully use the amount of depreciation deduction available, thereby making it a more attractive method of allocation to noncontributing partners when a contributing partner's property has a substantial difference between its book value and its tax value. However, the remedial method does not require any gain as it creates phantom revenue to permit the use of the full depreciation amount, and as such it is preferred by partners who contributed cash or property with little to no built-in gain.

The traditional method of allocation allocates built-in loss or gain to the contributing partner over the underlying property's useful life.

The ceiling rule limits a non-contributing partner's total tax depreciation allocation to the amount of that partner's book allocation, which can cause a distortion between a non-contributing partner's tax depreciation allocation and their book allocation due to the limited amount of tax depreciation that can be allocated.

The traditional method with curative allocations allows partnerships to offset the difference between property's book and tax depreciation by reallocating items of partnership gain, which is a "cure" to the ceiling rule.

Exhibit 1

Exhibit 2

Exhibit 3

Exhibit 4