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IRC 704(c) for Tax Counsel: Structuring Partnership Agreements for Contributions of Built-In Gain or Loss Property

Avoiding 704(c) and 737 Gain or Loss Shifting Pitfalls, Navigating Complex Basis Adjustment Rules

TUESDAY, JANUARY 24, 2017

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

Today's faculty features:

Lynn E. Fowler, Partner, **Kilpatrick Townsend & Stockton**, Atlanta

Noel P. Brock, Assistant Professor, **West Virginia University**, Morgantown, W. Va.

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IRC 704(c) for Tax Counsel: Structuring Partnership Agreements for Contributions of Built-In Gain or Loss Property

Noel P. Brock, Assistant Professor, Eastern Michigan University
Lynn Fowler, Kilpatrick Townsend & Stockton LLP, Atlanta, Georgia

January 24, 2017

KILPATRICK TOWNSEND

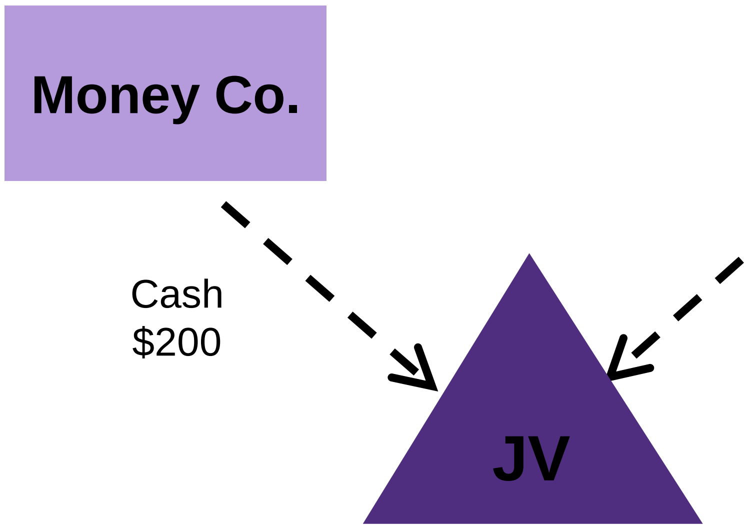
Section 704(c)

- Section 704(c) – generally requires the partner who contributes property other than money to a partnership to recognize any built-in gain or loss inherent in the property at the time of contribution. The rule prevents taxpayers from shifting gains and losses between and among partners.

- Solely deals with allocations for tax (not book) purposes.

- Arises any time either (1) property with a FMV different from its adjusted tax basis is contributed to a partnership or (2) a partnership revalues its assets (generally pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)).

Section 704(c) –



	FMV	ATB
Equipment	$100	$40
Land	100	80
Total	$200	$120

- Land and Equipment are both Section 704(c) property.
- Land (non-depreciable) – book/tax difference accounted for upon disposition.
- Equipment – book/tax difference accounted for through tax allocations of depreciation and gain/loss on disposition.
- OpCo is "contributing partner" and Money Co. is "noncontributing partner."
- All 704(b) Items allocated 50/50

Section 704(c)

Treas. Reg. § 1.704-3 sets forth three nonexclusive methods to eliminate any section 704(c) built-in gain or loss:

1. Traditional
2. Remedial
3. Traditional with Curatives

Must generally track each asset separately on a property by property basis. Limited ability to aggregate.

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Section 704(c) – Traditional Method

- Operative Rule – “Tax follows book”
  - **Noncontributing partner** receives tax allocations equal to its share of book items.
  - **Contributing partner** receives residual tax allocations.
- “Ceiling Rule” limitation
  - If insufficient tax items, noncontributing partners may not receive tax allocations equal to their share of book items.
- Applies to gain or loss from sale of property and to depreciation and/or amortization; generally, does not apply to **income** from the Section 704(c) property.

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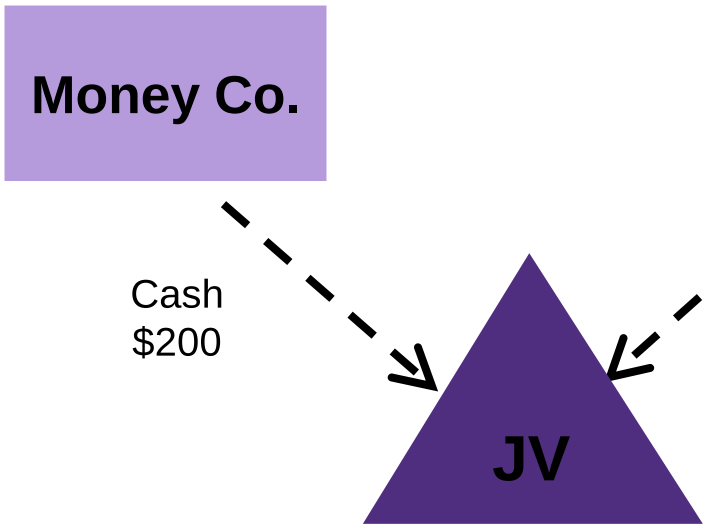
Section 704(c) - Traditional Method

- Step 1: Compute tax item
- Step 2: Compute book item
- Step 3: Allocate book item
- Step 4: Allocate tax to noncontributing partner to the extent of its share of the book item
- Step 5: Allocate residual tax, if any, to contributing/Section 704(c) partner

Section 704(c) – Traditional Method



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- OpCo is "contributing partner" and Money Co. is "noncontributing partner."
- Book depreciation allocated 50-50.

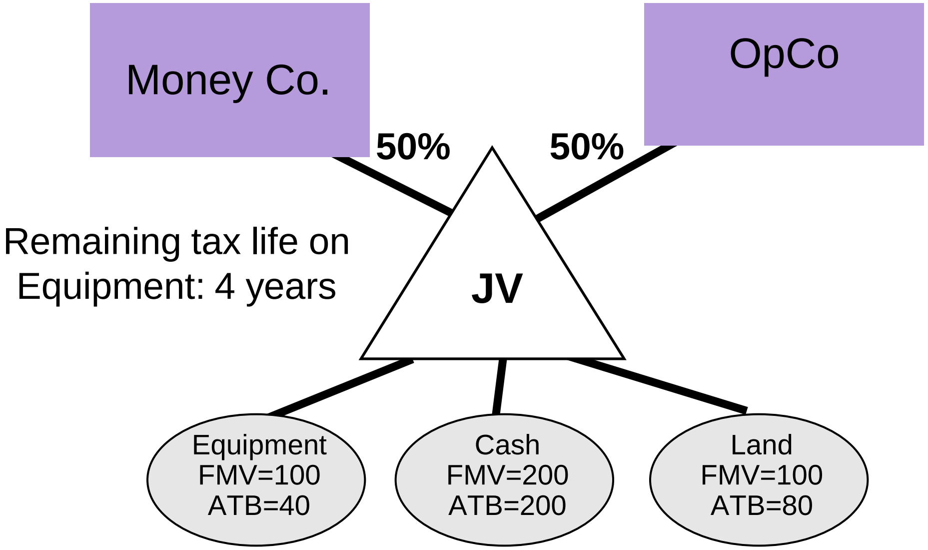
Section 704(c) – Traditional Method

Step One: Compute annual tax depreciation

$40/4 = $10

Step Two: Compute annual book depreciation

$10/$40 x $100 = $25



Step Three: Allocate book depreciation (50-50)

Step Four: Allocate tax depreciation to Money Co. (noncontributing partner) to extent of its share of book depreciation

Step Five: Allocate residual tax depreciation (if any) to OpCo as contributing partner

Section 704(c) – Traditional Method

	Partnership		Money Co.		OpCo	
	Book	Tax	Book	Tax	Book	Tax
Beginning	$100	$40	$100	$100	$100	$40
Year 1	$25	$10	$12.5	$10	$12.5	$0
End Yr 1	$75	$30	$87.5	$90	$87.5	$40
Year 2	$25	$10	$12.5	$10	$12.5	$0
End Yr 2	$50	$20	$75.0	$80	$75.0	$40
Year 3	$25	$10	$12.5	$10	$12.5	$0
End Yr 3	$25	$10	$62.5	$70	$62.5	$40
Year 4	$25	$10	$12.5	$10	$12.5	$0
End Yr 4	$0	$0	$50	$60	$50	$40

The ceiling limitation has prevented us from curing the entire book-tax discrepancy (a $10 discrepancy remains). The ceiling rule also causes the noncontributing partner's book and tax capital accounts to become noncongruent.

Section 704(c) – Traditional Method

- What if adjusted tax basis of equipment at contribution were $50?

	Partnership Book	Partnership Tax	Money Co. Book	Money Co. Tax	OpCo Book	OpCo Tax
Beginning	$100	$50	$100	$100	$100	$50
Year 1	$25	$12.5	$12.5	$12.5	$12.5	$0
End Yr 1	$75	$37.5	$87.5	$87.5	$87.5	$50
Year 2	$25	$12.5	$12.5	$12.5	$12.5	$0
End Yr 2	$50	$25	$75.0	$75	$75.0	$50
Year 3	$25	$12.5	$12.5	$12.5	$12.5	$0
End Yr 3	$25	$12.5	$62.5	$62.5	$62.5	$50
Year 4	$25	$12.5	$12.5	$12.5	$12.5	$0
End Yr 4	$0	$0	$50	$50	$50	$50

- No ceiling rule limitation and we have fully eliminated the book-tax discrepancy, while keeping the noncontributing partner’s capital accounts congruent (book and tax).

Section 704(c) – Remedial Method

Eliminates distortions caused by the ceiling rule by creating remedial tax items and allocating those items to the partners to reduce or eliminate disparities between section 704(b) book and tax items allocated to noncontributing partners under the traditional method.

Step 1: Do standard traditional method allocation (steps 1-5).

Section 704(c) – Remedial Method

- **Step 2**: If the ceiling rule causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of taxable income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner.

- **Step 3**: The partnership simultaneously creates an offsetting item in an identical amount and allocates it to the contributing partner.

Section 704(c) – Remedial Method

Rules:

1. Remedial allocations of income, gain, loss or deduction have the same tax attributes as the tax item limited by the ceiling rule.
2. Remedial items do not affect the partnership’s computation of its taxable income under section 703 or the adjusted tax basis of any partnership property.
3. Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners’ book capital accounts.

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Section 704(c) – Remedial Method

Rules (cont'd):

4. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest.

Now let's see how our original example, with the ceiling limitation, looks if the partnership adopts the remedial allocation method.

Section 704(c) – Remedial Method

	Partnership		Money Co.		OpCo	
	Book	Tax	Book	Tax	Book	Tax
Beginning	$100	$40	$100	$100	$100	$40
Year 1	$25	$10	$12.5	$10	$12.5	$0
Remedial				$2.5		$(2.5)
End Yr 1	$75	$30	$87.5	$87.5	$87.5	$42.5
Year 2	$25	$10	$12.5	$10	$12.5	$0
Remedial				$2.5		$(2.5)
End Yr 2	$50	$20	$75.0	$75	$75.0	$45
Year 3	$25	$10	$12.5	$10	$12.5	$0
Remedial				$2.5		$(2.5)
End Yr 3	$25	$10	$62.5	$62.5	$62.5	$47.5
Year 4	$25	$10	$12.5	$10	$12.5	$0
Remedial				$2.5		$(2.5)
End Yr 4	$0	$0	$50	$50	$50	$50

Section 704(c) – Traditional w/ Curative Allocations Method

- Eliminates distortions caused by the ceiling rule by making reasonable curative allocations to reduce or eliminate disparities between (704(b)) book and tax items allocated to noncontributing partners under the traditional method.
- Curative Allocation = an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item.
  - Tax item must have "same effect" on the partners as ceiling limited item.
  - For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of section 704(c) property, then the partnership may make a curative allocation to that partner of tax depreciation from another . . .

Section 704(c) – Traditional w/ Curative Allocations Method

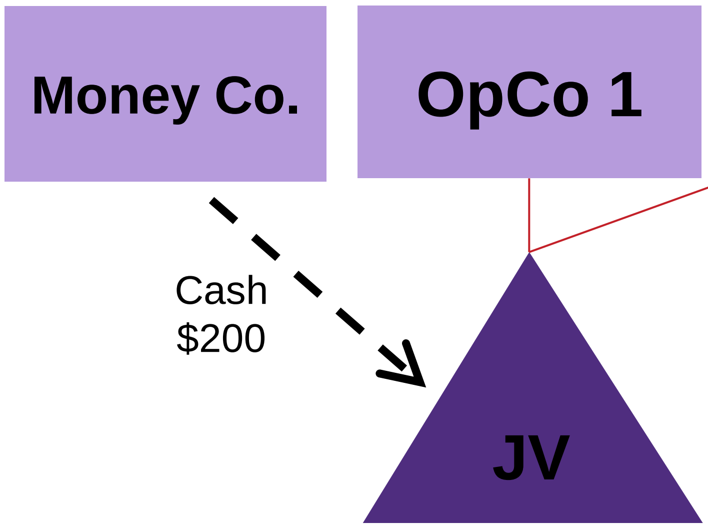
- Curative allocation (cont'd): item of partnership property to make up the difference, notwithstanding, that the corresponding book depreciation is allocated to the contributing partner.

- Generally, the curative allocations are made over the property's remaining tax life. This can result in an enormous tax hit for the contributing partner in a very short period of time.
- Now let's see how our original example, with the ceiling rule limitation, looks if the partnership adopts the traditional with curative allocation method.

Section 704(c) – Traditional w/ Curative Allocations Method

	Partnership		Money Co.		OpCo	
	Book	Tax	Book	Tax	Book	Tax
Beginning	$100	$40	$100	$100	$100	$40
Year 1	$25	$10	$12.5	$10	$12.5	$0
Curative				$2.5		$(2.5)
End Yr 1	$75	$30	$87.5	$87.5	$87.5	$42.5
Year 2	$25	$10	$12.5	$10	$12.5	$0
Curative				$2.5		$(2.5)
End Yr 2	$50	$20	$75.0	$75	$75.0	$45
Year 3	$25	$10	$12.5	$10	$12.5	$0
Curative				$2.5		$(2.5)
End Yr 3	$25	$10	$62.5	$62.5	$62.5	$47.5
Year 4	$25	$10	$12.5	$10	$12.5	$0
Curative				$2.5		$(2.5)
End Yr 4	$0	$0	$50	$50	$50	$50

Section 704(c) –



	FMV	ATB
Equipment	$100	$40
Land	100	80
Total	$200	$120

- Land and Equipment are both Section 704(c) property.
- Land (non-depreciable) – book/tax difference accounted for upon disposition.
- Equipment – book/tax difference accounted for through tax allocations of depreciation and gain/loss on disposition.
- OpCo 1 and OpCo 2 are “noncontributing partners” and Money Co. is “contributing partner.”
- All 704(b) Items allocated 50/25/25

Section 704(c) – Reverse Section 704(c)

- Section 704(c) also arises when a partnership revalues its assets pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(*4*).
- Treated as if each partner contributed an asset with a FMV different from its adjusted tax basis.
- Revaluing capital accounts generally erases minimum gain (because the built-in gain is now tracked under section 704(c)). See Treas. Reg. § 1.704-2(d)(4).

Section 704(c) – Reverse Section 704(c)

- Section 704(c) also arises when a partnership revalues its assets pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(*4*).

- As if each partner contributed an asset with a FMV different from its adjusted tax basis.

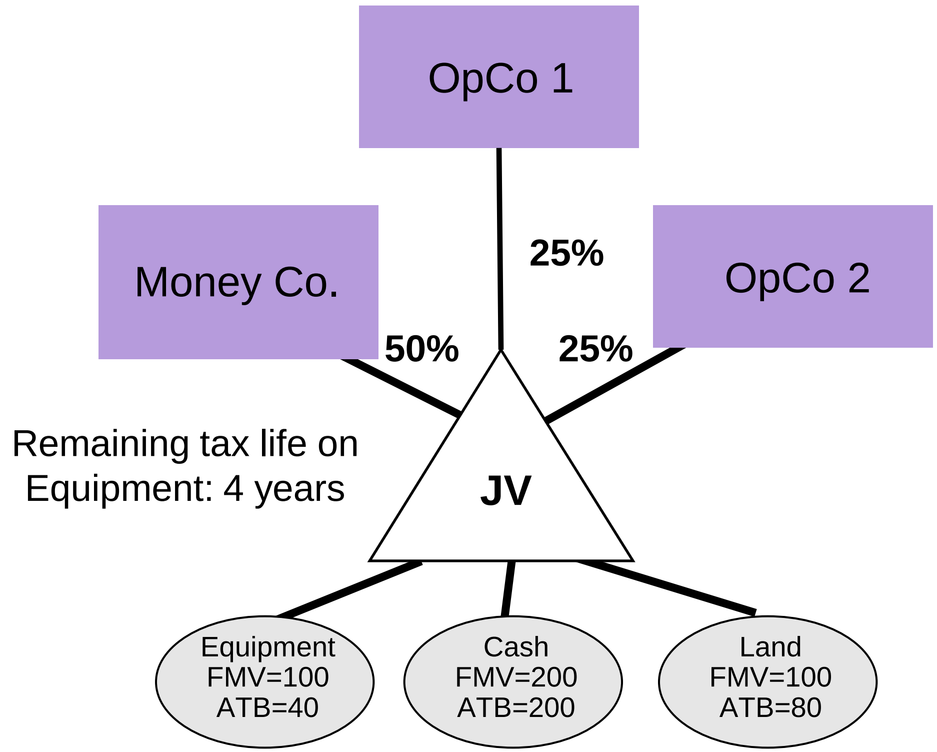
Reverse Section 704(c) – Traditional Method

Step One: Compute annual tax depreciation

$40/4 = $10

Step Two: Compute annual book depreciation

$10/$40 x $100 = $25



Step Three: Allocate book depreciation (50-50)

Step Four: Allocate tax depreciation to Money Co. (contributing partner) to extent of its share of book depreciation

Step Five: Allocate residual tax depreciation (if any) to OpCo 1 and OpCo 2 as contributing partner

Reverse Section 704(c) – Traditional Method

	Partnership		Money Co.		OpCo 1/OpCo 2	
	Book	Tax	Book	Tax	Book	Tax
Beginning	$100	$40	$100	$100	$100	$40
Year 1	$25	$10	$12.5	$10	$12.5	$0
End Yr 1	$75	$30	$87.5	$90	$87.5	$40
Year 2	$25	$10	$12.5	$10	$12.5	$0
End Yr 2	$50	$20	$75.0	$80	$75.0	$40
Year 3	$25	$10	$12.5	$10	$12.5	$0
End Yr 3	$25	$10	$62.5	$70	$62.5	$40
Year 4	$25	$10	$12.5	$10	$12.5	$0
End Yr 4	$0	$0	$50	$60	$50	$40

The ceiling limitation has prevented us from curing the entire book-tax discrepancy (a $10 discrepancy remains). The ceiling rule also causes the contributing partner’s book and tax capital accounts to become noncongruent.

KILPATRICK TOWNSEND

Partnership Agreement Provision – Section 704(c)

Except as otherwise provided in this Section 3.6, each item of income, gain, loss and deduction of the Company for federal income tax purposes shall be allocated among the Members in the same manner as such items are allocated for book purposes under this Article III. In accordance with Code Section 704(c) and the Regulations thereunder, income, gain, loss, and deduction with respect to any Property contributed to the capital of the Company shall, solely for tax purposes, be allocated among the Members so as to take account of any variation between the adjusted basis of such Property to the Company for federal income tax purposes and its initial Gross Asset Value (computed in accordance with the definition of Gross Asset Value) using [state the allocation method to be used pursuant to the Regulations under Section 704(c)].

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Partnership Agreement Provision – Reverse Section 704(c)

- In the event the Gross Asset Value of any Company asset is adjusted pursuant to subparagraph (ii) of the definition of Gross Asset Value, subsequent allocations of income, gain, loss, and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Code Section 704(c) and the Regulations thereunder using [state the allocation method to be used pursuant to the Regulations under Section 704(c)].