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Partnership Property Contributions: The Good, The Bad and the Ugly

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While contributions of real estate or other property to limited partnerships and limited liability companies (LLCs) frequently occur, the tax implications of such contributions are often not fully considered by all partners. The goals of the partner who contributed the property are not to pay tax on the contribution and be treated on the same basis that would occur if the contribution were made only with cash; those goals may sometimes be at odds with the Internal Revenue Service (IRS) as well as the other partners who need to fully consider the tax treatment. The choice of relevant tax elections, as well as actions later taken by the partnership (such as in making preferential cash distributions to the property contributor), can have a meaningful effect on all partners.

Just as in the epoch movie, *The Good, The Bad and The Ugly*, there are three players involved in any property contribution: the property contributor, the other partners, and the partnership although the IRS is also an interested party. The choice of who may be good, bad, or ugly is shaped by each party's perspective; what all parties can agree on is that the tax law resolution of all these competing claims can get ugly (or at least complicated). This article helps to frame these issues so that each partner can hopefully ride off into the sunset with a bounty they can keep, or at least achieve a balanced and supportable resolution of their potentially competing tax concerns.

This article focuses on three broad areas: the good being the rules that can make the property contribution a nonrecognition event to the contributing partner; the bad being the disguised sale rules that can foil an attempt to use the partnership rules to make a taxable sale tax-free; and the ugly being the complex rules to account for the disparity between the tax basis of the contributed property and its fair market value (''FMV'') on date of contribution, which nearly always exists.

THE GOOD: NONRECOGNITION FOR THE PROPERTY CONTRIBUTION

Taxable Sales

As background, if a partner *sells* appreciated property to a partnership in a taxable sale for a purchase price equal to the FMV of the property, the partnership will take a tax basis in the property equal to the purchase price.[1] That tax basis helps determine future depreciation deductions[2] claimed by the partnership, which serve to reduce the partnership's taxable income or generate tax losses. The adjusted tax basis is also used to determine gain or loss[3] on sale of the property, with the partnership's goal of insuring as high a tax basis as possible to lessen tax on sale. If property is purchased by the partnership, the partnership's assets will, however, be depleted by cash paid to the selling partner or burdened by added debt assumed in the purchase (or to which the property is subject).

The selling partner, in turn, will have to pay tax on the sale, with gain generally subject to tax at long-term capital gains rates (except for gain attributable to depreciation recapture that may be subject to higher rates).[4] If the selling partner owns more than a 50% capital interest or profits interest in the partnership

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[1] §1012(a). Unless otherwise stated, references to ''Section'' or ''§'' are to the Internal Revenue Code of 1986, as amended (the ''Code'') and references to ''Reg. §'' are to the Treasury regulations thereunder.

[2] Under §168.

[3] Under §1001(a).

[4] Section 1250 provides that depreciation recapture on the sale

("controlled partnership"), then capital gain treatment on the sale is denied.[5] If the sale is to a controlled partnership, but is at a loss, then §707(b)(1) disallows the loss. In that case, the partnership gets a cost basis in the property, but the partnership can use the disallowed loss to offset any gain on a later disposition of the property.[6]

Tax-Free Property Contributions

If a partner *contributes* appreciated property to a partnership in exchange for an interest in the partnership, then §721(a) creates the general nonrecognition rule that prevents gain from being recognized on the contribution. Likewise, if the property's FMV is less than its tax basis, nonrecognition also applies to prevent loss recognition.[7]

The partnership gets a *carryover* tax basis for the property.[8] For depreciation purposes, the partnership steps into the shoes of the contributing partner and continues to depreciate the property over its remaining recovery period and using the same depreciation method (e.g., straight-line depreciation) used by the contributing partner.[9] In comparison to a FMV basis achieved in a taxable purchase of the property, a carryover basis generates less depreciation deductions and more taxable gain (or a lower taxable loss) on sale of the property.

A person who contributes the property to a partnership in exchange for an interest in the partnership gets a *substituted* basis for the partnership interest received in the exchange, which equals the basis of the contributed property.[10] The capital account of the contributing partner is, however, credited with the FMV of the property on the date of contribution, which is referred to as the Book Value of the property.[11] As a result, there is a difference between the tax basis that the partnership has for the contributed property and the capital account of the partners, which forces the partnership to keep two separate sets of records (i.e., one for the tax basis of its assets and one for the capital accounts of its partners). This different treatment of tax basis and capital account carries over in later years. Each year, the tax basis of the property is used to determine depreciation deductions, which are then used to compute the partnership's taxable income and loss; for capital account purposes, depreciation is based on the Book Value of the contributed asset.[12] When the property is sold, the tax basis of the property determines the taxable gain or loss on sale, but for capital account purposes, gain or loss on the sale of the property is computed based on the Book Value of the property.[13] This article discusses later the impact of §704(c), which was adopted to deal with this disparity between the tax basis and the FMV (or Book Value) of contributed assets on how taxable income, gain, loss and deductions are allocated and computed.

It is understood that partnerships are preferable to corporations, as the income of a partnership is not subject to double tax (i.e., tax at the corporate level and tax on the shareholder when that income is distributed as a dividend to the shareholders).[14] Similarly, the partnership contribution rules are more beneficial than the corporate contribution rules of §351. For a shareholder making a contribution to a corporation, §351(a) affords nonrecognition treatment only to transferors who are in control of the corporation immediately after the contribution. The required minimum 80% stock ownership test[15] oftentimes means that §351 treatment is not available, whereas the partnership contribution rules have no required minimum ownership. Any partner, no matter how big or small, can get nonrecognition treatment on a contribution.

While partners who contribute appreciated property to a partnership desire nonrecognition treatment, the resulting *carryover* tax basis that the partnership has

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of real estate occurs if accelerated methods of depreciation were used. Real estate (other than land) is usually depreciated on a straight-line basis over 27½ years for residential property or 39 years for commercial property. §168(b)(3)(A), §168(b)(3)(B), §168(c). As a result, recapture tax may not be a concern. However, a 25% tax rate applies to long-term capital gain attributable to prior depreciation taken on real estate, which is known as the "unrecaptured Section 1250 gain." §1(h)(1)(E), §1(h)(6)(A).

[5] §1239. Section 1239(c) provides that the §267(c) attribution rules are applied in determining ownership of capital and profits interests, and cover indirect as well as direct sales. Section 707(b)(2) also treats the gain as ordinary income if the property sold or exchanged is not a capital asset to the partnership and the contributing partner owns more than a 50% interest in the capital or profits of the partnership.

[6] §707(b)(1). If there is no subsequent gain to be offset, the disallowance is a deferral of the loss until the liquidation of the interest.

[7] These rules apply regardless of how large or small an interest in the partnership may be owned by the contributing partner. These rules do not, however, apply to the receipt of a partnership interest for services, which can be structured to be tax-free if the partnership interest is a "profits interest" and not a "capital interest" in the partnership. *See* Manning, 711-2nd T.M., *Partnerships — Formation and Contributions of Property or Services*, at III.

[8] §723.

[9] §168(i)(7)(A). As a result, the partnership's annual depreciation deductions match the amounts that the contributing partner would have claimed if that partner had kept the property.

[10] §722. If the contributor already owns a partnership interest, then the outside basis for that interest is increased by the basis of the contributed property.

[11] Reg. §1.704-1(b)(2)(iv)(d)(1).

[12] Reg. §1.704-1(b)(2)(iv)(g).

[13] *Id.*

[14] §701 (a partnership is not subject to tax; rather, the partners pay tax on their share of partnership income and gain).

[15] §368(c).

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for the property disadvantages other partners by producing lower depreciation deductions than would have been allowed if the partnership purchased the property.[16] As discussed later in connection with §704(c),[17] the partnership has to choose one of three tax methods to try to rectify this shortfall in depreciation deductions; this choice can lead to a conflict between the contributing partner and the other partners as to which is best.

Exclusion for Contributions to Partnership Investment Company

Nonrecognition treatment is not allowed on transfers to partnerships that are classified as investment companies.[18] For the reasons set forth below, this restriction should not apply to a partnership that holds real estate.[19]

Section 721(b) does not define a partnership investment company but incorporates, by reference, the definition in the similar corporate provision of §351(e)(1); §351 does not contain a definition of investment company, which is then defined in the regulations.[20] The basic requirement for partnership investment company status is that the partnership is principally used as a vehicle to hold the investment portfolios of its partners. The regulations provide that a partnership is an investment company if, immediately after the receipt of property, more than 80% of the value of its assets: (i) are held for investment purposes and (ii) consist of readily marketable stocks or securities.[21]

Section 351(e)(1)(B) expands the scope of companies that may be investment companies. A partnership can now be an investment partnership if more than 80% of its assets are *any* stock or securities (i.e., stock of a publicly traded or private company), debt, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in regulated investment companies (regulated investment companies or mutual funds) or real estate investment trusts, or interests in entities substantially all of the assets of which are those listed, or, to the extent provided in regulations, interests in other entities. As real estate is not an investment asset under the regulations[22] or §351(c)(1)(B), this investment company limitation does not apply to partnerships that primarily hold interests in real estate or business assets.

A partnership that holds real estate mortgages may, however, be classified as an investment company and get caught by this rule. If a partnership is an investment company, gain is not recognized *unless* the transfer results in ''diversification'' of the transferor's investment assets.[23] Diversification generally occurs when the partners each contribute a different set of assets to the partnership unless the assets contributed are a ''diversified'' portfolio of assets.[24]

Impact If Boot Received in the Contribution (Subject to the Disguised Sale Rules)

As background, in a transfer of property to a corporation under §351, receipt by the contributing shareholder of anything other than stock is ''boot'' that will cause gain to be recognized to the shareholder.[25] Boot can occur in one of two ways: first, the corporation can give the shareholder cash (or other property) in addition to corporate stock;[26] or second, liabilities assumed by the corporation in the contribution exceed the tax basis of the contributed property.[27] In either case, the corporate rules will cause gain realized on the transfer to be recognized up to the amount of the boot.

By contrast, the partnership contribution rules under §721 are more favorable and may result in no taxable gain being recognized by the contributor who gets boot. If property is contributed to a partnership for both a partnership interest and boot, then the transaction may be bifurcated into two transactions: first, there is a nontaxable contribution of property to a partnership; second, there is a distribution of cash under the partnership distribution rules.[28] The boot is treated as a separate distribution on the partnership interest, which is generally tax-free to the extent it does not exceed that partner's outside basis in its partnership interest, as explained below. This treatment as-

[16] Also, more taxable gain (or a lower loss) can result on sale of the property.

[17] See text accompanying notes 83–94.

[18] §721(b).

[19] If a partnership primarily holds real estate mortgages then the partnership may be an investment company, which requires further review.

[20] Reg. §1.351-1(c).

[21] Reg. §1.351-1(c)(1)(ii).

[22] Reg. §1.351-1(c)(1)(ii).

[23] Reg. §1.351-1(c)(1)(i).

[24] Under a de minimis exception, a nominal or insignificant element of diversification is disregarded. Reg. §1.351-1(c)(5).

[25] §351(b).

[26] Reg. §1.368-2.

[27] §357(c). Tax may also result if the property is the corporation assumes the liability for a tax avoidance purpose. §357(b).

[28] *See* Reg. §1.752-1(e), §1.752-1(g) *Ex.* 1; Rev. Rul. 84-15, 1984-1 C.B. 158 (partner contributing encumbered property realizes gain only to extent the net reduction in their share of liabilities exceeds their outside basis for their partnership interest).

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sumes that the transaction is recognized as a contribution and distribution and not as a disguised sale. In 1984, Congress added §707(a)(2)(B), which authorizes the IRS to issue regulations that may recharacterize a contribution of property by a partner to a partnership and a related transfer of money or property to the partner as a taxable sale of the property. The regulations issued under this disguised sale provision are discussed later in this article.

To explain in more detail the treatment of distributions, the corporate rules make a distribution from a corporation taxable as a dividend to the extent of the corporation's current or accumulated earnings and profits (E&P), and once that E&P is exhausted, the excess distribution is first treated as a nontaxable return of basis, and once that basis is exhausted, taxable gain from the sale of corporate stock.[29]

By contrast, the partnership distribution rules provide that, in the case of a distribution by a partnership to a partner, gain shall *not* be recognized to such partner, *except* to the extent that any money distributed exceeds the partner's basis for their partnership interest immediately before such distribution.[30] For this purpose, marketable securities (such as shares of publicly traded stock) are treated as money and taken into account at FMV.[31] Cash distributions are applied to reduce the partner's basis for their partnership interest.[32] Loss is also generally not recognized to a partner receiving a partnership distribution.[33]

If property (other than cash or marketable securities) is distributed to a partner, then the nonrecognition rule will apply to the partner. If the distribution is made not in liquidation of the partner's interest in the partnership then the partner will get a *carryover* basis for the property,[34] and the partner's basis for their partnership interest will be reduced by a like amount.[35] If the distribution is made in liquidation of the partner's interest in the partnership, then the partner will get a *substituted* basis for the property, which equals the basis of their partnership interest. In either case, no gain or loss is recognized to the partnership.[36]

Transfers to Partnerships with Related Foreign Partners

The IRS has regulatory authority under §721(c) to provide for gain recognition on a transfer of appreciated property to a partnership, whether foreign or domestic, that has non-U.S. partners if the built-in gain on the contributed property, when recognized by the partnership, would be shifted to a non-U.S. person. No regulations have yet been published or proposed under this section.

Section 704(c) was added to the Code to ensure that any such built-in gain is allocated to the contributing partner when the property is sold by the partnership as well as allowing for other related adjustments in computing annual income and loss. Regulations promulgated under §704(c) require the partnership to choose one of three methods to make such adjustment, as discussed later in the article.[37]

In Notice 2015-54,[38] issued on August 6, 2015, the IRS stated that it will issue regulations under §721(c) to ensure that when a U.S. person transfers property to a partnership that has foreign partners *related* to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The regulations will provide that §721(a) nonrecognition treatment will not apply when a U.S. transferor contributes property to a partnership, unless the gain deferral method described in the notice is applied regarding the property.[39] The IRS recently indicated that it intends to issue in 2016 proposed regulations under §721(c) that will be retroactive to the August 6 date of the Notice 2015-54. The IRS further indicated that those regulations would mandate the use of one of the §704(c) allocation methods — the remedial method — if a transfer of appreciated property is made to partnerships with related foreign partners.[40]

Usage in Dealing with REITs: The UPREIT Structure

Nonrecognition treatment for property contributions is a valuable tool used by real estate investment trusts[41] (REITs) that want to acquire real estate or partnerships holding real estate. The sellers oftentimes

[29] §301(c)(1), §301(c)(3).

[30] §731(a)(1).

[31] §731(c).

[32] §733(1). Likewise, the FMV of marketable securities will also reduce the basis of the partner's interest.

[33] §731(a)(2). Loss can result if the partner only receives cash in liquidation of its partnership interest and the cash is less than its tax basis in its partnership interest.

[34] §732(a)(1).

[35] §733(2).

[36] §731(b).

[37] See text accompanying notes 83-94.

[38] 2015-34 I.R.B. 210.

[39] The regulations will include a de minimis rule under which §721(a) (if otherwise applicable) will continue to apply in specified circumstances described in the notice.

[40] L. Sheppard, *Outbound Partnership Transfer Regulations Coming*, 2015 Tax Notes Today 235-1 (Dec. 8, 2015).

[41] A REIT is a corporation that meets the requirements of §856. A REIT is taxed as a corporation but gets deductions for dividends it pays to its shareholders that meet certain requirements so that

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similarly want nonrecognition treatment. While those sellers may be concerned about holding a partnership interest that may not be marketable or easily converted into cash, those sellers find it beneficial to get a partnership interest that can be converted into an interest in a publicly traded REIT whose stock is a liquid asset that can easily be sold for cash.

Many REITS utilize an Umbrella Partnership REIT (UPREIT) structure where they cannot issue their stock in a tax-free transaction. In an UPREIT structure, a REIT will form an ''umbrella partnership'' through which the REIT owns all of its properties. Partners in the partnership (other than the REIT) may be entitled to distributions equal to the distributions on the stock of the REIT. In order to give the partners liquidity, the partnership agreement provides each partner with a ''put'' right entitling the partner to receive stock of the REIT or cash determined by the trading price of the REIT stock. Upon exercise of the put right, the contribution of the partnership interest to the REIT in exchange for REIT stock would be a taxable event. As a result, individual investors may desire to not convert into REIT stock during their lifetime; at death, their heirs get a step up in tax basis for the partnership interest so that a conversion into REIT stock after death, while taxable, will generate little or no tax liability.

Publicly traded REITs that desire to acquire a partnership holding real estate can utilize the UPREIT structure. The partners could contribute their interests in their partnership (or their partnership could transfer its assets) to a new (or existing) partnership controlled by the REIT (i.e., the UPREIT partnership) in exchange for partnership interests. This transfer should be tax-free as a contribution to capital under §721. The partnership agreement would reflect the economic arrangement of the parties and entitle the partners to receive the amounts they would have received if they had instead received an interest in the REIT. When the partners decide to sell their interests in the UPREIT partnership, they could put those interests to the partnership and receive cash or convert into stock in the REIT, which they could then sell in the public market.

THE BAD: DISGUISED SALES

Possible Use of Partnership Rules to Avoid Taxable Sales

A partner that wants to sell property to a partnership *solely* for cash, but in a tax-free manner, may try to assert that their sale for cash should actually be subdivided or converted into two separate transactions: first, a contribution of property subject to the general partnership nonrecognition rules; second, a cash distribution from the partnership, which is subject to the partnership distribution rules and is not taxable because it does not exceed the partner's basis for their partnership interest.

To illustrate the potential tax planning opportunity if the partnership tax rules are strictly applied, a partner owning property with a $40 tax basis wants to sell the property to the partnership for $100 cash; such sale will generate $60 of taxable gain (i.e., $100 sale price minus $40 basis), but that partner does not want to pay tax on such sale. That partner has a tax basis in its partnership interest of $60. As a possible tax planning opportunity, that partner could try to bifurcate the sale into two separate transactions under the general rules discussed above: (1) a contribution of the property to the partnership, followed by (2) a later $100 cash distribution from the partnership to the partner. If those two steps are not collapsed together under the step-transaction doctrine and are respected as creating two separate steps, then the following will occur: first, the contribution of property is nontaxable and that partner's outside basis in its partnership interest is increased by $40 (i.e., its basis in the contributed property) so the partner's outside basis now equals $100; second, the $100 cash distribution is not taxable because it does not exceed the outside basis for that partner's interest in the partnership, which outside basis is decreased to zero after the distribution. Through technical application of the partnership tax rules, the partner now has $100 cash and no tax liability. The IRS can always try to assert application of the step-transaction doctrine to collapse these two steps together so as to find a taxable sale, but the step-transaction doctrine is a subjective test the outcome of which is always uncertain, and its application ties up the use of IRS auditors who are already overworked and understaffed.

Disguised Sale Regulations

In 1984, Congress added §707(a)(2)(B), which authorizes the IRS to issue regulations that may recharacterize a contribution of property by a partner to a partnership and a related transfer of money or property to the partner as a taxable sale of the property. Disguised sale regulations have been issued to give guidance in this area.[42] There are different rules that apply if the contribution and distribution are simultaneous or nonsimultaneous (i.e., occur on different days).

Simultaneous contributions and distributions are disguised sales if, based on the facts and circum-

corporate level tax on the REIT can be eliminated. §857(b).

[42] Reg. §1.707-3

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stances, the transfer of money or other consideration by the partnership to the partner would not have been made "*but for*" the partner's transfer of property to the partnership.[43] The facts-and-circumstances test includes a list of 10 factors to be taken into account on the date of the earliest of the transfers (i.e., the earlier of the transfer of property by a partner to the partnership, or the transfer of money or other consideration by the partnership to the partner).[44] In the foregoing example, if (1) all steps occur on the same day, (2) the cash distribution was conditioned on the property contribution and equaled the FMV of the contributed property, and (3) the partner's interest in the partnership did not increase due to the transfer, then the partner would be treated as selling *all* the property for $100 cash and would recognize $60 of gain.[45]

However, what happens if a partner contributes property (with a FMV of $100 and a tax basis of $40) for a combination of cash (such as $20) and an additional interest in the partnership (such as an interest worth $80) — How much gain does the partner recognize? Where the amount of the boot is less than the FMV of the contributed property, the disguised sale regulations *bifurcate* the transaction into (1) a part taxable sale and (2) a part tax-free property contribution, based on the relative amount of consideration received in the transaction.[46] For the part taxable sale, 20% of the property (that is, $20 cash divided by $100 FMV) is treated as sold for $20 cash, and 20% of the tax basis of the property or $8 is allocated to that sold property; as a result, the contributor recognizes $12 of taxable gain.[47] For the part tax-free contribution, $80 of property with a tax basis of $32 is contributed to the partnership.

Nonsimultaneous contributions and distributions are considered a disguised sale if based on the facts and circumstances,[48] the later transfer is not dependent on the *entrepreneurial risk* of partnership operations.[49] To make this rule easier to apply, there are two rebuttable presumptions for determining whether nonsimultaneous transfers are a disguised sale: (i) if the transfers occur within a *two-year period* (regardless of the order in which the transfers occur), the transfers are presumed to be a disguised sale unless the facts and circumstances establish otherwise;[50] and (ii) if the transfers occur *more than two years apart* (regardless of the order in which the transfers occur), the transfers are presumed not to be a disguised sale unless the facts and circumstances clearly establish otherwise.[51]

The regulations do not provide for transactions that involve installment payments, whether completed within two years or after two years. In the absence of guidance, taxpayers who want to avoid disguised sale treatment should consider providing that all distributions are made after two years.

The transferring partner is required to disclose distributions within two years that are not considered part of a disguised sale by attaching Form 8275 to its income tax return for the year of the transfer.[52]

There are several exceptions to the disguised sale rules in the regulations that can be very helpful.

Exception #1: Reasonable Preferred Returns & Guaranteed Payments

When partners contribute cash or property to a partnership, partnerships often provide for a preferred cash distribution (or preferred return as it is often called) to the contributor before other distributions are made to the partners. For example, in a limited partnership where only the limited partners contribute cash to the partnership, the partnership agreement may provide that cash flow from operations (i.e., rental of the real estate) is first distributed to the limited partners until they receive an amount equal to five percent (5%) of their invested capital and second, all remaining cash flow is distributed 80% to the limited

[43] Reg. §1.707-3(b)(1)(i).

[44] Reg. §1.707-3(b)(2). The 10 factors are generally: (i) the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of the earlier transfer; (ii) the transferor has a legally enforceable right to the subsequent transfer; (iii) the partner's right to receive money is secured; (iv) any person has made contributions to the partnership in order to permit the partnership to make the transfer of money; (v) any person has loaned the partnership money necessary to permit it to make the transfer; (vi) the partnership has incurred debt to acquire money necessary to permit it to make the transfer; (vii) the partnership holds money, beyond the reasonable needs of the business, that are expected to be available to make the transfer; (viii) the partnership distributions, allocation or control of partnership operations is designed to exchange the benefits and burdens of property ownership; (ix) the transfer of money is disproportionately large in relation to the partner's long-term interest in the partnership profits; and (x) the partner has no obligation to return or repay the money to the partnership, or has such an obligation but it is unlikely to become due at a distant point in the future as to have a small present value.

[45] A potential exception would be if the cash is to reimburse the partner for development expenses. *See Park Realty Co. v. Commissioner*, 77 T.C. 412 (1981) (cash distribution to reimburse development expenses for land contributed is not disguised sale; cash treated as partnership distribution), *acq.*, 1982-2 C.B. 2.

[46] *See* Reg. §1.707-3(f) *Ex.* 1.

[47] This result is still more beneficial than the treatment under the corporate rules, which would cause $20 of gain to be recognized under §351(b).

[48] Reg. §1.707-3(b)(2).

[49] Reg. §1.707-3(b)(1)(ii).

[50] Reg. §1.707-3(c)(1).

[51] Reg. §1.707-3(d).

[52] Reg. §1.707-3(c)(2), §1.707-8.

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partners and 20% to the general partner, which is part of the carried interest given to the general partner. If the limited partners invested $100 and in the first year and there is $8 net cash flow, then the first $5 of cash flow (i.e., 5% of $100 invested capital) is distributed to the limited partners, and of the remaining $3 of cash flow, $2.40 (i.e., 80% of $3) is distributed to the limited partners and $.60 (i.e., 20% of $3) is distributed to the general partner.

These preferred return cash flow distributions may be sheltered from full taxation by depreciation deductions claimed by the partnership. However, preferred returns (such as the 6% preferred return discussed above), guaranteed payments and cash flow distributions can also be caught by the disguised sale regulations. If property is contributed to a partnership, a preferred return or other payment made within two years after the date of contribution can get caught by the presumption that it is being made for the transfer of property and thus, is subject to taxation under the disguised sale rules.

The regulations, however, provide that a guaranteed payment for capital is presumed to *not* be part of a disguised sale if it is *reasonable*.[53] In a similar vein, a transfer of money to a partner that is characterized by the partnership as a preferred return and is *reasonable* is presumed *not* to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.[54] A guaranteed payment or a preferred return on unreturned capital is considered reasonable if it is a rate equal to or less than 150% of the highest applicable federal rate (AFR), at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year.[55]

The AFR is modified monthly and released by the IRS.[56] In the case discussed above, if the right to preferential cash distributions first arose in January 2014, then the highest AFR since January 2014 was the long-term AFR for February 2014, which was 3.56% compounded annually;[57] because 150% of that AFR is 5.34%, the preferred return is reasonable under the safe harbor. However, the AFRs have not been very high in recent years, as this example demonstrates, so a preferred return that does not look very aggressive (such as a 6% rate) may not satisfy the safe harbor.

Exception #2: Reimbursement of Pre-formation Capital Expenditures

Before a contribution of property, the partner may have incurred capital expenditures to improve the property (such as installing drainage on raw land intended to be developed). After the contribution is made, the partnership may want to reimburse the partner for such expenses by making a special cash distribution to the partner equal to the pre-formation capital expenditures. However, that cash distribution can get caught by the disguised sale rules because it is made within two years after the contribution.

The regulations offer an exception to disguised sale treatment for cash distributions that reimburse the partner for capital expenditures (1) that were made by the partner within the two-year period preceding the date of contribution and (2) that were made for the property contributed to the partnership, but only to the extent the reimbursement does not exceed 20% of the FMV of such property on the date of contribution.[58] Any distribution exceeding the 20% threshold is, however, subject to the disguised sale rules. This disguised sale exception also applies to a distribution to reimburse the partner for partnership organization and syndication expenses (with no dollar limitation).[59]

Exception #3: Contributed Partner Qualified Liabilities

Sometimes, property contributed to a partnership is subject to a nonrecourse liability or the property may be encumbered by a recourse liability that the partnership may assume in the contribution. Before the contribution, *100%* of those liabilities were allocated to the contributing partner as the sole owner of the property. After the contribution, the contributing partner may be allocated *less than 100%* of such liabilities because those liabilities must now may be allocated among *all* the partners under the rules of §752.[60] As a general rule, a net *decrease* in a partner's individual

[53] Reg. §1.707-4(a)(1), §1.707-4(a)(3). *See* Reg. §1.707(a)(4) *Ex.* 1 (10% guaranteed payment with deduction allocated ratably is reasonable), *Ex.* 2 (guaranteed return not reasonable on complex facts when payable out of cash flow to other partners, and net result is similar to contribution of a ratable share of property and sale of the rest).

[54] Reg. §1.707-4(a)(2), §1.707-4(a)(3).

[55] Reg. §1.707-4(a)(3)(ii).

[56] *E.g.,* Rev. Rul. 2015-25 (AFRs for Dec. 2015).

[57] Rev. Rul. 2014-6 (AFRs for Feb. 2014).

[58] Reg. §1.707-4(d). Prop. Reg. §1.707-4(d) adds certain clarification to this rule. For example, the term ''capital expenditures'' has the same meaning as the term ''capital expenditures'' has under the Code and applicable Treasury regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses that taxpayers elect to treat as capital expenditures. Prop. Reg. §1.707-4(d)(3).

[59] Reg. §1.707-4(d)(2)(i).

[60] The §752 rules differentiate allocation of *recourse* liabilities

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liabilities or in a partner's share of partnership liabilities is considered to be a *deemed* distribution of money.[61] This *deemed* distribution of money can also result in a disguised sale.

To eliminate taxation where liabilities were not originally incurred with thought of doing a disguised sale,[62] the regulations provide for special treatment for *qualified* liabilities as compared to *other* liabilities.[63] A decrease in the contributing partner's share of qualified liabilities does *not* generally result in a disguised sale,[64] whereas a decrease in such partner's share of other liabilities is presumed to be part of a disguised sale.

Qualified liabilities of a partner are liabilities:

(i) incurred more than two years prior to the transfer of property to the partnership and that have encumbered the property throughout that two-year period;

(ii) not incurred in anticipation of the transfer of property, even though they are incurred within the two-year period prior to the transfer date, and that have encumbered the transferred property since they were incurred;

(iii) allocable to capital expenditures with respect to the property; or

(iv) incurred in the ordinary course of a trade or business in which such property was used, but only if all the assets of the trade or business are transferred to the partnership (other than assets that are not material to a continuation of the trade or business).[65]

Recourse liabilities assumed by the partnership are not qualified liabilities to the extent they exceed the fair market value of the property transferred.[66]

To illustrate application of these rules, consider the AB Partnership that was formed with A and B as equal partners (that is, each is a 50% partner). A contributed $500K cash to the partnership, and B contributed land with a gross FMV of $650K but subject to a nonrecourse liability of $150K to the partnership or a net FMV of $500K; the nonrecourse liability arose six months before the transfer. A's capital account is $500K, and B is treated as contributing property having a net FMV of $500K, which is credited to B's capital account. The land has a tax basis of $75K, and B does not want to recognize gain on the contribution under the disguised sale regulations.

If the cash borrowed under nonrecourse liability was used by B for making capital improvements to the land, then the liability is a qualified liability and the contribution is not affected by the disguised sale rules.[67] However, if the cash was used by B to acquire a Bentley since B needed a new car or used for anything other than the contributed property then the liability is not a qualified liability and the disguised sale rules apply. In that case, as A is a 50% partner, one-half of the nonrecourse liability (that is, $75K) that is allocated to A after the contribution would likely be a deemed cash distribution to B that would result in a taxable sale of *part* of the land to the partnership. The reason for this being a partial sale is that B received both a deemed cash payment of $75K and a partnership interest worth $500K, with the partnership interest being treated as not taxable to B.[68]

Sometimes, tax planners may try to avoid the disguised sale rules by reducing the contributing partner's share of liabilities at a *future* date after the contribution is made. To stop these attempts, the regulations provide that a partner's share of a liability assumed or taken subject to by a partnership is determined by taking into account certain subsequent reductions in the partner's share of the liability. A subsequent reduction in a partner's share of a liability is taken into account if (i) at the time that the partner-

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as compared to *nonrecourse* liabilities. Recourse liabilities are generally shared among the partners in accordance with how they share the ''economic risk of loss'' if there is a default on that loan and they must come out of pocket to repay the loan. Reg. §1.752-2(a). By contrast, no partner ever has to repay a nonrecourse loan; the lender's only recourse is against the property and not the partners. As a result, nonrecourse liabilities are generally allocated among the partners in the same way that they share in partnership profits because those profits are to be used to repay nonrecourse debt. Reg. §1.752-3(a)(3).

[61] §752(b).

[62] For example, the liability is *old and cold* and was incurred with no thought of a disguised sale or even a contribution of the property to the partnership.

[63] Reg. §1.707-5(a). Prop. Reg. §1.707-5(a) adds certain clarifications to these rules.

[64] Reg. §1.707-5(a)(5) contains a special rule that can bring the qualified liability back into the disguised sale equation, *but* only if a disguised sale is found to exist due to other factors (e.g., there is large cash distribution made to that partner at the time of the contribution). Absent this special rule, qualified liability status means that the liability does *not* result in any possible disguised sale treatment.

[65] Reg. §1.707-5(a)(6)(i).

[66] Reg. §1.707-5(a)(6)(ii).

[67] Alternatively, if the nonrecourse liability arose more than two years before the contribution, then it can also be a qualified liability. Reg. §1.707-5(f) *Ex.* 5.

[68] It is only the $75K deemed cash distribution that results in a taxable sale of part of the land. B's total consideration in the transfer is $575K (that is, the sum of the $500K partnership interest and the $75K deemed cash distribution). As a result, B is treated as having sold 13% of the land (that is, $75K divided by $575K) of the land in a taxable sale. The tax basis for the land sold is $9,750 (that is, 13% of $75K), the sale price is the $75K deemed cash distribution, and the taxable gain is $65,250 (that is, $75K minus $9,750).

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ship incurs, assumes, or takes property subject to the liability, it is anticipated that the partner's share of the liability will be subsequently reduced; and (ii) the reduction is part of a plan that has as one of its principal purposes minimizing the extent to which the distribution or assumption of, or taking property subject to, the liability is treated as part of a sale.[69]

Exception #4: Debt-Financed Distributions

Sometimes, partnerships that own real estate may borrow money that is secured by a mortgage on the property and then distribute the borrowed cash to the partners. This debt-financed cash distribution can be a way to distribute cash to the partners in a tax-free manner, for the following reason.

When the partnership incurs a liability for borrowed money, then the partners can *increase* their outside tax basis for their share of the liability.[70] When a partnership distributes cash to a partner, the cash distribution *decreases* the outside basis of that partner,[71] but it is not taxable unless it exceeds the outside basis.[72] In many cases, this debt-financed cash distribution is not be taxable to the partner because the *increase* and *decrease* in the outside basis will match each other. Eventually, the partnership will have to repay the loan, and that repayment will be funded from partnership cash flow and taxable income. As a result, at the time of repayment of the loan, the partner may incur a tax liability, but that may not happen for a long time. Before then, the partner has received the cash tax-free.

The disguised sale regulations can apply to *any* distribution made by the partnership to a partner contributing property to a partnership, including a debt-financed cash distribution. However, the regulations offer an exception that provides that the debt-financed cash distribution will not be subject to the disguised sale rules as long as it does not exceed the partner's share of the partnership borrowing or liability.[73] As this distribution usually matches the liability allocation, this debt-financed cash distribution can usually escape taxation under the disguised sale rules.

Tiered Partnerships

Sometimes, one partnership owns an interest in another, and the other partnership may in turn own an interest in a third partnership. These tiered partnership arrangements add to the complexity in applying these rules. Current regulations offer some special rules dealing with these tiered arrangements,[74] but there are still many unanswered questions. As a result, the IRS has proposed regulations to add more guidance.[75]

THE UGLY: ACCOUNTING FOR THE DISPARITY BETWEEN THE BASIS OF THE PROPERTY AND ITS FMV

The old expression "no good deed goes unpunished" is very appropriate for a partnership that receives property contributed in a nonrecognition transaction; the partnership must grapple with the complexity of §704(c) and §737 that deal with the disparity between the FMV of the property and its tax basis on date of contribution. If property with FMV \$100 and a tax basis of \$20 is sold to the partnership for \$100, then the partnership would get a tax basis in the property equal to \$100, and the seller would recognize \$80 of taxable gain. However, if a partner (Contributing Partner) contributes the property (Contributed Property) to the partnership in a nonrecognition transaction, the Contributing Partner pays no tax on the contribution and the partnership gets a lower carryover basis of \$20 for the Contributed Property. The difference between the FMV or Book Value of the property and the carryover basis reflects built-in gain in the Contributed Property.

For the partnership, the tax impact of built-in gain for depreciable real estate is that each year, the partnership will be claiming less taxable depreciation deductions than would have been allowed if the property had been acquired in a taxable purchase. While the impact of lower depreciation deductions is an acceptable price for the Contributing Partner who escaped taxation on contribution, those lower deductions are detrimental to the other partners (the Noncontributing Partners) who are paying the price of a lower carryover basis. In addition, when the property is sold, the lower tax basis can result in more gain recognition (or a lower taxable loss) at the partnership level, an added tax cost that should only be borne by the Contributing Partner.

Section 704(c) was adopted to deal with this Contributed Property situation and to try to remedy any adverse impact suffered by the Noncontributing Partners when *appreciated* property is contributed to the partnership. Similarly, if *depreciated* property is contributed to the partnership, these rules apply to prevent an unintended advantage that may be obtained by

[69] Reg. §1.707-5(a)(3).

[70] §752(a).

[71] §705(a)(2).

[72] §731(a)(1).

[73] Reg. §1.707-5(b). Prop. Reg. §1.707-5(b) adds certain clarifications to these rules.

[74] Reg. §1.707-5(e).

[75] Prop. Reg. §1.707-5(e)(2).

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the Noncontributing Partners (e.g., greater depreciation deductions allowed by use of the higher carryover basis compared to what would have been allowed if the Contributed Property had been purchased and its basis lowered to its then-FMV).

The §704(c) starting point is based on the fact that, while the partnership gets a carryover tax basis in the Contributed Property, the capital account of the Contributing Partner is credited with the FMV of the property, which is referred to as the Book Value of the property.[76] As a result of this tax basis and book value disparity, the partnership must keep two sets of records: one set of records determines its taxable income, gain, loss and depreciation deductions that are based on tax basis of assets; another set of records determines its book income gain, loss, and depreciation deductions based on the Book Value of assets, which is used in maintaining capital accounts.[77] Tax allocations (based on the tax basis of assets) show up on the partners' K-1s each year and are then included on each partner's tax return. These tax allocations normally also affect the Capital Account, which is increased by taxable income or gain allocated to a partner, and decreased by taxable loss and deductions allocated to a partner. However, for Capital Account purposes, depreciation and gain or loss on sale of the Contributed Property needs to be determined using the Book Value of the Contributed Property and not its tax basis.

For tax purposes, §704(c)(1)(A) deals with this disparity by requiring that depreciation, depletion, amortization, and gain or loss determined for tax purposes with respect to Contributed Property must be shared among the partners in a manner that takes into account the variation between the partnership's adjusted tax basis in the property and the FMV (or Book Value) of the property at the time of contribution. Section 704(c) forces the partnership to keep two sets of records for income tax purposes: one set to determine its overall taxable and loss without regard to §704(c) and another set to keep track of the adjustments required by §704(c) to determine each partner's share of such income and loss.[78]

Contribution of Nondepreciable Property (i.e., Land)

Before we explore the complications of §704(c) for *depreciable* real estate, let's first focus on a contribution of *nondepreciable* property (such as land) to illustrate the impact of §704(c).

Consider a contribution of land to the partnership where the tax basis of the land is less than its FMV (or Book Value) on date of contribution. This land has a built-in gain equal to the excess of its FMV (or Book Value) over its carryover basis. Because land is not a depreciable asset, the disparity between its tax basis and FMV has no impact on computing the operating taxable income of the partnership each year (i.e., no depreciation deductions can be claimed for the land). However, when the land is sold by the partnership, the fact that there was built-in gain on contribution means that the partnership recognizes more taxable gain (or a smaller taxable loss) than it would have recognized if the tax basis were equal to the FMV on date of contribution. As a result, §704(c) requires a special income allocation to the Contributing Partner equal to the lesser of (1) the gain recognized on the sale or (2) the built-in gain that existed on the date of contribution. Any excess gain is allocated without regard to §704(c).[79]

For example, consider the AB Partnership with A and B being equal 50% partners. A (the Contributing Partner) contributes $100 cash, and B (the Noncontributing Partner[80]) contributes land with a FMV (or Book Value) of $100 and a tax basis of $20. The land has a built-in gain equal to $80. Three years later, the land is sold for $160, and the cash is distributed $80 to A and $80 to B. The sale results in recognition of $140 taxable gain (that is, $160 sale price minus $20 carryover basis) to the Partnership, which must be allocated between A and B. Absent §704(c), the $140 gain would be shared equally between A and B, with each being allocated $70 gain.

Pursuant to §704(c), because B contributed the land with a built-in gain equal to $80, $80 of the $140 taxable gain is specially allocated to B under §704(c), and the remaining $60 of taxable gain is allocated equally between A and B so that A is allocated $30 of gain while B is allocated another $30 of gain. As a result, A, the Contributing Partner, recognizes a total of $110 gain from the sale while B, the Noncontributing Partner, recognizes only $30 of gain. For capital account purposes, B was initially credited with a capital account of $100 (and not $20) when the land was contributed to the partnership. As a result, for capital account purposes, the Partnership does not take into account the $140 of taxable gain but rather takes into

[76] Reg. §1.704-1(b)(2)(iv)(d)(1).

[77] Reg. §1.704-1(b)(4)(i).

[78] Recall that the partnership also keeps an added set of records for determining the capital accounts of the partners.

[79] As discussed below, the partnership needs to choose one of three special allocation methods under the §704(c) regulations to deal with the built-in gain. Each of these three methods would result in the same income allocation for gain or loss on the sale of a nondepreciable Contributed Property.

[80] When we call B a Noncontributing Partner, we are ignoring the fact that B contributed cash to the partnership since cash does not cause any built-in gain or built-in loss concerns that trigger §704(c).

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account the book gain (Book Gain) on sale, which is the sale price minus the FMV (or Book Value) on date of contribution, or $60 of Book Gain on the sale. For capital account maintenance purposes, that $60 of Book Gain on the sale is shared equally by A and B.

What happens if the land is sold for a *taxable* gain, but the gain is less than the *built-in gain* at time of contribution? In the prior case in which the land had a FMV of $100 and an $80 built-in gain on contribution, assume the land is sold for only $80, which results in $60 of taxable gain (that is, $80 sale price minus $20 basis). Section 704(c) will specially allocate the $60 gain to B, the Contributing Partner. But what about B's Capital Account, which was booked up to $100 when B contributed the land to the partnership? For capital account purposes, the taxable gain is again ignored with gain or loss computed for capital account purposes by reference to the land's Book Value, which equals its FMV on date of contribution or $100. Because the land was sold for $80, which is less than the land's Book Value of $100, there is actually a $20 Book Loss on the sale, which is shared equally between A and B based on their 50%/50% sharing ratio without regard to §704(c). As a result, A's and B's capital accounts will both be decreased by $10.

What happens if the land is sold for a taxable loss, but the land had built-in gain on its contribution to the partnership? In this case, the taxable loss would be shared by the partners with no special allocation under §704(c). For example, in the prior case, assume the land is sold for $10, which generates a $10 taxable loss. In this case, the $10 taxable loss is allocated between A and B in the regular way so that A is allocated a $5 loss and B is allocated a $5 loss. But what about B's Capital Account, which was booked up to $100 upon contribution of the land? For capital account purposes, the taxable loss is also ignored, with gain or loss computed by reference to the Book Value of the land, which was $100. In this case, there is a $90 Book Loss, which is allocated equally between A and B based on their 50%/50% sharing ratio. As a result, A and B's capital account will both be decreased by $45.

Contribution of Depreciable Property

In the case of the contribution of *depreciable* property (i.e., office building or apartment house), the partnership's annual determination of taxable income, gain, loss and deductions is affected by the depreciation deductions claimed on the property each year. Those depreciation deductions are affected by the built-in gain or built-in loss on the Contributed Property because the depreciation deductions are based on the tax basis of the Contributed Property, which does not equal its Book Value (or FMV) on date of contribution. As a result, the regulations create three reasonable methods for allocating taxable income, gain, loss and deductions among the partners to try to remedy this situation and help the Noncontributing Partners. The partnership must choose one of these three methods.

Before we discuss how these three methods work, let's first discuss what happens if no §704(c) adjustments are required. We then will discuss each of the three methods and show how each of the three methods changes this result.

Consider the newly formed AB Partnership, in which A and B are equal partners so that each has a 50% interest in the partnership. On January 1, 2016, A (the Contributing Partner) contributes property with a FMV of $100 and a tax basis of $40 (the Contributed Property) to the Partnership, and B (the Noncontributing Partner) contributes $100 cash to the Partnership. The Partnership gets a carryover basis for the Contributed Property so the inside basis of the Contributed Property is $40. Assume the Contributed Property is depreciable on a straight-line basis over 10 years and assume that for 2016, a full 10% of the property's basis can be claimed as a depreciation deduction, which is $4 (i.e., 10% of $40). Assume the Partnership uses the $100 contributed cash to purchase property for $100 (Purchased Property), which is also depreciable on a straight-line basis over 10 years. For 2016, the Partnership claims a depreciation deduction for the Purchased Property equal to 10% of its basis or $10 (i.e., 10% of $100). Assume further there is taxable income from the rental of the Purchased Property equal to $20 (ignoring depreciation) but no income from the Contributed Property.

In this case, the Partnership has a net taxable income of $6, which equals the $20 of income from the Purchased Property minus the $4 depreciation deduction for the Contributed Property and the $10 depreciation deduction for the Purchased Property. As A and B are equal partners, ignoring §704(c), A would be allocated 50% of such income, or $3 of income, and B would also be allocated $3 of income. However, if the inside basis of the Contributed Property would have equaled its Book Value of $100, then the depreciation deduction for the Contributed Property would have been $10 (i.e., 10% of $100), which we refer to as the Book Depreciation because it is based on the Book Value of the Contributed Property, and the Partnership would then have shown zero taxable income (i.e., $20 of income from the property minus $10 depreciation deduction for the Purchased Property and $10 depreciation deduction for the Contributed Property). The result of the built-in gain for the Contributed Property is that B, who contributed cash to the Partnership, is disadvantaged because B must report $3 of taxable income rather than zero taxable

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income. This situation is sometimes referred to as the Book-Tax Disparity, as the tax depreciation deductions do not match the Book Depreciations.

Now let's look at the three §704(c) methods available to the partnership to address this Book-Tax Disparity that results from the Built-In Gain[81] for the Contributed Property: (1) the traditional method; (2) the traditional method with curative allocations; and (3) the remedial method.[82]

Method #1: Traditional Method

The traditional method provides that each year, taxable income, gain, loss, and deduction are specially allocated among the partners to *avoid shifting* the impact of the built-in gain (or built-in loss) to the Noncontributing Partners.[83] In other words, the Noncontributing Partners who did *not* contribute the property (i.e., B in our example) will be specially allocated taxable items to match the Book Allocations with the goal being to have the tax depreciation allocated to such Noncontributing Partner equals the Book Depreciation. However, the traditional method is subject to the ceiling rule, which provides that any special allocation of tax depreciation cannot exceed the depreciation deductions claimed for the Contributed Property.[84]

In applying the traditional method, the partnership first determines the depreciation deductions that the partners would get for the Contributed Property based on the property's FMV or Book Value at the time of contribution, which are the Book Depreciation Deductions. After Book Depreciation is determined, the partnership specially allocates to the Noncontributing Partners the tax depreciation deductions up to the amount of their share of the Book Depreciation Deductions for the Contributed Property. Finally, any remaining tax depreciation deductions are allocated to the contributing partner or shared among the partners. The ceiling rule oftentimes reduces the ability to eliminate the Book-Tax Disparity, as shown below.

In this case, the goal is to try to specially allocate to B tax depreciation deductions that B would have been able to take if the inside basis for the Contributed Property were equal to its Book Value and, thus, tax depreciation would equal Book Depreciation. In this case, the Book Depreciation for the Contributed Property is $10 (i.e., 10% of $100) and B gets 50% of that deduction or $5 of Book Depreciation. However, the tax depreciation deduction for the Contributed Property is only $4 (i.e., 10% of the $40 tax basis), which is *less* than the Book Depreciation. The traditional method requires that all of the Tax Depreciation of $4 is specially allocated to B, but due to the ceiling rule, no further special allocation can be made to the Noncontributing Partner.[85] As a result, B, the Noncontributing Partner, would report $1 of taxable income (i.e., B's $10 share of taxable income from the properties minus the $4 special allocation of depreciation deduction for the Contributed Property and the $5 depreciation deduction for the Purchased Property). A, the Property Contributor, would report $5 of taxable income (i.e., A's $10 share of taxable income from the properties minus the $5 of depreciation deduction for the Purchased Property).

While the total taxable income reported by the Partnership is still $6, the traditional method provides that this income is no longer shared equally by the partners with more of that income allocated to A (the Contributing Partner). However, B (the Noncontributing Partner) is still *not* in the same position that B would have been in if the inside basis of the Contributed property were equal to its Book Value, which would have resulted in zero taxable income allocated to B.

Method #2: Traditional Method with Curative Allocations

The traditional method with curative allocations also provides that each year, taxable income, gain, loss, and deduction are specially allocated among the partners to *avoid shifting* that the impact of the built-in gain (or built-in loss) to the Noncontributing Partners.[86] As a result, the Noncontributing Partner (i.e., B in our example) will be specially allocated taxable items to match the Book Allocations with the goal being to have the tax depreciation allocated to such Noncontributing Partner equals the Book Depreciation.[87]

Most importantly, this method is *not* subject to the ceiling rule, and specifically adds a *curative provision*

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[81] A built-in loss for the Contributed Property (i.e., its FMV on date of contribution exceeds its tax basis) also results in a Book-Tax Disparity, but in this case, the Tax Depreciation exceeds the Book Depreciation. All the methods discussed above apply to a built-in loss situation as well.

[82] Reg. §1.704-3.

[83] Reg. §1.704-3(b).

[84] On a sale of the Contributed Property, the traditional method will specially allocate taxable gain equal to the Built-in Gain to the Property Contributor. However, §704(c) adjustments are also needed each year in allocating taxable income, gain, loss and deductions since tax depreciation is claimed for the Contributed Property (as discussed above). As a result of the annual Book Depreciation for the Contributed Property used in these computations, the Built-in Gain on the sale will be reduced each year to account for these depreciation deductions on the Contributed Property.

[85] Because no more tax depreciation deductions exist for the Contributed Property, A is allocated no tax depreciation deductions for the Contributed Property.

[86] Reg. §1.704-3(c).

[87] On a sale of the Contributed Property, the traditional method

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that allows the partnership to specially allocate depreciation deductions from *other* partnership properties to make the Noncontributing Partner whole.[88] As a result, this curative provision allows the partnership to specially allocate to the Noncontributing Partner tax depreciation deductions from *all* partnership properties that match the Book Depreciation such partner gets from the Contributed Partner.

In this case, B gets 50% of Book Depreciation or $5 of Book Depreciation from the Contributed Property. All of the tax depreciation of $4 from the Contributed Property is specially allocated to B, but that still leaves B with $1 of Book Depreciation for which comparable tax depreciation deductions has not been specially allocated to B.[89] As a result, the Partnership makes a curative allocation by specially allocating $1 of taxable depreciation for the Purchased Property to B, which now means there has been a cumulative special allocation of $5 of tax depreciation to B, and then the partnership allocates the remaining $9 of depreciation deductions for the Purchased Property (i.e., $10 depreciation deduction minus the $1 special allocation) equally between A and B (i.e., they each get a $4.50 depreciation deduction for the Purchased Property). B would now report $.50 of taxable income (i.e., B's $10 share of taxable income from the properties minus the $4 special allocation of depreciation deduction for the Contributed Property, the $1 special allocation of depreciation deductions for the Purchased Property, and the $4.50 regular allocation of depreciation deduction for the Purchased Property). A, the Property Contributor, would report $5.50 of taxable income (i.e., A's $10 share of taxable income from the properties minus the $4.50 of depreciation deduction for the Purchased Property).

While the total taxable income reported by the partnership is still $6, the traditional method with curative allocations provides that this income is no longer shared equally by the partners. While B is in a better position than by use of the traditional method, B is still *not* in the same position that B would have been in if the inside basis of the Contributed property were equal to its Book Value, which would have resulted in zero taxable income being allocated to B.

Method #3: Remedial Method

The remedial method starts with the traditional method so that it provides that each year, taxable income, gain, loss and deduction are specially allocated among the partners to *avoid shifting* that the impact of the built-in gain (or built-in loss) to the Noncontributing Partners.[90] As noted in the discussion of the traditional method, the Noncontributing Partner (B in our example) will be specially allocated taxable items to match the Book Allocations with the goal being to have the tax depreciation allocated to such Noncontributing Partner equal the Book Depreciation.[91] However, in applying the remedial method, the determination of Book Depreciation is determined differently than that used for the traditional method. The Book Depreciation under the remedial method is modified to match the additional tax depreciation the Partnership would have gotten if the Partnership purchased the Contributed Property, which complicates the comparison of the three methods.[92]

The traditional method was subject to the ceiling rule, which can limit its usefulness, and the remedial method is also subject to the ceiling rule. However, the remedial method adds a unique way to cure the problem caused by the ceiling rule. If the ceiling rule does not eliminate the Book-Tax Disparity (as it prevents allocating tax depreciation to the Noncontributing Partner equal to the Book Depreciation), then the remedial method *creates* (1) added or *notional* depreciation deductions for the partnership to specially allocate to the Noncontributing Partner, which is offset by (2) added or *notional* taxable income allocated to the Contributing Partner for that same year. In particular, the partnership *creates* (1) a remedial allocation of *notional* depreciation deductions allocated to the Noncontributing Partner equal to the excess of the Book Depreciation they get over the tax depreciation spe-

can specially allocate the Built-in Gain to the Property Contributor, but §704(c) adjustments are also needed each year when depreciation is claimed for the Contributed Property.

[88] The curative allocation must be reasonable. A curative allocation is reasonable (1) only up to the amount necessary to offset the effect of the ceiling rule (i.e., only up to the amount necessary to make the tax allocations to the Noncontributing Partner equal to its Book Allocation) for the current taxable year, and (2) only if it is made using a tax item that must be expected to have substantially the same effect on each partner's tax liability as the tax item affected by the ceiling rule. Reg. §1.704-3(c)(3)(i), §1.704-3(c)(3)(iii)(A).

[89] As no more tax depreciation deductions exist for the Contributed Property, A is allocated no tax depreciation deductions for the Contributed Property.

[90] Reg. §1.704-3(d).

[91] On a sale of the Contributed Property, the traditional method can specially allocate the built-in gain to the Property Contributor, but §704(c) adjustments are also needed each year when depreciation is claimed for the Contributed Property.

[92] Reg. §1.704-3(d)(2). Under the remedial method, the Partnership must bifurcate its Book Basis in the Contributed Property that is used to compute Book Depreciation: the portion of the Book Basis in the Contributed Property equal to its tax basis at time of contribution is depreciated over the remaining recovery period for the property at the time of contribution; the excess of the Book Basis over tax basis is recovered under any recovery period the Partnership can use for newly purchased property of the same type. By contrast, the Book Depreciation under both traditional methods use only the remaining recovery period for the property.

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cially allocated to them under the traditional method (as limited by the ceiling rule), and (2) a simultaneous, offsetting remedial allocation of *notional* income to the Contributing Partner.[93] For the partnership, the two remedial allocations offset one another, so there is no change in total partnership income. Remedial allocations do not actually affect the partnership's computation of its taxable income or affect the partnership's tax basis in partnership property, but remedial allocations do create added *notional* deductions and income that affect the partners.[94]

In the case discussed under the other two methods, the tax depreciation for the Contributed Property is $4, but the Book Depreciation under the traditional method was $5. However, as noted above, the Book Depreciation used under the remedial method is computed under a different method than that used for the traditional method, and must first be determined before the remedial method can be applied.

To illustrate the effect of remedial allocations, consider what happens if the remedial Book Depreciation allocable to the Noncontributing Partner is still $5. In that case, all of the $4 of tax depreciation deduction from the Contributed Property is allocated to the Noncontributing Partner and then to account for the excess Book Depreciation of $1 (i.e., $5 Book Depreciation minus $4 of specially allocated tax depreciation), the partnership would (1) allocate $1 of *notional* tax depreciation to the Noncontributing Partner and (2) allocate $1 of *notional* income to the Contributing Partner. As a result, the Noncontributing Partner now gets $5 of depreciation deductions relating to the Contributed Property while still getting 50% of the total depreciation deductions for the Purchased Property. However, the Contributing Partner is treated more harshly and incurs an added $1 of taxable income.

Next consider what happens if the remedial Book Depreciation allocable to the Contributing Partner is only $4. In that case, the remedial method does not improve the result under the traditional method, as they both specially allocate the $4 of tax depreciation for the Contributed Property. In fact, the remedial method will likely produce less of a benefit to the Noncontributing Partner compared to the traditional method with curative allocations, which can specially allocate other depreciation deductions to the Noncontributing Partner to cure the Book-Tax disparity.

As a general observation, the use of a different Book Depreciation for the remedial method as compared to the Book Depreciation used under both the traditional method and the traditional method with curative allocations complicates the comparison of the three methods and may make it look like the advisor is comparing ''apples with oranges.'' As a result, tax projection models may be needed to run under each of the three methods to determine their actual impact on the Noncontributing Partners and the Contributing Partner.

The partnership needs to choose one of the three §704(c) methods and the view of which one to adopt is usually different for the Contributing Partner as compared to the Noncontributing Partners. The choice of which method requires consultation with the partnership's tax advisors, attorneys, and accountants, and as noted above, preparation of sample projections of what taxable income, gain, loss, and deduction may be in the future and how each method may change how those items are allocated among the partners. That task is difficult, but it is oftentimes the best way to compare the impact of each of these three methods.

Impact of Later Property Distributions

Even if an initial property contribution is nontaxable to the Contributing Partner, there are two sets of rules that must be considered if the Contributed Property is later distributed to other partners or the partnership distributes other property to the Contributing Partner. If property contributed by a partner to a partnership is distributed to another partner within seven years of its contribution to the partnership, any pre-contribution gain or loss is recognized by the partnership and allocated to the contributing partner.[95] If a partner contributes appreciated property to a partnership and, within seven years of the contribution, the partnership distributes other property to the contributing partner, the contributing partner is required to recognize gain to the extent of the lesser of (i) the net pre-contribution gain on the Contributed Property, or (ii) the excess of the value of the distributed property (other than money) over the Contributing Partner's outside basis in its partnership interest (reduced, but not below zero, by the amount of money received in the distribution).[96]

CONCLUSION

Contributions of property to a partnership are fraught with complexity. Review of the tax results is needed by all partners and the partnership *before* the contribution is made to ensure that fair tax treatment is received by all. Tax efforts to use a property contri-

[93] Reg. §1.704-3(d)(1). A remedial allocation must be reasonable and thus, is only permissible to the extent it equals the amount necessary to offset the effect of the ceiling rule for that taxable year and only if it has the same tax attributes as the tax item limited by the ceiling rule. *See also* Reg. §1.704-3(d)(3).

[94] Reg. §1.704-3(d)(4)(i).

[95] §704(c)(1)(B).

[96] §737. *See* Reg. §1.737-1(a).

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bution to convert a taxable sale into a tax-free transaction need to be taken with careful planning given the complex tax rules created to halt such efforts. To paraphrase Dirty Harry, a taxpayer has to know his limitations. In the end, the tax advisor may share the role of being the good, the bad, and the ugly in ensuring that the property contribution is tax-free, advising the client that their efforts to use that as a device to avoid paying tax may need to be modified to stand up on audit, and explaining the difficult choices the partnership must make with respect to the contributed property.

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