Understanding Section 704(C) (PowerPoint)

Brian J. O'Connor

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Understand Section 704(c)

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BRIAN J. O’CONNOR co-chairs the Tax and Wealth Planning Group for the Washington, D.C. based law firm of Venable LLP. Mr. O’Connor practices in the areas of partnership, corporate, real estate and international taxation. Mr. O’Connor also teaches an advanced course on partnership taxation and the drafting of partnership agreements as an adjunct professor at Georgetown University Law Center. He regularly speaks across the country to professional groups on topics relating to business entities and taxation and is the author or co-author of numerous articles relating to business entities and taxation in professional journals and trade publications, including The Journal of Taxation, The Journal of Pass-through Entities, Tax Notes, Tax Management Real Estate Journal and Business Entities. Mr. O’Connor also has acted as a primary participant in the publication of the nationally recognized treatise Tax Planning for Real Estate Transactions. Mr. O’Connor has been regularly selected for The Best Lawyers in America for both Tax Law and Tax Litigation and Controversy and has been regularly included in Maryland Super Lawyers. Further, Mr. O’Connor was recently named a “Tax Lawyer of the Year” for Maryland. Before joining Venable, Mr. O’Connor was an attorney-advisor for the Office of Chief Counsel for the Internal Revenue Service where he participated in high profile legislative projects and drafted regulations and other published guidance relating to pass-through entities. He received his J.D. degree, magna cum laude, from Washington & Lee University and his LL.M. degree in Taxation, with distinction and the program’s highest possible grade point average, from Georgetown University Law Center. Mr. O’Connor is a member of the Virginia, Maryland and District of Columbia Bars as well as the Tax Sections for the Virginia, Maryland and American Bar Associations.
Built-in Gains/Losses: Section 704(c)(1)(A) and (C)
Section 704(c) – Introduction

If basis of contributed property differs from its Section 704(b) “book" value, Section 704(c)(1)(A) requires income, gain, loss, and deduction with respect to such property to be allocated among the partners “so as to take account of the variation between the basis of the property to the partnership and its FMV at the time of contribution.”

Regulations require “a reasonable method that is consistent with the purpose of section 704(c).”

Section 704(c) principles also apply in the context of a Section 704(b) revaluation, or “book-up,” through so-called “reverse section 704(c).”
Interface of Sections 704(b) and (c) – Two Universes

- The purpose of Section 704(b) is to govern the economics - looks to fair market value upon contribution.
- The purpose of Section 704(c) is to prevent taxable gain or loss inherent in property at time of contribution from being shifted to another partner - looks to the difference between adjusted tax basis and fair market value upon contribution.
- Section 704(c) tax allocations are determined after Section 704(b) book allocations are determined.
Section 704(c)(1)(C) – Built-in Losses

• If Section 704(c)(1)(A) property has a built-in loss—
  
  – such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

  – except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.
Example §704(c)(1)(C)

If B sells partnership interest to C, C cannot share in the built-in loss of Asset X, even if no §754 election to step down basis in Asset X. Built-in loss is personal to contributing partner.
Base Example 1

- 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.
- Op. Co. is "contributing partner" and Money Co. is "noncontributing partner."
- Book depreciation allocated 50-50.
Section 704(c) Available Methods

- Traditional method.
- Traditional method with curative allocations.
- Remedial method.
- Other reasonable methods.
Choice of Method – Impact

• Method affects taxable income.

• Partners have adverse interests – negotiate method up front.

• Method chosen more important if property’s depreciable tax basis less than noncontributing partner’s aggregate share of book value (i.e., ceiling rule).

• If parties are in different tax positions, choice of method may result in aggregate tax savings to parties that may be shared (subject to anti-abuse rule).

• Partnership may retain flexibility by: (1) determining the method on a property basis; and (2) waiting until partnership must report a Section 704(c) item on tax return before choosing methods.
Mix and Match Rules

- Different methods allowed for different property.
- Different methods can apply for “forward” Section 704(c) and to each layer of “reverse” Section 704(c) in the same property.
- Must consistently apply method to item of property.
- Overall mix-and-match must be reasonable.
- Aggregation is possible for securities partnerships and a few others Treas. Reg. §1.704-3(e).
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 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.
Five-Step Approach

• Step One: Compute tax item.
• Step Two: Compute book item.
• Step Three: Allocate book item.
• Step Four: Allocate tax to noncontributing partner to the extent of its share of the book item.
• Step Five: Allocate residual tax, if any, to contributing/Section 704(c) partner.
Example 2. Traditional Method – Allocating Depreciation

Step One: Compute annual tax depreciation
\[ \frac{50}{4} = 12.5 \]

Step Two: Compute annual book depreciation
\[ \frac{12.5}{50} \times 100 = 25 \]

Step Three: Allocate book depreciation (50-50)

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

Step Five: Allocate residual tax depreciation (if any) to Op. Co. as contributing partner

<table>
<thead>
<tr>
<th>Partnership</th>
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<th>(50%)</th>
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<tr>
<td>$25.0 $12.5</td>
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<td>$12.5 $0.0</td>
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</table>
Example 3. Traditional Method – Allocating Gain on Sale

Step One: Compute partnership tax gain
$100 - $50 = $50*

Step Two: Compute partnership book gain
$100 - $100 = $0*

Step Three: Allocate book gain (50-50)

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

Step Five: Allocate residual tax gain (if any) to Op. Co. as contributing partner

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<thead>
<tr>
<th>Partnership</th>
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<th>(50%)</th>
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<tbody>
<tr>
<td>Money Co.</td>
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<td>$0.0</td>
</tr>
<tr>
<td>Op. Co.</td>
<td>$0.0</td>
<td>$0.0</td>
</tr>
</tbody>
</table>

*Note, over time § value and tax basis will decrease due to depreciation.
Ceiling Rule

• **The Rule:** Total income, gain, loss or deduction allocated to noncontributing partners with respect to contributed property may not exceed total partnership income, gain, loss or deduction recognized by partnership with respect to that property for the taxable year (the ceiling rule).

• **Impact:** To the extent that tax items allocated to a noncontributing partner fall short of matching book items allocated to it, a portion of the built-in gain or loss is shifted to such partner.
Ceiling Limitation

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 book

Step Five: Allocate residual tax depreciation (if any) to Op. Co. as contributing partner

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<tr>
<td>$25.0 $10.0</td>
<td>$12.5 $10.0</td>
<td>$12.5 $0</td>
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Remaining tax life on Equipment: 4 years
Traditional Method With Curative Allocations
Addressing Ceiling Limitations

• This method is designed to help correct distortions created by ceiling rule.

• Partnerships may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of non-contributing partners.

• Same 5-step process as traditional method followed except that tax items (gain/loss/depreciation) from other property are used to make up for some or all ceiling rule distortions in Step 4.

• Tax allocations affected only; book allocations are unaffected.

(continued on next slide)
Addressing Ceiling Limitations

• Curative allocations must be *reasonable* in amount, timing, and type.
  
  – *Amount* - Curative allocation can’t exceed ceiling distortion for that year (or prior years if cure is for ceiling limitation on disposition).
  
  – *Timing* - A curative allocation can offset ceiling distortions for prior years if allocation is made over economic life of the property and allocation is provided in partnership agreement at time of contribution.
  
  – *Type* - Curative allocation must be expected to have substantially the same effect on each partner’s tax liability as the tax item limited by the ceiling rule. Expectation is generally tested at time the property is contributed and the curative allocation is made part of the partnership agreement.
Example 5. Traditional Method with Curative Allocations

Step One: Compute annual tax depreciation
   Equipment: $40/4 = $10
   Building: $200/2 = $100

Step Two: Compute annual book depreciation
   Equipment: $10/$40 x $100 = $25
   Building: $100/$200 x $200 = $100

Step Three: Allocate book depreciation (50-50)

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

Step Five: Allocate residual tax depreciation (if any) to Op. Co. as contributing partner and add curative

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<td>Book</td>
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<tr>
<td>Equipment</td>
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<td>$ 10.0</td>
</tr>
<tr>
<td>Building</td>
<td>$100.0</td>
<td>$100.0</td>
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</table>

JV uses $200 cash to purchase Building with 2 year tax life
Remedial Method

- Allows partnership to create (i.e., "fabricate") income and deduction items.
- Not dependent on adequacy of partnership items—thus completely prevents any ceiling rule limitations.
- Remedial items have no effect on book capital accounts.
- Calculation of book depreciation is different than traditional or curative method.
Book Depreciation
Remedial Method

• Book basis of asset is split into two components:
  – Tax amount which equals the actual tax basis, and
  – Book amount calculated as excess of book basis over tax basis.
• Amount of book basis equal to tax basis is recovered over remaining tax recovery period.
• Excess book basis treated as new asset and depreciated over applicable asset life.
• Follow same 5-step process as traditional method except that remedial tax items are “made up” to equal ceiling limitations in Step 4.
Example 6. Stage 1, Remedial Method – Years 1-4

Step One: Compute tax depreciation
Total: $40/4 = $10 x 4 = $40

Step Two: Compute book depreciation
Equipment: $10/$40 x $40 = $10 x 4 = $40
Equipment’: $60/10 = $6 x 4 = $24

Step Three: Allocate book depreciation (50-50)

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

Step Five: Allocate residual tax depreciation (if any) to Op. Co. as contributing partner

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<tr>
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<td>$20.0</td>
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<tr>
<td>Equipment’</td>
<td>24.0</td>
<td>12.0</td>
<td>12.0</td>
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<tr>
<td>Total</td>
<td>$64.0</td>
<td>$40.0</td>
<td>$32.0</td>
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</tbody>
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Example 6. Stage 2, Remedial Method
10

Step One: Compute tax depreciation
Total: $0/6 = $0

Step Two: Compute book depreciation
Equipment: $0
Equipment': $60/10 = $6 x 6 = $36

Step Three: Allocate book depreciation (50-50)

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

Step Five: Allocate residual tax depreciation (if any)
to Op. Co. as contributing partner; remedial item

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<td>Equipment</td>
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<td>$ 0.0</td>
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<tr>
<td>Equipment</td>
<td>36.0</td>
<td>18.0</td>
<td>18.0</td>
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<tr>
<td>Total</td>
<td>$ 36.0</td>
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## Summary – Remedial

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<td>Deprec. Yrs 1-4</td>
<td>$64.0</td>
<td>$40.0</td>
<td>$32.0</td>
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<td>Deprec. Yrs 5-10</td>
<td>36.0</td>
<td>0.0</td>
<td>18.0</td>
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<tr>
<td>Total</td>
<td>$100.0</td>
<td>$40.0</td>
<td>$50.0</td>
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Other Reasonable Method – Keep Your Own Method

- Partnership agreement allocates 100% of book depreciation deductions to contributing partner -- real economic risk associated therewith.
- Mechanically forces 100% of tax depreciation deductions to contributing partner because noncontributing partner has no book depreciation deductions to match with tax deductions.
- See e.g., PLR 9829016
General Rules for Planning —
Which Method Best for You

• Generally, methods will only differ if ceiling rule will apply - otherwise reach same result using traditional method.
  – Note that the remedial method is available even if there is not a current ceiling limitation as a protective measure for ceiling limited sale.

• If you are property contributor of built-in gain property –
  – Negotiate for traditional method (with potential for shifting tax consequences to money partner).
  – Generally don’t want curatives - too fast burn-off of built-in gain with phantom income allocated to property contributor.
  – Compromise on remedies or curative with partial cure (e.g., gain on sale only).
    • Especially if big book-up and long lives.
    • Remedial stretches out realization of built-in gain.

(continued on next slide)
General Rules for Planning (cont’d) – Which Method Best for You

• If you are cash contributor –
  – Negotiate for curatives (if adequate items) -
    • Fastest expensing of investment.
    • Especially if short remaining recovery cycle.
  – Don’t want traditional method with exposure for shifting tax consequences.
  – Potential compromise on remedials.
  – Special considerations if section 197 anti-churning applies.
General Rules for Planning (cont’d) – Which Method Best for You

• Caveat – Always Run the Numbers Before Picking a Method –
  – Surprising effect of guaranteed payments, preferred returns, or gross income allocations
  – If sale of interest, consider if buyer has §743(b) adjustment and share of §704(c) gain
  – Potential effect of tiered partnerships
  – Consider higher-built in gain share if negative tax capital accounts
  – Don’t forget there may be losses
  – Be creative, curative method can be partial cure
How to Adopt a Method

• Except for two provisions, neither the Code nor the Treasury Regulations specify how to adopt a Section 704(c) method.

  – Treas. Reg. §1.704-3(c)(3)(iii)(B) states that the general limitation on character applied to curatives does not apply to the disposition of property subject to the ceiling rule if provided for in the partnership agreement.

  – Treas. Reg. §1.704-3(c)(3)(ii) states that the partnership agreement in effect for the year of contribution must provide for curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year.

• Remember “mix and match rules” (e.g., different methods allowed for different property and Section 704(c) layers, consistency required).
Section 704(c) Anti-Abuse Rule

• Used to prevent a partnership from shifting the tax consequences of built gain or loss among the partners resulting in a reduction in the partners' aggregate federal tax liability.

• The IRS may conclude that an allocation method (or combination of methods) is “unreasonable.”

• However, the IRS may not force a partnership to adopt the remedial method.
Example 7. Stage 1, Section 704(c) Anti Abuse Rule

**Step One:** Compute annual tax depreciation

\[ \frac{30}{1} = 30 \]

**Step Two:** Compute annual book depreciation

\[ \frac{30}{30} \times 300 = 300 \]

**Step Three:** Allocate book depreciation (50-50)

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

**Step Five:** Allocate residual tax depreciation (if any) to Op. Co. as contributing partner

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<td>$150</td>
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<tbody>
<tr>
<td>Book</td>
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<td>$150</td>
</tr>
<tr>
<td>Tax</td>
<td>$30</td>
<td>$0</td>
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</table>
Example 7. Stage 2, Section 704(c) Anti-Abuse Rule

**Step One:** Compute partnership tax gain
$300 - $0 = $300

**Step Two:** Compute partnership book gain
$300 - $0 = $300

**Step Three:** Allocate book gain (50-50)

**Step Four:** Allocate tax gain to Money Co. (noncontributing partner) to extent of book

**Step Five:** Allocate residual tax gain (if any) to Op. Co. as contributing partner

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<td>Book Tax</td>
<td></td>
<td></td>
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<tr>
<td>Gain on sale</td>
<td>$300</td>
<td>$150</td>
<td>$150</td>
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JV sells the Equipment for $300 when the Section 704(b) book value and adjusted tax basis equal $0.
## Anti-Abuse Rule

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<td>$(150)</td>
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<tr>
<td></td>
<td>$(30)</td>
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<td>$(0)</td>
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<tr>
<td>Gain on sale</td>
<td>150</td>
<td>150</td>
<td>150</td>
<td>150</td>
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<tr>
<td>Net Impact</td>
<td>$ 0</td>
<td>$120</td>
<td>$ 0</td>
<td>$150</td>
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- By virtue of JV’s allocations, the parties have achieved a shift of $120 of built-in gain to Money Co.
- Money Co. may use its built-in gain to offset otherwise expiring net operating loss carryforwards.
Op. Co. and Money Co. decide they wish to share tax depreciation 50-50 despite Section 704(c).

JV’s partnership agreement is amended so as to reflect revised Section 704(b) book allocations of depreciation (75% to Op. Co, and 25% to Money Co.) to drive JV’s Section 704(c) tax allocations to the desired sharing ratio.
Example 8 (cont’d). Interaction of Sections 704(b) and 704(c)

Step One: Compute annual tax depreciation

\[ \frac{150}{4} = 37.5 \]

Step Two: Compute annual book depreciation

\[ \frac{37.5}{150} \times 300 = 75 \]

Step Three: Allocate book depreciation (75-25)

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

Step Five: Allocate residual tax depreciation (if any) to Op. Co. as contributing partner

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<th>(75%) Op. Co.</th>
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<td>$18.75</td>
<td>$56.25</td>
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<tr>
<td></td>
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<td>$18.75</td>
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Note: Partners may want to specially allocate gain on disposition to bring capital accounts back to 50-50.
Example 9. Stage 1, Revaluation/Reverse Section 704(c)

**Assumptions:**

- JV, formed with $400 cash 6 years ago, admits New Co. to partnership.
- New Co. contributes $200 cash for a 1/3 interest in JV.
- All items are shared equally among the partners prior to and after the admission of New Co.

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<tr>
<td>End. Capital</td>
<td>$200.0</td>
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</table>

Equipment has 4 year remaining life
- Equipment FMV=100 BV=40 ATB=40
- Land FMV=300 BV=300 ATB=300
Example 9. Stage 2, Reverse Section 704(c) – Sale of Property

Step One: Compute partnership tax gain
$100 - $40 = $60

Step Two: Compute partnership book gain
$100 - $100 = $0

Step Three: Allocate book gain (1/3 each)

Step Four: Allocate tax gain to New Co. (noncontributing partner) to extent of book

Step Five: Allocate residual tax gain (if any) to Money Co. & Op. Co. (contributing partners)

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<tr>
<th>Partnership</th>
<th>JV</th>
<th>(33.3%) Money Co.</th>
<th>(33.3%) Op. Co.</th>
<th>(33.3%) New Co.</th>
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<td>$600.0</td>
<td>$200.0</td>
<td>$200.0</td>
<td>$200.0</td>
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</table>
Assumptions:
• Properly maintained capital accounts
• Liquidating distributions – positive capital
• DRO
• Depreciation allocated 99% to Money Co. and 1% to Op. Co.; all other items 50-50.

Section 482:
• IRS may reallocate items among related parties to more clearly reflect income and prevent evasion of tax.
Example 10
Section 482 Considerations

- Section 704(b)?
- Section 482? Do the allocations represent a fair deal which would result from arms length negotiations between unrelated parties?
- What if the partnership agreement provides for a special allocation to Money Co. of gain on future dispositions of property to offset, dollar for dollar, its disproportionate allocation of depreciation?
Special Rules Under Section 704(c)

- **15% De minimis exception** (capped at $20,000 per partner per year).

- **Account payable**: If a cash basis partner contributes accrued but unpaid accounts payable, this item is treated as Section 704(c) property.

- **Transfers of partnership interest**: Transferee steps into shoes for Section 704(c) purposes.
Special Rules Under Section 704(c)

- **Tax-free dispositions (i.e., under Sections 721, 351, 1031, 1033) of Section 704(c) property.** Substituted basis property is treated the same as the transferred property.

- **Tiered partnerships.** If upper-tier partnership ("UTP") contributes Section 704(c) property to a lower-tier partnership ("LTP"), Section 704(c) still applies to UTP’s distributive share of LTP gain/deductions from the Section 704(c) property.
Special Rules Under Section 704(c) (cont’d)

• *Section 708(b)(1)(B) terminations:* No new Section 704(c) layer is created; can be used as an opportunity to change to a different reasonable method.

• *Section 704(c) allocation methods:* Any method used must be reasonable. Traditional, curative, and remedial methods are generally reasonable. Other methods may be reasonable (*e.g.*, the “keep your own” method – P.L.R. 9829016).

• *Effect on Depreciation Recapture:* Curative and remedial allocations can shift depreciation and recapture to the non-section 704(c) partners. *See §§1.704-3(a)(11), 1.1245-1(e)(2), and 1.1250-1(f).*
Section 704(c) –Other Developments

- **Final §704(c) anti-abuse regulations.** June 2010. IRS response to Enron. Takes into account tax liabilities of direct and indirect partners and looks at use of remedial allocation method by related partners.

- **PLR 200829023.** How to allocate “boot” gain when §704(c) asset with multiple layers is exchanged in §1031 (gain to more recent layers first is reasonable).

- **Notice 2009-70.** IRS requested comments on many open §704(c) items including whether to separately track or net multiple §704(c) gain layers involving gains and losses (e.g., book down of forward §704(c) asset).

- **Proposed Regulations under §704(c) relating to §704(c)(1)(C) and §704(c) revaluations.** On January 15, 2014, the IRS and the Treasury Department issued these proposed regulations providing additional guidance under §704(c).