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Use and Abuse of Section 703c

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I. INTRODUCTION

It is basic to income taxation that each taxpayer should be taxed on his or her economic income and that only taxpayers who suffer economic losses should derive tax benefits therefrom.[1] While these tenets are easily stated, they are difficult to enforce, particularly in the partnership setting where lines between the economic interests of partners are often blurred. The substantial economic effect rules of section 704(b) strive mightily to constrain partners' ability to shift income and losses in a manner inconsistent with the partners' economic arrangement. Nevertheless, when a partner contributes property to a partnership, the possibility exists that some of the gain or loss inherent in that property may be shifted from the contributor to the other partners. No gain or loss is recognized at the time of the contribution, and the partnership, as new owner of the property, takes the contributor's basis. Thus, upon any subsequent sale of the property, the gain or loss, including gain or loss inherent in the property when contributed, is generally treated as that of the partnership entity and, absent a special rule, would be divided amongst the partners.

This shifting of gain or loss was tolerated before 1984. Under section 704(c), partners were permitted to agree that the subsequent gain or loss would be reported by the contributing partner, but this treatment was never mandatory. Moreover, the regulations under section 704(c) contained rules constraining that agreement, the most significant of which came to be known as the "ceiling rule," providing that the gain or loss allocated to the contributing partner could not exceed the partnership's entire gain or loss on the sale. When the ceiling rule applied, precontribution gain or loss was effectively shifted to the noncontributing partners in spite of the partners' agreement to the contrary.

In 1984, Congress, concluding that the shifting of precontribution gain or loss to noncontributing partners should no longer be tolerated, made the prior permissive rule mandatory: Gain or loss inherent in contributed property *must* now be reported by the contributing partner. It gave the Treasury the task of drafting regulations to carry out this mandate. There is language in the legislative history to the 1984 Act implying that Congress intended the ceiling rule to continue after the 1984 legislation, despite the fact that its effect is inconsistent with the statutory mandate. In any event, the

1. See, e.g., Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930). There are exceptions to this rule. The most obvious is the rule of Crane v. Commissioner, 331 U.S. 1 (1947), which permits the holder of property subject to nonrecourse acquisition indebtedness to include the amount of that debt in basis. *Crane* often has the effect of permitting the ostensible owner of property to deduct losses that may ultimately be borne by the holder of the debt.

Treasury decided that it lacked authority to eliminate the ceiling rule and that while it could provide taxpayers with means to avoid or correct ceiling rule distortions, it could not compel them to do so.

Final regulations under section 704(c) were issued a full 10 years after their legislative authorization. The regulations appear to create clear and concise rules for taxpayers to follow in planning contribution transactions. However, those rules are qualified by an anti-abuse rule which, if broadly construed, could largely obscure the clarity of the main rules.

This article examines the section 704(c) regulations in detail, in an attempt to gauge the scope of the anti-abuse rule. Part II describes the history of section 704(c) and the regulations construing it. Part III evaluates the anti-abuse rule in particular. It concludes that a narrow reading of the rule is appropriate and consistent with subchapter K as a whole.

II. The Basic Operation of Section 704(c)

In explaining section 704(c), I rely on several simple examples and some variations. Example I and its variations illustrate the application of section 704(c) to nondepreciable property. Example II and its variations deal with depreciable property.[2]

A. *Contributions of Nondepreciable Property*

> *Example I. A* and *B* form an equal partnership to which *A* contributes land with a basis of $60 and a fair market value of $100 and *B* contributes $100 of cash. The land was a capital asset in *A*'s hands and is also a capital asset in the partnership's hands.

While *A* has effectively realized $40 of gain (she received a partnership interest worth $100 in exchange for the land), this gain is not recognized (section 721(a)). The partnership is the owner of the land with a basis equal to *A*'s basis of $60 (section 722). The partnership interest that *A* now holds is a capital asset in which she has a basis of $60 (section 723).

The partnership capital accounting rules require the partnership to account for this transaction for *book* purposes by giving *A* credit in her capital account for the land's full fair market value,[3] and the land should be reflected on the asset side of the partnership's balance sheet at that value.[4]

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2. For ease of reference, the facts of the examples are restated in the Appendix.

3. Regs. § 1.704-1(b)(2)(iv)(b).

4. Regs. § 1.704-1(b)(2)(iv)(d). Although partnerships are not required to follow the capital account maintenance rules unless they rely upon the safe harbor for substantial economic effect under § 1.704-1(b)(2)(ii), the regulations governing contributed property require partnerships that do not do so to use book capital accounts "based upon the same principles." Regs. § 1.704-3(a)(3).

As a result, a disparity exists between the partnership's tax and book accounts; the land has a tax basis of $60 but a book value of $100. To reflect these disparities, and to assist in tracing them to the partner to whom they are attributable, the regulations contemplate maintenance of "tax capital" accounts for the partners,[5] which essentially reflect each partner's share of the partnership's inside basis, net of liabilities. Thus, at formation, the partnership's balance sheet is as follows:

	Assets		
	Basis	Book	
Cash	$100	$100	
Land	60	100	
	$160	$200	

Liabilities and Capital		
	Capital Accounts	
	Tax	Book
A	$ 60	$100
B	100	100
	$160	$200

It is apparent from the balance sheet that if the partnership were to sell the land for $100, it would have a tax gain of $40, but no book gain. *A*'s book capital account reflects that she was credited with book gain of $40 when she contributed the property. Thus, if any of the $40 tax gain were reported by *B*, the result would be to tax *B* on book gain that was enjoyed by *A*. This shifting of gain was permitted by section 704(c)(1) before the 1984 amendment. Under former section 704(c)(1), *A* and *B* were permitted to agree to treat the $40 tax gain in the same manner as partnership gains generally,

5. The concept of tax capital accounts first appeared in the regulations under § 704(b). These regulations deal with a problem related to § 704(c): the consequences of a revaluation of partnership property. Under § 1.704-1(b)(2)(iv)(f), partnerships are permitted to revalue their assets and restate their capital accounts to reflect current values upon the occurrence of several specified events, the most common of which are the admission of a new partner and the liquidation of a partner's interest. See Regs. § 1.704-1(b)(2)(iv)(f)(5). When a partnership restates its capital accounts, the result is the creation of book/tax disparities like those that occur under § 704(c). The § 704(b) regulations, which were drafted after Congress enacted new § 704(c), but before regulations were issued under that provision, require that § 704(c) principles be applied in allocating the tax items associated with the revalued property. See Regs. § 1.704-1(b)(2)(iv)(f)(4). In examples of how that might be accomplished, the regulations introduce the concept of tax capital accounts. See, e.g., Regs. § 1.704-1(b)(5) exs. 13, 14. The regulations under § 704(c) apply both to standard § 704(c) situations (the contribution of appreciated or depreciated property) and to "reverse § 704(c) allocations" (those resulting from revaluations of partnership property under Regs. § 1.704-1(b)(2)(iv)(f)). Regs. § 1.704-3(a)(6).

i.e., in the same proportions as they share book gains. Alternatively, section 704(c)(2) allowed them to agree to allocate the gain to the contributing partner.[6]

The regulations provided rules for allocating built-in gain or loss to the contributor if the partners so elected under old section 704(c)(2).[7] Under those rules, which are continued in the new regulations as the "traditional method," the noncontributing partner is essentially treated as though she purchased an undivided interest in the property for its fair market value at the time of contribution, and allocations of tax items are made consistent with that treatment. As a result, where the contributed property is nondepreciable, only tax gains (or losses) corresponding to book gains (or losses) are allocated to noncontributing partners. In the example, if the partnership sells the property for \$100, none of the \$40 tax gain is allocated to *B* because she sustained no book gain. *A*, on the other hand, has a \$40 disparity in her tax and book capital accounts, reflecting the fact that she was credited with a book gain at the time of contribution, which has not yet been matched by a tax gain. Therefore all of the corresponding \$40 tax gain is allocated to her, fulfilling the basic mandate that tax must follow book, even though the tax allocation follows the book allocation on a delayed basis. This method dutifully accomplishes the goal of former section 704(c)(2) in many cases, as illustrated below:

> *Example I, Variation 1*. The property in Example I increases in value and *AB* sells it for \$120, resulting in a book gain of \$20 and a tax gain of \$60.

Under their agreement, *A* and *B* share the book gain equally, \$10 apiece. Under the traditional method, the tax gain is allocated as follows: *B*, the noncontributing partner, is allocated tax gain equal to her book gain of \$10, and *A* is allocated the balance, \$50. By allocating tax gain first to the

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6. Before the 1984 amendments, § 704(c)(1) and (c)(2) read as follows:

(1) General Rule. In determining a partner's distributive share of items described in section 702(a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.

(2) Effect of partnership agreement. If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

7. Reg. § 1.704-1(c)(2) (before amendment in 1993).

noncontributing partner, the traditional method maintains equality between *B*'s book and tax capital accounts. Once this is accomplished, the remaining tax gain is necessarily allocable to the contributing partner, *A*. In this variation, this allocation has the effect of eliminating entirely the tax/book disparity on the partnership's books.

The prior regulations imposed one important limitation on the partners' ability to avoid shifts of gain: the so-called "ceiling rule."[8] Under the ceiling rule, the amount that a partnership may allocate among its partners may not exceed the tax gain, income, loss, or deduction that the partnership, as an entity, recognizes for the year. In operation, the ceiling rule can cause serious distortions by shifting a portion of the built-in gain or loss to noncontributing partners.[9]

> *Example I, Variation 2*. The land in Example I goes down in value, and *AB* sells it for $70.

In this sale, although *AB* has a book loss of $30, it has a tax gain of $10. *A* and *B* suffer book losses of $15 each; however, since the partnership entity has not sustained a tax loss to match its book loss, *B* cannot claim a tax loss, violating the principle that tax gains and losses should match book gains and losses and thereby creating a tax/book disparity in *B*'s capital accounts. For tax purposes, the entire tax gain of $10 is allocated to *A*, but this amount is not sufficient to eliminate *A*'s tax/book disparity. Immediately after the sale, *AB*'s balance sheet is as follows:

	Assets		**Liabilities and Capital**	
	Basis	Book		
Cash	$170	$170		
			Capital Accounts	
			Tax	Book
		A	$ 70	$ 85
		B	100	85
			$170	$170

Although the tax/book disparity has been eliminated on the asset side of the balance sheet, a new one arises between *B*'s tax and book accounts because *B* has sustained an economic loss that has been taken into account

8. Id.; see Regs. § 1.704-3(b)(1).

9. See generally R. Donald Turlington, Section 704(c) and Partnership Book-Tax Disparities, The Ceiling Rule and the Art of Tax Avoidance, 46 Inst. on Fed. Tax'n § 26 (1988).

for book purposes but not for tax purposes: Her \$15 economic loss has not been matched by a tax loss. On the other hand, *A*, who enjoyed a book gain of \$40 when she contributed the property (and was given a book capital credit of \$100) and sustained an offsetting loss of \$15 when the property was sold (for a net gain of \$25), has only reported \$10 of tax gain, effectively (albeit temporarily) shifting \$15 of that gain to *B* (via the deferred loss deduction). These effects, which are compelled by the ceiling rule, will presumably be offset one day when the partnership liquidates or when one or both of the partnership interests are sold.[10] In the meantime, *B*'s loss and *A*'s gain are locked in.

B. *Contributions of Depreciable Property*

When the contributed property is depreciable, allocation of gain on sale, as in Example I, is not sufficient to accomplish the purpose of taxing the contributing partner on built-in gain because, if book depreciation is matched by real decline in value, there will be no gain on a sale made at the end the property's useful life. The only way to tax the contributor on built-in gain in depreciable property is to increase her share of presale income from the property. Under the traditional method, this is done by allocating depreciation away from the contributing partner: The noncontributing partner receives tax depreciation up to her share of book depreciation, and only if tax depreciation remains thereafter is it allocated to the contributing partner. The result is to tax the contributing partner on more than her book share of income from the property, thereby resolving the tax/book disparity over the property's life. The opposite is done for built-in loss.

> *Example II*: *C* and *D* form an equal partnership to which *C* contributes equipment with a basis of \$80 and a value of \$120 and *D* contributes \$120 cash. The equipment originally had a 10-year recovery period, and *C* elected to use the straight line method of cost recovery. Although only four years remain in its recovery period, if *CD* had purchased the equipment on the date of formation, it would have had a 10-year recovery period. *C* and *D* agree to share all book items equally. Upon formation, *CD*'s balance sheet is as follows:

10. If the partnership were immediately to liquidate, distributing cash of \$85 to each partner, *A* would recognize gain of \$15 under § 731(a)(1), and *B* would recognize a \$15 loss under § 731(a)(2). Similarly, if either partnership interest were sold, the selling partner would recognize deferred gain or loss under § 741.

	Assets		Liabilities and Capital
	Basis	Book	
Equipment	$ 80	$120	
Cash	120	120	
	$200	$240	

	Capital Accounts	
	Tax	Book
A	$ 80	$120
B	120	120
	$200	$240

CD must recover its transferred tax basis in the property over the property's remaining recovery period, using the same method as *C*, the straight line method.[11] Its *book* depreciation must be computed at the same rate as its tax depreciation.[12] Applying these rules to Example II:

1. *CD* must recover its $80 tax basis using the straight line method over its remaining recovery period of four years ($20 per year).
2. *CD* therefore *must* also recover its $120 book basis using the straight line method over four years ($30 per year).

Consistent with the general intent of the traditional method to treat noncontributing partners as if each purchased an undivided interest in contributed property for cash, the noncontributing partners are allocated (if possible) the same amount of cost recovery for tax purposes as they are for book purposes. If the partnership's cost recovery deduction exceeds the noncontributors' book share, the contributing partners are allocated the balance. On the facts of Example II, since each partner is entitled to $15 of depreciation for book purposes, the $20 of tax depreciation is allocated $15 to *D* and $5 to *C*. Thus, although *C* and *D* have the same book income, *C* has $10 more taxable income than *D*. If we assume for the moment that book income is a surrogate for economic income, *C* is overtaxed by $10 each year. In this way, *C* is taxed on the built-in gain over the life of the property. After four years, *C* has taken into account all $40 of built-in gain, and the difference between the property's book value and tax basis has been entirely eliminated.

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11. IRC § 168(i)(7).

12. Regs. § 1.704-1(b)(2)(iv)(g)(3). A partnership that does not maintain its capital accounts under the safe harbor rules of § 1.704-1(b)(2)(iv) must, for purposes of § 704(c), use book capital accounts applying the same principles. Regs. § 1.704-3(a)(3). However, it is not clear whether the book depreciation rules are among the principles that must be followed. For this reason, I assume that *CD* has chosen to follow the safe harbor rules.

When tax basis is less than the noncontributor's share of book basis, the ceiling rule prevents the traditional method from completely eliminating the contributor's book/tax disparity, and shifts some of the built-in gain to the noncontributing partner. In those circumstances, there is insufficient tax depreciation to allocate to the noncontributing partner.

> *Example II, Variation 1*: *C*'s adjusted basis for the equipment at the time of contribution, and hence *CD*'s initial adjusted basis, is $40. Thus, *CD* is permitted only $10 of annual depreciation for tax purposes. For each of its first four years, *CD* has $20 of ordinary business income before taking depreciation into account.

Although *D*'s share of the equipment's initial book value is $60, the total tax depreciation available under the ceiling rule is the $40 tax basis at the time of contribution. Thus, it will be impossible to treat *D* as though she purchased an undivided interest in the property. Although *CD* still has $30 of annual book depreciation, $15 of which is allocable to *D*, *CD* only has $10 of annual tax depreciation. Under the traditional method, all of this $10 is allocated to *D*. Nevertheless, since this allocation is insufficient to match *D*'s share of book depreciation, it creates a disparity between *D*'s tax and book capital accounts that will grow at the rate of $5 per year. After the first year, the partners' capital accounts are as follows:

	C		***D***	
	Book	Tax	Book	Tax
Initial Balance	$120	$ 40	$120	$120
Depreciation	(15)		(15)	(10)
Ordinary Income	10	10	10	10
	$115	$ 50	$115	$120

The $5 disparity that has been created in *D*'s capital accounts will grow to $20 after four years. In effect, the ceiling rule causes *D* to be overtaxed in the amount of $5 per year for four years, thereby taxing *D* on a portion of *C*'s built-in gain. Resolution of these disparities is deferred until the liquidation of the partnership or a sale of the partnership interests.

C. *Whence the Ceiling Rule?*

Before the enactment of subchapter K as part of the Internal Revenue Code of 1954, there was significant confusion over the appropriate treatment of contributed property.[13] The source of the confusion was the unresolved dichotomy between taxing partnerships as separate entities or as aggregates of their partners.[14] Under a pure entity approach, built-in gain and loss from contributed property would be allocated consistently with all other gains and losses, making no attempt to trace precontribution gain or loss to the contributing partner. Under a pure aggregate approach, the noncontributing partner would be treated as though he had purchased an undivided interest in the property for cash, essentially giving the noncontributor a cost basis in the contributed property, even if the transferred basis from the contributing partner is less. Methods based on the aggregate approach were coined "deferred sale" or "credited value" approaches. The first was published in 1932, in a general counsel memorandum proposing that the partners account for gain and loss from contributed property using a deferred sale approach, subject to the ceiling rule.[15] Apparently because of the perceived difficulty of applying the aggregate approach to partnerships with multiple partners contributing multiple properties, the general counsel memorandum was subsequently revoked, and was reportedly not followed in the field during the period prior to its revocation.[16]

Congress' goal in the partnership provisions of the 1954 Code was to resolve the confusion of prior law, and in this context, it did so by enacting sections 704(c)(1) and (c)(2). The legislative history reflects Congress' awareness of the shifting potential of section 704(c)(1). However, because the shifts would be resolved upon liquidation of the partnership or sale of a partner's interest, the problem was viewed one of "mere" deferral, prompting the simpler approach of section 704(c)(1). Section 704(c)(2) was viewed as an accommodation for taxpayers who wished to account more accurately for built-in gain or loss.[17]

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13. See generally S. Rep. No. 1622, 83d Cong., 2d Sess. 89, 93-94 (1954), reprinted in 1954 U.S.C.C.A.N 4621, 4721, 4725-27.

14. See Gregory Marich & William McKee, Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships, 41 Tax L. Rev. 627, 635 (1986) ("The ceiling rule and its distortions are a product of the entity-aggregate conflict that is deeply embedded within subchapter K").

15. G.C.M. 10092, XI-I Cum. Bull. 114 (1932), revoked by G.C.M. 26379, 1950-1 Cum. Bull. 58. In its recommendations to Congress in connection with the 1954 Code, the American Law Institute endorsed the entity approach, in spite of its attendant distortions, primarily because of its simplicity in contrast with the aggregate approach. The ALI did, however, advocate adoption of an elective aggregate approach. 2 American Law Institute Federal Income Tax Statute 355-56 (Feb. 1954 Draft).

16. See Jackson, et al., A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners, 9 Tax L. Rev. 109, 123 (1954).

17. This rule is admittedly more complicated than the entity rule, which is provided unless the partnership agreement provides otherwise. However, while the partnership remains in operation, this aggregate rule more

The legislative history of section 704(c)(2) is cited as the foundation for the ceiling rule. Although no express reference to the rule is made, support for it can be found in an example in which property with a basis of $40 and value of $100 is contributed to an equal two-person partnership. The Senate report notes that all $40 of depreciation should go to the noncontributor, and makes no reference to any deferred sale mechanism for increasing the depreciation to treat the noncontributor as though he had purchased an undivided interest.[18] The regulations under section 704(c)(2) imposed the ceiling limitation, and it has survived ever since.

In sum, the law before 1984 was that income, gain, loss, and deduction from contributed property could be freely shifted among partners unless the partners elected otherwise, and even if they did elect otherwise, the ceiling rule in some cases made it impossible to completely eliminate shifting of income and loss.

By 1984, Congress and the Treasury had become painfully aware of the time value of money, and the shifting permitted by section 704(c)(1) was no longer viewed as revenue neutral. The possibilities of abuse were readily apparent. Suppose that in Example I *A* is in the 40% tax bracket and *B*, because of an expiring capital loss carryforward, could report the built-in gain at no tax cost.[19] Unless *A* and *B* made an election under section 704(c)(2) (unlikely in these circumstances), some of the $40 gain would escape taxation. In 1984, Congress thus made mandatory the rule that the entire $40 gain should be reported by *A*, the contributing partner. The statute now requires that

> Under regulations prescribed by the Secretary . . . income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution . . . .[20]

> equitably computes the taxable income of the partners. Since this is not a matter involving revenue considerations to the Government, and since partners are not compelled to use this rule, your committee believes that partners should be free to choose this more complicated rule for dividing basis of property if they desire the more accurate tax results it brings.

S. Rep. No. 1622, 83d Cong., 2d Sess. 4725 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4725.

18. Id.

19. *B* might also be a tax-exempt pension fund or a nonresident alien that is brought into the partnership specifically with a view to absorbing *A*'s built-in gain.

20. IRC § 704(c)(1).

D. *What Remains of the Ceiling Rule?*

Although Congress made clear that it revised section 704(c) to preclude partners from shifting precontribution gain and loss among themselves, neither the statutory language nor the legislative history states whether Congress intended to abandon the ceiling rule. Because the ceiling rule results in just the type of distortions that the revised section 704(c) is intended to eliminate, arguably, the statute could be construed to eliminate the rule.[21] The more commonly held belief is that Congress intended that the ceiling rule continue, or at least that the Treasury should not impose aggregate treatment upon taxpayers.[22] The 1984 legislative history authorized taxpayers to rely on the former regulations until new ones were issued, and while the grant of regulatory authority is broad, no suggestion is made that the Treasury should adopt some sort of deferred sale method.[23] The presumption arising from the legislative history is that the traditional method would continue, although Treasury was authorized to provide various means of curing ceiling rule distortions.

A decade passed before final regulations were issued under section 704(c), and during this time, there was much debate and speculation over what they would ultimately provide.[24] Proposed regulations were issued in December of 1992[25] and were finalized on December 21, 1993.[26]

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21. See, e.g., Turlington, supra note 9, at 26-25.

22. See, e.g., New York State Bar Ass'n Tax Section Discusses Regulatory Issues Under Changes Made by '84 Act, 85 TNT 102-49 (May 22, 1985) (LEXIS, FEDTAX library, TNT file). See also Marich & McKee, supra note 14; John D. Steines, Jr., Partnership Allocations of Built-In Gain or Loss, 45 Tax L. Rev. 615-65 n.173 (1990).

23. The House report accompanying the 1984 legislation states:

> It is anticipated that regulations under [§ 704(c)(1)] generally will provide for the same result that is achieved under present law when a partnership elects with respect to all relevant items to provide for sharing of depreciation, depletion, and gain or loss among the partners so as to take into account fully the variation between the basis of the property of the partnership and its fair market value at the time of the contribution.

H.R. Rep. No. 98-432, 98th Cong., 2d Sess. pt. 2, at 1209 (1984), reprinted in 1984 U.S.C.C.A.N. 874, 876. In a footnote, the House report suggests that curative allocations of gain on a sale of depreciable property might be appropriate to resolve disparities created by ceiling limited depreciation. Id. n.3. This bolsters the argument that Congress intended the ceiling rule to remain in place.

24. See, e.g., New York State Bar Ass'n, supra note 22; Marich & McKee, supra note 14.

25. PS-164-84, 1993-1 C.B. 857.

26. T.D. 8500, 1994-1 C.B. 183. The rules on the remedial allocation method were not finalized until December of 1994. T.D. 8585, 1995-1 C.B. 120.

E. *The Regulations*

The regulations begin with the following statement:

> The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.[27]

This restatement of the statutory rule, preceded by a statement of the purpose of the statute, is followed by the edict that "the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c)."[28] The balance of the regulations is devoted to fleshing out what the Treasury means by "reasonable." The regulations include an anti-abuse rule providing that an allocation is *not* reasonable if "the contribution of property . . . and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."[29]

The regulations describe three allocation "methods" that are "generally" considered reasonable, and state that "other methods may be reasonable in appropriate circumstances."[30] The three methods are the traditional method, the traditional method with curative allocations, and the remedial allocation method. The traditional method is basically the same as the method of the old section 704(c)(2) regulations described above, ceiling rule and all. The traditional method with curative allocations provides a means of offsetting ceiling rule distortions in many cases, and the remedial allocation method allows ceiling rule distortions to be avoided altogether.

It has been noted that although the final regulations speak of the three methods as separate and distinct, the traditional method is effectively the only "horse in the barn."[31] The two other methods only modify that method as necessary to resolve distortions caused by the ceiling rule. The traditional method is a means of applying aggregate treatment to noncontributing

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27. Regs. § 1.704-3(a)(1).

28. Id.

29. Regs. § 1.704-3(a)(10).

30. Regs. § 1.704-3(a)(1).

31. Barksdale Hortenstin & Gregory J. Marich, An Analysis of the Rules Governing Partnership Allocations with Respect to Contributed Properties: The Final Regulations Under Section 704(c), at 12 (1994) (unpublished manuscript on file with author).

partners by maintaining an identity in each such partner's book and tax capital accounts, and this goal of book/tax equality is at the heart of each of the three methods in the regulations. For example, if a partnership elects the curative allocation method, but never encounters a ceiling rule limitation, its allocations will be precisely the same as if it had elected the traditional method. Nevertheless, because the regulations describe the three methods as alternatives, I describe them separately. Yet, it is useful to keep in mind that at the heart of each is the mandate that tax allocations should follow book allocations, and that tax/book disparities should be avoided whenever possible and resolved as quickly as possible when they do arise.

F. *Traditional Method with Curative Allocations*

Partnerships using the traditional method with curative allocations may elect to make reasonable curative allocations to eliminate ceiling rule distortions.[32] A "curative allocation" is a tax allocation of an item that differs from the allocation of the corresponding book item. The allocation is meant to "cure" disparities caused by the ceiling rule and is available only if the ceiling rule has created a book/tax disparity. Curative allocations must be reasonable in amount and of the same type as the item that was subject to the ceiling rule.[33] Absent an appropriate item to allocate, a curative allocation cannot be made. To illustrate how the rules work for nondepreciable property, consider the following:

> *Example I, Variation 3.* Assume the facts of Example I, but further assume that *AB* invests its $100 of cash in stock that appreciates in value to $150 and that the land declines in value to $70. *AB* sells the land for $70 (recognizing $30 of book loss and $10 of tax gain) and sells the stock for $150 (recognizing a $50 gain for both book and tax purposes).

After these sales, the capital accounts would, in the absence of curative allocations, be as follows:

	A		***B***	
	Book	Tax	Book	Tax
Initial Balance	$100	$60	$100	$100
Land Sale	(15)	10	(15)	--
Stock Sale	25	25	25	25
	$110	$95	$110	$125

32. Regs. § 1.704-3(c).

33. Regs. § 1.704-3(c)(3). In the case of depreciable property, the period of time over which the curative allocations are made must also be reasonable.

The ceiling rule has created a book/tax disparity for both partners of $15.

The gain on the stock sale, however, presents a possibility of eliminating the disparity by reallocating gain on the stock for *tax* purposes in the proportions $40 to *A* and $10 to *B*. The regulations permit this, so long as the reallocated amount does not exceed the amount of the ceiling limited item for the taxable year and is of the same type or character as that item. Since the amount of the curative allocation equals the amount of the distortion, and since the land and the stock are both capital assets, the curative allocation of the gain on the stock has the same effect as the loss limited by the ceiling rule. The allocation is therefore reasonable and results in the following adjustments to the partners' capital accounts:

	A		***B***	
	Book	Tax	Book	Tax
Initial Balance	$100	$ 60	$100	$100
Land Sale	(15)	10	(15)	--
Stock Sale	25	40	25	10
	$110	$110	$110	$110

As applied to depreciable property, reconsider variation 1 of Example II, which is restated here for convenience:

> *Example II, Variation 1*: Assume the facts of Example II, except that *C*'s adjusted basis in the equipment at the time of contribution is $40. Thus, *CD*'s initial adjusted basis in the equipment is also $40, and *CD* is permitted only $10 of annual depreciation for tax purposes. In addition, for each of the first four years, *CD* has $20 of ordinary business income before taking depreciation into account.

If *CD* elects to use the traditional method with curative allocations, it can eliminate the annual distortion caused by the ceiling rule by making curative allocations of its ordinary income. *CD* has $20 of ordinary income that the partners share equally—$10 each. By allocating $15 of this income for tax (but *not* book) purposes to *C* and $5 to *D*, the ceiling rule distortion is "cured." Since this allocation is reasonable in both amount and type, it would be respected. If it is done, the partners' capital accounts are adjusted as follows:

	C		***D***	
	Book	Tax	Book	Tax
Initial Balance	$120	$ 40	$120	$120
Depreciation	(15)		(15)	(10)
Ordinary Income	10	15	10	5
	$115	$ 55	$115	$115

The purpose of curative allocations is easily seen in the context of depreciable property. Under the traditional method, the built-in gain in the property is amortized over the life of the property, as it produces income. When the ceiling rule applies, the noncontributor, in the absence of curative allocations, reports more than his or her economic share of the property's income. The curative allocation of additional income to the contributing partner eliminates this distortion.[34]

G. *Remedial Allocation Method*

The second mechanism for curing ceiling rule distortions is the "remedial allocation method."[35] In essence, this method permits partners to ignore the ceiling rule, ensuring that tax allocations to the noncontributors are always available to match the book allocations to them. As applied to depreciable property, the method recalculates book depreciation in such a way that the noncontributors are treated, to some extent, as though they purchased undivided interests in the contributed property. The partners are authorized to create offsetting tax allocations to match the book allocations, with the result that the *net* amount allocated equals the partnership's total gain, loss, or deduction. Remedial allocations are fictitious, or notional, offsetting tax allocations; their only role is to eliminate disparities between book and tax accounts arising from the ceiling rule. They always equal the disparity and are of a character identical to that of the item limited by the ceiling rule. Because they are notional and offsetting, they have no effect on the partnership's taxable income or adjusted bases.[36] The partners, however, must treat remedial allocations as actual tax items, and the allocations may therefore affect both tax liability and outside bases.[37]

As discussed below, the remedial allocation method treats a contribution of property to a partnership in some ways as if it were a sale, with the gain on that sale recognized by the contributing partner only as necessary to neutralize application of the ceiling rule. It is a simplified descendant of the deferred sale method proposed by the ALI in 1954. It is the only pure aggregate approach authorized by the regulations.

To illustrate how this method applies to nondepreciable property, reconsider variation 1 of Example I, where the land falls in value and the *AB* partnership sells it for $70, resulting in $30 of book loss and $10 of tax gain. The book loss is allocated equally between *A* and *B*—$15 each. If the partnership uses the traditional method, the ceiling rule prevents *B* from receiving a tax loss to match her book loss because there is no tax loss. If, however,

34. See Marich & McKee, supra note 14, at 645.
35. Regs. § 1.704-3(d).
36. Regs. § 1.704-3(d)(4)(i).
37. Regs. § 1.704-3(d)(4)(ii).

the partnership elects the remedial allocation method, *B* is allocated tax loss of $15, characterized as if it were from the sale of the land, and *A* is allocated an offsetting tax gain of $15 of the same character. *A* thus reports gain of $25 (sum of $10 of partnership gain on the sale and $15 of remedial allocation), and *B* reports loss of $15, netting out to the partnership's gain of $10 and producing the appropriate result described above that was prohibited by the ceiling rule. Under the remedial method, the partners' capital accounts are adjusted as follows:

	A		*B*	
	Book	Tax	Book	Tax
Initial Balance	$100	$60	$100	$100
Land Sale	(15)	10	(15)	--
Remedial Allocation	0	15	0	(15)
	$ 85	$85	$ 85	$ 85

In contrast with the traditional method with curative allocations, these remedial allocations are not dependent on the partnership having other items of income or loss. If *AB* had used the traditional method with curative allocations, the lack of other capital gains would have blocked the elimination of the disparity created by the ceiling rule.

A partnership adopting the remedial allocation method for depreciable property must use a special rule for computing book items (including depreciation) with respect to the property. This rule is loosely based on the notion that the contributing partner sold the property on a deferred basis to the partnership on the date of contribution for its fair market value. To the extent of its transferred basis, the partnership steps into the shoes of the contributing partner for both book and tax purposes and must continue to use the contributing partner's cost recovery method. If the property's value exceeds its basis, the excess is treated for book purposes as if the partnership had purchased the property for this amount, and book depreciation is calculated on this amount using any method of cost recovery that is allowed for property of that type.[38]

The partnership then uses the traditional method to allocate the related tax items, with tax allocations to noncontributing partners following book allocations to the extent possible. If the ceiling rule prevents noncontributing partners from receiving tax allocations equal to the corresponding book allocations, the partnership makes offsetting remedial allocations of the appropriate character and amount to both contributing and noncontributing partners.

38. The partnership must also use the appropriate first year convention. See IRC § 168(d) (allowing half-year, mid-month, and mid-quarter conventions); Regs. § 1.704-3(d)(2) (also allowing first-year convention).

To illustrate, assume the partnership in variation 1 of Example II adopts the remedial allocation method. For book purposes, the partnership is treated as if it acquired two pieces of equipment, one contributed by *C* with a value and a basis of $40, and one that it purchases for $80 (the excess of the property's value ($120) over its basis ($40)). With respect to the contributed portion, the partnership steps into *C*'s shoes, recovering the $40 of basis for both book and tax purposes using the straight line method over the remaining four years of the property's life—depreciation of $10 per year for both tax and book purposes. With respect to the notionally purchased portion, the partnership may adopt any appropriate method of cost recovery. Ignoring conventions, if *CD* chooses the straight line method over 10 years, the purchased portion provides *CD* with $8 of book (but not tax) depreciation each year for 10 years. Therefore, *CD* has a book cost recovery deduction of $18 per year ($10 from the contributed portion and $8 from the purchased portion) for the first four years and $8 per year for the remaining six years. *CD*'s initial balance sheet looks as follows:

Assets	Basis	Book
Equipment	$ 40	$120
Cash	120	120
	$160	$240

Liabilities and Capital

Capital Accounts	Tax	Book
C	$ 40	$120
D	120	120
	$160	$240

For each of its first four years of operation, *CD* has $2 of income for book purposes and $10 of income for tax purposes, determined as follows:

	Book	Tax
Ordinary Income	$20	$20
Depreciation	(18)	(10)
	$ 2	$10

For book purposes, *C* and *D* are each entitled to one half of both the ordinary income ($10) and the depreciation ($9), a net of $1 each per year. For tax purposes, each is allocated $10 of ordinary income. However, under the traditional method, *D* is allocated $9 of depreciation, and *C* only $1. Therefore, *D* has $1 of taxable income, and *C* $9:

	C		***D***	
	Book	Tax	Book	Tax
Ordinary Income	$10	$10	$10	$10
Depreciation	(9)	(1)	(9)	(9)
	$ 1	$ 9	$ 1	$ 1

At the end of the first four years, the capital accounts of the partnership are as follows:

	C		***D***	
	Book	Tax	Book	Tax
Initial Balance	$120	$ 40	$120	$120
Aggregate Adjustments	4	36	4	4
	$124	$ 76	$124	$124

During this period, the book/tax disparity in *C*'s capital account declines from $80 to $48 because *C* takes only $1 a year in depreciation, while her book depreciation is $9. In effect, *C* over reports taxable income by $8 annually, thereby taking into account $32 of the $80 of built-in gain that was inherent in the property when it was contributed. To this point, the ceiling rule has not applied, and the partnership has not used remedial allocations.

The analysis changes thereafter. During years 5 through 10, the partnership continues to have $20 of ordinary income, but its book depreciation is only $8. The partnership's net annual book income is $12, and each partner's share is $6. For tax purposes, the partnership is no longer entitled to any depreciation. Although *D* is charged $4 of depreciation for book purposes, the ceiling rule prohibits any allocation of depreciation for tax purposes. Therefore, under the remedial allocation method, the partnership must make two offsetting remedial allocations of $4 each year. Each year, the partners' capital accounts have the following adjustments:

	C		***D***	
	Book	Tax	Book	Tax
Ordinary Income	$10	$10	$10	$10
Depreciation	(4)	0	(4)	0
Remedial Allocation		4		(4)
Annual Net Adjustment	$ 6	$14	$ 6	$ 6

Each year, *C* reports $8 more taxable income than she has for book purposes. This reduces the disparity between tax and book so that by the end of year 10, the disparity will have disappeared.

H. *Anti-abuse Rules*

As noted above, the Treasury's blessing of the three alternative methods for making section 704(c) allocations is subject to a general anti-abuse rule, providing that an allocation method is *not* reasonable if

> the contribution of property . . . and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[39]

The regulations provide some guidance in interpreting this apparently very broad rule in two examples—one involving the traditional method (example 2) and the other the traditional method with curative allocations (example 3).[40] In both examples, an equal partnership is formed with one partner contributing property with a value of $10,000 and an adjusted basis of $1,000 and the other partner contributing $10,000 cash. The property has only one year left in its recovery period, but has a substantially longer economic life, which for purposes of this analysis I assume to be 10 years.[41] As is developed in more detail below, central to the potential for abuse in both examples is the fact that the property's recovery period for tax purposes is significantly shorter than its useful life.

Example 2 illustrates unreasonable use of the traditional method. In this example, the property contributor (*C*) is in a high marginal bracket, and the cash contributor (*D*) is in the zero bracket because of a net operating loss deduction that will soon expire. The contribution of property is made "with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer."[42] Under the traditional method, the partnership takes $10,000 of depreciation for book purposes and $1,000 of depreciation for tax purposes in the first year, reducing the partnership's basis in the property to zero for both book and tax purposes and eliminating all of the section 704(c) gain. The partners share the book depreciation equally, while *D* is allocated all of the tax depreciation. The effect of the ceiling rule is to restrict *D*'s allocation of tax depreciation to $1,000, $4,000 less than his share of book depreciation.

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39. Regs. § 1.704-3(a)(10).

40. Regs. § 1.704-3(b)(2) ex. 2, (c)(4) ex. 3.

41. In example 2, it is stated that the property's useful life is "significantly longer" than its recovery period, and in example 3, the property has a 10-year economic life.

42. Regs. § 1.704-3(b) ex. 2(i).

If one views book income and deductions as reflecting economic income and loss, the noncontributing partner is overtaxed by $4,000, all in the first year. This view, however, does not reflect the true economics of the transaction. Ideally, *D* should be treated for tax purposes as though she had purchased for $5,000 an interest in property having a 10-year useful life. Using straight line depreciation, *D* should be allocated $500 of depreciation annually for 10 years. *D* is actually undertaxed in the first year because she receives $1,000 of depreciation instead of $500. In the absence of a sale, however, she will be overtaxed by $500 for each of the next nine years because there is no tax depreciation. The result at the end of the property's life is that *D* has been overtaxed by $4,000. Therefore, the effect of the ceiling rule in the first year is to lock in the amount of income ($4,000) that will eventually be shifted to *D*, although the actual shift occurs throughout the property's life.

To this point, the ceiling rule distortion is garden-variety: The partnership has insufficient tax depreciation to match the noncontributor's book depreciation. The distinguishing feature of this example, which is apparently what rendered it abusive in the Treasury's eyes, is that even though the property has been depreciated down to a book value of zero, its value at the beginning of year two is $10,000, which the partnership realizes both for book and tax purposes through sale. Under the partnership agreement, the resulting gain of $10,000 is shared equally for both book and tax purposes. If these allocations were respected, the capital accounts would be adjusted as follows:

	C		***D***	
	Tax	Book	Tax	Book
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	0	(5,000)	(1,000)	(5,000)
Sale	5,000	5,000	5,000	5,000
	$6,000	$10,000	$14,000	$10,000

The interplay of the one-year cost recovery period, the sale, and the traditional method results in a shift for tax purposes of $4,000 of gain from *C* to *D*, all occurring in year two. While this shift became inevitable in year one, when the ceiling rule restricts *D*'s depreciation deduction, the shift is actually realized for tax purposes when the property is sold in year two. In that year, *D* reports $4,000 of gain for tax purposes that should have been reported by *C*. The regulations note that if the partnership agreement had called for a curative allocation of an additional $4,000 of gain to *C*, the anti-abuse rule would not apply.[43]

43. Regs. § 1.704-3(b)(2) ex. 2(ii)(C).

The second example of the anti-abuse rule (example 3) involves unreasonable use of the traditional method with curative allocations.[44] The facts of this example are similar to the first, but there are important differences: The bracket positions of the partners are reversed—the property contributor (*J*) is the zero bracket taxpayer due to a net operating loss deduction, and the cash contributor (*K*) is in a high bracket; the partnership does not intend to sell the property; and the partnership generates $8,000 of sales income in its first year of operations. Under the traditional method with curative allocations, the partnership's $10,000 of book depreciation is shared equally, and the $1,000 of tax depreciation is allocated entirely to *K*. The partners make a curative allocation of sales income to *J* to make up for the ceiling rule limitation on *K*'s depreciation deduction: For book purposes, each partner receives $4,000 of sales income, but for tax purposes, all $8,000 is allocated to *J*.[45] If this were respected, the partners' capital accounts would be adjusted as follows:

	J		***K***	
	Tax	Book	Tax	Book
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	0	(5,000)	(1,000)	(5,000)
Sales Income	8,000	4,000	0	4,000
	$9,000	$ 9,000	$ 9,000	$ 9,000

The curative allocation eliminates the disparity between the tax and book capital accounts, thereby curing the ceiling rule distortion entirely in the first year. Had no curative allocation been made, the partners would have divided the sales income equally over the life of the equipment, and the book/tax disparity created in the first year would have continued indefinitely.

Nevertheless, the regulations find this to be an unreasonable use of the traditional method with curative allocations. *K* is undertaxed by $4,500 for year one,[46] but would, in the absence of the curative allocation, be overtaxed by $500 in each of the nine succeeding years. The overtaxation is fully offset by the curative allocation made for year one. Instead of depreciating its investment in the property over the 10-year life at the rate of $500 per year, the curative allocation effectively allows *K* to deduct its entire $5,000 investment in the first year. Therein lies the abuse: *K*, the high bracket

44. Regs. § 1.704-3(c)(4) ex. 3.

45. See Regs. § 1.704-3(c)(4) ex. 3(i). When the regulations were proposed in 1992, the curative allocation of sales income was only $750. Prop. Regs. § 1.704-3(c)(4) ex. 2(i). This was changed in the final regulations to make the shift more dramatic.

46. *K*'s economic income is $4,500 ($4,000 of sales income, less $500 of economic depreciation), but its taxable income is zero.

taxpayer, is essentially allowed to immediately deduct its entire cost of its share of the equipment at no tax cost to either *J* or the partnership. The built-in gain for which *J* should ultimately be responsible is accelerated, but since *J* is currently in the zero bracket, he owes no additional tax. According to the regulations, the curative allocations would be reasonable if they were made over the property's economic life.[47]

III. EVALUATION OF ANTI-ABUSE RULE

A. *Generally*

The anti-abuse rule has been described by commentators as the "heart" of the section 704(c) regulations[48] and as a "potent weapon" in the hands of the Service.[49] These characterizations reflect a concern that the anti-abuse rule is so broad that it could potentially apply to any contribution transaction if the ceiling rule works to the advantage of the partners by reducing their overall tax liability. The regulations contain a statement belying this notion: "An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability."[50] However, the Treasury refused to establish safe harbors from the anti-abuse rule, leaving open the possibility that the rule might apply even to the remedial allocation method in certain circumstances.[51]

I do not agree that the anti-abuse rule will be applied in such a broad fashion, nor do I believe that it should be so applied. While the regulations contain no explicit safe harbors (save the virtually useless one assuring that the traditional method is reasonable if the ceiling rule never applies), I believe that the traditional method is reasonable, and ceiling rule shifts will be tolerated, unless the partners plan the transaction to manipulate the timing of the ceiling rule shifts, or the correction of those shifts through curative allocations, so as to have them occur at minimal tax cost. Stated another way, the anti-abuse rule should apply to the traditional method only if the partners accelerate the ceiling rule shift in such a way as to substantially reduce the present value of their tax liability below that which it would have been had the ceiling rule shift occurred over the economic life of the contributed

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47. Regs. § 1.704-3(c)(4) ex. 3 (ii)(C).

48. William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 10.04[3][a] (2d ed. Supp. 1995).

49. Gregory J. Marich et al., The Remedial Allocation Method: A Viable Cure for the Ceiling Rule, 65 Tax Notes 1267, 1270 (Dec. 5, 1994).

50. Regs. § 1.704-3(a)(1).

51. See T.D. 8500, supra note 26, at 184 ("The IRS and Treasury believe it is appropriate to require that all allocation methods satisfy the anti-abuse rule").

property. In the context of the traditional method with curative allocations, the reach of the anti-abuse rule should be limited to curative allocations that are made at no significant tax cost over a period substantially shorter than the contributed property's economic life.

In the regulations, the Treasury accepted the traditional method's approach of maintaining tax/book disparities as the basic means of applying section 704(c) in all cases, authorizing variations only as necessary to avoid ceiling rule distortions. It apparently believes that it lacks authority to eliminate the ceiling rule. Whether or not this assumption is justified, if the ceiling rule is viewed as inviolate, use of the traditional method in most cases must be respected. The basic rule of the traditional method—that tax allocations should follow book allocations to the extent possible—often results in ceiling rule shifts of income, but it should be considered abusive only rarely. Those rare cases can be identified in advance: Tax allocations following book allocations are potentially abusive when the latter deviate significantly from economic reality because in those cases the timing of the ceiling rule shift can be manipulated.

The Treasury's illustrations of the anti-abuse rule support the conclusion that the traditional method is reasonable in all but the most unusual circumstances. In the examples, the anti-abuse rule is applied not to override shifts occasioned by the ceiling rule, but to control the timing of the making and correcting of the shifts. The examples illustrate that an anti-abuse rule is needed for two reasons: a ceiling rule that the Treasury believed it could not eliminate, and uneconomic cost recovery rules that it cannot fix. As a consequence, the Treasury chose to circle the wagons and issue in terrorem regulations whose bark is far worse than their bite.

B. *Survival of the Ceiling Rule*

Arguments have been made for and against retention of the ceiling rule, but the Treasury apparently decided that it lacked authority to repeal it. There is substantial evidence of this, both from informal statements from Treasury personnel and in the regulations. When commentators expressed concern about the Treasury's authority to override the ceiling rule through the remedial allocation method, the Treasury stated that the rule would be elective only, and the regulations state that neither that nor any other method based upon notional tax allocations may be imposed upon taxpayers.[52] The

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52. In exercising its authority under paragraph (a)(10) of this section to make adjustments if a partnership's allocation method is not reasonable, the Internal Revenue Service will not require a partnership to use the remedial allocation method described in this paragraph (d) or any other method involving the creation of notional tax items.

Regs. § 1.704-3(d)(5)(ii).

Treasury further stated that because of the elective nature of the remedial allocation method, it cannot be viewed as the baseline for measuring abuse.[53]

Once the ceiling rule is considered inviolate, except at the election of the taxpayer, one might ask why the traditional method, which relies on Treasury's basic principle of tax following book, can ever be considered abusive. Only in ceiling-limited situations does the method fail to accomplish the stated purpose of section 704(c), and the Treasury has accepted the ceiling rule as something it must live with. The answer lies in example 2 of the regulations.

C. *Interpreting the Examples of Abuse*

The Treasury's only guidance on the scope of the anti-abuse rule is that provided by the examples in the regulations. By varying the facts of example 2, it becomes apparent that the scope of the anti-abuse rule in the context of the traditional method is necessarily quite limited. In that example, the partnership sells the contributed property at the beginning of the second year, after its tax basis and book value have been reduced to zero by depreciation for the first year. Assume that rather than selling the property, the *CD* partnership uses it for its entire useful life, at which point its value is zero.

Under the traditional method, the ceiling rule limits the allocations for year one, creating a tax/book disparity, because there is insufficient tax depreciation to match the noncontributor's (*D*'s) book depreciation. As the property produces income over its useful life, *D* will include one half of the income from the property without any offsetting deduction for *D*'s investment in the property. The effect of the ceiling rule, therefore, is to deny to *D* cost recovery deductions for $4,000 of its investment in the property, thereby shifting $4,000 of the built-in gain from *C* to *D*. Unlike the example in the regulations, however, the shift of income to *D* occurs over the life of the property, not entirely in the year immediately following the contribution. Does this variation on the facts invoke the anti-abuse rule? Contrary to the view of some commentators,[54] I do not believe it should.

53. In response to a comment suggesting that the remedial allocation method be used as a baseline, the preamble to the 1994 regulations states: "[T]he IRS and Treasury believe that it would be inappropriate to adopt the remedial allocation method as a baseline for measuring whether the partners' aggregate tax liability has been reduced. Such a baseline would make the remedial allocation method preeminent, undercutting its elective nature." T.D. 8585, supra note 26, at 121.

54. See McKee et al., supra note 49, ¶ 10.04[3][b], at 510-55 (Supp. 1995).

The anti-abuse applies only if tax items are allocated "with a view" to reducing the present value of the partners' taxes by shifting built-in gain or loss.[55] In example 2, the proscribed "view" is described as an intention to take advantage of the disparity between the property's remaining recovery period and its economic life. The advantage derived from the disparity is *not* the fact of the ceiling rule shift of income, but the *timing* of the shift. And, it is not the ceiling rule that provides the abusive result, but the capital accounting rules dealing with cost recovery, for it is those rules that define the extent of the tax/book disparity.

Disregarding the plan to sell the property at the beginning of year two, the example merely illustrates a garden-variety ceiling rule shift; absent an acceleration of that shift through sale, the partners have not taken advantage of the difference between the cost recovery period and the useful life of the property. The planned sale does not cause the ceiling rule shift; it merely accelerates the shift. Had the Treasury viewed the shift alone as abusive, the sale would serve no purpose to the example. The effect of including the sale in the facts of the example is, therefore, to limit the scope of the anti-abuse rule to those situations where ceiling rule shifts are accelerated and not allowed to occur over the life of the property.

Had the Treasury wished to extend the reach of the anti-abuse rule to all ceiling rule shifts of income to lower bracket taxpayers, example 2 could have been significantly simpler. True, even if the property is not sold, the shift reduces the present value of the partners' aggregate tax liability below that which it would have been had there been no ceiling limitation (i.e., had they used the remedial allocation method). But, to find that abusive is anomalous. How can taxpayers be penalized for *not* electing a method that Treasury has stated it lacks the power to impose? To find abuse in this case would be nothing more than a back door repeal of the ceiling rule.

Thus, the distinguishing feature of example 2 appears to be *not* the *fact* of a shift of income, but the *timing* of the shift. Apparently, the prohibited abuse occurs where the parties arrange the transaction with a plan to accelerate the shift of income. In this example, the event accelerating the shift is the sale, and the partners could have avoided the anti-abuse rule by allocating the gain on sale to the contributing partner.[56] In addition, the

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55. Reg. § 1.704-3(a)(10).

56. Just when the sale must occur to fall within the anti-abuse rule is unclear. For example, should the anti-abuse rule apply if the partnership sells the land in year three, rather than year two? The answer turns on whether the reduction in tax is "substantial" and whether the requisite "view" exists (i.e., whether the sale in year was three planned and sufficiently definite). If the useful life of the property is 10 years, a sale in year three might well result in a substantial reduction in the present value of aggregate tax liabilities, compared to that which would have been incurred had the property been held to the end of its useful life. If the

regulations require that the allocations be made "with a view" to taking advantage of the disparity between recovery period and useful life. It thus appears that the scope of the anti-abuse rule is quite limited. Unless the parties planned the sale at the time of the contribution, and unless the sale actually occurs substantially before the end of the property's useful life, use of the traditional method should be considered reasonable.[57]

Analysis of example 3, illustrating unreasonable use of the traditional method with curative allocations, adds further support to the conclusion that the abuse potential is not in creating shifts of income, but in manipulating the timing of those shifts. As discussed above, in example 3, the curative allocation of $4,000 of sales income to the contributing partner in the first year eliminates the shift of income, but also has the effect of permitting the noncontributor to expense her investment in the contributed property in the first year. This is caused by the requirement that the full cost of the property be recovered for book purposes over the remainder of the contributor's recovery period (in this case, consisting of year one only), a rule that ignores the economic reality that the property has a significant remaining useful life. The regulations note that had the partnership agreement provided for curative allocations over the property's economic life, the allocations would have been reasonable. Thus, had the allocations of sales income to *J* been made at the rate of $400 per year, rather than $4,000 in the first year, they would have

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property's useful life is three years, the sale in year three likely does not significantly reduce tax liabilities, and the rule should not apply. See Regs. § 1.704-3(b)(2) ex. 2(ii).

57. Example 2 could be seen as an application of the broader anti-abuse rule of § 1.701-2, which qualifies all of subchapter K. The interaction of *C*'s view, *C*'s and *D*'s bracket position, and the quick sale suggest that *C*'s contribution of low-basis, high-value equipment is driven not by the need of the partnership for this particular equipment for the conduct of its operations but by the favorable tax consequences that flow from the interaction. In this sense, contribution of the equipment (rather than cash or other liquid assets available to *C*):

1. might be regarded as inconsistent with the overall purpose of subchapter K (in the words of § 1.701-2(a), to "conduct joint business . . . activities through a flexible economic arrangement") because use of the equipment in the partnership's business (as opposed to its sale) was not contemplated;
2. might contravene § 1.701-2(a)(1) as not made for "a substantial business purpose" (as distinguished from the general need of the partnership for working capital which could as well be provided by money or other property contributed by *C*); and
3. might violate the clear reflection of income requirement of § 1.701-2(a)(3).

Applying the omnibus anti-abuse rule in this setting requires considerable speculation and second-guessing. Presumably, as a general matter, it is not up to the government to decide for the partners' just what ingredients each brings to their combination to yield the greatest chance of success. In the § 704(c) context, the inquiry is more focused and requires less speculation. See Regs. § 1.704-2(a).

been respected. This makes sense because, except for the first year's deduction of $1,000, *K* would, under that scenario, write off the cost of the equipment over its economic life.

Both the traditional method and the traditional method with curative allocations are based on the notion that tax allocations must follow book allocations, thereby taxing the noncontributor as though he had purchased an undivided interest in the property. Where book allocations approximate economic income, this basic method taxes the partners economically, and cannot be abusive. The problems arise when book allocations bear little, if any, relationship to economic income, as is the case in both of the abuse examples. In the case of the traditional method, abuse arises only if the ceiling rule shifts are manipulated so as to occur over a period of time shorter than the property's economic life. In the case of the traditional method with curative allocations, abuse may exist if the curative allocations are made over a period substantially shorter than the economic life of the property. Because the remedial allocation method requires that the remedial allocations be made over the recovery period for the property, it is not susceptible to abuse.[58]

D. *The Key: Uneconomic Rules of Cost Recovery*

The foregoing analysis of the anti-abuse rule indicates that it is intended to deal with problems of timing, not shifts of income per se. It is thus possible to limit the rule to situations where book allocations deviate significantly from economic reality. In both of the examples illustrating the rule, the most significant factors are the disparity between cost recovery period and useful life and the elimination of all built-in gain in one year.[59]

58. Although the recovery periods of § 168 do not, nor were they intended to, reflect economic lives, the book recovery period dictated by the remedial allocation method for any excess of the contributed property's value over its basis—the recovery period under § 168 for newly purchased property—is far more likely to approximate economic life than is the remaining tax recovery period. McKee, Nelson, and Whitmire have suggested that the remedial allocation method may be abusive when depreciation on contributed property would not be ceiling limited, so that the contributor's depreciation under the remedial allocation method is greater than it would be under the traditional method. See McKee et al., supra note 49, ¶ 10.04[3][d] at 10-60. In the example they offer, the contributor's extra tax depreciation during the property's remaining recovery period is offset by later remedial allocations, a result which the authors suggest might be abusive if the contributor is taxable and the noncontributor is not. I disagree that use of the remedial allocation method falls under the anti-abuse rule in such a situation. While the contributor is described as receiving "extra" depreciation deductions under the remedial method as compared to the traditional method, the contributor, by entering into the partnership, gives up substantial depreciation deductions to the noncontributor, and it is difficult to imagine that the contribution would be made "with a view" to reducing the contributor's tax liability when her depreciation deductions are significantly reduced.

59. See Joel Scharfstein, An Analysis of the Section 704(c) Regulations, 48 Tax Law. 71, 89 (1994).

It therefore becomes necessary to examine the cost recovery rules that create the abuses in the examples.

In both examples, one year remains in the property's recovery period at the time of contribution, but economic life is substantially longer. The consequences of this discrepancy are, in example 2, that a sale in year two generates substantial tax gain with little if any economic gain and, in example 3, that the property generates substantial income after its tax basis has been reduced to zero.

At first blush, it appears appropriate for the partnership to depreciate the property over its economic life; indeed, if it did so, the perceived abuses would disappear in both cases. To illustrate, consider the results if the partnership in example 3 depreciates its book basis of $10,000 and its tax basis of $1,000 on a straight line basis over the property's economic life of 10 years. In each year, it would have $1,000 of book depreciation, divided equally between the two partners, and $100 of tax depreciation which, under the traditional method, would be entirely allocated to *K*, the noncontributing partner. If the agreement contained a curative allocation of sales income to *J* equal to the ceiling-limited depreciation (of $400 per year), the capital accounts at the end of the first year would be as follows:

	J		***K***	
	Tax	Book	Tax	Book
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	0	(500)	(100)	(500)
Sales Income	4,400	4,000	3,600	4,000
	$5,400	$13,500	$13,500	$13,500

The result is that the ceiling rule distortion ($400 annually) is contemporaneously eliminated by the curative allocation, but unlike example 3 in the regulations, *K* effectively deducts its investment in the property over the useful life of the property, rather than all in the first year. There is clearly nothing abusive in this result. It approximates the solution proposed in the regulations, but it goes one better, for in this example no book/tax disparity is ever created for *K*.

Similarly, in example 2, if the partnership's book and tax depreciation were spread over the property's economic life, the first year's book and tax depreciation would be $1,000 and $100, respectively. Under the traditional method, the book depreciation would be divided equally between *C* and *D*, and the tax depreciation would be allocated entirely to *C*, the noncontributing partner. The planned sale in year two would result in book gain of $1,000 and tax gain of $9,100, of which $8,100 represents built-in gain that must be allocated to *C*. The book gain of $1,000 is allocated equally between *C* and *D*, as is the last $1,000 of tax gain. The effect on the capital accounts would be as follows:

	C Tax	*C* Book	*D* Tax	*D* Book
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	0	(500)	(100)	(500)
Sale	8,600	500	500	500
	$9,600	$10,000	$10,400	$10,000

In this variation, instead of shifting $4,000 of *C*'s precontribution gain to *D*, the parties have shifted only $400, a result unlikely to be considered abusive.

The culprit leading to the abuses in the examples thus appears not to be any feature of section 704(c), but the depreciation methods used for book and tax purposes. The next obvious question, then, is why the Treasury chose the section 704(c) regulations as the forum for eliminating these abuses.

Although the method of depreciation described above seems quite reasonable, it is not permitted by the Code or the regulations. Under Code section 168(i)(7), the partnership is "treated as the transferor for purposes of computing the depreciation deduction . . . with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor." Thus, in the examples, where the contributing partner had $1,000 of basis in the property and one year left in its recovery period, the partnership's tax deduction for the first year *must* be $1,000, and cannot be computed over the useful life of the property.

This rule does not, however, dictate how the partnership should compute its book depreciation. Even if tax depreciation must be taken all in one year, the partnership could nevertheless use the useful life of the property as the measuring rod for book depreciation. Were this the case, the first year's tax depreciation in example 3 would be $1,000, and the first year's book depreciation would also be $1,000. Under the traditional method, both book and tax would be divided equally because this would provide *D*, the noncontributor, with tax depreciation equal to its share of book depreciation. On the sale for $10,000 in the second year, there is $9,000 of built-in gain, which can be entirely allocated to *C* under the traditional method. The remaining $1,000 of tax gain which matches the $1,000 of book gain would be divided equally. The effect on the capital accounts would be as follows:

	C Tax	*C* Book	*D* Tax	*D* Book
Initial Balance	$ 1,000	$10,000	$10,000	$10,000
Depreciation	(500)	(500)	(500)	(500)
Sale	9,500	500	500	500
	$10,000	$10,000	$10,000	$10,000

Thus, it appears possible to live with the rule of section 168(i)(7) and still avoid shifting of gain and losses; in this variation, the ceiling rule never comes into play. But consider the situation where the property is retained for its economic life. If book depreciation is based on the economic life of the property, tax depreciation in year one is again $1,000, and is again divided equally. In years two through ten, however, the ceiling rule applies, and even though *K* is entitled to $500 of book depreciation each year, there is no tax depreciation at all in those years. As a result, the capital accounts after the 10 years are as follows:

	C		*D*	
	Tax	Book	Tax	Book
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	(500)	(5,000)	(500)	(5,000)
	$ 500	$ 5,000	$ 9,500	$ 5,000

The result is an even greater tax/book disparity in *D*'s capital accounts than occurs under the method utilized by the regulations. This is caused by the fact that tax depreciation in the first year exceeds *D*'s share of book depreciation, so that some of it is allocated to the contributing partner. Thus, not only is the noncontributor deprived by the ceiling rule of sufficient tax depreciation to match its book depreciation, but some of the noncontributor's share is deducted by the contributing partner!

The rules for calculating book depreciation are found in section 1.704-1(b)(2)(iv)(g)(3) of the regulations. When that regulation was first issued in 1985, it permitted just the result described above: Book depreciation could be computed under any reasonable method, so long as, if the book value was greater than tax basis, book depreciation was not less than tax depreciation. The rules worked well so long as tax depreciation did not exceed the noncontributing partners' share of book depreciation. But when it did, as in the above example, the invariable result was the shifting of depreciation to the contributing partner, a sort of inverse ceiling rule problem.

In an attempt to plug that particular hole in the revenue dike, the Treasury revised the regulation to require that book depreciation be computed at the same rate as tax depreciation. It is because of this rule that the partnership in example 2 must, for book purposes, depreciate the property completely in the first year, even though its economic life is significantly longer.

IV. Conclusion

So long as the ceiling rule is with us, policy considerations favor a narrow construction of the section 704(c) anti-abuse rule. If the rule is interpreted so broadly as to potentially apply to every transaction in which appreciated or depreciated property is contributed to a partnership, all such transactions will have to be tested against the regulations' stated purpose of section 704(c): preventing shifting of tax consequences among partners with respect to precontribution gain or loss.[60] Whenever the traditional method is used and the tax attributes of the contributed property are ceiling limited, the transaction would fail that standard, and the applicability of the anti-abuse rule would turn on the factually difficult issues of whether the requisite "view" was present and whether the resulting reduction in tax liability is "substantial." I do not believe that this would be in the best interest of the tax administration.

Transfers of assets of ongoing business enterprises are essential parts of many partnership formation transactions. If one accepts the Treasury's recent statement of the intent of subchapter K—to "permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity level tax"[61]—allowing a free flow of property into and out of partnerships is an essential element. One of the most potent arguments in defense of the ceiling rule is that forcing contributing partners to include notional income items under some variation of a deferred sale method would violate the nonrecognition rule of section 721. Moreover, given the frequency and importance of contribution transactions, the certainty of a rule-based structure is a substantial benefit in this context.

Much has been written outside of the tax field on the choice between drafting laws as detailed rules or as broad standards.[62] The difference between the two approaches has been described as the difference between ex ante and ex post decision making: When a law is drafted as a rule, it is known in advance whether particular transactions or acts fall within or without the law. Laws setting out only broad standards create less certainty. It is up to some decision maker—usually, a court or administrative body—to determine whether a transaction or act satisfies the standard. Given the frequency with which property is contributed to partnerships, the costs of determining whether a transaction accomplishes or violates the purposes of section 704(c) could, if imposed on every contribution transaction, have the effect of discouraging partnership formations.[63] The costs of enforcing such

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60. See generally Frederick Schauer, Exceptions, 58 U. Chi. L. Rev. 871, 893-98 (1991).

61. Reg. § 1.701-2(a).

62. See, e.g., H.L.A. Hart, The Concept of Law 126-31 (1961); Ronald M. Dworkin, The Model of Rules, 35 U. Chi. L.R. 14 (1967); Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 Harv. L.R. 1685 (1976); Frederick Schauer, Playing by the Rules: A Philosophical Examination of Rule-Based Decisionmaking in Law and in Life (1991).

63. See Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557, 621 (1992), in which Professor Kaplow concludes, "The central factor influencing the desirability of rules and standards is the frequency with which a law will govern conduct . . . When behavior subject to the relevant law is frequent, standards tend to be more costly and result in behavior that conforms less well to underlying norms."

a standard, in contrast to a clear and understandable rule, would be great as well.

Limiting the reach of the anti-abuse rule as proposed in this article would not leave the Service helpless in the face of abusive transactions. So long as the ceiling rule exists, shifts of income will occur under section 704(c) in perfectly legitimate transactions, even though they might violate the stated purpose of section 704(c). The Service will have to live with these shifts. However, where ceiling rule shifts are accelerated by taxpayers exploiting the Treasury's own capital accounting rules, which ignore economic reality in calculating book depreciation, the anti-abuse rule may apply, as illustrated in the examples of the regulations. Where the ceiling rule does not apply, the traditional method successfully taxes the noncontributor under an aggregate approach, thereby leaving no room for abuse.

Beyond these situations, except in those few cases where transactions are so contrived as to fall under the general partnership anti-abuse rule of section 1.701-2, the Service should permit certainty in planning contributions of property to partnerships.[64]

The problem posed in this article is of the Treasury's own making. Had the Treasury abandoned the ceiling rule, the remedial allocation method could be required of all partnerships, and the section 704(c) regulations could be substantially simpler than they have turned out to be. Because of its nod to economic reality in computing book items, the remedial allocation method leaves little, if any, opportunity for creating shifts of income. Thus, I believe that abandonment of the ceiling rule would have been in the best interests of all. The Treasury's refusal to create safe harbors from the section 704(c) anti-abuse rule, and its insistence that all contribution transactions are potentially subject to that rule—which derive from its adherence to the ceiling rule—are in no one's best interests.

There may be room for in terrorem tax regulations. For example, the passive loss regulations issued under section 469 have successfully eliminated many abusive transactions. Some aspects of partnership taxation may deserve similar treatment. But, section 704(c) is too integral to the purpose and intent of subchapter K to be subject to such a rule.

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64. Section 1.701-2(b) requires that the provisions of subchapter K and the regulations thereunder be applied in a manner "consistent with the intent of subchapter K" as enunciated in that regulation. This anti-abuse provision clearly has a broader reach than the § 704(c) anti-abuse rule, which limits its focus to the purpose of § 704(c). Thus, even if an allocation method passes muster under the § 704(c) anti-abuse rule, it is subject to attack under the broader rule if the contribution transaction as a whole contravenes the intent of subchapter K. To the extent that § 1.701-2(b) is a codification of judicial doctrines, it is appropriate that merely satisfying the narrow § 704(c) anti-abuse rule should not insulate a contribution transaction from attack if it lacks substance.

APPENDIX

Example I. A and *B* form an equal partnership to which *A* contributes land with a basis of $60 and a fair market value of $100 and *B* contributes $100 cash. The land was a capital asset in *A*'s hands, and is also a capital asset in the partnership's hands. At formation, the partnership's balance sheet is as follows:

Assets

	Basis	Book
Cash	$100	$100
Land	60	100
	$160	$200

Liabilities and Capital

Capital Accounts

	Tax	Book
A	$ 60	$100
B	100	100
	$160	$200

Variation 1. The land in Example I increases in value, and *AB* sells it for $120, realizing book gain of $20 and tax gain of $60.

Variation 2. The land in Example I goes down in value, and *AB* sells it for $70, realizing book loss of $30 and tax gain of $10.

Example II: *C* and *D* form an equal partnership to which *C* contributes equipment (basis of $80 and value of $120) and *D* contributes $120 cash. The equipment originally had a 10-year recovery period, and *C* elected to use the straight line method of cost recovery. Although only four years remain in the recovery period at the time of the contribution, the equipment would have had a 10-year recovery period if *CD* had purchased it on the date of formation. Upon formation, *CD*'s balance sheet is as follows:

Assets

	Basis	Book
Equipment	$ 80	$120
Cash	120	120
	$200	$240

Liabilities and Capital

Capital Accounts

	Tax	Book
A	$ 80	$120
B	120	120
	$200	$240

Variation 1: *C*'s adjusted basis in the equipment at the time of contribution is $40, rather than $80. Thus, *CD*'s initial adjusted basis in the equipment is also $40, and *CD* is permitted only $10 of annual depreciation for tax purposes. For each of its first four years, *CD* has $20 of ordinary business income before taking depreciation into account.