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Built-in Gaine and Biuilt-in Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts

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I. INTRODUCTION

Partnerships frequently are formed with an in-kind contribution of property by one or more of the initial partners. Invariably, contributed property will have a value that differs from the contributing partner's adjusted basis representing built-in gain or loss. The partnership sections of the Internal Revenue Code (the "Code"[1]) contain numerous provisions designed to restrict partners from shifting the tax consequence of the built-in tax gain or tax-loss that is inherent in contributed property. In addition, a partner may be admitted to an existing partnership that has property with a basis that differs from the value of the property on the partnership books, which may in turn differ from the fair market value of the property as determined for calculating the price of admission for the new partner. This circumstance also may shift accrued gains or losses from existing partners to the entering partner. The presence of built-in gains and losses raise wonderfully complex issues regarding the structure of partnerships that challenge even the most sophisticated partnership tax lawyer.

This article is a primer on the issues faced by partners in dealing with the consequences of contributed built-in gain or loss property. The article explores the tax consequences of almost every aspect of the partnership treatment of built-in gain and loss property. While this article refers to partnerships throughout, the ubiquitous limited liability company,

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∗ Professor of Law, University of California, Davis. This article is based on a presentation by the author at the University of North Carolina, 2007 J. Nelson Young Tax Institute. Portions of the text and the facts of many of the examples are from Paul McDaniel, Martin McMahon, and Daniel Simmons, Taxation of Business Organizations (Foundation Press 4th ed. 2006). I gratefully acknowledge the permission of Foundation Press to use this material. Examples and discussion from Federal Income Taxation of Business Organizations are indicated by footnote reference but are not placed within quotation marks.

1. Internal Revenue Code of 1986, Title 26 United States Code, hereinafter cited as "IRC."

which is the favored form for many business activities, is treated as a partnership for Federal income tax purposes.[2] Thus, the problems of built-in gain and loss property of a partnership are the same for a limited liability company.

Subchapter K of the Internal Revenue Code is much maligned because of its complexity and the fact that its provisions are often used as the basis for transferring losses or avoiding gains in abusive tax shelter transactions.[3] However, the statutory and regulatory structure has evolved in a most elegant fashion. Subchapter K works if its basic principles are adhered to. These principles can be properly understood through close examination of the allocation of partnership gains and losses with an analysis of partnership capital accounts. As this article attempts to demonstrate, the solution to most issues under Subchapter K can be found by seeking harmony between the capital accounts and tax accounts of the partnership and the partners. The statutory provisions of Subchapter K should be interpreted within the overall context of Subchapter K's attempt to maintain a tax regime that accounts for economic allocations of partnership items.[4]

The article examines issues raised by the contribution of built-in gain and loss property at the formation of a partnership, largely through examples. The examples demonstrate that analysis of properly maintained capital accounts can be relied upon to determine the correct allocation of partnership tax items. Part II of the article discusses basic principles of partnership taxation that provide for the formation of partnerships and allocation of partnership book and tax items. A thorough understanding of these fundamental principles is a prerequisite to discussing the problems of built-in gain and loss property. Part III considers the problems raised by contributions of built-in gain property. The analysis demonstrates that recent proposed Treasury regulations regarding contributed built-in gain or loss property and partnership mergers in some circumstances create mischief by

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2. Treas. Reg. § 1.7701-3.

3. See e.g. TIFD III-E, Inc. v. United States, 459 F.3d 220(2d Cir. 2006). Lawrence Lokken, Taxation of Private Business Firms: Imagining a Future Without Subchapter K, 4 Fla. Tax Rev. 249, 254 (1999), states, "In this writer's opinion, because subchapter K's flexibility and susceptibility to abuse derive from the same source, the balances struck in the statutory scheme are inherently unstable. Uses of the partnership rules that the Treasury finds to be abusive will continue to push the law further into complexity, and this complexity will makes [sic] less and less feasible for more and more partnerships."

4. I recognize, of course, that the capital account provisions of the regulations can result in temporal mismatch of gains and losses and that commentators have recommended alternate approaches to avoid such results. See e.g. Darryll K. Jones, Towards Equity and Efficiency in Partnership Allocations, 25 Va. Tax Rev. 1047 (2006); Simon Friedman, Some Thoughts on Partners' Interests in Partnerships, 115 Tax Notes 925 (6/4/2007).

failing to fully address deferred recognition. Part IV looks at the complexity that is added by the existence of debt in the partnership. Part V addresses special problems created by built-in loss property, including the issues raised by section 704(c)(1)(C) enacted in 2004. The analysis in this part demonstrates the need for analyzing partnership capital accounts in order to apply the basis limitation of section 704(c)(1)(C)(ii) in the context of its statutory purpose and suggests an interpretation of section 704(c)(1)(C)(ii) in conjunction with optional basis adjustments that produces proper allocations of loss. Part VI considers partnership allocations that occur on the admission of a new partner to a partnership with built-in gain and built-in loss property.

II. FORMATION OF PARTNERSHIPS – GENERAL PRINCIPLES

A. Basic Economic Principles as Reflected in Capital Accounts

Capital accounts are the starting point for establishing the relationship of the partners in a partnership.[5] Aside from their role in determining appropriate allocations of tax consequence, properly maintained capital accounts define the economic relationship of the partners. Although the Treasury Regulations describing capital accounts can be daunting, the basic principles of properly maintained capital accounts are fairly straight-forward. At the most basic level, capital accounts simply reflect money (or value) in and money (or value) out.

On formation of a partnership, proper capital accounts are in reality an inventory of the assets contributed by each partner and a statement of each partner's interest in the partnership measured by the value of contributed property. The initial partnership capital accounts thereby demonstrate the economic arrangement among the partners, including any implicit or explicit agreements regarding the valuation of contributed property or services. When applied correctly, the capital account rules of Treasury Regulations section 1.704-1(b)(2)(iv) define both the economic and tax relationship of partners. For tax purposes, the core of federal taxation of partners and partnerships is found in the proper maintenance of partnership capital accounts, which are dispositive of allocation issues among partners. Indeed, the goal of the substantial economic effect test of the Code[6] is to insure that tax consequences to partners follow real economic consequences.[7]

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5. Detailed rules for maintaining capital accounts are in Treas. Reg. § 1.704-1(b)(2)(iv). See Mark P. Gergen, The End of the Revolution in Partnership Tax?, 56 SMU L.Rev. 343 (2003), for a discussion of the evolution of capital account analysis as the basis for economic effect in partnership allocations.

6. IRC § 704(b).

7. Lokken, supra note 3, 255, asserts that "despite their unworkable complexity" the economic effects regulations are not successful in eliminating

At the end of the life of a partnership, the net financial history of the partnership reflected in properly maintained capital accounts provides the partners with guidance as to the liquidation interests of each partner. Many practitioners will ignore partnership capital accounts in the allocation of tax items and make corresponding adjustments to capital accounts to match the partners' expectations.[8] This practice is workable if the partners can agree on their distribution rights, and, as long as capital account adjustments match the tax allocations with the economics of the partners' capital accounts, the tax allocations are sustainable. However, in the event of a dispute among the partners, which is not an uncommon occurrence, failure to maintain proper capital accounts may result in disagreement among the partners regarding their interests in partnership assets, sometimes requiring substantial fees for experts to reconstruct capital accounts.

A partner's initial capital account is the sum of the amount of any money contributed to the partnership by the partner, plus the fair market value of any property contributed by the partner.[9] A partner's capital account is increased for any subsequent contributions by the partner to the partnership and by the amount of partnership income allocated to the partner that has not been distributed.[10] These additions reflect the value of assets included in a partner's ownership interest in the partnership capital. On the debit side, a partner's capital account is decreased by the amount of any money distributed to the partner and by the partner' share of partnership

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allocations that distort partners' income, citing the ability to create transitory allocations over long periods or that distort timing principles. I agree that the complexity is substantial, but as I attempt to show in this paper, properly understood in the context of capital accounts neither the statute nor the regulations are unworkable. Professor Lokken is correct, however, that the partnership rules permit combinations of investment in a partnership that will change the nature of the taxation of the investment relative to single ownership.

8. See B. J. O'Conner and S. Schneider, Capital-Account-Based Liquidations: Gone With the Wind or Here to Stay? 102 Jo. Taxation 21 (2005). The authors describe liquidation arrangements based on schedules or formulae that allocate cash distributions (a so-called "waterfall") rather than relying on capital accounts. Id. at 22. Distributions of cash and property are used to determine allocations of income and loss. These arrangements are based in part on the notion that "many clients simply do not understand capital accounts or the significance of income and loss allocations." Id. Ironically, throughout the article the authors refer to an analysis of capital accounts in order to demonstrate how alternate liquidation schemes that incorporate priority distributions work. See also Friedman, supra note 4, at p. 930, who suggests allocations on the basis of an adjusted cash flow system.

9. Treas. Reg. § 1.704-1(b)(2)(iv)(*b).*

10. Id.

losses.[11] If property is distributed to a partner, the partner's capital account must be reduced by the fair market value of the distributed property.[12]

For capital accounts to be economically meaningful (economic effect), the partners must agree that liquidation distributions to a partner will be based on the partner's positive capital account balance, and that a partner with a deficit capital account will be required to restore the deficit in order to fund distributions of positive capital account balances to the other partners.[13] Capital accounts are meaningful only if they reflect what a partner ultimately may take out of the partnership. As a corollary, the interest of any one partner in any item is affected by the interests of the other partners. Capital accounts are not merely an accounting device designed to satisfy the regulation's substantial economic effect test. Properly maintained capital accounts designate the interest of each partner in the assets of a partnership at any point in time.

Capital accounts provide a picture of the partners' interests only if the partnership has assets available for liquidation distributions to partners with positive capital account balances.[14] The book value of assets on the partnership side of the balance sheet must equal the sum of the partners' capital accounts. Nonetheless, a partner may withdraw money or property from a partnership in excess of the partner's capital account, or a partner may be allocated losses in excess of the partner's capital account. These situations create a negative, or deficit, capital account for a partner. A negative capital account indicates that a partner has received assets or has been allocated losses that are attributable to the capital of other partners, or to borrowed capital. Properly maintained capital accounts should demonstrate to those other partners that the partner for whom a deficit capital account exists is receiving assets from the economic interests of non-deficit partners. In general, if a partner has no obligation to restore a capital account deficit, allocations of tax items to the partner that create a deficit are not permitted as they lack economic effect – the distributions or loss items are coming from the capital of other partners. The big exception to this general principle occurs in the presence of nonrecourse debt.

11. Id.

12. Treas. Reg. § 1.704-1(b)(2)(iv)(*e*). This process requires revaluation of distributed property to fair market value on the date of the distribution and an allocation of the book gains and losses resulting from revaluation to the partners in accord with their share of gains and losses attributable to the distributed property.

13. Treas. Reg. § 1.704-1(b)(2)(ii)((b)(3).

14. The result in the seminal case Orrisch v. Commissioner, 55 T.C. 395, aff'd *per curium*, 31 A.F.T.R. 2d 1069 (9th Cir. 1973), disregarding allocations of depreciation, turned on the partners' failure to provide for distributions of partnership assets in accord with the partners' capital accounts.

The utility of proper capital accounts can be illustrated with a simple example.[15]

Example 1. A, B, and C form a partnership to which A contributes $100,000 in cash, B contributes Whiteacre with an adjusted basis of $40,000, and C contributes Blackacre with an adjusted basis of $60,000. B and C have paid differing amounts to acquire the properties, but A, B and C agree that the fair market value of Whiteacre and Blackacre is $100,000 each, and each partner will be treated as contributing $100,000 to the partnership. This agreement is reflected in capital accounts. Under properly maintained capital accounts, the partnership's "cost" or book value of Blackacre and Whiteacre will be $100,000, their fair market values.[16] The partners' agreement as to the value of the contributed properties is objectively reflected in the capital account at book values, which, immediately after the formation of the ABC partnership, is as follows:

	Assets Book Value		Partners' Capital Accounts Book Value
Cash	$100,000	A	$100,000
Whiteacre	$100,000	B	$100,000
Blackacre	$100,000	C	$100,000
	$300,000		$300,000

Absent recognition of any realized gains or losses on disposition of the partnership assets, each partner is entitled to receive $100,000 on liquidation.

B. Basic Allocations−Income Items

The flexibility to freely allocate partnership income and expense items among the partners is one of the principal features of the partnership tax regime and is one of the principal benefits of the partnership form of doing business. For tax purposes, partners are allowed to allocate partnership items as they may agree as long as the allocation has "substantial economic effect,"[17] which means that in the event there is an economic benefit or

15. The example is from Paul McDaniel, Martin McMahon, Daniel Simmons, Federal Income Taxation of Business Organizations, 35 (Foundation Press, 4th ed. 2006).

16. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*).

17. IRC § 704(a) and (b). Section 704(a) provides for allocation of partnership items as determined by the partnership agreement. Section 761(c) provides that the partnership agreement includes any modifications up to the due date for filing the partnership tax return. These provisions permit the partners to adjust allocations of partnership items up to the date for filing the partnership return.

economic burden that corresponds to a tax allocation, the partner to whom the tax allocation is made must receive such economic benefit or bear such economic burden.[18] The scope of this flexibility can be examined through analysis of capital accounts.

Example 2 - Suppose in Example 1, B's basis and the partnership's basis in Whiteacre is $100,000[19] and the partnership sold Whiteacre for $130,000. The partnership has book and tax gain of $30,000. The partners can agree to share the $30,000 gain in any portion they choose as long as the book gain and tax gain are allocated the same way.[20] Thus, if the partners agree that the gain is shared equally, one-third each, each partner is allocated $10,000 of book gain to the partner's capital account, and each partner is allocated $10,000 of tax gain. The partnership capital accounts will be adjusted accordingly.

Assets	Book Value	Partners' Capital Accounts	Book Value
Cash	$230,000	A	$110,000
Blackacre	$100,000	B	$110,000
		C	$110,000
	$330,000		$330,000

These capital accounts demonstrate that each partner has received $10,000 of gain because each of the partners will receive a $110,000 distribution on liquidation of the partnership.

Alternatively, the partners might agree to allocate all $30,000 of the book gain to A, in which case the partnership capital accounts are as follows:

18. Treas. Reg. § 1.704-1(b)(2)(ii). The substantial economic effect test encompasses two distinct parts; (1) an allocation must have economic effect, and (2) the economic effect must be substantial in the sense that it affects the dollar amount that a partner will receive independent of tax consequences. Treas. Reg. §1.704-1(b)(2)(iii)(*a*). Since this paper focuses on the details of formation rather than allocations, I am omitting a discussion of the substantiality requirement.

19. Basis equal to fair market value at contribution avoids application of IRC § 704(c), discussed infra in the text beginning at note 40.

20. Any allocation of gain to partners with positive capital account balances will satisfy the substantial economic effect test of Treas. Reg. § 1.704-1(b)(2), or, if the formalities of that test are not met, will be treated as in accord with the partners' interests under Treas. Reg. § 1.704-1(b)(3).

Assets	Book Value		Partners' Capital Accounts Book Value
Cash	$230,000	A	$130,000
Blackacre	$100,000	B	$100,000
		C	$100,000
	$330,000		$330,000

This latter allocation has economic effect because A will receive the $30,000 of gain on liquidation of the partnership in accord with the partnership capital accounts. Partnership taxation deviates here from normal tax principles in the sense that the partnership mechanism permits partners to agree to assign items of income and deduction by agreement. The assignment of partnership items is respected as long as there is a corresponding economic consequence to the assignment. The partnership capital accounts reflect the partners' economic arrangement as long as the capital accounts control the amount that a partner can ultimately withdraw from the partnership.[21] Thus, the assignment of $30,000 gain to one of the partners has an economic impact if the gain is recoverable by the partner through liquidation of the partner's interest or earlier in a non-liquidating distribution. Accordingly, the regulations provide that in order for allocations to be treated as having economic effect for tax purposes, allocations must be reflected in properly maintained capital accounts in a partnership that provides for liquidation distributions to the partners in accord with positive account balances in their capital accounts.[22]

C. Basic Allocations−Loss Items

In general, the allocation of loss follows the same pattern as allocations of gain. Loss may be allocated to partners for tax purposes as long as the allocation reflects an allocation of the economic burden of the loss. The regime of loss allocations is more complex, however, because of the use of partnerships as vehicles in tax shelter transactions for creating tax loss deductions that are divorced from economic losses. The detailed complexity of the section 704(b) regulations is beyond the scope of this paper. Nonetheless, the fundamental principles are reasonably accessible. There are basically three guiding principles under the regulations.

21. These rules have been criticized because the flexibility inherent in the partnership scheme does permit partners to reallocate income in ways that do not necessarily reflect overall economic income. Lokken, supra note 3, 259.

22. Treas. Reg. § 1.714-1(b)(2)(ii)(*b*)(2).

1. You can always allocate loss items to the positive balance in a partner's capital account. As long as no partner has a deficit capital account balance, and reductions in a partner's capital account reflect a reduction in the amount ultimately distributable to a partner, the partner whose capital account is reduced by a loss allocation bears the economic burden of the loss.[23]

2. Losses can be allocated against capital that a partner is committed to contribute to the partnership in the future, including a deficit restoration obligation or partner recourse debt. To the extent that a partner is liable to restore a negative capital account, thereby making the other partners whole for positive capital account balances, the partner with an obligation to restore a deficit capital account will bear the economic burden of any loss allocation.[24]

3. No allocation of deductions financed by nonrecourse debt[25] can have economic effect. Loss items which no partner is ultimately obligated to restore may be allocated to the partners in proportion to each partner's allocation of the income or gain that will be recognized on payment of partnership liabilities that gave rise to the item (a minimum gain chargeback), e.g. nonrecourse debt funded items are allocable by profit share.[26]

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23. This principle is derived from the rules of Treas. Reg. § 1.704-1(b)(2)(ii) (substantial economic effect), (b)(2)(ii)(d) (the alternative economic effects test), and (b)(2)(ii)(i) (economic effect equivalence). While an allocated loss produces an immediate tax deduction, the ultimate economic burden of the loss is postponed to liquidation of the partnership. However, as the loss is immediately reflected in a devaluation of a partner's capital account, in effect the economic impact of the loss is immediately realized in a devaluation of the value of the partner's interest relative to the interests of other partners.

24. This principle is part of the economic effect test itself. Treas. Reg. § 1.704-1(b)(2)(ii)(c). This principle permits an immediate deduction for a loss that is funded by debt, a promise to repay in the future, but that is the case with any debt-funded expenditure whether incurred inside or outside of a partnership.

25. Nonrecourse debt is debt for which no partner is personally liable. Treas. Reg. § 1.752-1(a)(2). Allocations of items attributable to nonrecourse debt may be made in conformity with the safe-harbor described in Treas. Reg. § 1.704-2.

26. This is the minimum gain concept of Treas. Reg. § 1.704-2(d), which is consistent with the normal tax treatment of nonrecourse debt funded expenditures by a single taxpayer.

D. Basic Tax Principles − Contribution of Property

In general, gain or loss is recognized on an exchange of property for a different asset,[27] which could include the contribution of property in exchange for an interest in a partnership. However, Subchapter K provides a nonrecognition regime that results in tax-deferral for transfers of property by a partner to a partnership. Recognition of gain or loss is deferred through statutory provisions that exchange the tax basis of contributed property for the contributor's basis in the received partnership interest, and transfer the contributor's basis in contributed property to the partnership. Thus, section 721 provides that no gain or loss will be recognized by a partner or a partnership in the contribution of property in exchange for a partnership interest.[28] Section 722 provides that a partner's basis in the partner's partnership interest shall be the amount of money plus the basis of property contributed to the partnership. Section 723 provides that the partnership's basis in contributed property shall be the same as the basis of the contributing partner. Under this regime, built-in gains and losses are preserved both in the differential between the value and basis of the contributing partner's partnership interest and the differential between value and basis of assets within the partnership. As discussed below,[29] section 704(c) operates to insure that a contributing partner ultimately recognizes pre-contribution gains and losses by allocating the tax effect of built-in gains or losses to the contributing partner. Otherwise, the partnership tax regime ultimately avoids double inclusion of gains or double deduction of losses with offsetting gains or losses recognized on the termination of a partner's partnership interest, although in particular circumstances tax gain or loss may be accelerated into a current taxable year to be offset in a later year.

Example 3 - Applying these tax rules to the ABC Partnership in Example 1, B does not recognize the $60,000 gain realized on the exchange of Whiteacre for a partnership interest worth $100,000, and C does not recognize the $40,000 gain realized on the exchange of Blackacre for the partnership interest. Nor does the partnership recognize gain on the receipt of Whiteacre and Blackacre. Instead, the gains are preserved through the exchange basis rules; B's basis in B's partnership interest is $40,000, C's basis in C's partnership interest is $60,000. The ABC Partnership's basis in Whiteacre is $40,000, and its basis in Blackacre is $60,000. The basis numbers are reflected in the partnership capital account as follows:

27. IRC § 1001(c).

28. Section 721 applies only to contributions of property. Receipt of a partnership interest in capital in exchange for services is a taxable event. See Treas. Reg. § 1.721-1(b)(1).

29. Infra, text at note 39.

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Whiteacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Blackacre	$100,000	$ 60,000	C	$100,000	$ 60,000
	$300,000	$200,000		$300,000	$200,000

In this case, just as the values of the partnership assets are equal to the partners' capital, the sum of the inside bases of partnership assets is equal to the sum of the outside bases of the partners' partnership interests. This equality of inside and outside bases does not always occur.[30]

E. Character and Holding Period

Consistent with the nonrecognition and exchange basis nature of the tax treatment of contributions of built-in gain and loss property, the tax regime contains rules for maintaining the tax character of the property. In general, a gain or loss on the sale or exchange of a partnership interest is treated as capital gain or loss to the selling partner, even though the partnership interest may have been acquired in exchange for assets that would produce ordinary income upon sale, such as inventory.[31] In addition, if the contributed property was a section 1231 asset or a capital asset, a partner's holding period for his partnership interest includes the period for which he held the contributed property.[32] Similarly, the partnership's holding period will include the period that the contributing partner held the

30. The purchase and sale of partnership interests and some distributions may cause a disparity between inside and outside bases. In general, the disparity can be corrected with an election under § 754, which triggers adjustments under §§ 734(b) (distributions) and 743(b) (sales of a partnership interest).

31. IRC § 741. However, if a partnership's property consists of inventory or unrealized accounts receivable, § 751(a) will require the recognition of ordinary income on a sale of the partnership interest to the extent of the selling partner's interest in unrealized receivables and inventory, notwithstanding classification of a partnership interest as a capital asset. Treas. Reg. § 1.751-1(a)(2) provides that the amount treated as ordinary income is the amount of gain that would be allocated to the selling partner if the partnership sold unrealized receivables and inventory for fair market value. The remaining amount of gain treated as capital gain is determined by subtracting the amount of ordinary gain from the selling partner's overall amount of gain or loss realized. In some situations, this subtraction can produce a capital loss in addition to ordinary income.

32. IRC § 1223(1).

property.[33] If the contributed property was an ordinary income asset in the hands of the contributing partner, however, the holding period of the partnership interest commences when the interest is received.

If the contributing partner contributes assets consisting both of capital gain property and ordinary income property, the application of the holding period rules is not specifically spelled out. Although a partnership interest is generally viewed as a unitary asset, fragmentation of the partnership interest into pieces with different holding periods seems to be the most logical answer to this problem.[34] Once the partnership interest itself is held for more than one year, disposition of the interest will produce long-term gains or losses.

With respect to the partnership, contributed property is characterized as a capital asset, section 1231 asset, or ordinary income asset based on the purpose for which the partnership holds the property.[35] There are some significant exceptions:

> 1. Unrealized receivables contributed by a partner, such as a cash method service provider's accounts receivable, retain their ordinary income character permanently.[36]
>
> 2. Inventory items contributed by a partner retain their ordinary character for five years, even if the property is not held as inventory by the partnership.[37]
>
> 3. Property with a built-in capital loss at the time of the contribution retains its character as a capital asset, to the extent of the built-in loss, for five years even though the partnership holds the asset as an ordinary income asset.[38]

These rules, in tandem with section 704(c), insure that a person contributing built-in ordinary gain property will ultimately recognize the property's pre-contribution gain as ordinary or pre-contribution capital loss as a capital loss.

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33. IRC § 1223(2).
34. McDaniel, et. al. supra note 15, 41
35. Under IRC § 702(b), partnership items are characterized at the partnership level and retain their character when passed-through and reported by the partner.
36. IRC § 724(a).
37. IRC § 724(b).
38. IRC § 724(c).

III. CONTRIBUTION OF BUILT-IN GAIN PROPERTY[39]

A. Allocation of Recognized Built-in Gain

Section 704(c)(1)(A) provides that, "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 . . ." In other words, pre-contribution built-in gain or loss is recognized by the contributing partner as an allocation from the partnership when recognized by the partnership. This rule prevents shifting of pre-contribution gain or loss from the contributing partner to other partners.[40]

Example 4 - Assume that the ABC partnership agreement in Example 1 provides for an equal one-third division of all partnership profit and loss. The partnership balance sheet immediately following contributions by A, B, and C is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Whiteacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Blackacre	$100,000	$ 60,000	C	$100,000	$ 60,000
	$300,000	$200,000		$300,000	$200,000

If Whiteacre were sold for $100,000, the partnership has no gain for book purposes, but there is $60,000 of recognized tax gain. Allocating the $60,000 tax gain in proportion to 1/3 interests of each partner would shift B's pre-contribution built-in gain to partners A and C. A look at the resulting capital accounts demonstrates that this is the wrong result:

39. Built-in gain or loss property is contributed property with a difference in the book value and tax basis at the time of contribution. Treas. Reg. § 1.704-3(a)(3)(ii).

40. Section 704(c)(1)(A) is applied on a property by property basis. The contributing partner is not permitted to aggregate the bases and value of contributed property to offset built-in gain on one asset with a built-in loss on another. Treas. Reg. § 1.704-3(a)(2).

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	\$100,000	\$100,000	A	\$100,000	\$120,000
Whiteacre/cash	\$100,000	\$100,000	B	\$100,000	\$ 60,000
Blackacre	\$100,000	\$ 60,000	C	\$100,000	\$ 80,000
	\$300,000	\$260,000		\$300,000	\$260,000

The allocation creates a disparity in the cash partner A's book and tax accounts by the amount of the gain. Recognition of the \$20,000 of tax gain allocated to A on sale of Whiteacre is translated into a \$20,000 tax loss that is deferred until the date A disposes of or liquidates A's partnership interest.[41] B recognizes only \$20,000 of B's \$60,000 pre-contribution built-in gain. The remaining \$40,000 of B's gain, which has been shifted to A and C, is deferred until a disposition or liquidation of B's partnership interest.

To prevent the shifting of B's built-in gain to the other partners, section 704(c) requires that the partnership's \$60,000 tax gain be allocated to the contributing partner, B. Thus,

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	\$100,000	\$100,000	A	\$100,000	\$100,000
Whiteacre/cash	\$100,000	\$100,000	B	\$100,000	\$100,000
Blackacre	\$100,000	\$ 60,000	C	\$100,000	\$ 60,000
	\$300,000	\$260,000		\$300,000	\$260,000

The allocation required by section 704(c)(1)(A) has the effect of eliminating the book/tax disparity in B's capital account. Although the allocation rules of the regulations[42] applying section 704(c) are complex, the guiding principle is that allocations related to differences in fair market value and basis at the time of contribution of property to a partnership are to be made in a manner that reduces the disparity between partners' book and tax accounts. Thus, properly maintained capital accounts are the guide to section 704(c) allocations. This can be seen in the following example:

Example 5 - Assume in Example 4 that Whiteacre is sold for \$130,000, producing \$30,000 of book gain (\$130,000 - \$100,000) and \$90,000 of tax gain (\$130,000 - \$40,000). The book gain is allocated equally

41. Liquidation of the partner's interest for a cash payment that is less than basis results in a recognized loss to the partner. IRC § 731(a)(2).

42. Treas. Reg. § 1.704-3.

among the partners, 1/3 each. $10,000 of tax gain is allocated to each partner to match the allocation of book gain, so A and C are each allocated $10,000 of tax gain. B also is allocated $10,000 of tax gain to match B's share of the book gain. In this respect, the tax consequences of the $30,000 of recognized book gain follow the economic allocation of this gain. The remaining $60,000 of tax gain ($90,000 - $30,000), B's pre-contribution built-in gain, is allocated to B. B's total tax gain is $70,000. The result is reflected in partnership capital accounts as follows:

Assets	Book Value	Basis	Partners' Capital Accounts	Book Value	Basis
Cash	$100,000	$100,000	A	$110,000	$110,000
Whiteacre/cash	$130,000	$130,000	B	$110,000	$110,000
Blackacre	$100,000	$ 60,000	C	$110,000	$ 70,000
	$330,000	$290,000		$330,000	$290,000

A's and B's book and tax accounts are the same. C's tax account is $40,000 less than book reflecting C's pre-contribution built-in gain for Blackacre.

B. Allocation Methodologies

Complications arise when tax items attributable to built-in gain and loss property are not sufficient to match book gains and losses.

Example - Assume in Example 4 that Whiteacre is sold for $70,000. In this case the partnership realizes a $30,000 book loss ($70,000 - $100,000) that is shared equally by the partners, $10,000 each. There is recognized tax gain of $30,000 ($70,000 – adjusted basis of $40,000).

1. Traditional Method with the Ceiling Rule

Under the traditional method of Treasury Regulations section 1.704-3(b), on the disposition of contributed property the partnership must allocate to the contributing partner the built-in gain or loss inherent in the property at the time it was contributed to the partnership. There is no provision for matching the economic gains or losses of the partners as reflected in their capital accounts with tax items. Indeed, the traditional regulation specifically limits allocations of tax items with a so-called "ceiling rule."[43] Thus, In

43.Treas. Reg. § 1.704-3(b)(1) provides that, "the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)." For a discussion of the ceiling rule and other allocation methods under the regulations see Laura Cunningham, Use

Example 6, the $30,000 tax gain is allocated entirely to B. Partners A and C each have a $10,000 book loss but no accompanying tax loss. The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$ 90,000	$100,000
Whiteacre/cash	$ 70,000	$ 70,000	B	$ 90,000	$ 70,000
Blackacre	$100,000	$ 60,000	C	$ 90,000	$ 60,000
	$270,000	$230,000		$270,000	$230,000

The allocation of a book loss to A with no corresponding tax loss creates a disparity in A's book and tax accounts. A's partnership basis is $10,000 higher than A's capital account. This excess basis reflects A's share of economic loss, but not tax loss, on the sale of Blackacre. A's recognition of this economic loss is deferred for tax purposes until A realizes a $10,000 loss on disposition of A's partnership interest. Likewise, C's book loss will be reflected as a $10,000 reduction of gain realized on disposition of C's partnership interest. B's realization of B's remaining $20,000 pre-contribution gain ($60,000 - $10,000-$30,000) is also deferred. As a result, deferral of B's built-in gain causes a timing shift with the creation of deferred recognition of economic loss to A and C.

2. Traditional Method with Curative Allocations

Reasonable curative allocations permit a partnership to eliminate the timing distortions caused by the ceiling rule with curative allocations of other partnership income or deduction items of the same character as the tax items affected by the ceiling rule.[44] These curative allocations of other partnership tax items of income, gain, loss, or deduction may be used to "cure" disparities caused by the ceiling rule by equalizing the overall allocations of economic and tax items to non-contributing partners, but only to the extent the curative allocation offsets the effect of the ceiling rule.[45] Curative allocations of tax deviate from the book allocations of the same items. Thus, except as they are expressly permitted by Treasury Regulations section 1.704–3(c), curative allocations generally would not be valid under the substantial economic effect tests of Treasury Regulations section 1.704–1(b).

Example 6A - Assume that the partnership in Example 6 had $20,000

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and Abuse of Section 704(c), 3 Fla. Tax Rev. 93 (1996).

44. Treas. Reg. § 1.704-3(c). See McDaniel et. al., supra note 15, 157.

45. Treas. Reg. § 1.704-3(c)(3).

of expense and $20,000 of income from sources that matched the character of the partnership's $30,000 tax gain from the sale of Whiteacre. The partnership thus breaks even apart from its gain on the sale of Whiteacre. The partnership's only book item is its $30,000 book loss realized on the sale of Whiteacre. Although there are no allocations of book income and loss attributable to the partnership's offsetting income and loss, in order to match the $20,000 of book loss that is divided between A and C on the sale of Whiteacre with a tax loss, the partnership's $20,000 of tax deductible expenses may be allocated to A and C, and none to B. This allocation cures the absence of allocable tax loss and matches the book loss from the sale of Whiteacre. Thus, A and C may each be allocated $10,000 of net tax loss. Although there is no book income to match the operating income, the full $20,000 of taxable operating income is allocable to B to balance the $20,000 of expense allocated to A and C. B also is allocated the $30,000 of tax gain from disposition of Whiteacre.[46] The allocation of the partnership's tax items is as follows:

	Total	A	B	C
Gain from Whiteacre	$30,000		$30,000	
Income	$20,000		$20,000	
Deductible Expense	($20,000)	($10,000)		($10,000)
Total Tax Affect	$30,000	($10,000)	$50,000	($10,000)

These allocations reduce or eliminate disparities in the partners' book and tax accounts by matching each partner's tax allocation with the partner's book loss.[47] The partnership capital account is as follows:

Assets	Book Value	Basis	Partners' Capital Accounts	Book Value	Basis
Cash	$100,000	$100,000	A	$ 90,000	$ 90,000
Whiteacre/cash	$ 70,000	$ 70,000	B	$ 90,000	$ 90,000
Blackacre	$100,000	$ 60,000	C	$ 90,000	$ 50,000
	$270,000	$230,000		$270,000	$230,000

46. IRC § 704(c)(1)(A).

47. The book/tax disparity in C's capital account is attributable to the difference in basis and value of C's initial contribution of built-in gain property that remains preserved in the difference between the value of C's partnership interest and outside basis.

3. Remedial Allocations

Rather than curative allocations of existing partnership items, the remedial allocation method of Treasury Regulations section 1.704-3(d) eliminates distortions of the ceiling rule with tax allocations of *notional* partnership gain or income that are offset by tax allocations of *notional* partnership deduction or loss.[48] The creation of notional items of income or loss that do not reflect economic income or loss creates tax items without any recognition event.[49] However, remedial allocations result in each partner recognizing total partnership income, gains, deductions, or loss for the year equal to the partner's share of book gain or loss. Remedial allocations are in addition to allocations under the ceiling rule. Thus, the partnership makes a remedial allocation of notional income, gain, deduction, or loss (without affecting allocations of actual partnership income, gain, deduction, or loss) to the non-contributing partner equal to the difference in book and tax allocations caused by the ceiling limitation, and a simultaneous offsetting notional allocation of income, gain, deduction, or loss to the contributing partner.

Example 6 - In Example 6, where the partnership has a book loss of $30,000 and a tax gain of $30,000 on sale of the property contributed by B, and no other items of income or loss, the partnership may make remedial allocations to give each partner tax items equivalent to the partner's book items. Thus –

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Gain (loss) from Whiteacre		($10,000)	$30,000	($10,000)		($10,000)
Remedial Allocation	($10,000)		$20,000		($10,000)	
	($10,000)	($10,000)	$50,000	($10,000)	($10,000)	($10,000)

The partnership capital account is the same as in Example 6A.

A's and C's remedial deductions, and B's corresponding notional income item, must be of the same character as the income item from the property that was sold.[50] If the property is a capital asset, the remedial allocations must be capital gain and loss; if the property is an ordinary income asset, the remedial allocations must be ordinary gain and loss. If, as

48. See McDaniel et. al., supra note, 15, 158.
49. Treas. Reg. § 1.704-3(d)(5)(i).
50. Treas. Reg. § 1.704-3(d)(3).

is often likely, the property is a section 1231 asset, the remedial allocations must be section 1231 gain and loss, even though in some cases a character mismatch may occur after taking into account each partners other items of section 1231 gain and loss.[51] Remedial allocations must also be treated as arising from the same activity as the underlying section 704(c) item for purposes of applying the passive activity loss rules of section 469.[52]

Even though remedial allocations involve purely notional tax items, remedial allocations of income, gain, deduction, and loss are treated as real tax items that are taken into account in adjusting partners' bases in their partnership interests under section 705 in the same manner as distributive shares of partnership taxable income.[53] Remedial allocations, however, do not affect either partnership taxable income under section 703 or the partnership's adjusted basis in any of its property.[54]

Example 7- To demonstrate that we are on the right track here, assume that in either Example 6A or 6B the partnership sells Blackacre for $100,000, realizing no book gain or loss and a $40,000 tax gain. The tax gain must be allocated to C (the contributing partner) under section 704(c)(1)(A). The partnership capital accounts are now –

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$ 90,000	$ 90,000
Whiteacre/cash	$ 70,000	$ 70,000	B	$ 90,000	$ 90,000
Blackacre/cash	$100,000	$100,000	C	$ 90,000	$ 90,000
	$270,000	$270,000		$270,000	$270,000

The partnership has eliminated all of its inside built-in gain and loss and there are no built-in gains or losses in the partners' interests. The various 704(c) allocations, along with either the curative or remedial allocations of Treas. Reg. section 1.704-3(c) or (d) eliminate the partners' book/tax differences with the result that each partner recognizes tax gains and losses appropriate to the partner's share of economic gain or loss.

C. Allocation of Depreciation Deductions Attributable to Contributed Built-in Gain Property

Contribution to a partnership of depreciable property with a value different than adjusted basis raises the same sort of allocation issues with

51. McDaniel et al., supra note 15, 159.
52. Id.
53. Treas. Reg. § 1.704-3(d)(4)(ii).
54. Treas. Reg. § 1.704-3(d)(4)(i).

respect to the allocation of depreciation deductions among the partners as allocations of recognized pre-contribution gain. Under section 704(c)(1)(A), allocations of depreciation and of gain or loss on depreciable property must reflect the difference between the contributing partner's basis in the property and the book value of the property included in the contributing partner's capital account. Tax depreciation and book depreciation generally must be computed at the same rate in order to maintain capital accounts in the required manner. Thus, book depreciation is the same proportion of book basis as tax depreciation bears to adjusted basis so that book and tax depreciation is accounted for at the same rate.[55]

The principles of section 704(c) apply to allocations of depreciation deductions attributable to contributed property with built-in gain or loss in the same fashion as allocations of built-in gain. The overriding principal is that allocations of tax depreciation to a non-contributing partner should match the partner's share of book depreciation. Any remaining tax depreciation is allocated to the contributing partner. Section 704(c) principles thereby assure that depreciation deductions allocated to the partners for tax purposes reflect the economic deductions allocated to the partners' capital accounts. Again, properly maintained capital accounts provide the guide to consistent allocations under section 704(c). Correct allocations will reduce the disparity between the partners' book and tax accounts.

Example 8 - D and E form a partnership to which D contributes $100,000 cash and E contributes depreciable property with a book value of $100,000 and a basis of $60,000.[56] Each partner has a 50% interest in partnership capital and profits. The initial partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Cash	$100,000	$100,000	D	$100,000	$100,000
Depreciable Property	$100,000	$ 60,000	E	$100,000	$ 60,000
	$200,000	$160,000		$200,000	$160,000

55. Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3). In the case of capital recovery deductions, the rules for book income and expense depart from economic reality. By allowing capital recovery methods for book depreciation that mirror the accelerated tax depreciation methods of IRC § 168, the capital account rules require capital recovery for book purposes that does not necessarily represent the actual annualized cost of depreciable assets.

56. This example is derived, with changes, from McDaniel et. al., supra note 15, 160.

Assume, for simplicity, that under section 168 the property has a ten-year cost recovery period with five years remaining and its cost is recoverable using the straight line method. Also assume that the DE partnership breaks even for both tax and book purposes apart from the annual depreciation deductions. Under the traditional method, book depreciation is computed using the property's remaining tax cost recovery period for the entire book value.[57] Thus, the annual tax depreciation is $12,000 per year (starting basis of $120,000/10 years) and book depreciation for each of the remaining five years is $20,000 ($100,000/5 years). D and E's annual share of book depreciation is $10,000 each. In effect, D has purchased a 50% interest in the property for $50,000 and should, therefore, be entitled to $10,000 of depreciation in each of the remaining five years of the asset recovery period. To match the non-contributing partner's share of book depreciation, D must be allocated $10,000 of tax depreciation. The remaining $2,000 of tax depreciation is allocated to E.[58] Over five years, the disparity between book and tax accounts is reduced, then eliminated, as follows:

	D		E	
	Book	Tax	Book	Tax
Initial Capital Account	$100,000	$100,000	$100,000	$60,000
Year 1 Depreciation	($ 10,000)	($ 10,000)	($ 10,000)	($ 2,000)
End of Year 1 Capital Account	$ 90,000	$ 90,000	$ 90,000	$58,000
Year 2 Depreciation	($ 10,000)	($ 10,000)	($ 10,000)	($ 2,000)
End of Year 2 Capital Account	$ 80,000	$ 80,000	$ 80,000	$56,000
Year 3 Depreciation	($ 10,000)	($ 10,000)	($ 10,000)	($ 2,000)
End of Year 3 Capital Account	$ 70,000	$ 70,000	$ 70,000	$54,000
Year 4 Depreciation	($ 10,000)	($ 10,000)	($ 10,000)	($ 2,000)
End of Year 4 Capital Account	$ 60,000	$ 60,000	$ 60,000	$52,000
Year 5 Depreciation	($ 10,000)	($ 10,000)	($ 10,000)	($ 2,000)
End of Year 5 Capital Account	**$ 50,000**	**$ 50,000**	**$ 50,000**	**$50,000**

1. The Ceiling Limitation

The ceiling limitation on the traditional method will create timing distortions when the remaining tax depreciation on contributed property is

57. Treas. Reg. § 1.704-3(b)(2), Ex. (2).

58. This is the traditional method of Treas. Reg. § 1.704-3(b).

less than the book depreciation allocable to the non-contributing partner. Under the ceiling limitation, allocations of tax items cannot exceed the total partnership income, gain, loss, or deduction attributable to the contributed property.[59] Thus, in the absence of sufficient basis at the time of contribution, tax depreciation available for allocation to non-contributing partners will be less than the non-contributing partner's allocation of book depreciation.

Example 9A - Assume in Example 8 that E's adjusted basis in the contributed depreciable property is only $40,000. In this case there is again $20,000 of annual book depreciation, but only $8,000 of annual tax depreciation (starting basis of $80,000/10 years). The full $8,000 of tax depreciation must be allocated to D, which is insufficient to match D's $10,000 share of book depreciation.

	D		E	
	Book	Tax	Book	Tax
Initial Capital Account	$100,000	$100,000	$100,000	$40,000
Year 1 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
End of Year 1 Capital Account	$ 90,000	$ 92,000	$ 90,000	$40,000
Year 2 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
End of Year 2 Capital Account	$ 80,000	$ 84,000	$ 80,000	$40,000
Year 3 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
End of Year 3 Capital Account	$ 70,000	$ 76,000	$ 70,000	$40,000
Year 4 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
End of Year 4 Capital Account	$ 60,000	$ 68,000	$ 60,000	$40,000
Year 5 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
End of Year 5 Capital Account	**$ 50,000**	**$ 60,000**	**$ 50,000**	**$40,000**

While D has paid $50,000 for a 50% interest in the depreciable property, D is allowed only $40,000 of tax depreciation over the remaining useful life of the property, leaving $10,000 of unrecovered cost in D's outside partnership basis. D will recover that cost on final disposition of D's partnership interest as a $10,000 loss, thereby deferring cost recovery beyond what is allowed under the depreciation method.

59. Treas. Reg. § 1.704-3(b)

2. Curative Allocations

The distortions created by the ceiling rule can be cured with reasonable curative allocations.[60] The curative method permits a curative allocation of a deductible item for current expenses to the non-contributing partner (without a matching reduction in book income) or a curative allocation of ordinary income to the contributing partner (again without a matching allocation of book income).

Example 9B - If the DE partnership in Example 9A also had $4,000 of gross income each year, or $4,000 of additional deductions, these items could be allocated differently from the partners' share of the items for book purposes in order to cure the disparity between the book and tax accounts. Assume that each year the partnership has an additional $4,000 of ordinary income that is allocated $2,000 to each partner for book purposes. In order to cure D's $2,000 shortfall in tax depreciation, the full $4,000 of tax includible gross income may be allocated to E, even though E's share of the income for book purposes is only $2,000. As a result, each year D receives $2,000 of book income without a corresponding allocation of taxable gross income to offset the $2,000 shortfall in allocated depreciation. E pays the tax on the $2,000 of book income allocated to D. The allocations of income and depreciation to the partners are as follows –

	D		E	
	Book	Tax	Book	Tax
Initial Capital Account	$100,000	$100,000	$100,000	$40,000
Year 1 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 1 Income	$ 2,000	0	$ 2,000	$ 4,000
End of Year 1 Capital Account	$ 92,000	$ 92,000	$ 92,000	$44,000
Year 2 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 2 Income	$ 2,000	0	$ 2,000	$ 4,000
End of Year 2 Capital Account	$ 84,000	$ 84,000	$ 84,000	$48,000
Year 3 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 3 Income	$ 2,000	0	$ 2,000	$ 4,000
End of Year 3 Capital Account	$ 76,000	$ 76,000	$ 76,000	$52,000
Year 4 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0

60. Treas. Reg. § 1.704-3(c).

Year 4 Income	$ 2,000	0	$ 2,000	$ 4,000
End of Year 4 Capital Account	$ 68,000	$ 68,000	$ 68,000	$56,000
Year 5 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 5 Income	$ 2,000	0	$ 2,000	$ 4,000
End of Year 5 Capital Account	**$ 60,000**	**$ 60,000**	**$ 60,000**	**$60,000**

Over the recovery period of the depreciable property, the allocation of an extra $10,000 of taxable income to E (which lacks economic effect because the economic allocation of income between the partners does not match the allocation of tax consequence), and the allocation of $10,000 of book income without an allocation of tax income, cures D's loss of $10,000 of depreciation deductions attributable to D's cost in book terms of D's interest in the depreciable property.

The same result could be accomplished if the partnership had a current expense deduction of $4,000. While the book allocation of the expense would be $2,000 to each partner, the full $4,000 tax deduction could be allocated to D as a curative allocation, representing D's $2,000 book share of the item and an additional $2,000 deduction representing the cure for D's depreciation shortfall.

3. Remedial Allocations

The remedial allocation method is available to cure the timing distortions of the ceiling rule if a partnership with depreciable built-in gain property lacks sufficient income or expense items to cure the distortion.[61] However, application of remedial allocations requires a two part process that has the effect, when compared to curative allocations, of delaying capital recovery for the non-contributing partner. Under the regulations,[62] a portion of the partnership's book basis in property equal to its tax basis is recovered in the same manner as the tax basis. The remainder of the partnership's book basis over adjusted tax basis is recovered under the recovery method available to the partnership for newly purchased property as of the date of the contribution. In this second step, the excess of book basis over tax basis is recovered as if the property were placed in service in the year of the contribution.

Example 9C - Assume in Example 9A that the partnership has no ordinary income items or expenses other than its depreciation deductions. To determine the remedial allocations, first an amount of the book value of the asset equal to its tax basis is recovered for book purposes over the remaining

61. Treas. Reg. § 1.704-3(d).
62. Treas. Reg. § 1.704-3(d)(2).

tax cost recovery period of the contributed asset. In the DE partnership this amount is $8,000 per year ($40,000 adjusted basis recovered over 5 years). The $60,000 difference between the book value of the depreciable property ($100,000) and its adjusted basis ($40,000) is treated as depreciable property placed in service in the year of the contribution. This second item generates $6,000 of annual book depreciation deductions over ten years (on a straight line basis). The two depreciation items are combined during the remaining tax recovery period of the contributed asset. Thus, total book depreciation in each of the first five years is $14,000 ($8,000 plus $6,000), which is allocated equally to each partner. In years 6 – 10 there is $6,000 of book depreciation, allocable $3,000 to each partner. In years 1 – 5, the $8,000 of tax depreciation is available to allocate $7,000 to D (the non-contributing partner) to match D's share of the book depreciation in those years, leaving $1,000 of tax depreciation for allocation to E. In years 5 – 10, D's share of the book depreciation is $3,000 but there is zero tax depreciation. During this second period, D is allocated a notional tax depreciation deduction equivalent to D's $3,000 share of book depreciation. A remedial amount of notional taxable income of $3,000 must be allocated to E. The partnership allocations in each of the ten years of the useful life of the depreciable property are as follows:

	D		E	
	Book	Tax	Book	Tax
Initial Capital Account	$100,000	$100,000	$100,000	$40,000
Year 1 Depreciation	($ 7,000)	($ 7,000)	($ 7,000)	($ 1,000)
Year 2 Depreciation	($ 7,000)	($ 7,000)	($ 7,000)	($ 1,000)
Year 3 Depreciation	($ 7,000)	($ 7,000)	($ 7,000)	($ 1,000)
Year 4 Depreciation	($ 7,000)	($ 7,000)	($ 7,000)	($ 1,000)
Year 5 Depreciation	($ 7,000)	($ 7,000)	($ 7,000)	($ 1,000)
Year 6 Depreciation	($ 3,000)	($ 3,000)	($ 3,000)	0
Notional Income				$ 3,000
Year 7 Depreciation	($ 3,000)	($ 3,000)	($ 3,000)	0
Notional Income				$ 3,000
Year 8 Depreciation	($ 3,000)	($ 3,000)	($ 3,000)	0
Notional Income				$ 3,000
Year 9 Depreciation	($ 3,000)	($ 3,000)	($ 3,000)	0
Notional Income				$ 3,000
Year 10 Depreciation	($ 3,000)	($ 3,000)	($ 3,000)	0
Income				$ 3,000
End of Year 10 Capital Account	**$50,000**	**$50,000**	**$50,000**	**$50,000**

Over the ten year period, D receives capital recovery deductions representing D's full cost for the depreciable property. E's pre-contribution gain is recovered through reduced depreciation deductions and nominal allocations of ordinary income.

D. Comparison of the Three Methods

Over the life of a partnership investment, including liquidation or disposition of a partner's interest, the total income and loss realized for tax purposes is the same for each partner under each of the three methods: the traditional method with the ceiling rule, curative allocations, or remedial allocations. However, the timing of the tax consequences varies with each method. One partner's timing advantage is the other partner's timing disadvantage. Comparing the alternative allocations in Example 9 reveals that the curative allocation is most beneficial to D, allowing D to recover the additional $10,000 of depreciation deductions more rapidly than either of the other methods, while the traditional method is the least beneficial to D because D's deductions for depreciation are less than D's book loss and D's full recovery is deferred to disposition of D's partnership interest. Conversely, the traditional method is the most beneficial to E, allowing E to avoid recognition of a portion of E's pre-contribution built-in gain until disposition of E's partnership interest, while the curative allocation method is the least beneficial to E because it requires recognition of additional taxable income earlier than under the remedial method.

The treasury is not affected by these choices unless the partners are in different tax rate brackets or one of the partners is a tax exempt entity. At any given discount rate, the net present value of the aggregate net income or loss of the partners over the cost recovery period of the asset is identical.[63] This is the reason that partners are given the flexibility to choose among the different methods. However, if an allocation is made with a view to shifting tax consequences among partners in a manner that substantially reduces the present value of the aggregate tax liability, the anti-abuse rule of the regulations will cause the allocation to be disregarded as unreasonable.[64]

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63. McDaniel, et. al, supra note 15, 167.

64. Treas. Reg. § 1.704-3(a)(10) provides: "An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse § 704(c) allocations) 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." Prop. Reg. § 1.704-3(a)(10) (2008) would require that in testing for a shift in tax consequences, the tax consequences of both indirect and direct partners be taken into account. Indirect partners include the participants in an entity that is a partner in the partnership that has § 704(c) items. The proposed regulation would apply to a

Given the shift of income, actual or notional, to a contributing partner, the contributor of low basis high value depreciable property is not going to have a strong interest in agreeing to either curative or remedial allocations in a partnership agreement, or at least without some form of compensation for the acceleration of income. Nonetheless, competent representation of a non-contributing partner in this situation would seem to require raising the issue in negotiating contributions of built-in gain property to account for the present value of the loss of the depreciation deductions.[65]

E. Sale of Depreciable Property

Allocations of depreciation with respect to contributed built-in gain or loss property affect the allocation of gain or loss on the partnership's disposition of the property. Again, section 704(c) operates to allocate tax gain and loss to the non-contributing partner(s) to match the non-contributing partner's book gains and losses, subject to the ceiling rule.[66] Taxable gain or loss in excess of book gain is allocated to the contributing partner.

Example 10 - Suppose the DE partnership in Example 8 sold the depreciable property at the end of year 2 for $70,000. Immediately before the sale, after two years of depreciation deductions, the partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Cash	$100,000	$100,000	D	$ 80,000	$ 80,000
Depreciable Property	$ 60,000	$ 36,000	E	$ 80,000	$ 56,000
	$160,000	$136,000		$160,000	$136,000

partnership, subchapter S corporation, estate, trust, or a controlled foreign corporation that is a 10 percent partner. Indirect partners also include members of a consolidated group of corporations where a member of the group is a partner in the partnership. Prop. Reg. § 1.704-3(a)(1) would provide that the allocation methods of Treas. Reg. § 1.704-3 would apply only to contributions to a partnership that "are otherwise respected." The proposed regulations would add that even though an allocation complies with the literal language of Treas. Reg. § 1.704-3(b), (c), or (d), "the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of subchapter K." The proposed changes would be effective on publication of final regulations in the Federal Register.

65. For an analysis of the impact of depreciation on the after-tax return from depreciable property see Paul McDaniel, Martin McMahon, Daniel Simmons, and Gregg Polsky, Federal Income Taxation, 1193 *et. seq.* (Foundation Press 6th ed. 2008).

66. Treas. Reg. § 1.704-3(b)(1). See discussion supra, text at note 43. See also Treas. Reg. § 1.704–3(b)(2), Ex. (1)(ii).

Under the partnership agreement, the partnership's book gain of $10,000 ($70,000 - $60,000) is allocated equally between D and E, $5,000 each. Under § 704(c), the partnership's tax gain, $34,000 ($70,000 - $36,000), is allocated $5,000 to D to match D's book gain, and $29,000 to E, the contributing partner. As a result, the partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Cash	$100,000	$100,000	D	$ 85,000	$ 85,000
Depreciable Property/cash	$ 70,000	$ 70,000	E	$ 85,000	$ 85,000
	$170,000	$170,000		$170,000	$170,000

For purposes of determining the amount of any tax gain recognized by a partner that is treated as ordinary income under the section 1245 recapture rules,[67] each partner will recapture the partner's share of depreciation allocated to the partner while the property was held by the partnership.[68] Curative and remedial allocations to a non-contributing partner as a substitute for depreciation deductions are included in the partner's share of section 1245 recapture.[69] Also, curative allocations of income to the contributing partner increase the non-contributing partner's share of section 1245 recapture.[70] Curative and remedial allocations of ordinary income items to the contributing partner reduce the contributing partner's share of section 1245 recapture, which has already been recovered as ordinary income recognized by the contributing partner.[71] Curative allocations of deduction items to non-contributing partners reduce the contributing partner's share of section 1245 recapture.[72] Thus, additional ordinary income allocated to the contributing partner is treated as a recapture of the contributing partner's

67. IRC § 1245(a) requires that on any disposition of depreciable personal property, the transferor will recognize as ordinary gain the lesser of the amount realized (or fair market value of the property) over its adjusted basis, or the amount of basis recomputed by adding back all adjustments such as depreciation over adjusted basis. In other words, § 1245 recaptures as ordinary income the lesser of gain recognized or past depreciation deductions.

68. Treas. Reg. § 1.1245-1(e)(2)(ii)(A).

69. Treas. Reg. § 1.1245-1(e)(2)(ii)(C)(*2*) and (*3*).

70. Treas. Reg. § 1.1245-1(e)(2)(ii)(C)(*2*).

71. Treas. Reg. § 1.1245-1(e)(2)(ii)(C).

72. Id. Recall that the non-contributing partner's share of tax depreciation can be enhanced either by curative allocations of income items to the contributing partner or curative items of deduction to the non-contributing partner. See supra*,* text at note 60.

depreciation deductions, but not in an amount in excess of the depreciation claimed by the contributing partner.[73]

F. Distribution of Built-in Gain Property to a Non-Contributing Partner

The allocation of recognized built-in gain or loss to the contributing partner under section 704(c)(1)(A) is not possible if the contributing partner leaves the partnership before the gain is recognized, or if the property is distributed to another partner without partnership level recognition of the pre-contribution gain. Sections 704(c)(1)(B) and 737 restrict these potential routes of escape from the built-in gain or loss of contributed property by requiring the contributing partner to recognize the built-in gain or loss.

1. Distributions to Other Partners While the Contributing Partner Remains a Partner

Section 704(c)(1)(B) requires the contributing partner to recognize gain or loss on the distribution of contributed property subject to section 704(c)(1)(A) to a partner other than the contributing partner within seven years of the date of contribution. The contributing partner's gain or loss is the amount that would have been allocated to the contributing partner if the partnership had sold the property to the distributee partner for its fair market value. The amount of pre-contribution built-in gain or loss remaining in the contributed property on the date of its distribution will depend on allocations of income and deductions, such as depreciation, during the period that the property is held by the partnership. Thus, the amount of gain or loss recognized will depend on the particular allocation method adopted by the partnership, e.g., traditional method with the ceiling rule versus curative or remedial allocations.[74] The character of the contributing partner's gain or loss is the same as it would have been if the property had been sold by the partnership to the distributee partner.[75]

Example 11- In Example 9B, using curative allocations, after three years of depreciation the partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Cash	$112,000	$112,000	D	$ 76,000	$ 76,000
Depreciable Property	$ 40,000	$ 16,000	E	$ 76,000	$ 52,000
	$152,000	$128,000		$152,000	$128,000

73. Treas. Reg. § 1.1245-1(e)(2)(ii)(C)(*2*) and (*3*) each provide for a reduction in the recapture amount but not below zero.

74. See Treas. Reg. § 1.704-4(a)(5), Ex. (1) – (3).

75 Treas. Reg. § 1.704-4(b).

Assume that the property is distributed to D in a partial reduction of D's partnership interest when fair market value of the depreciable property is the same as its book value, $40,000. If the partnership had sold the depreciable property for $40,000, the partnership's $24,000 of tax gain ($40,000 - $16,000) would have been allocated to E (there is no book gain).[76] Thus, E must recognize $24,000 of tax gain on the distribution to D.[77] E's basis in E's partnership interest is adjusted for the gain recognized by E.[78] Likewise, the partnership's basis in the property is adjusted to reflect gain or loss recognized by the contributing partner.[79]

Analysis of the tax consequence of the distribution to D, the non-contributing partner, requires an examination of the basic rules applicable to partnership distributions. First, the partnership capital accounts are adjusted by revaluing the distributed property to its fair market value, as generally will be agreed to by the partners in approving the distribution, and allocating any book gain or loss among the partners in accord with the partnership agreement.[80] As a practical matter, on any distribution of property (other than cash), including the liquidation of a partner's interest, or admission of a new partner,[81] capital accounts should be revalued as permitted by the regulations in order to properly reflect the partners' interests in the partnership immediately following the transaction.[82] D's capital account is reduced by $40,000 to reflect the fair market value of the distributed property.[83]

76. Any additional gain, creating book gain, would require an allocation of the additional tax gain to D and E in the amount of the allocation of book gain. Thus, if the property had been sold for $42,000, creating $2,000 of book gain and $26,000 of tax gain, D would be allocated $1,000 of the tax gain to match D's book gain, and E would be allocated $25,000 of tax gain ($1,000 + $24,000).

77. See e.g. Treas. Reg. § 1.704-4(a)(5), Ex. (3).

78. IRC § 704(c)(1)(B)(iii); Treas. Reg. § 1.704-4(e)(1) and (2).

79. Id.

80. Treas. Reg. § 1.704-1(b)(2)(iv)(f).

81. See infra, text at note 124.

82. Howard E. Abrams, The Section 734(b) Basis Adjustment Needs Repair*,* 57 Tax Law., 347-348 (2004), who states, "Although current aw does not require the restatement, most advisors recommend it, [fn omitted] and the regulations are clear that if a restatement is not made, the partnership will be closely scrutinized to determine if the failure to restate capital accounts represents an inappropriate sifting of value between related parties." See also, Gergen, supra note 5, 347, 352 *et. seq*., who indicates that professionally drafted partnership agreements routinely require adjustments on shifts of partner interests and advocates that mandatory revaluation of assets on a distribution that changes partners' sharing ratios.

83. Treas. Reg. § 1.704-1(b)(2)(iv)(e). Since the example assumes that the property's fair market value is the same as its book value, there are no adjustments to the partnership's book accounts to reflect revaluation.

Distribution of the property out of the partnership reduces the partnership's capital account to reflect the value of property leaving the partnership.[84]

Section 731(a) provides that no gain or loss is recognized on the distribution of money or property to a partner, except to the extent that a distribution of money exceeds the partner's basis in the partner's partnership interest. D does not recognize gain or loss on the non-liquidating distribution of partnership property. As a corollary to this nonrecognition provision, the basis of the distributed property is unchanged; the partnership's basis (as adjusted to reflect the gain allocated to contributing partner by section 704(c)(1)(B)) is transferred to D.[85] The distributee partner's basis in the partnership interest is reduced by the basis transferred to the distributed property,[86] which reflects the transfer of a portion of the distributee's after-tax investment in the partnership to the distributed property. Thus' D's basis in the distributed property is $40,000; the partnership's $16,000 adjusted basis increased by the $24,000 gain recognized by E. D's basis in D's partnership interest is reduced by the amount of D's basis in the distributed property, $40,000, to $36,000.

While D and E may generally continue as 50% partners with respect to operating income of the partnership, the distribution of $40,000 of property to D changes the financial relationship of each partner to the partnership. The changed relationship and the impact of the distribution can be demonstrated by following the transaction through properly maintained capital accounts. In addition, the fact that the analysis of this transaction is correct is confirmed by the partnership capital accounts after the distribution, which are adjusted as follows –

84. Treas. Reg. § 1.704-2(b)(iv)(*b*).

85. IRC § 732(a). The transferred basis is limited to the distributee partner's basis in the distributee's partnership interest. IRC § 732(a)(2).

86. IRC § 733(2).

	D		E	
	Book	Tax	Book	Tax
Initial Capital Account	$100,000	$100,000	$100,000	$40,000
Year 1 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 1 Income	$ 2,000	0	$ 2,000	$ 4,000
Year 2 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 2 Income	$ 2,000	0	$ 2,000	$ 4,000
Year 3 Depreciation	($ 10,000)	($ 8,000)	($ 10,000)	0
Year 3 Income	$ 2,000	0	$ 2,000	$ 4,000
End of Year 3 Capital Account	$ 76,000	$ 76,000	$76,000	$52,000
Distribution	**($ 40,000)**	**($ 40,000)**		
Recognized Built-in Gain				**$24,000**
Final Capital Account	**$ 36,000**	**$ 36,000**	**$ 76,000**	**$76,000**

And the partnership capital account is –

	Partnership Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Cash	$112,000	$112,000	D	$ 36,000	$ 36,000
			E	$ 76,000	$ 76,000
	$112,000	$112,000		$112,000	$112,000

There is no built-in gain or loss inside the partnership. The harmony between the partners' capital and tax accounts indicates that all of the pre-contribution built-in gain and loss issues have been reflected in allocations to the partners. In addition, properly reflecting the various allocations to the partners, along with the distribution to D in the capital accounts indicates clearly to both D and E their rights to partnership assets.

a. Exceptions to the application of section 704(c)(1)(B).

The distribution scheme of Subchapter K is designed to permit distributions of property to partners without recognition of gain as long as built-in gain or loss inherent in the distributed property is preserved to be recovered by the distributee partner on the ultimate disposition of distributed property. Section 704(c)(1)(B) is a necessary exception to this principle to prevent the shifting of pre-contribution built-in gain or loss from the contributing partner to another partner under the nonrecognition element of the distribution rules. The Code and regulations recognize some situations in which the contributing partner's pre-contribution built-in gain or loss is preserved following distributions of contributed built-in gain or loss property to a non-contributing partner.

Section 704(c)(2) incorporates the principles of deferral in like-kind exchanges by providing that gain or loss required to be recognized under section 704(c)(1)(B) is reduced by the amount of built-in gain or loss attributable to property that is like-kind to the property distributed to another partner under section 1031 that is distributed to the contributing partner not later than the 180th day after the distribution to the non-contributing partner or, if earlier, the due date (with extensions) of the tax return of the contributing partner for the taxable year in which the distribution to the non-contributing partner occurs.[87] In essence, the like-kind property distributed to the contributing partner is treated as received in exchange for the contributed property that is distributed to another partner. Under the language of section 704(c)(2), to the extent of the fair market value of the like-kind property, section 704(c)(1)(B) is to be applied as if the contributing partner had contributed the like-kind property at the outset. Thus, there is no distribution of contributed property to another partner. The contributing partner's basis in the distributed like-kind property will be the same as the partnership's basis.[88] The contributing partner's basis in the distributed like-kind property is determined without regard to any gain recognized by the contributing partner under section 704(c)(1)(B), e.g. the partnership's basis in the distributed like-kind property will transfer to the contributing partner.[89]

The Treasury regulations provide additional, non-statutory, exceptions to the application of section 704(c)(1)(B). The contributing partner is not required to recognize gain under section 704(c)(1)(B) on distribution of an interest in contributed property to another partner in complete liquidation of the partnership if the contributing partner also receives an interest in the contributed property that has a built-in gain or loss in an amount that is at least equal to the amount of gain that would be

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87. IRC § 704(c)(2)(B); Treas. Reg. § 1.704-4(d)(3). These deadlines mirror the rules for deferred like-kind exchanges in § 1031(a)(3)(B), which requires that a deferred exchange be completed within 180 days, or the due date for the exchanging taxpayer's tax return, whichever is earlier.

88. Treas. Reg. § 1.704-4(d)(3). The regulation states, "The contributing partner's basis in the distributed like-kind property is determined as if the like- kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section." See IRC § 732(a).

89. Id. The regulations warn, however, that the distribution of the like-kind property to the contributing partner may in some circumstances be treated as a sale under the disguised sale rules of Treas. Reg. § 1.707-3.

recognized by the contributing partner under section 704(c)(1)(A) on a sale of the contributed property for its fair market value.[90] In this case, the exchange basis in the distributed property on liquidation of the partnership will preserve the contributing partner's remaining built-in gain or loss.[91] Section 704(c)(1)(B) does not require recognition of gain by the contributing partner in the event of a deemed distribution and reformation of a partnership under the partnership termination rule of section 708(b)(1)(B) (termination of a partnership in a 50% ownership change).[92] In this case, the built-in gain or loss of the contributing partner is preserved by treating the property in the hands of the re-formed partnership as section 704(c) property.[93] Similarly, section 704(c)(1)(B) gain is not recognized on the transfer of built-in gain or loss assets to a new partnership followed by a distribution of interests in the new partnership in liquidation of the original partnership – an assets over partnership reorganization.[94] Again built-in gain or loss is preserved by treating the assets as section 704(c) assets of the new partnership.[95] The regulations also provide that section 704(c)(1)(B) does not require recognition of gain on incorporation of a partnership,[96] or on a distribution of an undivided interest in partnership property to the extent that the interest received by the contributing partner does not exceed the undivided interest in the property contributed by the distributee.[97]

2. Distribution of Property to the Contributing Partner

Section 704(c)(1)(B) allocates built-in gain or loss to the contributing partner, as a partner, on distribution of partnership property to a non-contributing partner. Section 704(c)(1)(B) can not allocate pre-contribution gain or loss if the contributing partner is no longer a member of the partnership at the time the contributed property is distributed. Section 737 fills this gap by requiring that the contributing partner recognize pre-contribution built-in gain on the distribution of any other property to the contributing partner, notwithstanding the fact that a distribution would otherwise be without recognition.

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90. Treas. Reg. § 1.704-4(c)(2).

91. IRC § 732(b). See Treas. Reg. § 1.704-4(c)(7), Ex. (1).

92. Treas. Reg. § 1.704(c)(3).

93. Id.

94. Treas. Reg. § 1.704-4(c)(4). Partnership mergers are discussed infra, text beginning at note 110.

95. Id.

96. Treas. Reg. § 1.704-4(c)(5).

97. Treas. Reg. § 1.704-4(c)(6).

Normally a distribution of money or property to a partner does not require the recognition of gain, except to the extent that a distribution of money exceeds the distributee partner's basis in the partnership interest.[98] Section 737, however, requires recognition of gain on a distribution to the extent of the lesser of the fair market value of any property (other than money) distributed to the partner over the adjusted basis of the partner's partnership interest, or the amount of any pre-contribution gain of the partner, meaning the amount of gain that would be recognized by the partner under section 704(c)(1)(B) if contributed property were distributed to another partner. There is no provision for recognition of pre-contribution loss. Gain recognized under section 737 increases the partner's basis in the partnership interest immediately before the distribution.[99] In addition, the partnership's basis in property contributed by the distributee partner is also adjusted to reflect gain recognized by the contributing partner.[100]

Example 12 - Suppose, that D contributed Delta stock, with a fair market value of $1,000 and a basis of $200 to the ABCD partnership in year 1; in year 3, when the fair market value of Delta stock is $800, the partnership distributed Omega stock to D in complete liquidation of D's partnership interest; and in year 5 the partnership distributed the Delta stock to A.[101]

Section 704(c)(1)(B) does not apply to the distribution of the Delta stock to A because at the time of the distribution D is no longer partner. However, section 737 taxes D on the receipt of the Omega stock in year 3 in an amount equal to the gain that would have been recognized if the Delta stock had been distributed to another partner at the time of the distribution to D in year 3, $600 ($800 - $200).[102] D's basis in D's partnership interest is increased to $800 ($200 + $600) immediately before the distribution, and D, therefore, takes the Omega stock with an $800 exchange basis. The partnership's basis in the Delta stock is increased to $800.

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98. IRC § 731(a).

99. IRC § 737(c)(1). The impact of this basis increase depends upon the nature of the distribution. In the case of a distribution of property in complete liquidation of the distributee's partnership interest, the basis increase would be reflected in the exchange basis of the distributed property. See IRC § 732(b).

100. IRC § 737(c)(2). This adjustment is tantamount to a mandatory § 734(b) adjustment, but which is clearly beneficial to the partnership, and in the case of a current distribution, also benefits the contributing partner by reducing or eliminating future § 704(c) gain.

101. With some clarifying revisions, the example is from McDaniel, et. al., supra note 15, 394-395.

102. Without § 737, the year 3 distribution of capital asset #2 to D would not require recognition of gain by D (IRC § 731(a)) who would take asset #2 with a basis equal to D's basis in his partnership interest, $200.

a. Exceptions to Section 737

As is the case with respect to section 704(c)(1)(B),[103] exceptions to the application of section 737 mitigate the reach of the provision in cases where the contributing partner's built-in contribution gain is preserved. Section 737(d) provides that if a distribution consists of property contributed by the distributee, such property will not be taken into account in computing gain recognized under section 737(a) or in computing the distributee's pre-contribution gain.[104] Regulations provide additional exceptions for partnership terminations under section 708(b)(1) where assets are treated as transferred to a new partnership,[105] partnership asset-over mergers, partnership divisions,[106] incorporation of a partnership,[107] and nonrecognition transactions where the property received is thereafter treated as the contributed property for section 704(c) purposes.[108]

3. Extending the Distribution Rule Clock with a Partnership Merger

In an "assets-over" partnership merger, the merged partnership is treated as transferring its assets to the continuing partnership in exchange for a partnership interest in the continuing partnership.[109] Invariably, the value of the transferred assets will differ from their bases resulting in built-in gain or loss property. The merged partnership is then liquidated with a distribution of a partnership interest in the continuing partnership to the partners of the

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103. See text supra, beginning with note 87.

104. See also Treas. Reg. §1.737-2(d). Section 737(d) also provides that if the distribution consists of an interest in an entity, the exception from § 737 recognition only applies to the extent of the interest of the entity in the contributed property. Section 737(d)(2) adds that § 737 is not applicable to the extent that § 751 (recognition of gain on distributions that change a partner's interest in unrealized receivables and appreciated inventory) applies.

105. Treas. Reg. §1.737-2(a).

106. Treas. Reg. §1.737-2(b).

107. Treas. Reg. §1.737-2(c).

108. Treas. Reg. §1.737-2(d)(3).

109. Treas. Reg. § 1.708-1(c)(3)(i). An assets-up merger involves a transfer of partnership assets to the partners in liquidation of the merged partnership, followed by a contribution of assets to the continuing partnership. Treas. Reg. § 1.708-1(c)(3)(ii). The partners must be treated as the owners of the distributed assets. The former partners of the merged partnership then contribute the assets to the continuing partnership. A merger that is not an assets-over form, or an assets-up form, e.g. a merger in which the partners transfer partnership interests to the continuing partnership, an interests-over form, is treated as an assets-over form of merger. Treas. Reg. § 1.708-1(c)(3)(i), -1(c)(5), Ex. (4). (For a discussion of partnership mergers and divisions, see McDaniel, et. al., supra note15, 399-409.

merged partnership, who become partners in the continuing partnership.[110] The partnership that is treated as continuing is the partnership whose original partners hold more than 50% of the partnership interests in the resulting partnership.[111] The merged partnership is terminated.[112] The transfer of assets to the continuing partnership by the merged partnership in exchange for a partnership interest in the continuing partnership is a nonrecognition transaction under section 721. The liquidation distribution to the partners of the merged partnership of an interest in the continuing partnership is shielded from recognition by section 731(a).[113]

Treasury regulations section 1.704-4(c)(4) provides that section 704(c)(1)(B) does not apply in an assets-over merger to require recognition of gain or loss by the merged partnership or its partners on distribution of contributed built-in gain or loss property to the continuing partnership. The regulation adds, however, that a subsequent distribution of built-in gain or loss property that remains subject to section 704(c)(1)(B) will require recognition of gain or loss by the original contributing partner to the same extent that a distribution by the merged partnership would have required recognition. In other words, the original contributing partner is required to recognize built-in gain or loss on a distribution by the continuing partnership of built-in gain or loss property that was contributed to the merged partnership within seven years preceding the distribution. Likewise, Treasury regulation section 1.737-2(b)(1) provides that section 737 does not apply to require recognition of gain on a distribution of interests in the merged partnership in an assets-over merger.[114] The regulations further state, however, that a distribution of property to a partner who was formerly a member of the merged partnership who contributed built-in gain property will be subject to section 737 to the same extent that a distribution from the merged partnership would have triggered gain under section 737.

In Rev. Rul. 2004-43[115] the IRS attempted to extend the seven year limitation of sections 704(c)(1)(B) and 737 by restarting the clock on built-in

110. Treas. Reg. § 1.708-1(c)(3)(i). Any form of merger that is not an assets-up form will be treated as an assets-over merger. Id.

111. Treas. Reg. § 1.708-1(c)(1).

112. Id.

113. Changes in liabilities for purposes of § 752(a) and (b) are netted for each partner. Treas. Reg. § 1.752-1(f). The basis of the former partners of the merged partnership in their interests in the continuing partnership is the same as their basis in the merged partnership, adjusted for liabilities and distributions of money. IRC § 732(b).

114. The preamble to these regulations when proposed expressly stated that §§ 704(c)(1)(B) and 737 were not applicable in an assets-over partnership merger. Notice of Proposed Rulemaking, Partnership Mergers and Divisions, REG-111119-99, 2001-1 C.B. 455, 456.

115. 2004-1 C.B. 842.

gain or loss existing at the time of the transfer of property from the merged partnership to the continuing partnership. The IRS ruled that the seven year period during which built-in gain property is subject to recognition under sections 704(c)(1)(B) would re-commence on the date of the assets-over merger with respect to the amount of built-in gain or loss existing at the time of the merger that is attributable to property contributed to the continuing partnership, reduced by the built-in gain or loss present at the time of the initial contribution to the merged partnership. The net figure is referred to as new built-in gain. With respect to the amount of built-in gain existing at the time of the initial contribution of property to the merged partnership (old built-in gain), however, the seven year period would commence on the date of the original contribution.[116] In response to comments that the approach of Rev. Rul. 2004-43 was inconsistent with the existing regulations,[117] the IRS revoked the ruling[118] and announced that it would promulgate regulations implementing the principles of Rev. Rul. 2004-43 effective for distributions after January 19, 2005.[119] Proposed regulations were issued on August 21, 2007.[120]

The examples in the proposed regulations can be examined through the lens of partnership capital accounts.[121] These examples were first explained in Rev. Rul. 2004-43.[122]

Example 13A.[123] - On January 1, 2005, A and B form the PRS1 partnership. A contributes Asset #1 with a fair market value of $300 and a basis of $200. B contributes $300 cash. The partnership capital accounts are thus –

PRS1 Partnership Assets			Partners' Capital Accounts		
	Book	Basis		Book	Basis
Asset #1	$300	$200	A	$300	$200
Cash	$300	$300	B	$300	$300
	$600	$500		$600	$500

116. The status of built-in gain or loss property in the continuing partnership is unchanged.

117. District of Columbia Bar Taxation Section, Comments on Assets-Over Partnership Merger Guidance, 2004 Tax Notes Today 135-28 (7/7/2004).

118. Rev. Rul. 2005-10, 2005-1 C.B. 492.

119. Notice 2005-15, 2005-1 C.B. 527.

120. Reg-143397-05, 72 Fed. Regis. 46932.

121. Prop. Reg. § 1.704-4(c)(4)(ii)(F) (2007).

122. 2004-1 C.B. 842.

123. Prop. Reg. § 1.704-4(c)(4)(ii)(F), Ex. (1) (2007).

Also on January 1, 2005, C and D form partnership PRS2. C contributes Asset #2 with a fair market value of $200 and a basis of $100. D contributes $200 cash. The PRS2 partnership capital accounts are thus –

	PRS2 Partnership Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Asset #2	$200	$100	C	$200	$100
Cash	$200	$200	D	$200	$200
	$400	$300		$400	$300

On January 1, 2008, the PRS1 and PRS2 partnerships undertake an assets-over merger with PRS1 as the surviving partnership. At the time of the merger Asset #1 has appreciated to $900 and Asset $2 has appreciated to $600. Revaluing partnership assets as permitted by the regulations[124] in the case of distributions and admissions of new partners is necessary in order to ascertain the relative interests of the partners in partnership property following the merger. The revalued capital account of PRS1 partnership is as follows:[125]

	PRS1 Partnership Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Asset #1	$ 900	$200	A	$ 600	$200
Cash	$ 300	$300	B	$ 600	$300
	$1,200	$500		$1,200	$500

The differences in the partners' book and basis accounts demonstrate the presence of built-in gain and instructs as to its allocation. If Asset #1 were disposed of for $900, the $700 of tax gain would be allocated to $400 to A to account both for A's pre-contribution section 704(c) gain of $100 and A's reverse section 704(c) gain of $300 resulting from the revaluation, and $300 to B to account for B's $300 of reverse section 704(c) gain.[126]

The revalued capital account of partnership PRS2 is as follows:

	PRS2 Partnership Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Asset #2	$600	$100	C	$400	$100
Cash	$200	$200	D	$400	$200
	$800	$300		$800	$300

124. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*).
125. The partnership book gain of $600 is allocated equally to A and B.
126. IRC § 704(c)(1)(A); Treas. Reg. § 1.704-1(b)(iv)(*i*).

The capital account demonstrates that on a sale of Asset #2 for $600, $300 of gain is allocable to C to account for C's pre-contribution built-in section 704(c) gain of $100 and C's $200 share of reverse section 704(c) gain, and $200 of gain is allocable to D to account for D's $200 of reverse section 704(c) gain.[127]

In the assets-over merger, PRS2 is treated as contributing its assets to the continuing PRS1 partnership in exchange for an interest in the PRS1 partnership,[128] which is then distributed to C and D in liquidation of the PRS2 partnership.[129] C and D thus become partners in PRS1 partnership.[130] The capital account of the continuing partnership is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1	$ 900	$200	A	$ 600	$200
Asset #2	$ 600	$100	B	$ 600	$300
Cash	$ 500	$500	C	$ 400	$100
			D	$ 400	$200
	$2,000	$800		$2,000	$800

Again, the differences in the partners' book accounts and basis demonstrate that the $1,200 of gain that would be recognized on sale of Assets 1 and 2 is allocable among the partners in a manner that would account for both pre-contribution and reverse section 704(c) gains.[131] The amount of built-in gain allocable to each partner is evident from the book and tax difference in each partner's capital account. In general, under the approach of the proposed regulations, the reverse section 704(c) gain in the assets of the merged PRS2 partnership becomes regular section 704(c) gain in the continuing PRS1 partnership as a result of the contribution of the PRS2 assets in the merger.

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127. Id.

128. The transfer of CD assets is a contribution in exchange for a partnership interest under § 721. The CD partnership's basis in its interest in PRS1 partnership is the same as its basis in the transferred assets, $300. IRC § 722. CD partnership's $100 basis in Asset #2 transfers to PRS1 partnership. IRC § 723.

129. Treas. Reg. § 1.708-1(c)(3)(i).

130. C and D do not recognize gain on the liquidation distribution of partnership interests in PRS1 partnership. IRC § 731(a)(1). C's and D's bases in their PRS1 partnership interests are the same as their respective bases in the CD partnership, $100 and $200. IRC § 732(b).

131. The allocations would be the same as described supra*,* text at notes 126 and 127, $400 to A, $300 to B, $300 to C, and $200 to D. Gain on the sale of Asset #1 would be allocated to A and B, gain on the sale of Asset #2 would be allocated to C and D.

The example of the proposed regulations[132] describes the consequence of a distribution on January 1, 2013 of Asset #2 to A in complete liquidation of A's partnership interest. The distribution is eight years after C's initial contribution and five years after the merger. At the time of the distribution the values of the partnership assets remain at $900 and $600. Under the existing Treasury regulation section 1.704-4(c)(4), which applies section 704(c)(1)(B) to require recognition of built-in gain only to the extent that a distribution from the merged partnership (PRS2) would have triggered recognition, C avoids recognition of C's original built-in gain because the distribution is more than seven years after C's contribution.[133] Likewise, section 737 does not require A to recognize gain attributable to A's pre-contribution built-in gain with respect to Asset #1, which was contributed to the PRS1 partnership more than seven years prior to the distribution.[134] A will not recognize gain or loss on the liquidation distribution.[135] A's $200 basis in A's PRS1 partnership interest is exchanged to become A's basis in Asset #2. At this point in the analysis, the PRS1 partnership capital account is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1	$ 900	$200	B	$ 600	$300
Cash	$ 500	$500	C	$ 400	$100
			D	$ 400	$200
	$1,400	$700		$1,400	$600

The $100 disparity between the partnership's inside basis in assets and the sum of the partners' outside bases is attributable to the increase in the basis of Asset #2 from $100 inside the partnership to $200 in A's hands as a result of the liquidation distribution. A's $400 of gain built into A's partnership interest (consisting of A's $100 precontribution gain and $300 revaluation gain) is now reflected as $400 of gain built-in to Asset #2. Thus, recognition of A's pre-contribution and partnership gain is deferred to disposition by A of Asset #2. The partnership provisions have allowed A to exchange an

132. Prop. Reg. § 1.704-4(c)(4)(f), Ex. (1) (2007). The same analysis is in Rev. Rul. 2004-43, 2004-1 C.B. 842, revoked, Rev. Rul. 2005-10, 2005-1 C.B. 492.

133. IRC § 704(c)(1)(B) only applies to a distribution within seven years of the date of the contribution.

134. Prop. Reg. § 1.737-2(b)(1)(ii)(F), Ex. (1) (2007). IRC § 737(b)(1) limits recognition under § 737 to pre-contribution gain on assets contributed within seven years of a distribution of other property to the contributing partner.

135. IRC § 731(a).

interest in Asset #1 for an interest in Asset #2 without recognition of gain or loss, albeit after a seven year waiting period.

In addition, the PRS1 partnership's $500 of built-in gain in Asset #2 has been transformed into $400 of gain on Asset #2 in A's hands. Also, while the partnership has $700 of built-in gain in Asset #1, the sum the built-in gain in of the partners' interests is $800. This situation permits the partners to defer recognition of $100 of pre-contribution and/or reverse section 704(c) gain on sale of Asset #1 until a liquidation of the partnership. Thus, if Asset #1 were sold for $900, the partnership would have zero book gain and $700 of tax gain. The partnership's $700 tax gain is allocated $300 to B[136] and $200 each to C and D. The partnership would now have the following capital account:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1/cash	$ 900	$ 900	B	$ 600	$ 600
Cash	$ 500	$ 500	C	$ 400	$ 300
			D	$ 400	$ 400
	$1,400	$1,400		$1,400	$1,300

Although the partnership itself has no unrealized gains or losses, the $100 disparity between the partnership inside asset basis and the sum of the partners' outside bases represents $100 of deferred tax gain that will be recognized by C on a disposition of C's partnership interest.[137]

A section 734(b) adjustment under a section 754 election, would resolve the disparity with respect to the partnership by decreasing the basis of Asset #1 by $100 to account for the $100 increase in the basis of Asset #1. The PRS1 partnership capital account after application of a section 743(b) adjustment would be as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1	$ 900	$100	B	$ 600	$300
Cash	$ 500	$500	C	$ 400	$100
			D	$ 400	$200
	$1,400	$600		$1,400	$600

136. This allocation represents B's share of reverse § 704(c) gain resulting from revaluation of PRS1 assets at the time of the merger. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) and (*g*).

137. C's deferred gain relates back to the built-in gain inherent in Asset #2 at the time of C's initial contribution. See text and capital account supra following note 123.

The capital accounts demonstrate the appropriate allocations of both the section 704(c) gains and revaluations gains. On sale of Asset #1, the $800 tax gain is allocable $300 to B, $300 to C, and $200 to D. The capital accounts provide ready guidance to the appropriate cash flows and tax accounting throughout this transaction.

Unlike the current regulations, the proposed regulations would require recognition of gain by the partners of the merged partnership on the distribution of built-in gain property to A. Following the approach of Rev. Rul. 2004-43, the proposed regulations treat the assets-over merger of PRS2 into PRS1 as a contribution of built-in gain property by PRS2 to PRS1 at the time of the merger, but only to the extent that the built-in gain attributable to the property exceeds the built-in gain present at the time of the original contribution.[138] Rev. Rul. 2004-43 indicated that while existing Treasury regulation section 1.704-4(c)(4) requires that the seven year period with respect to pre-contribution built-in gain in Asset #2 commence on the date of its initial contribution to the PRS2 partnership,[139] the IRS asserted that there is nothing in section 1.704-4(c)(4) to prevent the creation of new section 704(c) gain or loss when the assets are contributed by one partnership to another. The proposed regulations confirm this position by treating the difference between fair market value and basis at the time of an assets-over merger as section 704(c) gain. The $100 difference in the fair market value and adjusted basis of Asset #2 at the time of C's contribution to PRS 2, the merged partnership, is treated as original section 704(c) gain or loss (old built-in gain) for which the seven year clock began to run on the date of the initial contribution.[140] The remaining section 704(c) gain (the revaluation gain) is treated as new section 704(c) gain for which the seven year clock began to run on the date of the partnership merger.[141] As a consequence, the $400 revaluation gain identified on the transfer of Asset #2 from the PRS2 partnership to the PRS1 partnership, within seven years of the distribution to A, triggers recognition of the new pre-contribution built-in gain to C and D who step into the shoes of the PRS2 partnership as partners in the PRS1 partnership and who are thus treated as the contributors of the built-in gain property.[142] The proposed regulations thus conclude that C and D, as the

138. Prop. Reg. § 1.704-4(c)(4)(ii)(B) (2007). The proposed regulations do not explicitly define new built in gain. However, the limitation on new built-in gain is implicit in Prop. Reg. § 1.704-4(c)(4)(ii)(B) (2007), which states that the seven year period with respect to old built-in gain, built-in gain existing at the time of contribution to the transferor partnership, will not restart on the assets-over merger.

139. Under this application of Treas. Reg. § 1.704-4(c)(4), gain is recognized under § 704(c)(1)(B) only to the extent gain would be recognized on a distribution by PRS2, here zero.

140. Prop. Reg. § 1.704-4(c)(4)(ii)(A) (2007).

141. Prop. Reg. § 1.704-4(c)(4)(ii)(B) (2007).

142. Treas. Reg. § 1.704-4(d)(2) treats the transferee of a partnership

contributors of Asset #2, must each recognize $200 of gain on the distribution to A.[143] Recognition of this $400 of gain would increase the partnership basis in Asset #2,[144] but that basis adjustment is lost on the distribution to A, whose basis in Asset #2 remains as $200.[145] Under this analysis, the resulting partnership capital account is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1	$ 900	$200	B	$ 600	$ 300
Cash	$ 500	$500	C	$ 400	$ 300
			D	$ 400	$ 400
	$1,400	$700		$1,400	$1,000

The $500 basis in Asset # 2, as adjusted to reflect the recognized gain under section 704(c)(1)(B),[146] is decreased to $200 to A in the liquidation distribution.[147] The loss of this basis in Asset #2 creates a $300 disparity between the partnership's inside basis in assets and the sum of the partners' outside bases. The presence of this increased disparity in inside and outside bases demonstrates that the proposed regulations accelerate partners' recognition of built-in gain in advance of a partnership level recognition.[148] Recognition of $700 of tax gain on a sale of Asset #1 by the partnership would require the partners to recognize more tax gain than is reflected in the built-in gain in their partnership interests, and defers recovery of this excess gain until recognized as loss (or a reduction of gain) on disposition of the partnership interests.[149]

The potential doubling of tax on a partnership sale of Asset# 1 can be avoided with a section 734(b) adjustment under a section 754 election which would resolve the inside/outside basis disparity by increasing the basis

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interest as the contributing partner with respect to built-in gains an losses subject to IRC § 704(c)(1)(B).

143. Prop. Reg. § 1.704-4(c)(4)(ii)(F), Ex. (1)(ii) (2007). IRC § 737 does not apply to require A to recognize gain attributable to A's contribution of Asset #1 because that property was contributed to the PRS1 partnership more than seven years preceding the distribution. Prop. Reg. § 1.737-2(b)(1)(ii)(F), Ex. (1)(ii).

144. IRC § 704(c)(1)(B)(iii).

145. IRC § 732(b).

146. IRC § 704(c)(1)(B)(iii).

147. IRC§ 732(b). Note again that A ultimately exchanges in interest in appreciated Asset #1 for an interest in Asset #2 without recognition of gain.

148. This recognition may also be described as recognition of built-in gain deferred from the date of the partnership merger.

149. The partnership tax gain would be allocated $300 to B, and perhaps $200 each to C and D,

of Asset #1 to $500.[150] As adjusted, the partnership capital account would be as follows:

PRS1Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1	$ 900	$ 500	B	$ 600	$ 300
Cash	$ 500	$ 500	C	$ 400	$ 300
			D	$ 400	$ 400
	$1,400	$1,000		$1,400	$1,000

As a consequence of these adjustments, D's book and basis accounts no longer reflect a disparity. B has $300 of built-in gain that reflects B's share of revaluation gain at the time of the merger, and C's $100 of built-in gain is attributable to C's precontribution gain with respect to Asset #2. The capital account disparities demonstrate that on a sale of Asset #1 for $900, the $400 of tax gain is appropriately allocable $300 to B and $100 to C.

150. Abrams, supra note 82, 344, notes that when inside and outside basis are not equal, taxpayers can exploit the difference. In this situation, where the partner's outside basis is greater than the partnership's inside basis, a sale of partnership interests reduces aggregate gain relative to a sale of partnership assets. Id. See also William D. Andrews, Colloquium on Partnership Taxation: Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions, 47 Tax Law Rev. 3, 10 (1991), "Inside and outside basis should be the same because they are essentially the same thing, just divided up or allocated differently." Professor Abrams recommends that § 743(b) adjustments be allocable only to the partner to whom distributions trigger the adjustment, as is the case with § 743(b) adjustments that are made in the case of a sale or exchange of a partnership interest, in order to avoid shifting the benefits or burdens of the adjustment to other partners. Abrams, supra note 82, 344, 351. In the case of non-pro rata current distributions, Professor Abrams recommends remedial allocations of gain to the non-distributee partner and loss to the distributee partner (which has the disadvantage of creating negative basis). Professor Karen Burke suggests that the same result can be achieved with a deemed sale approach under which the non-distributee partner is treated as selling the partner's interest in distributed property (an aggregate approach) in a taxable transaction. Karen C. Burke, Repairing Inside Basis Adjustments, 58 Tax Law. 639, 645-646 (2007). Citing Andrews, supra at 66, Professor Burke also points out that a partial liquidation approach, treating a non-pro rata distribution to a continuing partner as a partial liquidation of the partner's interest, coupled with a mandatory § 734(b) adjustment would reach the correct allocation of built-in gains or losses. Id. at 657. Both of these recommendations have the obvious disadvantage of triggering recognition of gain on distributions, which does not occur under the current statutory scheme except in the case of a distribution of money (or release of debt) in excess of the distributee's basis. See also Leigh Osofsky, Solving Section 734(b), 60 Tax Law. 473 (2007).

Rather than limiting the amount of built-in gain subject to sections 704(c)(1)(B) and 737 to revaluation gain created at the time of an assets-over merger, the proposed regulations might have restarted the seven year period with respect to the full amount of built-in gain or loss as of the date of the merger. Indeed, section 704(c)(1) refers to property contributed to a partnership by a partner.[151] If property received by the continuing partnership from the transferring partnership or partners is treated as contributed to the partnership, then the express language of section 704(c)(1)(B) would seem to apply to all of the built-in gain inherent in the property at the time of contribution, not just gain attributable to the period the property is held by the transferring partnership. Thus, in the example above, under this approach C would be required to recognize C's $100 of pre-contribution gain with respect to Asset #2 in addition to C's share of the $400 revaluation gain arising prior to the merger. Such an approach would capture all of C's built-in gain within C's partnership interest, which may be appropriate as C exchanges an interest in Asset #2 for an interest in Asset #1. D would be required to recognize D's revaluation gain identified at the time of the merger. The resulting partnership capital account would be as follows:

PRS1Partnership Assets			Partners' Capital Accounts		
	Book	Basis		Book	Basis
Asset #1	$ 900	$200	B	$ 600	$ 300
Cash	$ 500	$500	C	$ 400	$ 400
			D	$ 400	$ 400
	$1,400	$700		$1,400	$1,100

With a section 754 election and a section 734(b) increase in the basis of Asset #1, the partnership capital account would be as follows:

PRS1Partnership Assets			Partners' Capital Accounts		
	Book	Basis		Book	Basis
Asset #1	$ 900	$ 600	B	$ 600	$ 300
Cash	$ 500	$ 500	C	$ 400	$ 400
			D	$ 400	$ 400
	$1,400	$1,100		$1,400	$1,100

151. Section 704(c)(1)(A) provides, "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," and subdivision (B) applies "if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed – . . ."

With or without the section 754 election, requiring C to recognize the full amount of C's share of built-in gain eliminates any disparity in C's book and basis accounts. However, this approach may go too far. In enacting section 704(c)(1)(B) Congress indicated that a seven year break between the contribution of property and distribution of the property to another is sufficient to permit continuation of the deferral normally available on the transfer of built-in gain or loss property to a partnership. Indeed, since the contributed property has been in a partnership longer than the seven year period of section 704(c)(1)(B), it may not be appropriate to accelerate recognition of built-in gain because of the intervening assets-over merger. The distinction drawn by the proposed regulations between pre-contribution built-in gain or loss and the revaluation gain or loss inherent in property at the time of a partnership merger appears is purely a policy choice to accelerate recognition that may not be supportable under the language of the statute. There is nothing in sections 707(c)(1)(B) or 737 that justifies a differentiation between the total built-in gain or loss present at the time of contribution of assets to the continuing partnership. Also, while technically required by the language of both sections 704(c)(1)(B) and 737,[152] the proposed regulations restart the seven year clock with respect to only one of the partnership parties to the merger. There is no sound policy justification for restarting the seven year clock with respect to some, but not all, built-in gain or loss property in the resulting partnership. From a planning perspective, there would be an advantage to arranging the partnership merger so that the partnership with the least built-in gain survives as the continuing partnership.

Example 13B - Examples in the proposed regulations also address revaluation gains and losses resulting from the entry of a new partner into the merged partnership prior to the merger. Unrealized gains and losses accruing to partnership assets that are reflected in restated capital accounts on the entry of partner with a contribution to the partnership are allocated among the partners in the case of a distribution subject to section 704(c)(1)(B) in manner that reflects the allocation of book gains and losses to the entering partner under section 704(c)(1)(A) principles.[153] The examples in the proposed regulations address both revaluation losses and revaluation gains restated to capital accounts on the entry of a new partner into the transferor partnership. Discussion of the revaluation loss example will illustrate the approach of both.

Assume the PRS2 partnership in example 13A admits E as a new partner in 2005 when the fair market value of Asset #2 has depreciated from

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152. There is no contribution of built-in gain or loss property to the continuing partnership.

153. Prop. Reg. §1.704-4(f), Ex.'s (2) and (3) (2007).

its contribution value of $200 to $150.[154] Twenty-five dollars of book loss is allocated to C and D. E contributes $175 cash for a one-third interest in PRS2. The restated PRS2 capital account is as follows:

PRS2 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #2	$150	$100	C	$175	$100
Cash	$375	$375	D	$175	$200
			E	$175	$175
	$525	$475		$525	$475

PSR2 merges into PSR1 on January 1, 2008, when the value of Asset #1 has appreciated to $900 and Asset #2 has appreciated to $600. The $600 increase in the value of Asset #1 is allocated equally to A and B, increasing their capital accounts to $600 each. The $450 increase in the value of Asset #2 increases C, D, and E's capital accounts by $150 each. The resulting restated capital account of the continuing PRS1 partnership is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #1	$ 900	$200	A	$ 600	$200
Asset #2	$ 600	$100	B	$ 600	$300
Cash	$ 675	$675	C	$ 325	$100
			D	$ 325	$200
			E	$ 325	$175
	$2,175	$975		$2,175	$975

The partnership distributes Asset #2, worth $600, to A in liquidation of A's partnership interest on January 1, 2013, more than seven years after C's contribution of Asset #2 to PRS2, but within seven years of the contribution of Asset #2 to PRS1 in the assets-over merger. Under the analysis in the proposed regulations,[155] there is $500 of section 704(c) gain in Asset #2. The unrealized loss that was reflected in the restated capital accounts on E's admission to the partnership reduces the old section 704(c) gain to $50. The new section 704(c) gain that originates with the merger[156] is $450, which is the difference between the total section 704(c) gain ($500) and the old section 704(c) gain ($50). The new section 704(c) gain matches the pre-merger appreciation in Asset #2 realized after E's admission into the PRS2

154. Prop. Reg. §1.704-4(f), Ex. (3) (2007).
155. Prop. Reg. §1.704-4(f), Ex. (3)(ii) (2007).
156. Prop. Reg. §1.704-4(c)(4)(ii)(B) (2007).

partnership. On distribution of Asset #2 to A, the new section 704(c) gain is recognized by C, D, and E ($150 each) under section 704(c)(1)(B). Asset # 2 is treated as having been contributed to the continuing partnership by C, E, and D within seven years of the distribution to A.[157] The remaining $50 of built-in gain in Asset #2 at the time of the merger, the old section 704(c) gain, resulted from C's contribution to PRS2 more than seven years prior to the distribution to A, and is, therefore, not subject to recognition under 704(c)(1)(B).

Example 13C - For purposes of identifying gain recognized under section 737, the proposed regulations apply the same distinctions between built-in gain existing at the time of the original contribution of property to a partnership and new built-in gain that is identified from the revaluation of partnership assets at the time of an assets-over merger.[158] The first example of the proposed section 737 regulations[159] is situation 2 of Rev. Rul. 2004-43.[160] Assume that on January 1, 2012, the fair market value of Asset #1 in the PRS1 partnership of example 13A is $275. Asset #1 is distributed to C in liquidation of C's interest in the PRS1 partnership. Revaluing the partnership assets to allocate the $625 book loss[161] on Asset #1 is useful (if not necessary) to determine C's capital account for purposes of determining the liquidation distribution required to liquidate C's interest.[162] The revalued capital account is as follows:

PRS1 Partnership Assets			Partners' Capital Accounts		
	Book	Basis		Book	Basis
Asset #1	$ 275	$200	A	$ 412.50	$200
Asset #2	$ 600	$100	B	$ 412.50	$300
Cash	$ 500	$500	C	$ 275.00	$100
			D	$ 275.00	$200
	$1,375	$800		$1,375.00	$800

Rev. Rul. 2004-43 holds that the distribution of Asset #1 to C does not trigger recognition of A's precontribution gain on Asset #1 under section

157. Id.

158. Prop. Reg. § 1.737-2(b)(1)(ii)(A) and (B) (2007).

159. Prop. Reg. § 1.737-2(b)(1)(ii)(F), Ex. (1) (2007).

160. Supra note 115, 2004-1 C.B. 842, 843.

161. $900 - $275 = $625. 30% of the loss, $187.50 is allocated each to A and B, 20% of the loss, $125.00, is allocated each to C and D.

162. Revaluation of asset #1 and allocation of the book loss among the partners is required by Treas. Reg. § 1.704-1(b)(2)(iv)(*e*), which provides that distributed property must be revalued to fair market value, book gains and losses allocated to the partners' capital accounts, then the distributee partner's capital account is reduced by the fair market value of distributed property.

704(c)(1)(B) because A contributed Asset #1 to the partnership more than seven years preceding the distribution.[163] The ruling also states that section 704(c)(1)(B) is not applicable to reverse section 704(c) gain, so the revaluation of Asset #1 on the merger of PRS2 partnership into PRS1 (which continued to hold Asset #1) does not trigger section 704(c) gain that would be recognized by A or B on distribution of Asset #1 to C.[164] However, the ruling asserts that the contribution of Asset #2 to PRS1 in the merger of PRS2 within seven years of the date of the distribution to C creates precontribution section 704(c) gain that is subject to recognition under section 737. As described above,[165] section 737 requires a distributee partner who contributed built-in gain property to a partnership within seven years preceding the distribution to recognize gain on a distribution of property to the extent of the contributor's built-in gain. The PRS2 partnership, in which C was a partner, contributed Asset #2 with $500 of built-in gain to PRS1; $100 that was attributable to C's precontribution gain and $400 attributable to appreciation while the property was held by the PRS2 partnership. Under section 737, C is required to recognize the lesser of C's gain on the distribution, $175, or C's share of the PRS2 partnership built-in gain, $200. Thus, C recognizes $175 of gain on the distribution of Asset #1. Under section 737(c), C's basis in C's partnership interest is increased by the $175 of recognized gain to $275, and PRS1 partnership's basis in Asset #2 is increased to reflect C's recognized gain with respect to Asset #2.[166] C's exchange basis in the distributed Asset #1 is $275.[167] The resulting partnership capital account is as follows:

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163. A's precontribution gain would be $75, the amount of gain that the partnership would recognize on a taxable disposition of Asset #1 for its fair market value. IRC § 704(c)(1)(B)(i). Also see Treas. Reg. § 1.704-4(c)(7); § 704(c)(1)(B) does not apply to reverse § 704(c) gain.

164. The text of the ruling indicates that while Treas. Reg. § 1.704-3(a)(6)(i) provides that the allocation rules of Treas. Reg. § 1.704-3 apply to reverse § 704(c) items, there are no corresponding regulations under §§ 704(c)(1)(B) and 737 requiring recognition of gain attributable to reverse § 704(c) allocations. Rev. Rul. 2004-43, supra note 115, 2004-1 C.B. 842, 844. This position is incorporated in Prop. Reg. § 1.704-4(f), Ex. (4) (2007), and Prop. Reg. § 1.737-2(b)(1)(F), Ex. (4) (2007).

165. Supra text at note 98.

166. See Treas. Reg. § 1.737-3(c).

167. IRC § 732(b).

	PRS1 Partnership Assets Book	Basis		Partners' Capital Accounts Book	Basis
Asset #2	$ 600	$275	A	$ 412.50	$200
Cash	$ 500	$500	B	$ 412.50	$300
			D	$ 275.00	$200
	$1,100	$775		$1,100.00	$700

The $75 difference between the partnership's inside property basis and the sum of the partners outside bases is attributable to the increased basis of Asset #1 from the partnership basis of $200 to its $275 basis to C. A section 754 election and section 734(b)(2)(B) adjustment would require a decrease in the basis of Asset #2 of $75, to $200.

If the approach of the proposed regulations and Rev. Rul. 2004-43 is not applied in this example, and Asset #2 contributed initially by C outside of the seven year period of section 704(c)(1)(B) so that 737(b)(1)[168] is not applicable, C would not recognize gain on the distribution of Asset #1[169] and C's exchange basis in Asset #1 would be $100. The resulting PRS1 partnership capital account would be as follows:

	PRS1 Partnership Assets Book	Basis		Partners' Capital Accounts Book	Basis
Asset #2	$ 600	$100	A	$ 412.50	$200
Cash	$ 500	$500	B	$ 412.50	$300
			D	$ 275.00	$200
	$1,100	$600		$1,100.00	$700

Here the $100 difference between the partnership's inside property basis and the sum of the partners outside bases is attributable to the decreased basis of Asset #1 from the partnership basis of $200 to its $100 basis to C. A section 754 election and section 734(b)(1)(B) adjustment would increase the basis of Asset #2 to $200.

168. IRC § 737 operates by requiring recognition of the lesser of gain on the distribution or the distributee partner's net precontribution gain, which is defined in § 737(b) as the gain that would be recognized by the distributee partner under § 704(b)(1)(C) if built-in gain property contributed within seven years of the distribution had been distributed to another partner. In the example, C's net precontribution gain would be limited to $100, the difference between book value and basis at the time of C's original contribution to the CD partnership.

169. IRC § 731(a).

After applying section 734(b) adjustments, whether or not the distributee is required to recognize section 737 gain on appreciation existing at the time of the assets-over merger, the partnership capital account is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
Asset #2	$ 600	$200	A	$ 412.50	$200
Cash	$ 500	$500	B	$ 412.50	$300
			D	$ 275.00	$200
	$1,100	$700		$1,100.00	$700

This capital account comparison demonstrates that the amount of deferred built-in gain remaining in the partnership is the same, whether or not the seven year period of sections 704(c)(1)(B) and 737 is restarted by the assets-over merger. The approach of the proposed regulations affects only the distributee by forcing recognition of gain that would otherwise be deferred in the basis of property distributed in complete liquidation of the partner's interest. The proposed regulations accelerate recognition of $175 gain to C, with a $175 basis increase in the distributed property, contrasted with the existing approach that would defer C's recognition of the pre-merger revaluation gain to C's disposition of Asset #1.[170] The impact of this analysis is confirmed by looking at what happens on sale of Asset #2 for its $600 book value. The $400 tax gain is allocated under section 704(c) principals to eliminate book/tax disparities in the partners' capital accounts caused by contribution and reverse section 704(c) gains, $75 to D (the contributor of Asset #2), $112.50 to B, and $212.50 to A, which accounts for revaluation gains and losses attributable to their interests. The resulting partnership capital account is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
			A	$ 412.50	$ 412.50
Cash	$1,100	$1,100	B	$ 412.50	$ 412.50
			D	$ 275.00	$ 275.00
	$1,100	$1,100		$1,100.00	$1,100.00

170. Of course C could avoid recognition by dying, at least before Dec .31, 2009, or perhaps after December 31, 2010, by operation of IRC § 1014.

This is as it should be.

In the absence of a section 734(b) adjustment, the section 737 gain recognized by C on the distribution does affect the continuing partners by reducing the deferred built-in gain allocable to other partners. In the example, after application of section 737, C's $175 of recognized gain permits a deferral of $75 gain by A, B, and D on a sale of Asset # 1 through the $75 basis increase to Asset #1. This is demonstrated by the higher inside asset bases in the partnership relative to the sum of the partners' outside bases. If C is not required to recognize section 737 gain, C's deferral of $175 gain into the distributed Asset #1 accelerates recognition of $100 of gain to B, C, and D on a disposition of Asset #1 by the partnership. Again this is demonstrated by the capital accounts where the partnership inside bases exceed the sum of the outside bases of the partners. In addition, in either scenario, the allocations of gain on disposition of Asset #1 by the partnership present difficulties. Assume that C recognizes C's section 737 gain and shortly thereafter the PRS1 partnership sells Asset #1 for $600, recognizing zero book gain and $325 tax gain ($600 - $275). D, as the surviving contributor of Asset #2 to PRS1 in the assets-over merger, should be allocated the first $75 of the gain to reflect D's contribution gain remaining after D's book loss on revaluation. The remaining $250 of tax gain should be allocated to A and B in a fashion that proportionately reduces the disparity between their capital accounts and basis. The section 704(c) regulations do not mandate, or perhaps even permit, this result because A and B are not contributors of Asset #2, and A's and B's revaluation gains and losses are attributable to Asset #1, which is no longer in the partnership.[171] Nonetheless, it seems that the only reasonable method for allocating this tax gain is in a fashion that reduces the disparity between the partners' book and tax accounts.[172] Thus, $112.50 of the tax gain should be allocated to B; the gain is allocated to the extent of the difference between B's book and tax accounts. The remaining $137.50 of tax gain is allocated to A, who thus continues to be able to defer a portion of A's pre-contribution gain. The resulting partnership capital account would be as follows:

171. See Treas. Reg. §1.704-3(a)(2), § 704(c) allocation methods are applied on a property-by-property basis.

172.Treas. Reg. § 1.704-3(a)(1). This deferred gain results from A's $100 precontribution built-in gain on contribution with respect to Asset #1, which is reduced in this example by devaluation of Asset #1 to $275.

PRS1 Partnership Assets				Partners' Capital Accounts	
	Book	Basis		Book	Basis
			A	$ 412.50	$ 437.50
Cash	$1,100	$1,100	B	$ 412.50	$ 412.50
			D	$ 275.00	$ 275.00
	$1,100	$1,100		$1,100.00	$1,025.00

The $75 difference between the partnership inside basis and the sum of the partners' outside bases reflects A's deferred gain that would be recognized on a liquidation distribution of the partnership cash.[173] The end result demonstrated by these capital accounts is deferral of gain at the partner level even though all of the partnership gains and losses have been recognized.

Deferral for both the partnership and distributee partner remains a problem if section 737 is not applied to require C to recognize a portion of the built-in gain that existed on the date of the assets-over merger. In the absence of section 737, C will receive the liquidation distribution of Asset #2 without recognition of gain or loss and will exchange C's $100 basis in C's partnership interest for a $100 basis in Asset #2. C thus has $175 of deferred gain in Asset #2. In this case, the remaining partner's share a deferred loss represented by the fact that the partners' outside bases is $100 greater than the partnership inside asset basis.[174] Now on sale of Asset #2 for its book value, $600, the partnership recognizes $500 of tax gain. Again, $75 of the gain must be allocated to D to account for the disparity in D's book and tax accounts as a result of the section 704(c) gain attributable to D from contribution of Asset #2 in the assets-over merger. Beyond that, there is no sensible way to allocate the remaining $425 of gain that would eliminate book/tax disparities.[175] A and B both have gain built into their partnership interests attributable to precontribution and revaluation gains in Asset #1. Allocating one-half of the remaining gain attributable to Asset #2 to each partner, $212.50, produces the following capital account:

173. IRC §731(a). Allocating the $250 gain equally between A and B causes an overstatement of B's basis, which would be $425, creating immediate recognition of gain and a deferred loss, and allows A to defer additional loss.

174. See the partnership capital account in the text supra, following note 169.

175. Allocating more than $75 of gain to D may be unreasonable under the regulations, see Treas. Reg. §1.704-3(a)(2) because such an allocation would create deferred loss for C and increase deferred gain to A and B, contrary to the purpose of § 704(c).

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
			A	$ 412.50	$ 412.50
Cash	$1,100	$1,100	B	$ 412.50	$ 512.50
			D	$ 275.00	$ 275.00
	$1,100	$1,100		$1,100.00	$1,200.00

While this allocation is appropriate as to A, B ends up recognizing accelerated gains at the price of a deferred loss. Alternatively, the $425 of tax gain may be allocated between A and B in proportion to the difference between the book and tax amounts in their respective tax accounts; $278 to A,[176] and $147 to B.[177] The resulting partnership capital account is as follows:

PRS1 Partnership Assets	Book	Basis	Partners' Capital Accounts	Book	Basis
			A	$ 412.50	$ 478
Cash	$1,100	$1,100	B	$ 412.50	$ 447
			D	$ 275.00	$ 275
	$1,100	$1,100		$1,100.00	$1,200

In either scenario, although the partnership itself has recognized all of its gains and losses, one or two of the partners is overtaxed on gain with an accompanying deferral of loss, perhaps good for the fisc, but not the appropriate end result for application of Subchapter K.

This analysis demonstrates that the correct solution to deferred gains and losses lies in the section 754 election and the application of section 734(b) adjustments. While partners and partnerships in varying situations can determine whether to tolerate or take advantage of temporal deferral of gains and losses with the availability of the election, to the extent that Congress is concerned with eliminating deferrals, a required section 734(b) adjustment in the case of section 704(c)(1)(B) and section 737 recognition of gains, is the best potential solution.[178]

176. ($212.50/$325) x $425 = $277.88.
177. ($112.50/$325) x $425 = $147.12.
178. See Andrews, supra note 150

IV. CONTRIBUTION OF ENCUMBERED PROPERTY AND DEBT IN GENERAL

A. Some Basic Rules Regarding Partnership Debt

Money makes the world go around, and in the partnership context much of the money comes from borrowed funds. Property contributed to a partnership often is encumbered with liabilities that shift among the partners. The impact of partnership debt on allocations of income and expense items is one of the most complicated parts of partnership taxation. The rules affect contributions of property subject to liabilities because the contributing partner's liabilities may be shifted to other partners.

The presence of partnership debt facilitates the pass-through of losses and is the foundation of partnership tax shelters. Section 752(a) provides that any increase in a partner's share of partnership liabilities, or an increase in a partner's share of individual liabilities by virtue of an assumption of partnership liabilities will be treated as a contribution of cash. The deemed cash contribution increases the partner's basis in the partnership interest.[179] Thus, a partner may use the partner's share of partnership liabilities to support the deduction of partnership losses and avoid the restriction of section 704(d), which limits a partner's deduction of losses to the partner's basis in the partnership interest.

Section 752(b) provides that any decrease of a partner's share of partnership liabilities, or a decrease in a partner's individual liabilities by reason of an assumption by the partnership of individual liabilities, shall be treated as a distribution of cash from the partnership. Under section 731 cash distributions are received without tax except to the extent that the distribution exceeds the partner's basis in the partnership interest. Under section 733(1), cash distributions reduce the partner's basis in the partnership interest. This is the offset provision. To the extent that a partner relies on partnership liabilities to create basis and support loss deductions, reduction or elimination of the liabilities comes back to the partner as recognized gain.

In any particular situation, whether a partner's share of liabilities is increased or decreased depends upon the rules for identifying the partner's share of partnership liabilities. Application of those rules varies by whether one or more partners have personal liability for a debt, or whether the liability is without recourse to any partner.

179. IRC § 722.

B. Recourse Liabilities

A recourse liability is any liability for which any partner bears the economic risk of loss.[180] In general, a partner bears the economic risk of loss with respect to a partnership liability (even if the liability is nonrecourse as to the partnership) if upon a hypothetical liquidation of the partnership in which all of its assets are treated as worthless, the partner (or a related person) "would be obligated to make a payment to any person (or a contribution to the partnership) * * * and the partner or related person would not be entitled to reimbursement from another partner [or person related to that partner]."[181] In simpler terms, if the partnership comes unglued, and everybody goes after everybody else for all they can get, the partner who is ultimately liable for a partnership debt is the partner who bears the economic risk of loss. This determination requires an examination of all obligations of the partners to outside parties, such as guarantees, and obligations among the partners to make contributions to the partnership or to make-up any deficit capital accounts.[182] A partner's obligation is reduced to the extent that a partner has a right of reimbursement from other partners.[183] Applying this approach, a partner's share of partnership liability is the amount of the liability for which the partner bears the ultimate economic risk of loss.[184]

A partner contributing encumbered property with built-in gain faces the possibility of recognized gain if the reduction in the contributing partner's share of recourse liability exceeds the contributing partner's basis in the contributed property.

Example 14A - Partner F contributes Greenacre to the newly formed FGH partnership with a fair market value of $200,000 and a basis of $100,000. Greenacre is subject to a mortgage of $180,000 for which F is personally liable. The partnership assumes F's liability for the mortgage. G and H each contribute $20,000 of cash. Partnership gains and losses are shared equally by the three partners.

As a starting point, F does not recognize gain on the contribution of property to the partnership[185] and F's starting basis for his partnership interest is the basis of the contributed property, $100,000.[186] However, as a result of the contribution and assumption of liabilities by the partnership, F's share of partnership liability is reduced from $180,000 to $60,000, while G and H each pick up a one-third share of the liabilities. F is treated under

180. Treas. Reg. § 1.752-1(a)(1).
181. Treas. Reg. § 1.752-2(b).
182. Treas. Reg. § 1.752-2(b)(3).
183. Treas. Reg. § 1.752-2(b)(5).
184. Treas. Reg. § 1.752-2(a).
185. IRC § 721.
186. IRC § 722

section 752(b) as receiving a cash distribution of $120,000, which exceeds F's partnership basis by $20,000 and results in $20,000 of gain recognized by F.[187] F's basis in the partnership interest is reduced to zero.[188]

F's capital account contribution is measured by the net value of the property, e.g. the fair market value reduced by the amount of the mortgage, and is thus $20,000.[189] G and H, as general partners with liability for partnership debt, each increase their share of partnership liabilities by $60,000.[190] Thus, G and H are each treated as making a $60,000 cash contribution to the partnership that increases their respective bases to $80,000.[191] Immediately after formation, the partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Greenacre	$200,000	$100,000	Liability	$180,000	
Cash	$ 40,000	$ 40,000	F	$ 20,000	$ 0
			G	$ 20,000	$ 80,000
			H	$ 20,000	$ 80,000
	$240,000	$140,000		$240,000	$160,000

There is a $20,000 difference between the partnership's inside property basis and the partners' outside basis that is attributable to the fact that F was required to recognize $20,000 of gain under section 731(a). A section 754 election and the adjustment under section 734(b)(1) would allow the partners to increase the basis of Greenacre by $20,000.

Example 14B - If in Example 14A, F were to remain personally liable for the mortgage on Greenacre, without any rights of indemnification from G or H (a limited partnership or LLC whereby only F is liable for the debt), then F's share of the debt would remain $180,000. F would not recognize gain, F's basis in F's partnership interest would remain $100,000 (F's liability is neither increased nor decreased) and G and H would not

187. IRC § 731(a).

188. F's $100,000 starting basis for F's partnership interest is reduced, but not below zero, by the amount of the § 752(b) deemed distribution of cash. IRC § 733.

189. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*).

190. IRC § 752(a). This result assumes that each partner is responsible for one-third of the partnership liabilities. If the partnership property were to be worthless and the partnership liquidated, creditors would have the right to recover the liability from each of the partners, and each partner would then have a right of reimbursement against the other partners for their share of the debt. See Treas. Reg. § 1.752-2(b)(1) and (5).Treas. Reg. § 1.752-1(a)(2).

191. IRC §§ 752(a), 722.

include any of the liability in their bases. The partnership capital accounts would be –

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Greenacre	$200,000	$100,000	Liability	$180,000	
Cash	$ 40,000	$ 40,000	F	$ 20,000	$100,000
			G	$ 20,000	$ 20,000
			H	$ 20,000	$ 20,000
	$240,000	$140,000		$240,000	$140,000

C. Nonrecourse Liabilities

If no partner is ultimately liable for partnership debt, the debt is a "nonrecourse" liability.[192] An allocation of a tax deduction or tax loss that is funded by of nonrecourse debt, meaning an item that is not funded with equity capital contributed by a partner or by debt for which partners will be required to make a contribution, cannot have economic effect.[193] Where expenses are incurred with money for which a lender is ultimately liable, no partner bears the economic risk of loss with respect to the expenditure.[194] The regulations allow deductions of items funded by nonrecourse debt only where the partnership agreement contains provisions to insure that allocations of nonrecourse deductions will be matched with a corresponding future allocation of gain as debt is eliminated – partnership minimum gain.[195] The rules that determine a partner's share of nonrecourse liability reflect the absence of economic responsibility for the debt and the gain chargeback requirement. A partner's share of nonrecourse liability is the sum of three components – (1) the partner's share of partnership minimum gain under Treas. Reg. § 1.704-2(g)(1), which broadly is the partner's share of gain that would be recognized by the partnership on a disposition of property encumbered by nonrecourse liability that exceeds the basis of the property; (2) the partner's share of partnership gain that would be allocated to the partner under section 704(c) if all of the partnership's property subject to

192. Treas. Reg. § 1.752-1(a)(2).

193. Treas. Reg. § 1.704-2(b)(1).

194. Id.

195. See Treas. Reg. § 1.704-2(b)(2) and (d). These provisions of the allocation rules treat allocations of deductions attributable to nonrecourse debt as being in accord with a partner's interest in the partnership. Note that this result mirrors the tax treatment of nonrecourse debt incurred by a single individual. The nonrecourse debt is included in basis of acquired property, supports depreciation deductions, and is taken into account as amount realized on disposition of the property causing gain recognition to the extent that the debt exceeds the adjusted basis of the property. See *Crane,* 331 U.S. 1 (1947); *Tufts*, 461 U.S. 300 (1983).

nonrecourse mortgages were disposed of in satisfaction of the mortgages and for no additional consideration; and (3) remaining partnership nonrecourse liabilities are allocated in accord with the partner's share of partnership profits.[196]

The second of the three nonrecourse debt allocation rules ensures that a partner contributing property encumbered with nonrecourse debt that has a basis less than the amount of the liability will not be required to recognize gain under section 731(a) on the deemed cash distribution triggered by section 752(b).[197]

Example 14C - In Example 14A, if the mortgage encumbering Greenacre were a nonrecourse debt, under the second component of the allocation rules, F's share of the partnership nonrecourse liability includes the gain that would be allocated to F under section 704(c) if Greenacre were sold for the amount of the nonrecourse liability, $80,000 ($180,000 debt - $100,000 basis). The remaining $100,000 of the nonrecourse liability is allocated to the partners in accord with their profit share, one-third each. Thus, F's share of the liability is reduced from $180,000 to $113,333 ($80,000 + 33,333). The $66,667 reduction in F's liability is treated as a cash distribution that reduces F's basis in his partnership interest to $33,333. G and H are allocated $33,333 of the liability, which is treated as a cash contribution and added to their respective partnership bases.[198] The partnership capital account is as follows:

196. Treas. Reg. § 1.752-3(a). The first of these provisions assures that a partner recognizes gain to the extent that the partner has been allocated expense or loss items in excess of positive capital contributions (or a deficit make-up), e.g allocations of nonrecourse debt funded deductions. With respect to the third item, Treas. Reg. §1.752-3(a)(3) permits the partnership agreement to specify a partner's share of partnership profits for the purpose of allocating residual partnership nonrecourse debt. The specified shares will be respected as long as they are reasonably consistent with some other significant item of partnership income or gain that has substantial economic effect under the § 704(b) regulations. Alternatively, Treas. Reg. § 1.752-3(a)(3) permits the partnership agreement to specify that excess nonrecourse indebtedness will be allocated with respect to the proportion in which partners reasonably can be expected to be allocated nonrecourse deductions. Such a provision is important in any partnership that has nonrecourse debt, and in any LLC because all debt of an LLC that is not guaranteed by a member is nonrecourse debt.

197. This provision also applies to situations where the partnership capital accounts have been revalued under Treas. Reg. § 1.704-1(b)(2)(ii)(f) which requires using § 704(c) principles to address book/tax differences.

198. IRC § 722.

	Assets			Partners' Capital Accounts	
	Book	Basis		Book	Basis
Greenacre	$200,000	$100,000	Liability	$180,000	
Cash	$ 40,000	$ 40,000	F	$ 20,000	$ 33,333
			G	$ 20,000	$ 53,333
			H	$ 20,000	$ 53,334
	$240,000	$140,000		$240,000	$140,000

V. BUILT-IN LOSS PROPERTY

A. General Rules

As described above,[199] section 704(c)(1)(A) requires that all allocations with respect to built-in gain or loss property take into account the difference between adjusted basis and fair market value at the time of contribution. With respect to built-in loss property, this requires that pre-contribution losses be allocated to the contributing partner. Section 704(c)(1)(C), added by the 2004 Act,[200] contains additional rules with respect to built-in loss property that do not change the basic principles of section 704(c)(1)(A), but which contain their own set of complexities. Section 704(c)(1)(C) contains two separate rules. First, "if any property so contributed has a built-in loss – (i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner."[201] This provision appears to be a restrictive subset of section 704(c)(1)(A) intended to insure that a built-in loss can be taken into account *only* by the contributing partner. Section 704(c)(1)(C)(ii) adds an additional rule that provides, "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." This provision buttresses the rule that only the contributing partner may take into account a pre-contribution built-in loss, but has additional implications.

Section 704(c)(1)(C) is clear in its limitation of built-in loss to the partner who contributed built-in loss property. This rule is consistent with section 704(c)(1)(A) and does not appear to change the allocation rules of

199. Part III, supra, beginning at note 39.

200. American Jobs Creation Act of 2004, Pub.L. No. 108-357, § 833(c), 118 Stat. 1589 (2004). Section 704(c)(1)(C) is applicable to contributions after Oct. 22, 2004.

201. For purposes of subparagraph (C), the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution. IRC § 704(c)(1)(C), flush language.

that section. The second part of the limitation, the provision limiting basis of the non-contributing partners to fair market value at the time of the contribution, raises some questions that may ultimately be resolved by the exercise of the regulatory authority provided by its terms. While the contributing partner remains a member of the partnership, application of section 704(c)(1)(C)(i) prevents the transfer of built-in loss or excess depreciation to other partners, as does section 704(c)(1)(A). Indeed, in the hierarchy of the Code, section 704(c)(1)(A) should be controlling with respect to allocations attributable to either built-in gain or built-in loss property. However, as is discussed below in the context of the examples, even while the contributing partner remains in the partnership, independent application of section 704(c)(1)(C)(ii) may create realized gain by the non-contributing partners on the disposition of built-in loss property. This does not appear to be an intended result. Section 704(c)(1)(C)(ii) should be read to require all allocations of loss attributable to contributed built-in loss property be made to the contributing partner as long as the partner remains in the partnership. Section 704(c)(1)(C)(ii) should come into play to adjust the basis of contributed built-in loss property with respect to other partners only if allocations to the contributing partner are not possible because the partner has left the partnership. These propositions are not clear from the face of the statute, however.

B. Allocations of Built-in Loss

In general, under both section 704(c)(1)(A) and (C), allocations of recognized built-in loss attributable to contributed property are the same as allocations of built-in gain.

Example 15A - Assume that A, B, and C form a partnership to which A contributes \$100,000 in cash, B contributes Gainacre, for which B paid only \$40,000 but which is worth \$100,000, and C contributes Lossacre, for which C paid \$130,000 but which is worth only \$100,000. The partnership agreement provides that the partners will share all gains and losses one-third each. Immediately after the formation of the ABC partnership, the partnership capital account is follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	\$100,000	\$100,000	A	\$100,000	\$100,000
Gainacre	\$100,000	\$ 40,000	B	\$100,000	\$ 40,000
Lossacre	\$100,000	\$130,000	C	\$100,000	\$130,000
	\$300,000	\$270,000		\$300,000	\$270,000

If the partnership sells Lossacre for \$100,000, its book value, the \$30,000 partnership tax loss must be allocated entirely to C under § 704(c)(1)(A) and (C)(i). The resulting partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre/cash	$100,000	$100,000	C	$100,000	$100,000
	$300,000	$240,000		$300,000	$240,000

The equality between C's capital account and basis indicates that C's pre-contribution loss has been eliminated with C's recognition of the loss.

Example 15B - If the partnership in Example 15A were to sell Lossacre for $85,000, the partnership would have $15,000 of book loss, which is allocated equally among the partners, $5,000 each. A portion of the partnership's tax loss ($45,000) is allocated equally to each partner in accord with each partner's share of the book loss. The remaining $30,000 of tax loss is allocated to C under § 704(c)(1)(A). This allocation is consistent with § 704(c)(1)(C)(i) in that the full $30,000 pre-contribution loss is allocated to the contributing partner. In addition, under section 704(c)(1)(C)(ii), the tax loss allocated to each of A and B is consistent with treating each of them as having a basis in Lossacre equal to its fair market value at the time of C's contribution. The resulting partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$ 95,000	$ 95,000
Gainacre	$100,000	$ 40,000	B	$ 95,000	$ 35,000
Lossacre/cash	$ 85,000	$ 85,000	C	$ 95,000	$ 95,000
	$285,000	$225,000		$285,000	$225,000

Again, the allocation eliminates the disparity in C's book and tax accounts.

Section 704(c)(1)(C)(ii) begins to cause trouble where a partnership has both book gain and tax loss with respect to contributed built-in loss property.

Example 15C - If the partnership in Example 15A were to sell Lossacre for $115,000, the partnership has $15,000 of book gain and a $15,000 tax loss. The book gain is allocated $5,000 to each partner. Section 704(c)(1)(A), standing alone, would require that the full partnership tax loss be allocated to C. The resulting partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$100,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 40,000
Lossacre/cash	$115,000	$115,000	C	$105,000	$115,000
	$315,000	$255,000		$315,000	$255,000

The remaining unrecognized pre-contribution built-in loss with respect to Lossacre will be recovered by C on a disposition of C's partnership interest; C's outside basis exceeds C's capital interest in an amount equal to the unrecovered built-in loss. A, the cash partner, will recognize A's book gains on disposition of the partnership interest. B's book gain on sale of Lossacre is also reflected in an additional $5,000 difference between B's capital account and tax basis.

The allocations in this example permit the non-contributing partners to take advantage of C's pre-contribution loss to defer recognition of realized book gains. $15,000 of C's $30,000 pre-contribution loss offsets post-contribution appreciation of Lossacre. Section 704(c)(1)(C) might be applied to prevent this result by requiring recognition of gain by the non-contributing partners. Section 704(c)(1)(C)(i) provides that pre-contribution loss "shall be taken into account only in determining the amount of items allocated to the contributing partner." In this example, C's pre-contribution loss is taken into account to avoid an allocation of tax gain to match book and economic gain to A and B. Section 704(c)(1)(C)(i) could be interpreted to mean that only C may take advantage of the basis in Lossacre in excess of $100,000 in order to avoid recognition of gain attributable to Lossacre's post contribution appreciation. C's $5,000 share of the $15,000 of this book gain is offset by C's section pre-contribution loss. Eliminating C's pre-contribution built-in loss from consideration, there is no basis to be used by A and B to offset their combined $10,000 of book gain, thereby requiring recognition of $5,000 of tax gain by A and B each.[202] This analysis of section

202. Tracing basis suggests that of the $130,000 basis, only C may take advantage of the $30,000 basis in excess of the fair market value of Blackacre at the time of contribution. Of this $30,000 C claims $15,000 of tax loss as permitted by § 704(c)(1)(A) and the traditional allocation with the ceiling rule of Treas. Reg. § 1.704-3(b)(1). Another $5,000 of C's excess pre-contribution basis absorbs C's share of the post-contribution appreciation, leaving $10,000 of pre-contribution basis that may or may not offset A's and B's share of post-contribution appreciation.

704(c)(1)(C)(i) is consistent with a literal application of section 704(c)(1)(C)(ii), which provides that, for purposes of determining the amount allocated to the non-contributing partners, A's and B's basis in Lossacre is limited to $100,000, its fair market value at the time of C's contribution. Thus, also under section 704(c)(1)(C)(ii) A and B each must recognize taxable gain on the disposition of Lossacre.[203] Sale of Lossacre for $115,000 with a $100,000 basis would result in $5,000 of tax gain allocable to A and B each, a tax gain equivalent to their respective book gains. The resulting partnership capital account would be as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$105,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 45,000
Lossacre/cash	$115,000	$115,000	C	$105,000	$115,000
	$315,000	$255,000		$315,000	$265,000

The inside/outside basis disparity created by this analysis suggests that the result is not correct.[204] The $10,000 of excess outside basis is the result of $10,000 of gain recognized by the partners outside of the partnership that is not attributable to a recognized partnership tax gain.[205] This interpretation of section 704(c)(1)(C) creates a notional partnership tax item that produces partner tax gain. Section 704 applies to the allocation of partnership tax items.[206] Section 704 does not allocate book gains and losses, nor create tax items to match book items.[207] The opposite is the case; generally the tax allocation rules of section 704(b) are designed to insure that

203. See L. Rachuba, New Issues With Partnership Built-In Loss Property, 111 Tax Notes 1569 (2005).

204. Note also that since the transaction is neither a distribution of property nor a sale of a partnership interest, this inside/outside basis disparity cannot be corrected by a § 754 election.

205. Importantly, while §§ 734(b) and 743(b) are intended to eliminate book/tax disparities caused by the application of structural provisions of Subchapter K, these provisions to not provide an adjustment to eliminate book/tax disparities created by the gain recognized here.

206. By its terms, § 704(a) applies to determine a "partner's distributive share of income, gain, loss, deduction or credit." Section 704(c)(1)(A) begins by referring to "income, gain, loss, and deduction with respect to property contributed to the partnership . . ." Section 704(c)(1)(C)(i) refers to taking into account built-in loss "in determining the amount of items allocated to the contributing partner."

207. The exception to this statement is the provision in the Treas. Reg. § 1.704-3(d) for remedial allocations that creates notional items of offsetting tax

tax items are allocated to follow economic allocations. Section 704 does not create tax items. In addition, section 704(c)(1)(C)(ii), by its terms, provides only that in determining allocations of partnership items, the basis of contributed built-in loss property is limited. The language does not create partnership taxable gain; it merely addresses the allocation of recognized partnership items. The allocation of $5,000 of recognized tax gain to A and B in this example inappropriately creates a tax item that does not exist in the partnership.

If section 704(c)(1)(C)(ii) is to be read to require recognition of notional gain, reaching the correct capital account balance would require a remedial allocation of a notional $10,000 tax loss to C (to offset the $10,000 notional tax gain allocated to A and B), in which case the partnership capital account would be –

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$105,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 45,000
Lossacre/cash	$115,000	$115,000	C	$105,000	$105,000
	$315,000	$255,000		$315,000	$255,000

The balanced capital account suggests this result may be correct, or at least appealing. The result is good for C who is able to recover C's full pre-contribution loss offset with C's share of the post-contribution economic gain, but not so good for A and B who are required to accelerate recognition of their book gain.

As suggested above,[208] as a matter of statutory construction, § 704(c)(1)(A) should be read to operate first to allocate built-in loss to the contributing partner, as long as the contributing partner remains a partner. In addition, the legislative history of § 704(c)(1)(C) indicates that the statutory purpose is to prevent a transfer of tax loss from the contributing partner to others.[209] Although A and B in example 15C might be able to take advantage

208. Text supra at note 201.

209. Rachuba, supra note 203, also states that § 704(c)(1)(C) is designed to prevent duplicate loss and gives the following example, "Assume A contributes property to partnership AB with FMV of $50 and basis of $100 and B contributes $50 cash. Assume all allocations are made 50-50. Assume that A then sells its interest for $50 to C. Because A's outside basis was $100, A recognizes a $50 loss on the sale. Suppose the partnership thereafter sells the property for $50 and recognizes the $50 loss. Under pre-section 704(c)(1)(C) Treas. reg. § 1.704-3(a)(7), the 'built-in loss' is allocated to the transferee partner 'as it would have been allocated to the transferor partner,' that is, the transferee steps into the shoes of the transferor. Thus, C now recognizes a $50 loss that, of course, A had already

of the contributing partner's pre-contribution loss in order to defer recognition of book gain, ultimately none of C's pre-contribution loss is transferred to A and B. Nor is the loss duplicated in the form of recognition by other than the contributing partner. The deferral of gain recognition does not require acceleration of unrealized tax gains by non-contributing partners on disposition of built-in loss property. The basis provision of section 704(c)(1)(C)(ii) is not necessary as long as pre-contribution loss can be allocated to the contributing partner. Presumably, regulations ultimately will clarify this ambiguity. On the other hand, if the partners agree to permit the contributing partner to take advantage of the partner's pre-contribution loss at the time of sale, the curative and remedial allocation provision of Treas. Reg. section 1.704-3(c) and (d) appear to be available to achieve that result.

C. Allocations of Depreciation Deductions with respect to Built-in Loss Property

Allocations of depreciation attributable to built-in loss property do not create the same type of book/tax disparity as allocations with respect to built-in gain property because in the former case the tax allocations exceed book allocations. There will be sufficient tax basis to match tax allocations of depreciation and other capital recovery deductions with the book allocations to non-contributing partners. The full amount of the tax allocation in excess of book depreciation can be made to the contributing partner. In addition, section 704(c)(1)(C) should bar the allocation of depreciation to non-contributing partners that is calculated on an adjusted basis in excess of the fair market value of contributed built-in loss property as of the date of the contribution.

Example 16 - Assume that in Example 15A C contributes depreciable property with a fair market value of $100,000 and an adjusted basis of $130,000. Also assume for the sake of simplicity that the property has a remaining recovery period of 10 years and is subject to straight line depreciation. The partnership's annual book depreciation is $10,000 and tax depreciation is $13,000. A, B, and C are each allocated $3,333 of book depreciation. A and B are also allocated $3,333 of tax depreciation (which is consistent with a $100,000 basis in accord with § 704(c)(1)(C)(ii)), leaving the remaining $6,334 of tax depreciation for allocation to C (C's share of

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recognized. Of course, C has to reduce its basis in its partnership interest to $0 and, were the partnership to immediately liquidate, C would recognize an offsetting capital gain of $50 because its liquidating distribution would equal $50. However, as long as the partnership continues in existence, the gain is deferred and a loss has been accelerated, or, to put it differently, two partners have 'benefited' from the same loss – one of them, C, in exchange for the obligation to recognize gain at a later date."

book depreciation of $3,333 plus the $5,000 excess tax depreciation over book depreciation attributable to C's pre-contribution built-in loss).

At the end of the depreciable property's ten year recovery period, A and B each recover their $33,333 "cost" for the depreciable property,[210] and C recovers C's pre-contribution basis in the depreciable property. The partnership capital account is as follows –

	Assets			**Partners' Capital Accounts**	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$ 66,667	$ 66,667
Gainacre	$100,000	$ 40,000	B[211]	$ 66,667	$ 6,667
Depreciable Property	0	0	C	$ 66,666	$ 66,666
	$200,000	$140,000		$200,000	$140,000

D. Liquidation of the Contributing Partner

When the partnership interest of a partner who contributed built-in loss property is completely liquidated, allocations of tax items reflecting pre-contribution loss are no longer possible. The rule of section 704(c)(1)(C)(ii) limits the basis of "other partners" to the fair market value of contributed property at the time of contribution after the contributing partner's interest is liquidated. As a result, the pre-contribution built-in loss is available only to the contributing partner.

Example 17 - Assume that the partnership in Example 15A distributed $100,000 cash to C in complete liquidation of C's interest in the partnership when the fair market value of the property contributed by C remained $100,000.

C recognizes a $30,000 loss ($100,000 - $130,000) on the receipt of cash in liquidation of C's partnership interest.[212] Under the limitation of § 704(c)(1)(C)(ii), the continuing partners' basis in Lossacre is now limited to $100,000. The partnership capital account is thus −

210. Rounded off. Book depreciation is $3333.33/$3333.34 per year.

211 The disparity in B's book and tax accounts is attributable to the $60,000 of pre-contribution gain in Whiteacre at the time of its contribution to the partnership.

212. IRC § 731(a)(2). Loss is recognized on a distribution in complete liquidation of a partner's interest where the distributee receives only cash and/or inventory and unrealized receivables (the basis of which is limited to the partnership basis) and the amount of the cash or the basis of the inventory and unrealized receivables is less than the partner's basis in the partnership interest.

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	0	0	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$100,000			
	$200,000	$140,000		$200,000	$140,000

C recognizes C's pre-contribution loss on the liquidation distribution, thus C's loss is preserved. Section 704(c)(1)(C)(ii) prevents duplication of C's pre-contribution loss with the basis reduction that prevents A and B from again taking advantage of the pre-contribution built-in loss.[213]

The same result would occur if the partnership had a section 754 election in effect. Section 734(b)(2)(A) requires a reduction in the basis of partnership property in the amount of loss recognized by a partner under section 731(a)(2). Thus, on the distribution to C, the partnership would have been required to reduce the basis of partnership property by the amount of C's recognized loss.[214] The basis reduction would have been allocated to Lossacre as depreciated section 1231 property or capital gain or loss property under the rules of section 755.[215] Indeed, as a companion to section 704(c)(1)(C)(ii), Congress required mandatory basis adjustments on distributions and transfers of a partner's interest with substantial built-in losses.[216]

213. Absent § 704(c)(1)(C)(ii), A and B could have sold Blackacre after C's departure from the partnership and recognized the built-in $30,000 loss. The loss would have decreased A's and B's bases in their partnership interest and thereby increased gain (or decreased loss) on the ultimate disposition of their partnership interest by either A or B.

214. IRC § 734(b)(2)(A).

215. IRC § 755(b) requires that increases or decreases in partnership basis required under the rules of either §§ 734(b) or 743(b) (applicable to partnership distributions and transfers of a partnership interest, respectively) attributable to (1) capital assets or § 1231 property, or (2) any other property, shall be allocated to property of like character. Section 755(a) requires that any increase or decrease in the basis of partnership property will be applied first to reduce the difference between the fair market value and basis of property, then as provided in regulations. Treas. Reg. § 1.755-1 contains extensive rules for these allocations. If the partnership possessed several depreciated assets, a § 734(b)(2) basis reduction would not necessarily be allocated to contributed built-in loss property.

216. Pub. Law No. 108-357, § 833, 118 Stat. 1589 (2004), amending IRC §§ 734 and 743. Notice 2005-32, 2005-1 C.B. 895, requires a partnership subject to a basis reduction to file a statement with the partnership return for the year of the adjustment under Treas. Reg. §§ 1.735-1(d) or 1.743-1(k) as if a § 754 election were in effect.

E. Required Basis Adjustments with respect to Built-in Losses

1. Distributions

As amended in 2004,[217] section 734 requires an adjustment to partnership asset bases on a distribution to a partner if there is a "substantial basis reduction." A substantial basis reduction occurs if the reductions to partnership bases described by section 734(b)(2) exceed $250,000.[218] Section 734(b)(2) provides for a decrease in the bases of partnership assets on a distribution to a partner in complete liquidation of the partner's interest if (A) the distributee partner recognizes a loss under section 731(a)(2),[219] or (B), the basis of property other than money, inventory, or unrealized receivables is increased in the hands of the distributee partner over the basis of the property to the partnership.[220]

Example 18 - Add one zero to each number in Examples 15A and 17. The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$1,000,000	$1,000,000	A	$1,000,000	$1,000,000
Gainacre	$1,000,000	$ 400,000	B	$1,000,000	$ 400,000
Lossacre	$1,000,000	$1,300,000	C	$1,000,000	$1,300,000
	$3,000,000	$2,700,000		$3,000,000	$2,700,000

On distribution of $1,000,000 cash in complete liquidation of C's interest, C will recognize a $300,000 loss.[221] Section 734(b)(2)(A) requires a reduction in the basis of partnership property of $300,000, which is a substantial basis

217. Pub. Law No. 108-357 (2004), § 833(c), 118 Stat. 1591.

218. IRC § 734(d).

219. Loss is recognized only on a distribution in complete liquidation of a partner's interest where the amount of money and the basis to the distributee of distributed inventory or unrealized receivables (the basis of which is limited to the partnership's basis) is less than the distributee partner's basis in the partnership interest. IRC § 731(a)(2).

220. IRC § 732(b) provides that the basis of property other than money distributed to a partner in liquidation of the partner's interest shall be an amount equal to the distributee's basis in the partnership interest. The partner's basis is first allocated to unrealized receivables and inventory in an amount equal to the partnership's basis in such assets. The remaining basis is allocated to other properties. If the distributee partner's remaining basis is greater than the partnership basis in these assets, the increase is allocated first to properties with unrealized appreciation (in proportion to the unrealized appreciation in the assets), then to all properties in proportion to fair market value. IRC § 732(c).

221. IRC § 731(a)(2).

reduction. The reduction will be allocated under section 755 principles to reduce the basis of Lossacre by $300,000.[222]

The resulting partnership balance sheet is −

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Gainacre	$1,000,000	$ 400,000	A	$1,000,000	$1,000,000
Lossacre	$1,000,000	$1,000,000	B	$1,000,000	$ 400,000
	$2,000,000	$1,400,000		$2,000,000	$1,400,000

If § 704(c)(1))(C)(ii) were to be applied, the basis of Lossacre as to the non-contributing partners also would be reduced to $1,000,000. Note, however, that the mandatory basis adjustment of section 734 is not limited to losses generated by contributed built-in loss property.

The mandatory basis adjustment of section 734(b)(2) and the basis limitation of section 704(c)(1)(C)(ii) prevent the continuing partners from duplicating losses on a subsequent disposition of partnership built-in loss property. As is the case with respect to allocations under section 704(c)(1)(C)(i), the liquidated partner's share of built-in loss, as reflected in an excess of the partner's partnership basis over the value of the partner's capital account, is preserved with a loss deduction on distribution of cash, or in the difference in the fair market value and basis of distributed property.[223]

2. Transfer of a Partnership Interest

In general, on the sale or exchange of a partnership interest, the selling partner recognizes gain or loss treated as gain or loss from the sale or exchange of a capital asset.[224] However, if the partnership has unrealized receivables or inventory,[225] a portion of the amount realized by the selling partner is treated as realized for the partner's interest in the unrealized receivables and inventory.[226] The selling partner recognizes ordinary gain or loss based on the selling partner's share of the partnership basis in the

222. See supra, note 215.

223. Under IRC § 732(b), the basis of property received in liquidation of a partner's interest is the basis of the partner's partnership interest reduced by the amount of money received.

224. IRC § 741.

225. Broadly, unrealized receivables and inventory include any property which, if sold by the partnership, would produce ordinary gain or loss. IRC § 751(c) and (d).

226. IRC § 751(a).

unrealized receivables and inventory.[227] Section 743(a) provides that the basis of partnership property will not be changed as a result of a transfer of a partnership interest. However, section 743(b) provides for adjustments in the bases of partnership assets to reflect the difference between a transferee partner's basis for the acquired partnership interest and the transferee partner's share of the partnership asset bases. Normally section 743(b) is optional,[228] but, under the 2004 changes, section 743(b) adjustments are mandatory if the partnership has a substantial built-in loss immediately after the transfer.[229]

Traditionally, the transferee partner steps into the shoes of the transferor with respect to built-in gains and losses.[230] However, section 704(c)(1)(C) changes this pattern with respect to pre-contribution built-in losses of the transferor partner. Under section 704(c)(1)(C)(i), built-in loss with respect to contributed property is taken into account only in allocations to the partner who contributed built-in loss property. Under section 704(c)(1)(C)(ii), for purposes of determining allocations to "other partners," the basis of contributed built-in loss property is limited to its fair market value at the time of contribution. This basis limitation raises some difficult questions when the value of contributed built-in loss property has increased between the date of contribution and the date of a transfer of the contributing partner's partnership interest. As the examples below will demonstrate, the correct approach is to apply section 704(c)(1)(C)(ii) to limit the basis of the transferee in contributed built-in loss property to fair market value at the time of contribution and rely on section 743(b) adjustments to properly reflect the transferee's outside basis.

a. Mandatory Basis Adjustments on the Transfer of a Partnership Interest

Section 743, as amended in 2004, requires basis adjustments on the sale or exchange of a partnership interest if immediately after the transfer if the partnership has a "substantial built-in loss."[231] A partnership has a substantial built-in loss if the partnership's basis in partnership property

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227. Treas. Reg. § 1.751-1(a)(2) provides that the selling partner recognizes as ordinary gain or loss the amount of gain or loss that would be allocated to the partner under the principles of § 704 if the partnership had sold its unrealized receivables and inventory for fair market value.

228. Section 734(b) and 743(b) adjustments are triggered with an irrevocable partnership election under IRC § 754.

229. See infra, text at note 231.

230. Treas. Reg. § 1.704-3(a)(7).

231. Pub. Law No. 108-357, § 833(d), 118 Stat. 1591 (2004). The required basis adjustment of § 743 is effective with respect to transfers of partnership interests after Oct. 22, 2004.

exceeds the fair market value of its property by $250,000.[232] Where a purchasing partner acquires a partnership interest with built-in loss, the purchaser's cost basis will be less than the purchaser's share of the inside partnership's total basis in assets. In this case, section 743(b)(2) provides for a decrease in the adjusted basis of partnership property in the amount that the transferee's proportionate share of the adjusted basis of partnership property exceeds the transferee's basis in the acquired partnership interest.[233] The mandatory basis reduction prevents the partner acquiring an interest in a partnership with a substantial built-in loss from taking advantage of that loss on disposition of depreciated partnership property.[234] The provision is intended to avoid a duplication of loss, which presumably has been accounted for by the selling partner on the disposition of the partnership interest.

The adjustment under section 743(b) is the difference between the transferee partner's basis in the transferee's partnership interest and the transferee's "proportionate share of the adjusted basis of partnership property." Regulations provide that the transferee's share of the adjusted basis of partnership property is the sum of (1) the transferee partner's interest as a partner in the partnership's "previously taxed capital," plus (2) the transferee partner's share of partnership liabilities.[235] The transferee partner's interest in previously taxed capital is the amount of cash the partner would receive on a liquidation of the partnership after a hypothetical sale of all partnership assets for fair market value increased by the amount of tax loss, or decreased by the amount of tax gain, that would have been allocated to the transferee partner (including gains and losses allocable under section 704(c)[236]) as a result of the hypothetical sale.[237] This methodology identifies the new partner's share of asset bases while accounting for any gain or loss that would be allocated to the partners because of allocations of built-in gain or loss to the

232. IRC § 743(d)(1).

233. IRC § 743(b)(2). Section 743(b)(1) provides for an increase in the basis of partnership assets to the extent that a transferee partner's basis in the acquired partnership interest exceeds the transferee partner's proportionate share of the a partnership's basis in partnership assets.

234. The basis adjustment under § 743(b) is with respect only to the transferee partner and does not affect gain or loss allocated to other partners. IRC § 743(b), flush language.

235. Treas. Reg. § 1.743-1(d).

236. The hypothetical allocations of gain and loss take into account any § 704(c) amount that would have been allocated to the transferee partner as a result of stepping into the shoes of the transferor partner, as well as any remedial allocations to the transferor partner.

237. Treas. Reg. § 1.743-1(d)(1).

partner under section 704(c) and the corresponding reverse allocation rules of the regulations.[238]

Although there are similarities between the mandatory basis adjustments required under section 734(b) in the case of distributions where there is a substantial basis reduction[239] and the adjustment under section 743(b) in the case of a transfer of an interest in a partnership with substantial built-in loss, the two provisions are not symmetrical. A partnership from which a distribution in liquidation of a partner will trigger a mandatory section 734(b) adjustment does necessarily require a mandatory adjustment on a transfer by the same partner.

Example 19A - Assume in the ABC partnership described in Example 18, that C sold C's partnership interest to D for $1,000,000. C recognizes a $300,000 loss on the sale. D's basis in the acquired partnership interest is $1,000,000.

C's recognized loss is attributable to C's pre-contribution built-in loss in Lossacre. However, for purposes of determining whether the partnership has a substantial built-in loss, the pre-contribution built-in gain attributable to Gainacre offsets the built-in loss of Lossacre. The mandatory adjustment rule of section 743 is not applicable.[240] Nonetheless, if section 704(c)(1)(C)(ii) is applicable to the ABD partnership to limit "other" partners' basis in contributed property to fair market value on the date of contribution, the basis of Lossacre with respect to A, B, and D is limited to $1,000,000. The partnership balance sheet would be as follows:

Assets			Partners' Capital Accounts		
	Book Value	Basis		Book Value	Basis
Cash	$1,000,000	$1,000,000	A	$1,000,000	$1,000,000
Gainacre	$1,000,000	$ 400,000	B	$1,000,000	$ 400,000
Lossacre	$1,000,000	$1,000,000	D	$1,000,000	$1,000,000
	$3,000,000	$2,400,000		$3,000,000	$2,400,000

This is the same result that would occur if section 743(b) adjustments were required.[241]

238. See infra, text at note 262.

239. See supra, text at note 217.

240. Compare the application of the mandatory adjustment rule of § 734(b) in the case of a cash distribution to C upon which C recognized a $300,000 loss, supra, text at note 222.

241. Section 743(b) would apply if a § 754 election were in effect for the partnership. D's share of the partnership asset basis is $1,000,000 that would be distributed on a liquidation following a hypothetical sale of assets increased by $300,000 of loss that would be allocated to D who steps into C's shoes with respect to the required § 704(c)(1)(A) of pre-contribution loss attributable to Blackacre. The

Example 19B - Assume in the ABC partnership described in Example 18, that B had contributed cash instead of Gainacre. The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$2,000,000	$2,000,000	A	$1,000,000	$1,000,000
Lossacre	$1,000,000	$1,300,000	B	$1,000,000	$1,000,000
			C	$1,000,000	$1,300,000
	$3,000,000	$2,300,000		$3,000,000	$2,300,000

Now suppose that C sells C's partnership interest to D for $1,000,000. The partnership has a substantial built-in loss. The mandatory application of section 743(b) requires a $300,000 reduction of the basis of partnership assets, which is only allocable to Lossacre. Thus −

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$2,000,000	$2,000,000	A	$1,000,000	$1,000,000
Lossacre	$1,000,000	$1,000,000	B	$1,000,000	$1,000,000
			D	$1,000,000	$1,000,000
	$3,000,000	$2,000,000		$3,000,000	$2,000,000

Section 704(c)(1)(C)(ii) would also limit Lossacre's basis to $1,000,000 with respect to A, B, and D.

F. The Trouble with Post-Contribution Appreciation of Built-In Loss Property and a Transfer of the Contributor's Interest

On disposition of contributed built-in loss property that has appreciated above its fair market value on the date of the contribution, pre-contribution built-in loss may be used by continuing partners to shelter book

excess of D's share of partnership basis over D's $1,000,000 basis in the transferred interest produces a $300,000 basis reduction in Blackacre to $1,000,000, attributable only to D, thereby eliminating the loss allocable to Blackacre. As discussed infra, text accompanying note 250, applying § 704(c)(1)(C)(ii) to this determination, and otherwise limiting the basis of Blackacre to $1,000,000, eliminates any § 743(b) adjustment and again eliminates potential loss allocable to D on disposition of Blackacre.

gains from immediate recognition.[242] The problem is compounded when the partner who contributed built-in loss property transfers the partnership interest to a new partner. A strict application of section 704(c)(1)(C)(ii), limiting the new partner's basis in the contributed built-in loss property to its value as of the date of the original contribution, produces the correct result under Subchapter K principles. Indeed, the application of section 704(c)(1)(C)(ii) eliminates an anomaly in book and tax accounts that would exist in the absence of the basis limitation .

Under traditional applications of section 704(c)(1)(A), the purchaser of a partnership interest steps into the shoes of the seller with respect to the seller's share of any allocations required by section 704(c)(1).[243] If section 704(c)(1)(C)(i) is applied in the same fashion, allocations of tax items attributable to built-in loss property contributed by the selling partner are allocable to the purchasing partner. Without more, however, this produces a duplicated tax loss attributable to the contributed built-in loss property, one loss recognized by the contributing partner on disposition of the partnership interest, and a second loss at the partnership level on disposition of the contributed property. Section 704(c)(1)(C)(ii) eliminates the partnership level loss by limiting for allocation purposes the basis of the built-in loss property to its fair market value at the time of the contribution. However, applying this rule to a partner who purchases an interest in the partnership after the contributed built-in loss property has appreciated by an amount not in excess of its basis creates a built-in gain for the purchasing partner. A section 754 election and section 743(b) provide an appropriate mechanism to eliminate this gain.

Example 20 - Return to the ABC partnership of Example 15A.

Assets	Book Value	Basis	Partners' Capital Accounts	Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$130,000	C	$100,000	$130,000
	$300,000	$270,000		$300,000	$270,000

Now suppose that when Lossacre has appreciated to $115,000 C sells C's partnership interest to D for $105,000. C recognizes a $25,000 loss[244] and

242. This issue was considered in example 15C, supra, text preceding note 202.

243. Treas. Reg. § 1.704-3(a)(7).

244. IRC § 741.

D's basis in the partnership interest is $105,000.[245] The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$130,000	D	$100,000	$105,000
	$300,000	$270,000		$300,000	$245,000

The $25,000 disparity between the partnership's asset bases and the partners' bases in their partnership interest occurs because C's recognized $25,000 loss is not reflected in adjustments to the basis of partnership assets.[246]

In the absence of section 704(c)(1)(C), under section 704(c)(1)(A), D, the transferee partner, would step into C's shoes and would be allocated the first $30,000 of loss on the sale of Lossacre.[247] If Lossacre were sold for $115,000, the partnership would recognize $15,000 of book gain, allocated equally to A, B, and D, and $15,000 tax loss allocable to D. The partnership capital account would then be –

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$100,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 40,000
Lossacre/cash	$115,000	$115,000	D	$105,000	$ 90,000
	$315,000	$250,000		$315,000	$235,000

The loss attributable to the pre-contribution built-in loss in Lossacre is duplicated; $25,000 is recognized by C on disposition of the partnership interest and $15,000 is recognized on disposition of Lossacre by the partnership. D's recognized loss would be recovered on a disposition or liquidation of D's interest with $15,000 of built-in gain. In addition, these allocations have the effect of worsening disparities in the partners' book and tax accounts.

Again, ignoring the potential application of section 704(c)(1)(C)(ii), the partnership can eliminate its section 704(c) issues and the remaining built-in loss attributable to Lossacre with a section 754 election. The

245. IRC § 742.
246. IRC § 743(a).
247. Treas. Reg. § 1.704-3(a)(7).

accompanying § 743(b) adjustment would reduce the basis of Lossacre to $115,000, which is its fair market value at the time of D's purchase of the partnership interest.[248] Only D is affected by this basis reduction. The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$115,000	D	$100,000	$105,000
	$300,000	$255,000		$300,000	$245,000

Now, if Lossacre is sold for $115,000, its fair market value, the partnership recognizes $15,000 of book gain allocated equally among the partners, and no tax gain or loss. The partnership capital account is as follows:

Assets			Partners' Capital Accounts		
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$100,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 40,000
Lossacre/cash	$115,000	$115,000	D	$105,000	$105,000
	$315,000	$255,000		$315,000	$245,000

Even with the section 754 election, there remains a $10,000 disparity between inside and outside bases that is attributable to the $10,000 of book gain on Lossacre that is allocable to A and B, but which does not produce tax gain. A's and B's book appreciation is offset by $10,000 of the contributing partner's pre-contribution loss.[249] Recognition of this gain will be deferred until A and B dispose of their partnership interests.

The application of section 704(c)(1)(C) to this situation is not crystal clear. One could assert that A's and B's use of C's pre-contribution loss to offset an allocation of gain is contrary to section 704(c)(1)(C)(i), which

248. The excess of D's share of partnership inside basis over D's outside basis is $15,000. D's share of partnership inside basis is D's share of previously taxed capital, which is the $105,000 that would be distributed to D on sale of partnership assets and complete liquidation, increased to $120,000 by the $15,000 loss that would be realized by the partnership on sale of Blackacre and allocated to D under § 704(c)(1)(A) principles. Treas. Reg. § 1.743-1.

249. C's share of the book appreciation is already reflected in C's cost basis for the partnership interest.

should, therefore, require recognition of tax gain by A and B to match their book gain. Under a literal application of section 704(c)(1)(C)(ii), A, B, and D, as other partners, would be treated as having a basis in Lossacre that is limited to its fair market value on contribution. Under this approach, A, B, and D must each recognize $5,000 of gain on the disposition of Lossacre. This interpretation of section 704(c)(1)(C)(ii) is creating a notional tax gain for the partners where there is no recognized gain in the partnership. The partnership capital accounts would be as follows:

Assets	Book Value	Basis	Partners' Capital Accounts	Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$105,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 40,000
Lossacre/cash	$115,000	$115,000	D	$105,000	$110,000
	$315,000	$255,000		$315,000	$255,000

Here D has purchased an interest in Lossacre for one-third of its current value and selling price but is forced to recognize a tax gain in the absence of a corresponding economic gain. D is required to recognize a tax gain that is not matched by an economic gain, which shows up in the difference between D's capital account and basis. In essence D's current tax gain will be translated into a later recognized loss (or reduction of gain) on final disposition of D's interest in the partnership.

This recognition of gain today with loss tomorrow is an inappropriate acceleration of tax liability to D. However, the acceleration of recognized tax gain or loss is a common feature of Subchapter K when a purchaser acquires a partnership interest with a basis that varies from the acquiring partner's share of inside partnership basis. The answer in Subchapter K to this anomaly is to make a section 754 election. In the example, limiting the basis in Lossacre as to each partner to $100,000, and making the adjustment under section 743(b) to account for D's purchase price, increases the basis of Lossacre with respect to D by $5,000.[250] Here, section 704(c)(1)(C)(ii) is applied to give all partners a date of contribution basis in contributed built-in loss property for purposes of making section

250. D's share of previously taxed partnership capital is $105,000 less $5,000 of gain that would be allocated to D (without regard to the § 743(b) adjustment) on disposition of Blackacre for fair market value after applying § 704(c)(1)(C)(ii) to limit the basis of Blackacre to its date of contribution value. D's basis in D's partnership interest, $105,000 exceeds D's share of partnership capital by $5,000, which results in a $5,000 increase in the basis of partnership assets. IRC § 743(b)(1); Treas. Reg. § 1.743-1.

743(b) adjustments as well as for allocating gains and losses. In this case the sale of Lossacre for $115,000 produces $10,000 of partnership gain ($115,000 - $105,000) which is allocated equally to A and B. The resulting partnership capital account demonstrates that this is the correct result.

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$105,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 45,000
Lossacre/cash	$115,000	$115,000	D	$105,000	$105,000
	$315,000	$255,000		$315,000	$255,000

There is no disparity between the partnership's inside basis and the sum of the partners' bases in their partnership interest. Also, there is no book/tax disparity between A's and D's capital and tax accounts. The $60,000 difference between the partnership's capital account and basis, and between the sums of the partners' capital accounts and bases, is attributable to B's pre-contribution gain on Gainacre and will be eliminated on disposition of Gainacre.

There are alternate ways to apply section 704(c)(1)(C)(ii) to mitigate the result to D. First, as one commentator has suggested, section 704(c)(1)(C)(ii) might be broadly interpreted to apply the fair market value limitation to basis to a transferee partner as of the date of the transferee's acquisition of the partnership interest.[251] In this case, as to D, the basis of Lossacre would be treated as $115,000, its fair market value on the date of D's acquisition from C, the contributing partner. A's and B's bases in Lossacre would be treated as $100,000, the value of Lossacre on the date of its contribution. This interpretation would result in recognition of no gain by D on sale of Lossacre for $115,000, and recognition of $5,000 of gain by A and B.[252] The resulting partnership capital account would be as follows:

251. Rachuba, supra note 203, at 1573

252. Sale for $115,000 of the property with a $100,000 basis results in $15,000 of gain. A's and B's one-third share is $5,000 each. D's share of this gain is ignored because D is treated as having a $115,000 basis in Blackacre, which results in no recognized gain.

Assets	Book Value	Basis	Partners' Capital Accounts	Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$105,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 45,000
Lossacre/cash	$115,000	$115,000	D	$105,000	$105,000
	$315,000	$255,000		$315,000	$255,000

This approach is no different than a section 754 election that increases the partnership's basis in Lossacre on behalf of D. It avoids the inconvenience and complexities of an irrevocable section 754 election that might produce adverse results in other contexts. The approach balances the partnership capital accounts and requires the continuing partners to recognize their realized gains. On the negative side, this approach creates notional partnership tax gains where none are recognized within the partnership. The approach also requires an application of the statute in a manner that is outside the statutory language. The regulatory authorization in section 704(c)(1)(C)(ii), however, would allow Treasury to promulgate regulations to mandate this approach.

An alternative approach would recognize that, by its terms, section 704(c)(1)(C)(ii) applies to determine items allocated to other partners by treating the basis of contributed built-in loss property as fair market value on the date of contribution, but does not operate to create notional tax gain.[253] Section 704(c)(1)(C)(ii) thus may be applied as a limitation on the allocation of partnership tax items. In other words, section 704(c)(1)(C)(ii) could be applied with a ceiling rule. Under this approach, when the ABD partnership sells Lossacre for $115,000 and recognizes a $15,000 tax loss, if A, B, and D, as other partners, are treated for purposes of allocating the loss as having a basis of only $100,000 in Lossacre, no loss is allocable to any of them. The loss, which is not allocable to any partner, disappears. Under this approach, the ABD partnership capital account is as follows:

	Assets Book Value	Basis	Partners' Capital Accounts	Book Value	Basis
Cash	$100,000	$100,000	A	$105,000	$100,000
Gainacre	$100,000	$ 40,000	B	$105,000	$ 40,000
Lossacre/cash	$115,000	$115,000	D	$105,000	$105,000
	$315,000	$255,000		$315,000	$245,000

253. This interpretation is consistent with the assertion in the text supra, surrounding note 202, that § 704(c)(1)(C) should not be interpreted as creating nominal tax gain where none is recognized by the partnership.

The disparity between the inside partnership basis and the sum of the partners' outside bases is attributable to the $10,000 book gain realized by A and B, but not recognized. The gain will be reflected in taxable income on a disposition of A's and B's partnership interests.

The best interpretation is the strict application of section 704(c)(1)(C)(ii) to all partners, limiting the basis of contributed property to fair market value at the date of contribution, with the adjustments allowed under section 743(b) with a section 754 election to avoid recognition by a transferee partner. Since book/tax differences can be eliminated through a section 754 election (as properly applied by taking into account section 704(c)(1)(C)(ii)), there is no reason to develop a convoluted application of section 704(c)(1)(C)(ii) in order to avoid the mis-match between book and tax losses.

G. Post-Contribution Depreciation of Built-In Loss Property and a Transfer of the Contributor's Interest

Literal application of section 704(c)(1)(C)(ii) and relying on section 743(b) adjustments as determined by taking section 704(c)(1)(C)(ii) into account also works when contributed built-in gain loss has declined in value after the date of the contribution.

Example 21 - Again go back to the partnership in example 15A.

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$130,000	C	$100,000	$130,000
	$300,000	$270,000		$300,000	$270,000

Now suppose that the value of Lossacre has declined to $85,000, and C sells C's partnership interest to D for $95,000. C recognizes a loss of $35,000.[254] Absent a section 754 election, the partnership's asset bases are not changed.[255] The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$130,000	D	$100,000	$ 95,000
	$300,000	$270,000		$300,000	$235,000

254. IRC § 741.
255. IRC § 743(a).

The $35,000 difference between the partnership's inside asset basis and the sum of the partner's outside bases reflects C's $35,000 loss recognized outside of the partnership.

Applying section 704(c)(1)(C)(ii), to limit A's, B's, and D's basis in Lossacre to $100,000, a sale of the property results in a $15,000 book loss and a $15,000 tax loss. The losses are allocated equally to A, B, and D. The resulting partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$ 95,000	$ 95,000
Gainacre	$100,000	$ 40,000	B	$ 95,000	$ 35,000
Lossacre/cash	$ 85,000	$ 85,000	D	$ 95,000	$ 90,000
	$285,000	$225,000		$285,000	$220,000

As was the case with gain in example 20, this approach permits the transferee partner to recognize a tax loss when the partner suffered no economic loss. Again, the solution to this anomaly is provided in Subchapter K by section 743(b) adjustments.

Taking section 704(c)(1)(C)(ii) into account, a section 743(b) adjustment would require the partnership to decrease the basis of Lossacre by $5,000 with respect to D's partnership interest.[256] The resulting partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Cash	$100,000	$100,000	A	$ 95,000	$100,000
Gainacre	$100,000	$ 40,000	B	$ 95,000	$ 40,000
Lossacre	$100,000	$ 95,000	D	$ 95,000	$ 95,000
	$300,000	$235,000		$285,000	$235,000

Now, on sale of Lossacre for $85,000, the partnership recognizes a

256. The excess of D's share of partnership inside basis over D's outside basis is $5,000. D's share of partnership inside basis is D's share of previously taxed capital, which is the $95,000 that would be distributed to D on sale of partnership assets and complete liquidation, increased to $100,000 by the $5,000 loss that would be realized by the partnership on sale of Blackacre and allocated to D if the partnership basis in Blackacre were limited to $100,000. Treas. Reg. § 1.743-1. The basis of partnership property is decreased by the excess of D's share of partnership basis and D's $95,000 outside basis. In this case, the decrease can only be allocated to Blackacre, the only partnership depreciated property.

tax loss of $10,000. Since the section 743(b) basis adjustment affects only D,[257] the tax loss is allocated equally to A and B. The resulting capital account validates this approach.

	Assets Book Value	Assets Basis		Partners' Capital Accounts Book Value	Partners' Capital Accounts Basis
Cash	$100,000	$100,000	A	$ 95,000	$ 95,000
Gainacre	$100,000	$ 40,000	B	$ 95,000	$ 35,000
Lossacre/cash	$ 85,000	$ 85,000	D	$ 95,000	$ 95,000
	$285,000	$225,000		$285,000	$225,000

A and B have recognized their shares of realized partnership loss. D's book loss has already been reflected in the purchase price and basis of D's partnership interest. Book tax disparities have been eliminated for the partners.[258]

H. Back to Basis: Post-Contribution Appreciation of Built-In Loss Property and a Transfer of the Contributor's Interest

A final validation of the application of section 704(c)(1)(C)(ii) limiting the basis of a transferee partner to the date of contribution value of contributed built-in loss property appears from consideration of the allocation of gains when the contributed built-in loss property has appreciated to equal or exceed the contributing partner's adjusted basis.

Example 22 - Assume that Lossacre in example 15A has appreciated to $130,000 so that its value now equals C's adjusted basis at the time of contribution. C sells C's partnership interest to D for $110,000. C recognizes a $20,000 loss,[259] which reflects the fact that C's pre-contribution loss has not been offset by recognized partnership gain on a sale of the contributed built-in loss property. The partnership capital account, including D's purchased interest is as follows:

	Assets Book Value	Assets Basis		Partners' Capital Accounts Book Value	Partners' Capital Accounts Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$130,000	D	$100,000	$110,000
	$300,000	$270,000		$300,000	$250,000

257. IRC § 743(b), flush language.

258. The $60,000 difference attributable to B's contributed built-in remains to be accounted for on disposition of Whiteacre.

259. IRC § 741.

The inside-outside basis disparity is attributable to C's $20,000 loss recognized outside of the partnership. Applying section 704(c)(1)(C)(ii) to limit the partners' basis in Lossacre to its contribution fair market value changes the inside-outside disparity as follows:

	Assets Book Value	Basis		Partners' Capital Accounts Book Value	Basis
Cash	$100,000	$100,000	A	$100,000	$100,000
Gainacre	$100,000	$ 40,000	B	$100,000	$ 40,000
Lossacre	$100,000	$100,000	D	$100,000	$110,000
	$300,000	$240,000		$300,000	$250,000

Now the partner's outside bases are $10,000 greater than the partnership inside asset bases, which occurs because D's purchase price reflects appreciation in Lossacre over its book value and basis. Sale of Lossacre for $130,000 would result in $30,000 of book and tax gain, allocable equally to the partners. D will be required to recognize $10,000 of tax gain notwithstanding the fact that D has no economic gain. Again, this issue can be resolved with a section 754 election that would increase the basis of Lossacre by $10,000[260] with respect to D and eliminate D's recognition of gain. The resulting capital accounts after the sale and allocation of $10,000 of book gain to each partner and $10,000 of tax gain to A and B, are as follows:

	Assets Book Value	Basis		Partners' Capital Accounts Book Value	Basis
Cash	$100,000	$100,000	A	$110,000	$110,000
Gainacre	$100,000	$ 40,000	B	$110,000	$ 50,000
Lossacre/cash	$130,000	$130,000	D	$110,000	$110,000
	$330,000	$270,000		$330,000	$270,000

260. The excess of D's of partnership basis over D's share of partnership inside basis is $10,000. D's share of partnership inside basis is D's share of previously taxed capital, which is the $110,000 that would be distributed to D on sale of partnership assets and complete liquidation, decreased to $100,000 by the $10,000 gain that would be realized by the partnership on sale of Blackacre and allocated to D if the partnership basis in Blackacre were limited to $100,000. Treas. Reg. § 1.743-1. The basis of partnership property is increased by the excess of D's outside basis over D's $100,000 share of partnership inside basis.

Here again, literal application of section 704(c)(1)(C)(ii) to limit the basis of all partners to the fair market value of contributed built-in loss property reaches the correct result under the overall pattern of Subchapter K.

VI. ADMISSION OF A NEW PARTNER TO THE PARTNERSHIP WITH BUILT-IN GAIN OR LOSS PROPERTY – REVERSE ALLOCATIONS

Section 704(c), by its terms, applies to control allocations only in the case of a contribution of built-in gain or loss property to a partnership by a partner. Nonetheless, similar allocation issues arise when a new partner contributes cash for an interest in a partnership that holds built-in gain or loss property. In addition, a new partner entering a partnership that has contributed built-in loss property will be subject to the basis limitation of section 704(c)(1)(C)(ii), which raises interesting questions regarding the impact on the new partner on disposition of the built-in loss property.

A. Admission of a Partner to a Partnership with Built-in Gain Property

Admission of a new partner by contribution does not require adjustments to the partnership capital accounts. However, the regulations permit a partnership to revalue its assets to fair market value for capital account purposes upon admission of a new partner by contribution.[261] Although voluntary, as a practical matter revaluation of partnership assets on admission of a partner is important, and probably necessary, to allow the partnership to properly reflect the partners' interests in partnership capital.

As partnership assets are revalued, book gains and losses are allocated to the partner's capital account in the manner that gains and losses are shared under the terms of the partnership agreement. Revaluation affects only the partnership book accounts. No tax gain or loss is triggered by the revaluation. Accounting for book gains and losses without corresponding tax items thus creates a disparity in the partnership book and tax accounts. After revaluation, the regulations apply section 704(c) principles to allocate tax items to reduce book/tax disparities in the same manner as allocations attributable to contributed property.[262] These "reverse allocations" insure that built-in gain or loss attributable to periods before a new partner is admitted is allocated to the old partners. Curative and remedial allocations[263] are available to offset distortions caused by the ceiling rule when there are insufficient tax items to match the partners' share of book items.

261. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*).
262. Treas. Regs. §§ 1.704–1(b)(2)(iv)(f), –1(b)(4)(i), and 1.704–3(a)(6)(i).
263. Treas. Reg. § 1.704-3(c) and (d). See text supra, at note 44.

Example 23A.[264] - I and J form the IJ partnership with cash contributions of $90,000. The partnership purchases property for $180,000. The partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property	$180,000	$180,000	I	$ 90,000	$ 90,000
			J	$ 90,000	$ 90,000
	$180,000	$180,000		$180,000	$180,000

When the partnership property has appreciated to $300,000, K is admitted to the partnership as a one-third partner with a cash contribution of $150,000.

Without a revaluation, the partnership capital accounts are as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property	$180,000	$180,000	I	$ 90,000	$ 90,000
Cash	$150,000	$150,000	J	$ 90,000	$ 90,000
			K	$150,000	$150,000
	$230,000	$230,000		$230,000	$230,000

These capital accounts do not reflect the economic relationship of the partners. K is admitted as a one-third partner on the basis of valuations of partnership property, while the capital accounts show K as a 62% owner of partnership capital. Ultimately reconciliation of the capital accounts with the economics of the partnership requires a special allocation of partnership gain on sale of the property to reflect the economic division of appreciation between I and J before K became a partner. Rather than relying on capital accounts, the post-hoc allocation requires an amendment to the partnership agreement to provide for the appropriate allocation of book and tax items. Thus, a partnership provision may be incorporated to allocate the first $120,000 of gain on the sale of the property to I and J, with any gain in excess of $120,000 to be divided equally. The tax gain would follow.[265] Revaluing the capital accounts to reflect fair market value at the time of K's admission has the same economic and tax result, but has the additional

264. The example is from McDaniel et. al. supra note15, 169.

265. This allocation has economic effect under the economic effects test of Treas. Reg. § 1.704-1(b)(2)(ii) or the alternative test of Treas. Reg. § 1.704-1(b)(2)(ii)(*d*), depending on whether the partners have an obligation to restore a capital account deficit.

advantage of accurately reflecting the partners' economic relationship without special allocations.[266]

Revaluing the partnership asset to fair market value results in a partnership book gain of $120,000, which is allocated equally to I and J causing a $60,000 increase in each partner's capital account.[267] After admitting K to the partnership, the revalued partnership capital account is as follows:

	Assets Book Value	Basis		Partners' Capital Accounts Book Value	Basis
Property	$300,000	$180,000	I	$150,000	$ 90,000
Cash	$150,000	$150,000	J	$150,000	$ 90,000
			K	$150,000	$150,000
	$450,000	$230,000		$450,000	$230,000

Now suppose that the partnership sells the property for $330,000. The partnership realizes a book gain of $30,000, which is allocated $10,000 to each partner. The partnership recognizes $150,000 of tax gain. $10,000 of tax gain is allocated to each partner to match each partner's book gain. The remaining $120,000 of tax gain is allocated equally to I and J to reflect their unrealized appreciation prior to K's admission to the partnership. Thus I and J each recognize $70,000 of gain. The resulting partnership capital account is as follows:

	Assets Book Value	Basis		Partners' Capital Accounts Book Value	Basis
Property/cash	$330,000	$330,000	I	$160,000	$160,000
Cash	$150,000	$150,000	J	$160,000	$160,000
			K	$160,000	$160,000
	$480,000	$480,000		$480,000	$480,000

Example 23B - Suppose the partnership in Example 23A sells the partnership asset for $270,000. The partnership has a $30,000 book loss allocable to each of the partners, and a $90,000 tax gain. The partnership has no other income or loss. Under the traditional method of Treas. Reg. section 1.704-3(b), the tax gain is allocable to I and J, $45,000 each. Under the

266. This can be critically important in the event of a break-up of the partnership where the partners dispute their respective shares of partnership assets. The maintenance of accurate capital accounts throughout the life of a partnership facilitates the division of partnership assets in the event of a dispute.

267. Treas. Reg. § 1.704-1(b)(2)(iv)(g)(1).

ceiling rule there is no tax loss to allocate to K to match K's book loss. In addition, there are no additional items of income or expense with which to make curative allocations.[268] However, the partnership could make a remedial allocation of a notional $10,000 tax loss to K coupled with a remedial allocation of $5,000 of taxable gain to I and J. Using remedial allocations the partnership capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$270,000	$270,000	I	$140,000	$140,000
Cash	$150,000	$150,000	J	$140,000	$140,000
			K	$140,000	$140,000
	$420,000	$420,000		$420,000	$420,000

In the absence of a revaluation of partnership property, there is no way to adjust capital accounts to reflect K's economic loss. On sale of the property for $270,000 the partnership has a book and tax gain of $90,000 ($270,000 - $180,000). A special allocation might be crafted to allocate this gain equally to I and J, which avoids treating K as realizing an economic loss. The resulting partnership capital accounts, which now do not reflect one-third interests of the partners, would be as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$270,000	$270,000	I	$135,000	$135,000
Cash	$150,000	$150,000	J	$135,000	$135,000
			K	$150,000	$150,000
	$420,000	$420,000		$420,000	$420,000

This result may end in confusion amongst the partners who may expect a one-third division of partnership assets, which is contrary to the result shown by the capital accounts.

B. Depreciation and Capital Recovery Provisions

Revaluation of partnership assets on admission of the new partner is also important to properly allocate depreciation and other capital recovery deductions among the partners to reflect the cost to the new partner of an interest in depreciable property.

268. Treas. Reg. § 1.704-3(c).

Example 23C - Suppose the property purchased by I and J in Example 23A is a section 197 intangible and that I and J have taken five years of capital recovery deductions ($12,000/year) reducing the basis of the asset to $120,000. At the end of five years, when the asset has appreciated to $300,000, K joins the partnership with a $150,000 capital contribution. At the time of K's admission, the partnership assets are revalued. The partnership recognizes $180,000 of book gain which is allocated to I's and J's capital accounts, $90,000 each. The partnership breaks even other than the section 197 amortization deductions. On K's admission to the partnership, the partnership capital accounts are as follows:

	Assets Book Value	Basis		Partners' Capital Accounts Book Value	Basis
Property	$300,000	$120,000	I	$150,000	$ 60,000
Cash	$150,000	$150,000	J	$150,000	$ 60,000
			K	$150,000	$150,000
	$450,000	$270,000		$450,000	$270,000

The year three § 197 amortization produces a $30,000 book expense and a tax deduction of $12,000. K's allocation of the book loss is $10,000. Thus, K must be allocated a tax deduction of $10,000 to match the book loss. The remaining $2,000 of the § 197 amortization is divided equally between I and J.

At the end of ten years, each partner will have been allocated $100,000 of book expense. K will have been allocated $100,000 of tax loss, reducing K's basis to $50,000. I and J each will have been allocated $10,000 of tax loss, reducing their respective bases to $50,000. The resulting capital account at the end of year ten will be as follows:

	Assets Book Value	Basis		Partners' Capital Accounts Book Value	Basis
Property	0	0	I	$ 50,000	$ 50,000
Cash	$150,000	$150,000	J	$ 50,000	$ 50,000
			K	$ 50,000	$ 50,000
	$ 50,000	$150,000		$150,000	$150,000

C. Admission of a Partner to a Partnership with Contributed Built-in Loss Property

Section 704(c)(1)(C) complicates the allocations of built-in loss to partners after admission of a new partner. Fundamentally, section 704(c)(1)(C) should be read to apply subdivision (i) to allocate all recognized built-in loss to the contributing partner as long as the contributing partner remains a partner in the partnership. Subdivision (ii) should be applied to eliminate partnership loss only after the contributing partner leaves the partnership by treating the basis of contributed built-in loss property as equal to fair market value on contribution as to the other partners.

Example 24 - L and M form a partnership with a contribution of $90,000 cash by L and a contribution of property by M with a fair market value of $90,000 in which M's basis is $135,000. When the property has appreciated to $120,000, N joins the partnership with a cash contribution of $105,000. The partnership agreement provides that the partners will share gains and losses equally. Without restating the capital accounts, after N's admission into the partnership, the partnership capital account would be as follows.

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property	$ 90,000	$135,000	L	$ 90,000	$ 90,000
Cash	$ 90,000	$ 90,000	M	$ 90,000	$135,000
Cash from N	$105,000	$105,000	N	$105,000	$105,000
	$285,000	$330,000		$285,000	$330,000

If the partnership were to sell the contributed property for $120,000, the partnership recognizes $30,000 of book gain, which should be specially allocated L and M to reflect the fact that the gain accrued before N became a partner, and a $15,000 tax loss. Under both traditional section 704(c) principles, and following the mandate of section 704(c)(1)(C)(i), the $15,000 tax loss is allocated to M. The resulting capital account is as follows –

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$120,000	L	$105,000	$ 90,000
Cash	$ 90,000	$ 90,000	M	$105,000	$120,000
Cash from N	$105,000	$105,000	N	$105,000	$105,000
	$315,000	$315,000		$315,000	$315,000

Restating the capital accounts under Treasury Regulation section 1.704–1(b)(2)(iv)(*f*) demonstrates that this is the correct result. Restating capital accounts on N's admission to the partnership would require booking up the property value to $120,000 and allocating the book gain equally between L and M. The resulting capital accounts would reflect the true economic relationship of the partners as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$135,000	L	$105,000	$ 90,000
Cash	$ 90,000	$ 90,000	M	$105,000	$135,000
Cash from N	$105,000	$105,000	N	$105,000	$105,000
	$315,000	$330,000		$315,000	$330,000

On sale of the property for $120,000 there is no partnership book gain because it has already been reflected in the partnership capital accounts. The tax loss of $15,000 is again allocated to M by virtue of both section 704(c)(1)(A) and (c)(1)(C)(i).

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$120,000	L	$105,000	$ 90,000
Cash	$ 90,000	$ 90,000	M	$105,000	$120,000
Cash from N	$105,000	$105,000	N	$105,000	$105,000
	$315,000	$315,000		$315,000	$315,000

Applying the basis limitation rule of § 704(c)(1)(C)(ii) to this situation while the contributing partner remains in the partnership produces a distorted result. If the "other partners," L and N are treated as having a basis of only $90,000 in the property, they would each be required to recognize their share of tax gain of $10,000 ([$120,000 - $90,000]/3). The resulting capital account would be as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$120,000	L	$105,000	$100,000
Cash	$ 90,000	$ 90,000	M	$105,000	$120,000
Cash from N	$105,000	$105,000	N	$105,000	$115,000
	$315,000	$315,000		$315,000	$335,000

The allocation has created an inside/outside basis disparity by allocating $10,000 of tax gain to N in the absence of either book gain or economic gain (which are synonymous when capital accounts are restated). That does not appear to be the result intended by the enactment of section 704(c)(1)(C), which is to avoid duplicating and accelerating loss. In this case, section 704(c)(1)(C)(ii) should be applied to recognize that its basis limitation rule only applies to govern allocations of recognized tax items. On the context of its statutory purpose, section 704(c)(1)(C)(ii) should not be interpreted as creating notional tax items out of partnership book gains and losses.[269]

D. Admission of a Partner to a Partnership with Contributed Built-in Loss Property and Liquidation of the Contributing Partner

Where the contributing partner is no longer a member of the partnership, section 704(c)(1)(C)(ii) limits the other partners to the basis of contributed property at the time of contribution.

Example 25 - Suppose in Example 24, after N is admitted to the partnership for a $105,000 cash contribution and the partnership capital accounts are revalued,[270] M's partnership interest is liquidated with a cash distribution of $105,000. M, who contributed the built-in loss property, recognizes a $30,000 loss on the liquidation distribution. IRC section 731(a)(2). After the liquidation distribution, restated capital accounts are as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$135,000	L	$105,000	$ 90,000
Cash	$ 90,000	$ 90,000	N	$105,000	$105,000
	$210,000	$210,000		$210,000	$195,000

Under section 704(c)(1)(C)(ii), the basis of the contributed property as to L and N (the "other partners") must be reduced to $90,000. Using this basis, on sale of the property, the partnership now would recognize zero book gain and $30,000 tax gain. Under the reverse § 704(c) allocation principles of Treas. Reg. section 1.704-1(b)(2)(iv)(*g*), the first $15,000 of tax gain is allocated to L. The remaining gain is split between the partners, $7,500 each. The resulting capital account is as follows:

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$120,000	L	$105,000	$112,500
Cash	$ 90,000	$ 90,000	N	$105,000	$112,500
	$210,000	$210,000		$210,000	$225,000

269. See the discussion in the text, supra, note 204.

270. Treas. Reg. § 1.704-1(b)(2)(iv)(g)(1). $30,000 of book gain that results from the revaluation of the property from $90,000 to $120,000 is allocated equally to L and M, increasing their capital accounts to $105,000. On distribution of $105,000, M's recognized loss is allowed under § 731(a)(2).

This analysis taxes the partners on $15,000 of excess gain, as demonstrated by the $15,000 inside/outside basis disparity. The problem can be avoided with a section 734(b)(2)(A) adjustment that would reduce the property basis on the liquidation distribution to M by $30,000.

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property	$120,000	$105,000	L	$105,000	$ 90,000
Cash	$ 90,000	$ 90,000	N	$105,000	$105,000
	$210,000	$195,000		$210,000	$195,000

On sale of the property for $120,000, the $15,000 gain is allocable to L under Treasury regulation section 1.704-1(b)(2)(iv)(*g*).

	Assets			Partners' Capital Accounts	
	Book Value	Basis		Book Value	Basis
Property/cash	$120,000	$120,000	L	$105,000	$105,000
Cash	$ 90,000	$ 90,000	N	$105,000	$105,000
	$210,000	$210,000		$210,000	$210,000

Here the section 754 election and application of section 734(b) reach the correct result both economically and temporally.[271] In effect, the partnership is treated as having a basis in the property of $90,000 as to L, which is consistent with the application of section 704(c)(1)(C)(ii) to L. However, with the section 734(b) adjustment, N is treated as having a basis of $105,000, the fair market value of the property at the time of N's admission to the partnership. There are suggestions that section 704(c)(1)(C)(ii) be applied to limit the basis of a contributing partner to fair market value at the time of the contribution.[272] However, with the strict application of section 704(c)(1)(A) and (C)(i) to allocate losses to the contributing partner while the contributing partner is still a partner, and the availability of section

271. The role of § 734(b) adjustments in eliminating the deferral of gains and losses provides a strong argument for making § 734(b) adjustments mandatory. See Andrews, supra note 150, 23; Noël B. Cunningham, Needed Reform: Tending the Sick Rose, 47 Tax L. Rev. 77, 81 (1991). Professor Andrews points out that mandatory § 734(b) adjustments would not involve the accounting complexity that would be associated with mandatory adjustments under § 743(b) because the former does not require separate accounting for the adjustments with respect to individual partners. But see also Abrams, supra note 82, at 351, who recommends that § 734(b) adjustments attributable to non-liquidating distributions be allocated to the distributee partner's continuing interest.

272. Rachuba, supra, note 203.

734(b) adjustments where the contributing partner's interest has been completely liquidated, there is no need for stretched interpretations of section 704(c)(1)(C)(ii) that apply the provision differently in different contexts. Section 704(c)(1)(C)(ii) should not be applied to overrule or revise application of the basis reduction calculated under section 734(b)(2).

VII. CONCLUSION

If nothing else, this foray into the intricacies of changing partnership interests in built-in gain and loss property sustains the viability of capital account analysis as the key to understanding the correct application of the rules of Subchapter K. Analysis of disparities in the capital accounts and tax accounts (basis) provides key guidance to the allocation of both contributed built-in gains and losses and built-in gains and losses within a partnership on the entry of new partners. At the most basic level, realized pre-contribution built-in gain and loss is allocable to the contributing partner to the extent of the differences in the contributing partner's capital account and basis. Similarly, built-in gain and loss inherent in partnership assets at the time of entry of a new partner into a partnership is properly allocable to the continuing partners to the extent of the differences between the fair market value and adjusted basis of the continuing partners' partnership interests. Revaluation of partnership capital accounts on the entry of a new partner, or on distributions that change partners' interests, presents a clear picture of the partners' interests resulting from those events.

Analysis of partnership capital accounts and an examination of disparities between partners' capital and the bases of partnership interests also provides guidance regarding the proper application of the separate subdivisions of section 704(c)(1)(C). The mismatch between the cumulative partnership inside asset bases and outside bases of the partners demonstrates that a strict application of section 704(c)(1)(C)(ii) to produce notional tax gain to non-contributing partners is the wrong result. Likewise, a variable application of section 704(c)(1)(C)(ii) to apply different basis rules to a transferee of a partnership interest is not appropriate within the overall scheme of Subchapter K. Accelerations of gains and losses among the partners in the event of distributions by a partnership or transfers of partnership interests with built-in loss property are resolved by the elective adjustments provided by sections 734(b) and 743(b).

Although the capital account provisions of the Treasury regulations were adopted to govern allocations of tax items, the principle of tax allocations that requires a match to economic consequences requires capital accounting that reflects partners' interests. While practitioners advising partners and partnerships primarily grapple with the tax rules, advising partnerships to maintain consistent capital accounts will aid partnership investors in understanding the nature of their interests. At the same time, capital accounts will provide a guide to the proper allocation of tax items.