REPORT #790

TAX SECTION

New York State Bar Association

Report on Treasury Regulation § 1.704-3T and
Certain Other Section 704(c) Matters

April 25, 1994

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Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Section 704(c) Regulations

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a Report by the New York State Bar Association Tax Section concerning the temporary and proposed regulations under Section 704(c) of the Code, as well as certain other matters concerning Section 704(c).

The Report "enthusiastically supports" the remedial method of partnership allocations permitted by the regulations, and supports the simplified allocation methods for securities partnerships provided in the regulations. In addition, the Report makes a number of suggestions for modifications to the regulations as well as suggestions for other issues arising under Section 704(c) that are in need of regulations.

Among the Report's suggestions, which are summarized at the beginning of the Report, are the following:

1. The remedial method of partnership allocations should be a “safe harbor” for taxpayers, as well as the baseline for testing whether other methods of allocation are abusive.

2. Certain clarifications should be made to the description of the remedial method.

3. The definition of the term “securities partnership” should be broadened and additional guidance should be provided regarding allocations made by securities partnerships, including adoption of a rule permitting such a partnership to use any method that it can demonstrate is reasonable under the circumstances.

4. Future regulations should provide guidance on contributions to partnerships before the effective date of the present regulations, the determination of fair market value of contributed property, the consequences of contributing property to a partnership with built-in depreciation recapture, and the permissibility of the “undivided interests” method of allocation following a constructive partnership termination.

We would be happy to provide further help in the development of these regulations if you think it would be useful.

Very truly yours,

Michael L. Schler
Chair, Tax Section

Tax Report #790

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON PARTNERSHIPS

Report on Treasury Regulation § 1.704-3T and Certain Other Section 704(c) Matters

April 25, 1994

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON PARTNERSHIPS [*]/

Report on Treasury Regulation § 1.704-3T And Certain Other Section 704(c) Matters

April 25, 1994

I. Introduction

This report comments upon Treasury Regulation § 1.704-3T (the "Temporary Regulations") and certain other matters arising under Section 704(c).[1]/ The Temporary Regulations, which also serve as proposed regulations, were promulgated in December along with Treasury Regulation § 1.704-3 (the "Final Regulations").[2]/ The Final Regulations prescribe the basic Section 704(c) rule that a partnership may use any "reasonable" method in allocating income, gain, loss and deduction with respect to property contributed by a partner to the partnership to take into account any difference between its tax basis and its fair market value at the time of contribution.

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[*]/ The principal authors of this report were Andrew N. Berg and William B. Brannan, who are the co-chairs of the Committee on Partnerships. Helpful comments were provided by Geoffrey R. S. Brown, Peter C. Canellos, Joseph G. Giannola, Robert C. Holmes, Stephen B. Land, Carolyn Joy Lee, Richard O. Loengard, Jr., David P. Mason, Stephen L. Millman, Richard L. Reinhold, Robert D. Schachat, Joel Scharfstein, Michael L. Schler, Alan J. Tarr and Lary S. Wolf.

[1]/ Unless otherwise indicated, all Section references herein are to the Internal Revenue Code of 1986, as amended to date.

[2]/ The Temporary Regulations were promulgated by T.D. 8501, 58 Fed. Reg. 67684 (Dec. 22, 1993), and crossreferenced as proposed regulations by PS-56-93, 58 Fed. Reg. 67744 (Dec. 22, 1993). The Final Regulations were promulgated by T.D. 8500, 58 Fed. Reg. 67676 (Dec. 22, 1993).

The Final Regulations go on to describe in detail two specific Section 704(c) allocation methods that are "generally" considered to be reasonable--the traditional method and the traditional method with curative allocations. The Final Regulations also contain certain other rules, including an anti-abuse rule that provides that an allocation method will not be considered to be reasonable if the property contribution and the Section 704(c) allocation method relating thereto are made with a view to substantially reducing the present value of the aggregate tax liability of the partners.

The Temporary Regulations describe a third specific Section 704(c) allocation method that is generally considered to be reasonable--the remedial allocation method. The remedial method provides for the creation of tax items with respect to contributed property that are allocated to non-contributing partners to make up for any shortfall in actual tax items that is caused by the ceiling rule (and for the creation of offsetting tax items to be allocated to the contributing partner). The Temporary Regulations also set forth special aggregation rules for securities partnerships. Both the Final Regulations and the Temporary Regulations apply for purposes of so-called "reverse" Section 704(c) allocations, which arise in connection with a revaluation of partnership property pursuant to Treasury Regulation § 1.704-l(b)(2)(iv)(f). [3]/

[3]/ See Treas. Reg. §§ 1.704-l(b)(1)(vi) and 1.704-l(b)(2)(iv)(d)(3), as amended by T.D. 8500, and Final Regulation § 1.704-3(a)(6)(i). The term "reverse" Section 704(c) allocations is a misnomer, since such allocations are fundamentally the same as, not the reverse of, Section 704(c) allocations with respect to contributed property. In this report, any discussion referring to contributed property also applies to property that is revalued pursuant to Treas. Reg. § 1.704-l(b)(2)(iv)(f), unless otherwise indicated. It also should be noted that this report usually discusses Section 704(c) issues with built-in gain property in mind, but analogous principles generally should apply in the case of built-in loss property.

II. Summary

As discussed below, the Committee generally supports the adoption of the remedial method and the aggregation rule for securities partnerships. However, the Committee has a number of comments on the Temporary Regulations and certain other Section 704(c) matters. The Committee's principal comments are as follows:

(1) the regulations should provide that the remedial method is a “safe harbor” method for making Section 704(c) allocations and that it is the baseline for analyzing the effect of other Section 704(c) methods on the tax liabilities of the partners for anti-abuse rule purposes;

(2) the remedial allocation regulations should be clarified by adding a more complete statement of general principles, by simplifying the determination of the character of remedial items and by modifying the rules relating to the extent to which remedial allocations are treated as actual tax items;

(3) the regulations regarding aggregation by securities partnerships should be changed by (a) expanding the definition of securities partnerships qualifying for the aggregation rule (or, alternatively, adopting a very expansive definition of securities partnerships qualifying for the aggregation rule so long as those partnerships use the remedial allocation method), (b) permitting a partnership meeting the definition of a securities partnership to use the same Section 704(c) aggregation method for all securities held by that partnership,

including any securities that are not readily tradable on an established securities market within the meaning of Treasury Regulation § 1.704-l(b)(2)(iv)(f)(5)(iii), (c) providing more specific guidance concerning the requirement that gains be separately aggregated from losses (and possibly eliminating that requirement) and (d) permitting securities partnerships that do not meet all the technical requirements of the securities partnership aggregation regulations but which nonetheless want to aggregate assets for Section 704(c) purposes to demonstrate that their allocation system is reasonable under the circumstances; and

(4) certain Section 704(c) issues that are not addressed by the Final or Temporary Regulations should be addressed in future regulations, including (a) the Section 704(c) law that applies to partnerships to which property was contributed before the December 21, 1993, effective date of the Final and Temporary Regulations, (b) the determination of the fair market value of contributed property for Section 704(c) purposes, (c) the Section 704(c) aspects of the contribution of property with built-in depreciation recapture and (d) the availability of the undivided interests method for partnerships that have undergone a technical termination under Section 708(b)(1)(B).

III. General Conceptual Comments

A. Adoption of the Remedial Method

The Committee enthusiastically supports the adoption of the remedial method. The remedial method replaces the deferred sale method contained in the prior proposed Section 704(c)

regulations.[4]/ The deferred sale method had the potential to be quite complex, and it raised a number of difficult questions relating to the proper treatment of contributed property that is subsequently disposed of by the partnership in a nonrecognition transaction. The deferred sale method also was at variance with the general rule under Section 721 that the contribution of property to a partnership is not a taxable event, which was particularly troubling in view of the fact that the old proposed Section 704(c) regulations seemed to contemplate that the Service could force a partnership to use the deferred sale method if the method the partnership originally adopted was not reasonable. [5]/ Furthermore, the deferred sale method could cause adverse tax consequences to the contributing partner under Sections 752 and 731 where the property was encumbered by nonrecourse debt.

The remedial method represents an innovative solution to those problems. It also should result in a higher compliance level than the deferred sale method, since all relevant tax items presumably will be reflected on the Schedule K-ls prepared by the partnership (as opposed to the deferred sale method under which

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[4]/ See Prop. Treas. Reg. § 1.704-3(d), PS-164-84, 57 Fed. Reg. 61345 (Dec. 24, 1992) (the "Proposed Regulations"). It should be noted that the Committee originally proposed in its 1985 report on partnership tax matters that the deferred sale method be an allowable Section 704(c) method. See New York State Bar Association Tax Section, Comments Relating to Proposed Regulations To Be Issued Pursuant to Sections 704(c), 707(a)(2) and 752 (Apr. 30, 1985). For the reasons discussed below, the Committee prefers the new remedial method.

[5]/ Like the Final and Temporary Regulations, the old proposed regulations did not specify what Section 704(c) method a partnership would be required to use if its chosen Section 704(c) method was not reasonable, but, unlike the Final and Temporary Regulations, the old proposed regulations did not rule out the possibility that the deferred sale method (now replaced by the remedial method) could be required.

the individual partners would have had to ascertain the tax consequences to them outside the partnership). As discussed below, the principal difference between the remedial method and the deferred sale method in terms of bottom line result to the partners is that the remedial method typically results in the contributing partner accounting for the book-tax difference associated with the contributed property prior to the ultimate sale of the contributed property through ordinary income allocations, whereas the deferred sale method would have resulted in such book-tax difference being accounted for with capital gain (except to the extent that ordinary income treatment were required under the recapture rules. Section 707(b)(2), Section 1239 or otherwise). There also could be differences to the transferee of the interest of a contributing partner under Section 743 if a Section 754 election is in effect, since the contributing partner's share of the inside basis would be different under the two methods.

As a theoretical matter, the remedial method would seem to produce the most appropriate Section 704(c) result as compared to the result under either of the other two specified methods (i.e., the traditional method and the traditional method with curative allocations). The remedial method results in the noncontributing partner receiving the benefit of the tax basis inherent in the contributed property at the time of its contribution over the remaining tax life of the contributed property, which is consistent with the statutory “step-in-the-shoes” framework for contributed property under Sections 721, 723 and 168(i)(7). The noncontributing partner receives the benefit of the difference between the contributed property's book basis and its tax basis over its statutory recovery period--i.e., as if

the zero basis portion of the contributed property had been sold to the partnership for its fair market value.

In contrast, the traditional method has the infirmity of the ceiling rule, which often results in the noncontributing partner not being put in the proper Section 704(c) position because of the insufficiency of tax items attributable to the contributed property (either depreciation or amortization prior to sale or gain or loss on sale). [6]/ The traditional method also is hampered by the somewhat subtle rule (the "Sale Rule") that the book-tax difference that must be accounted for in applying the traditional method at the time the property is sold should be limited to the difference between the book basis and the tax basis of the contributed asset at the time of sale, rather than the original book-tax difference. [7]/ Since the difference between the book basis and the tax basis inherent in contributed depreciable or amortizable property will decline over time as both converge towards zero, the Sale Rule will prevent the original book-tax difference with respect to any depreciable or amortizable property from being fully accounted for under the traditional method if the ceiling rule creates a book-tax difference for the noncontributing partner prior to the sale of

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[6]/ It should be noted that the ceiling rule should not be applicable with respect to built-in loss property prior to the sale of the property, since there always will be enough tax depreciation or amortization attributable to any built-in loss property to service both the noncontributing partner and the contributing partner.

[7]/ The starting point for the Sale Rule is Final Regulation § 1.704-3(b)(1), which states that allocations under the traditional rule must be made to avoid shifting "built-in gain or loss" among the partners. Final Regulation § 1.704-3(a)(3)(ii), in turn, defines the terms "built-in gain" and "built-in loss" with respect to a property by reference to the difference between the book basis and the tax basis of such property at the time the built-in gain or built-in loss is being measured. See also the examples in Final Regulation § 1.704-3(b)(2).

the property, even if enough tax gain is realized on the sale of the property to overcome that ceiling rule distortion. [8]/

The traditional method with curative allocations generally overcomes the foregoing problems that are caused by the ceiling rule and the Sale Rule. However, it will fail to do so if the partnership does not have sufficient other tax items, or the partnerships fails to elect to use a broad enough basket of other tax items, to make full curative allocations. Moreover, the traditional method with curative allocations in effect lets the noncontributing partner write off his share of the difference between the book basis and the tax basis of the contributed property over the remaining tax life of the property at the time of contribution, with the only limitation being the anti-abuse

[8]/ An extreme example of this phenomenon is contained in Final Regulation § 1.704-3(b)(2) (Example 2), which involves the contribution of low basis property with one year of tax life left at the time of contribution. After that one-year period (during which time the ceiling rule prevented the noncontributing partner from receiving the proper amount of tax depreciation), there was no more book-tax difference to account for under the traditional method, since the book and tax basis of the property had become equal (i.e., zero). The example concludes that the use of the traditional method was unreasonable under the circumstances. It should be noted that the legislative history of the Tax Reform Act of 1984 specifically suggested that the Sale Rule (which was implicit in the old Section 704(c)(2) regulations) be modified to require that extra tax gain from the sale of the property be allocated to the contributing partner to prevent this distortion. See H. R. Rep. No. 98-432 (Pt. 2), 98th Cong., 2d Sess. 1209, n.3 (1984) (the "House Report"); and S. Rep. No. 169, 98th Cong., 2d Sess. 215, n.2 (1984) (the "Senate Report"). See also Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 213, n.4 (Jt. Comm. Print 1984) (the "Blue Book"). In the Committee's view, that suggestion should have been adopted in the Final Regulations.

rule. That may artificially accelerate the Section 704(c) adjustments for the partners in certain situations. [9]/

B. Elective Nature of the Remedial Method

The Committee endorses the rule set forth in Temporary Regulation § 1.704-3T(d)(4) that the Service may not force a partnership to use the remedial method if its chosen Section 704(c) allocation method is not reasonable. Despite its theoretical appeal, the remedial method involves the novel approach of computing hypothetical tax items that are then treated as real tax items. It also may involve a fair degree of complexity. Thus, it does not seem appropriate that the Service could force a partnership to use that method.

C. Continuing Need for a "Safe Harbor"

The Committee is troubled by the fact that the Final Regulations and the Temporary Regulations do not contain a generally applicable "safe harbor" method for making Section 704(c) allocations, since there is some amount of uncertainty inherent in any general rule that a taxpayer may do anything "reasonable". [10]/ As a related point, the Committee also is troubled by the fact that the anti-abuse rule in the Final Regulations does not set forth any baseline for measuring whether the Section 704(c) method used by a partnership has the

[9]/ For examples of the anti-abuse rule applying because a curative allocation is too rapid, see Treas. Reg. § 1.704-3(c)(4) (Examples 1 and 3). This problem also can result under the traditional method, but it is likely to be less significant in that context because of the ceiling rule.

[10]/ Final Regulation § 1.704-3(b)(1) does seem to provide that the use of the traditional method is always reasonable where it is applied to all items of contributed property and no item of contributed property is limited under the ceiling rule. However, that is a very limited case.

effect of substantially reducing the present value of the aggregate tax liabilities of the partners. Because a partnership's choice of Section 704(c) method is driven almost exclusively by the desire to minimize the aggregate tax liability of the partners where that is possible (the only other consideration being ease of administration, which usually takes a back seat to reducing taxes where real money is at stake), the "view" requirement of the anti-abuse rule will usually be satisfied. Hence, the question of whether a partnership's Section 704(c) method has substantially reduced the present value of the tax liabilities of the partners is the only real issue under the anti-abuse rule. [11]/ Given the absence of a definite frame of reference for evaluating that issue, the practical effect of the anti-abuse rule may be that a partnership must choose the Section 704(c) method that produces the worst tax result for the partners if the choice of Section 704(c) method would have a significant effect on the present value of the aggregate tax liabilities of the partners. In other words, "heads we win/tails you lose".

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[11]/ In partnerships where the partners are fully taxable at the same effective marginal tax rate, it generally would not be possible to reduce the aggregate tax liability of the partners through the choice of Section 704(c) method in the typical scenario where the partnership simply holds the contributed properties for a period and then sells them for cash and liquidates. However, for a given partnership transaction, the choice of Section 704(c) method might reduce the aggregate tax liability of the partners if the transaction involves distributions in kind, non-pro rata redemptions of interests or other steps that result in the partners being put into different tax positions. Moreover, since the anti-abuse rule refers to whether the contribution of property, taken together with the choice of Section 704(c) method, was made with the intent to reduce the tax liabilities of the partners, it is possible that the anti-abuse rule involves more than a mere comparison of tax effects of different Section 704(c) methods for a given partnership transaction and requires an examination of what the tax position of the partners would have been had the property not been contributed to the partnership. Under that more expansive conceptual framework for the anti-abuse rule, it is even more likely that a tax avoidance effect would be determined to result.

The Committee recognizes that the above-stated problems also arose under the prior proposed Section 704(c) regulations and that the Treasury chose to not adopt a safe harbor method or baseline for anti-abuse rule purposes in the Final Regulations. However, the Committee believes that there is an important opportunity to resolve these problems now that the Treasury has adopted the rule that it will not force a partnership to use the remedial method.[12]/ Given that choice, it seems likely that the Section 704(c) law will evolve such that, except in truly abusive cases, the traditional method with curative allocations effectively will be a safe harbor method and baseline for anti-abuse rule purposes for the following reasons. First, it is likely that courts will tend to regard one or more of the three Section 704(c) methods that are described in detail in the regulations as being in the nature of a safe harbor and a baseline for anti-abuse rule purposes, since the regulations expressly provide that those methods "generally" will be considered to be reasonable and the courts may not be very receptive to the "heads we win/tails you lose" aspect of the regulations. Second, it is unlikely that, absent very unusual circumstances, a court would permit the Service to force a partnership whose chosen Section 704(c) method was not reasonable to use a method other than one of the three methods that are specifically described in the regulations, since it would be fundamentally unfair to allow the Service to invent a new Section 704(c) method on audit for the purpose of maximizing the tax liabilities of the partners. Because the decision has been made that the Service may not force a partnership to use the remedial method, the Service's only choices on audit are the traditional method and the traditional method with curative allocations. Of the two, the traditional method with curative allocations clearly has more theoretical appeal, particularly where the curative

[12]/ See Temporary Regulation § 1.704-3T(d)(4).

allocation is made over the economic useful life of the property. [13]/ Thus, the Committee believes that the de facto law under the regulations in their present form would likely become that the traditional method with curative allocations over the economic useful life of the property should generally be regarded as a safe harbor/baseline for anti-abuse rule purposes.

The Committee strongly urges that the Section 704(c) regulations be revised to reflect the foregoing considerations, since it is in the interest of both the government and taxpayers that there be more objectivity and certainty in the Section 704(c) law. In the Committee's view, the regulations should expressly select a Section 704(c) method to function as (i) a safe harbor method that, except in cases of extreme abuse, may not be challenged by the Service and (ii) the baseline for measuring the effect of a particular Section 704(c) method on the tax liabilities of the partners. The two logical candidates for that role are the traditional method with curative allocations over the economic useful life of the property and the remedial method. Each of those methods has theoretical appeal, and, as a practical matter, they would tend to produce the same tax results. [14]/

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[13]/ See the discussion on pp. 9-11, supra. The preamble to the Final Regulations and Final Regulation §§ 1.704-3(c)(3)(ii) and -3(c)(4) (Example (3)(ii)) contain suggestions that curative allocations generally should be made over the economic useful life of the property.

[14]/ While the remedial method uses the statutory depreciable life of the property instead of the actual economic useful life of the property, the statutory useful life of a property often approximates its actual economic useful life and in any event partnerships would tend to use the statutory useful life as a measure of economic useful life for convenience reasons in the absence of clear evidence to the contrary.

The Committee recommends that the remedial method be selected as the safe harbor method/baseline for anti-abuse rule purposes for several reasons. [15]/ First, the remedial method would be more of a true safe harbor inasmuch as it does not require that a judgment be made as to the economic useful life of the property or the effect of a tax allocation of the tax liabilities of the partners, which are factual issues arising under the traditional method with curative allocations alternative that could provide a basis for challenge by the Service. [16]/ Second, the remedial method is certain to avoid any ceiling rule problem (and, therefore, any Sale Rule problem as well), whereas the traditional method with curative allocations will not if the partnership does not have sufficient other tax items of the proper type to correct ceiling rule distortions. [17]/ Third, the Committee's general belief is that the remedial method generally has less potential for abuse than the traditional method with curative allocations, which belief is corroborated by the fact that the Temporary Regulations do not contain

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[15]/ In its 1993 report on Section 704(c) matters, the Committee recommended that a safe harbor method be adopted, and it suggested the deferred sale method for that purpose. See New York State Bar Association Tax Section, Report on Proposed Regulation Section 1.704-3 Relating to Allocations under Section 704(c) of the Internal Revenue Code (Dec. 15, 1993).

[16]/ Although Temporary Regulation § 1.704-3T(d)(3) seems to require that a partnership using the remedial method make an inquiry as to the effect of its remedial allocations on the tax liabilities of its partners, the Committee believes that remedial allocations may be made mechanically without making that inquiry, as explained on pp. 22-24, infra.

[17]/ If the traditional method with curative allocations were selected as the safe harbor method/baseline for anti-abuse rule purposes, the regulations should require that the partnership use all available tax items of the proper type to effect its curative allocations in order to minimize this problem.

an example of a remedial allocation that is not reasonable. [18]/ Fourth, it presumably would be more expedient to select the remedial method as the safe harbor method/baseline for anti-abuse rule purposes, since that could be accomplished by modifying the Temporary Regulations, as opposed to modifying the Final Regulations (or issuing a published ruling thereunder) in order to select the traditional method with curative allocations.

There are two possible drawbacks to this recommendation. First, it would create some tension with the rule that the Service may not force a partnership to use the remedial method, as it would be somewhat anomalous that the Service could not force a partnership whose chosen Section 704(c) method was not reasonable to use the method that was so generally acceptable that it could not be challenged by the Service. However, the Service presumably could force such a partnership to use the traditional method with curative allocations over the economic useful life of the property, which, as noted earlier, would tend to approximate the results under the remedial method. Second, the

[18]/ The preamble to the Temporary Regulations does refer to a sketchy fact pattern involving the contribution of the stock of a controlled foreign corporation that has a built-in gain where, according to the preamble, the use of the remedial method may violate the anti-abuse rule because the contributing partner may avoid potential Section 1248 income by effectively converting it into remedial capital gain. However, the Committee questions whether the tax benefit for the contributing partner in that fact pattern really is a product of the remedial method, since a similar tax benefit could result under the traditional method with curative allocations and, if there were sufficient tax gain on the sale of the stock that the ceiling rule would not be applicable, under the traditional method. Moreover, a similar tax benefit for the contributing partner could be obtained even if the stock had no built-in gain at the time of contribution; see Scharfstein, "The Section 704(c) Regulations--The Allocation (and the Creation) of Partnership Tax Items", The Tax Club, Feb. 16, 1994 (unpublished paper), at 29-31. In any event, the Service could challenge the use of the remedial method under the Committee's proposal if the transaction represented an extreme abuse.

Committee's recommendation might put partnerships holding contributed depreciable property with an economic useful life that was shorter than its statutory depreciation period at a disadvantage, because such partnerships would not have the protection of the safe harbor rule if they chose to use the traditional method with curative allocations over the economic useful life of the property. However, such partnerships could safely elect to use that method if they satisfied general principles of the Section 704(c) regulations. Thus, on balance, the Committee favors the remedial method as the safe harbor method/baseline for anti-abuse rule purposes. [19]/

IV. Specific Comments on the Remedial Method

The following section of the report makes several specific comments on the remedial method.

A. General Principles

The Committee recommends that there be a clearer statement of the general principles of the remedial allocation method in the regulations. The Temporary Regulations use the term “remedial allocation” as if it had some clear, preestablished meaning, which is not the case. [20]/ Moreover, the text of the regulations is somewhat cryptic, which makes careful study of the

[19]/ One way to alleviate both of the above-described problems would be to designate the curative method as the safe harbor method but make the traditional method with curative allocations over the economic useful life of the property (or possibly its statutory life) the baseline for anti-abuse rule purposes.

[20]/ Both the traditional method with curative allocations and the remedial method “cure” or “remedy” the problems caused by the ceiling rule. In the case of the traditional method with curative allocations, such problems are solved by borrowing actual tax items that are unrelated to the contributed property. In the case of remedial allocations, such problems are solved by fabricating new tax items.

examples necessary to fully understand what is intended. Accordingly, the Committee suggests that the following language be substituted for the existing language in Temporary Regulation § 1.704-3T(d)(1) to state more clearly the general principles of the remedial method (and also to conform the language to that used in describing the traditional method):

> "(d) REMEDIAL ALLOCATION METHOD--(l) IN GENERAL. This paragraph (d) describes the remedial method of making section 704(c) allocations, which is intended to eliminate ceiling rule disparities between the book and tax items allocated to noncontributing partners through the creation of notional tax items that make up for the shortfall in actual tax items. In general, the remedial method involves the following four-step process with respect to each item of contributed property: First, the partnership must compute the amount of book items attributable to the property under the rules of paragraph (d)(2) of this section and then allocate those book items among the partners as provided in the partnership agreement. Second, the partnership must allocate the actual tax items attributable to the property to the non-contributing partners in the same manner as the corresponding book items are allocated to them to the extent that such tax items are available and then allocate any remaining such tax items to the contributing partner. Third, to the extent that the actual tax items allocated to the noncontributing partners pursuant to step two are less than the corresponding book items that are allocated to them pursuant to step one, the partnership must compute notional tax items of the same type to make up for that shortfall and then make remedial allocations of those notional tax items to the noncontributing partners in the same manner as such book items are allocated. Fourth, to the extent that the partnership makes allocations of notional tax items to the noncontributing partners pursuant to step three, it must compute offsetting notional tax items under the rules of paragraph (d)(3) of this section and then make remedial allocations of those offsetting notional tax items to the contributing partner. Such remedial allocations do not affect the capital accounts of the partners, but they generally are otherwise treated as actual tax allocations for purposes of the taxation of the partners. In the absence of specific published guidance providing otherwise, the method described in this paragraph (d) is the only reasonable section 704(c) method using remedial allocations."

It should be noted that the foregoing language works for both built-in gain property and built-in loss property.

B. Effect of Remedial Items on Partners' Tax Liabilities

The Committee recommends that Temporary Regulation § 1.704-3T(d)(3) be clarified and simplified. That regulation provides generally that:

> "Remedial allocations of income, gain, loss, or deduction must have the same effect on each partner's tax liability as the tax item limited by the ceiling rule. This means that, when relevant, such attributes as the source, character, or (e.g., under section 469) nature of the item limited by the ceiling rule must be taken into account. Thus, if the item limited by the ceiling rule is loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be gain from the sale of the property. If the item limited by the ceiling rule is depreciation or other cost recovery, the offsetting remedial allocation of income to the contributing partner must be of the same type of income that the contributed property produces."

The Committee finds that language to be somewhat confusing.

With respect to remedial allocations to the contributing partner, the general requirement that the remedial allocation have the same effect as the tax item limited by the ceiling rule (as set forth in the first sentence of the regulation) does not seem to make sense, since the relevant effect for the contributing partner is the opposite of the effect of the tax item limited by the ceiling rule (e.g., the contributing partner must be allocated notional ordinary income where the tax depreciation allocable to the noncontributing partner is limited by the ceiling rule). Moreover, the specific rule that the contributing partner be allocated remedial items of the same type as income from the contributed property or gain from the sale of the property, depending upon the tax item that is limited under the ceiling rule (as set forth in the third and fourth sentences of the regulation), would seem to be the only thing that needs to be said as to the contributing partner. All other tax consequences to the contributing partner (e.g., character and source) would seem to follow automatically.

With respect to remedial allocations to the noncontributing partner, the language of the regulation seems to be unnecessarily complicated. The items to be allocated to the noncontributing partner are simply notional tax items that are exactly the same as the actual tax items that are limited under the ceiling rule. No further inquiry as to character, source, effect on tax liability, etc., seems to be necessary, since by definition there is no difference between the remedial item and the item that is limited under the ceiling rule.

C. Remedial Items as Actual Items.

The Committee believes that there should be a clearer statement in the regulations regarding the extent to which the notional tax items that are created for remedial allocation purposes should be treated as actual tax items.

At the partnership level, remedial allocations do not have any tax consequence. Specifically, any notional depreciation or amortization deductions that are created to make a remedial allocation should not reduce the tax basis of the contributed property. While not intuitively obvious, reducing the tax basis of the contributed property by the notional depreciation or amortization deductions would result in the partnership realizing too much tax gain when it ultimately disposes of the contributed property (in addition to introducing the frightening prospect of creating true negative tax basis). The reason is that, unlike the case with ordinary depreciation or amortization deductions, remedial depreciation or amortization deductions do not arise by reason of an investment in property whose basis must be reduced to prevent a double benefit when property is sold. Instead, remedial depreciation or amortization deductions are immediately offset by allocations of ordinary income to the contributing partner. As a corollary to the foregoing, remedial allocations do

not increase the amount of depreciation recapture inherent in depreciable property.

For purposes of the taxation of the partners, however, it seems clear that the notional tax items that are created for remedial allocation purposes generally should be treated as actual tax items for all purposes. Thus, for example, any notional depreciation that is created for purposes of a remedial allocation to overcome a ceiling rule limitation with respect to depreciable property should be treated as actual depreciation for purposes of determining the bases of the noncontributing partners in their partnership interests.

The one exception to the general rule that remedial allocations should be treated as actual items for purposes of taxation of the partners is that remedial allocations, like any other Section 704(c) allocation, do not affect the "book" capital accounts of the partners as maintained in accordance with the Section 704(b) regulations. However, remedial allocations would affect the "tax" capital accounts of the partners that often are maintained for convenience to keep track of Section 704(c) issues.

Certain special considerations relating to the effect of remedial allocations on depreciation recapture are discussed in Part V(D) below.

D. Temporary Regulation § 1.704-3T(d)(4)

Temporary Regulation § 1.704-3T(d)(4) provides that the Service may not force a partnership whose chosen Section 704(c) method is not reasonable to use "the remedial method described in this paragraph (d)" (emphasis added). The Committee is concerned

that such language may create the implication that the Service may force a partnership to use another type of remedial method. [21]/ In addition, that language does not preclude the possibility that the Service could attempt to force a partnership to use some type of deferred sale method. While Final Regulation § 1.704-3(a)(1) would seem to rule out those possibilities in declaring that they are not reasonable in the absence of specific published guidance to the contrary, that point should be made clear in the Temporary Regulations themselves. Accordingly, the Committee recommends that Temporary Regulation § 1.704-3T(d)(4) be reworded to state that the Service may not force a partnership to use "the remedial allocation method described in this paragraph (d) (or any other remedial method involving the creation of notional tax items) or any deferred sale method".

V. Securities Partnerships

A. Introduction

The Final Regulations continue the property-by-property/partner-by-partner approach of the old proposed Section 704(c) regulations, permitting aggregation only in the limited circumstances described in Final Regulation § 1.704-3(e)(2). The Final Regulations reserve on the treatment of "securities partnerships", which are permitted to aggregate gains and losses from different properties for purposes of making reverse Section 704(c) allocations under Temporary Regulation § 1.704-3T(e)(3).

[21]/ Compare the wording of the last sentence of Temporary Regulation § 1.704-3T(d)(1), which states that, in the absence of published guidance to the contrary, "the [remedial] method described in this paragraph is the only reasonable section 704(c) method using remedial allocations". That language suggests that there are other types of remedial allocations.

We commend the Treasury for acknowledging the difficulties faced by many securities partnerships in performing Section 704(c) allocations on a strict asset-by- asset/partner-by-partner basis and for explicitly soliciting comments on how to define a securities partnership. The classic securities partnership is a partnership among unrelated persons that is formed for the purpose of obtaining professional management of their money or increasing or diversifying their investment opportunities through a larger capital pool. These partnerships are not tax motivated. The tax accounting for these partnerships typically attempts to match allocations of taxable income and loss of the partnership with the actual economic gains and losses of the partners to the extent practicable without becoming unduly complicated or costly to the partnership.

B. The Definition of Securities Partnership

The Temporary Regulations limit the application of the securities partnership aggregation rule to reverse Section 704(c) allocations. The Temporary Regulations further provide that gains must be aggregated separately from losses. The Committee believes that these limitations on the application of the securities partnership aggregation rule reduce the potential for abuse so significantly that the general anti-abuse rule should be sufficient to police any potential abusive transactions. Accordingly, an expansive definition of the term "securities partnership" is warranted.

The Committee believes that, as a general matter, limiting the securities partnership aggregation rule to reverse Section 704(c) allocations is appropriate. [22]/ In practice, securities partnerships maintain capital accounts on a mark-to-market basis. These partnerships are open for cash contributions and cash withdrawals periodically (e.g., quarterly or semiannually). [23]/ At the opening of each accounting period, the partnership computes its net profits and net losses based on the net change in the values of its assets during the period since the prior closing. Capital accounts are adjusted and sharing percentages are recomputed to take into account any contributions and distributions. Contributions of securities to such

[22]/ One situation where the securities partnership aggregation rule should apply to regular Section 704(c) allocations is where a partnership has undergone a technical termination under Section 708(b)(1)(B). The deemed recontribution that occurs under Section 708(b)(1)(B) will result in regular Section 704(c) allocations. For all practical purposes, however, these allocations are indistinguishable from the reverse Section 704(c) allocations to which the securities partnership aggregation rule does apply.

[23]/ Certain so-called "hub and spoke" partnerships -- partnerships among regulated investment companies -- are open for contributions and withdrawals on a daily basis. However, that is a somewhat special situation. Most securities partnerships are open for contributions and withdrawals only at specified periods during the year.

partnerships are not common, and in many cases would not be Section 704(c) transactions, since Section 721(b) would be applicable. Accordingly, the allocations of greatest concern to these partnerships are the reverse Section 704(c) allocations.

By limiting the securities partnership aggregation rule to reverse Section 704(c) allocations, the potential for abusive manipulation of Section 704(c) allocations through the aggregation of assets is substantially reduced. If appreciated property is contributed to a partnership and the partnership applies Section 704(c) on an aggregated basis, there is a real potential for income shifting. For example, a partner could contribute appreciated property to a partnership that already holds appreciated property and, through the aggregation rule, shift gain away from himself if his property is the first appreciated property to be sold (since he would not be allocated the full amount of the built-in gain attributable to his property). Similar shifts could occur with built-in loss property. Since the opportunity for income shifting through aggregation is greatest when contributions of appreciated or depreciated properties are involved, the potential for manipulation is greatly reduced by limiting the aggregation rule to reverse Section 704(c) allocations, which are applicable only to the unrealized gain or loss inherent in the assets of a preexisting partnership to which a new partner is admitted.

In a similar vein, the ability to net gains and losses in an aggregation situation can result in manipulation. For example, a partnership with offsetting unrealized gain and loss positions has no net unrealized gain or loss. If a partner makes a cash contribution to such a partnership, tax shifting could occur through realization of either the unrealized gain position or the unrealized loss position if the partnership does not

separately aggregate gains and losses. That potential for manipulation has already been eliminated. [24]/

The Committee believes that the limitations contained in the Temporary Regulations for securities partnership aggregation, coupled with the general anti-abuse rule, provide ample protection against income shifting transactions. As a result, the Committee believes there is no reason to impose a restrictive definition of securities partnership.

The Committee recommends that the Final Regulations adopt a broad, simple definition of securities partnership. For example, a securities partnership could be any partnership more than 90% of whose assets (other than cash or cash equivalents) constitute, directly or indirectly, stocks or securities of corporations, commodities futures contracts or other financial instruments. The Treasury may consider limiting the application of such an expansive definition to partnerships where the underlying economic arrangement requires revaluations at least annually and where it is reasonable to anticipate that the usual partner-by-partner/asset-by-asset approach would be significantly more difficult or costly to administer than an aggregated approach. [25]/ The Treasury may also consider, and the Committee

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[24]/ The Committee believes that the ability to contribute appreciated property would involve a more significant potential for abuse than the ability to make a cash contribution to a partnership with offsetting unrealized gain and loss positions. Accordingly, limiting the aggregation rule to reverse Section 704(c) allocations provides the larger measure of protection. Separate allocation of gains and losses provides an additional, albeit lesser, measure of protection. For this reason, the Committee later in this report suggests circumstances under which the separate aggregation of gains and losses need not be required.

[25]/ The number of separate accounts that need to be maintained in the partner-by-partner/asset-by-asset approach is at least equal to the product of the number of partners and the number of assets. The Treasury could consider some mechanical rule whereby a partnership would not be eligible to be treated as a securities partnership unless that product exceeded a certain number.

would support, limiting application of any expansive definition of securities partnerships to partnerships that elect to use the remedial allocation method with respect to gains and losses realized on the disposition of securities. [26]/ The Treasury may also consider permitting partnerships that maintain large securities portfolios but also conduct other businesses to use the aggregation rule for their securities portfolio but not for any other operations of the partnership.

Should the Treasury choose not to adopt such a broad-based definition in the final regulations, we submit the following specific comments on the definition contained in the Temporary Regulations. Temporary Regulation § 1.704-3T(e)(3)(ii) contains four separate requirements for a securities partnership.

The first requirement, A, is that the partnership would satisfy the requirements of Section 851(b)(4) if it were a domestic corporation. While the Committee believes that, in practice, most securities partnerships would meet that test, the Committee is nonetheless of the view that it is not appropriate to impose the mechanical RIC tests for purposes of determining whether a partnership qualifies for the securities aggregation rule. The real issue is whether the partnership has a sufficient number of securities positions and/or partners that accounting on a partner-by- partner/asset-by-asset basis would be unduly burdensome for the partnership.

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[26]/ As described below, the Committee is also recommending that in certain circumstances Section 704(c) allocation methods which do not separately aggregate gains and losses and which do not lend themselves to the remedial method nevertheless be considered to be reasonable. If the Treasury decides to follow that recommendation, then it may consider limiting any expansive definition of securities partnership to only those partnerships separately aggregating gains and losses and using the remedial allocation method.

The failure to meet the Section 851(b)(4) test should not necessarily preclude the partnership from relying on the securities aggregation rule. Perhaps the Treasury could state requirement A in the alternative, i.e., that the partnership either (i) satisfies the Section 851(b)(4) test or (ii) otherwise reasonably determines, based on the anticipated number of partners and number of securities positions, that accounting on a partner-by-partner/asset-by-asset basis would be substantially more burdensome than on an aggregated basis.

The requirement in B, that at least 90% of the fair market value of the partnership's non-cash assets represent assets described in Treasury Regulation § 1.704-l(b)(2)(iv)(f)(5)(iii), is too restrictive. [27]/ First, it would be a helpful clarification if the readily tradable requirement could be determined by reference to the definition in the Section 1273 regulations. Second, it is not uncommon for securities partnerships to invest a substantial portion of their assets in so-called “lock-ups”, i.e., securities issued in private placement transactions, such as venture capital investments in start-up companies, that are not readily marketable. These partnerships could easily hold more than 10% of their assets in securities of this type. The Committee would suggest a lower percentage requirement, say 75%. The Committee's concern here is that partnerships that hold primarily readily marketable securities but that also hold a significant amount of illiquid securities be permitted to aggregate. Accordingly, the Committee would not object to a rule that would require 75% of the securities partnership's assets to be readily tradable securities

[27]/ The Committee notes that the SEC permits open-ended investment companies and mutual funds to have up to 15% of their assets in illiquid securities. See Guidelines for Form Nl-A, Guide 4, as amended by Investment Company Act Release No. 18612 (March 12, 1992).

so long as at least, say, 90% of the partnership's assets constitute securities.

Requirement C, that the partnership be registered under the Investment Company Act of 1940 as a management company or is not closely held, should be deleted. While the Committee appreciates the Treasury's concern that closely-held partnerships involve greater potential for abuse, the Committee believes that is insufficient reason for the wholesale denial of the aggregation method to such partnerships. A family partnership or small investment club partnership could easily be closely held. Yet these are precisely the types of partnerships where it may not be financially feasible to incur the accounting expenses associated with an asset-by-asset/partner-by-partner allocation system. Even outside of the small partnership context, it is possible for a securities partnership to flunk the five or fewer/50% rule yet still be the type of partnership where asset-by-asset/partner-by-partner allocations would be unduly burdensome. For example, if several large institutional investors owned in the aggregate more than 50% of a partnership which had many other partners and many securities positions, there is no reason to deny aggregation.

Requirement D, that book allocations be in proportion to book capital accounts, except for a reasonable override to the general partner, should be deleted. While many securities partnerships would meet requirement D, a number of difficult interpretive issues would arise. For example, some partnerships allocate profits away from investors and to the general partner on the basis of each investor's individual business deal with the general partner (or on the basis of each investor's individual return since he joined the partnership); some partnerships set up separate classes of units in order to comply with certain

regulatory requirements. There is some question whether the foregoing arrangements would satisfy requirement D. Moreover, in the absence of some identifiable abuse, the Committee believes that it is not sound policy for the Treasury to mandate a specific economic sharing arrangement in order to qualify for the aggregation rule.

C. Aggregation

1. Assets Permitted to be Aggregated. The Temporary Regulations provide that it is generally reasonable for partnerships that meet the definition of a "securities partnership" to aggregate gains and losses from securities and similar investments (as defined in Treasury Regulation § 1.704-1(b)(2)(iv)(f)(5)(iii)) for purposes of making reverse Section 704(c) allocations.

As threshold matter, the Committee strongly urges the Treasury to permit partnerships meeting the definition of a securities partnership to use the same 704(c) method (i.e., the same aggregation method) for all of their security-type assets, not just those securities meeting the definition of Treasury Regulation § 1.704-1 (b)(2)(iv)(f)(5)(iii). As a practical matter, a securities partnership either marks all of its securities holdings to market or it marks none of them to market.Partnerships that mark to market typically have a high percentage of assets that are readily tradable securities. However, such partnerships can also have some securities which are not readily tradable (e.g., the "lock-ups" mentioned earlier). Those securities are nonetheless revalued at the end of each fiscal period of the partnership. Once a partnership is afforded the substantial benefits of simplification that the aggregation rule brings, the Committee believes that it would be

unduly burdensome for that partnership to maintain a separate property-by- property allocation system for a portion of its portfolio.

2. Need for a Full Explanation of the Securities Aggregation Rule. The portion of the Temporary Regulations dealing with the Section 704(c) allocation method to be used by securities partnerships is cryptic, stating only that "(g)ains must be aggregated separately from losses". It is not readily obvious what the requirement that gains be aggregated separately from losses means, and no specific method that would satisfy it is described. Set forth in section (4) below is a detailed description of a method that the Committee believes, based upon informal conversations with Treasury representatives, complies with the requirement that gains be aggregated separately from losses. In describing this allocation method, the Committee is not suggesting that it is the only method of complying with the regulations.

3. Status of Allocations Not Complying with All the Requirements of the Securities Partnership Aggregation Rule. The Committee believes that, in practice, it is possible there will be many partnerships that will not technically comply with all the requirements of any final regulations concerning aggregation.

These partnerships will likely use some type of Section 704(c) allocation method that involves aggregation. The Committee is concerned that the Final Regulations could be read to mean that all Section 704(c) allocation methods must be done on a property-by-property basis (except where aggregation is expressly authorized), with there being no possibility of arguing that an aggregated allocation method satisfies the general "reasonable method" test. If that were the case, a securities partnership using an aggregation system and not complying with all the requirements of the aggregation regulations would find its allocations to be per se invalid. The Committee strongly believes that this should not be the result. Securities partnerships should be afforded an opportunity to defend their allocation systems as reasonable, notwithstanding their use of an aggregation method that does not literally comply with all the terms of the final regulations.

There are very practical reasons for the foregoing recommendation. The Committee makes the following anecdotal observations. There are many securities partnerships presently in existence that have allocation systems that will not comply with the final regulations, assuming such regulations are substantially similar to the Temporary Regulations. In most of these cases, tax abuse is neither intended nor does it result. It is likely that many of these partnerships will not change their allocation system in response to final regulations, because of cost considerations, the complexities associated with changing systems in midstream or other reasons. It is submitted that if the conclusion is that the allocation methods used by these partnerships are per se invalid, as an administrative matter it would be infeasible for the Service to determine the proposed audit adjustment--presumably the Service would have to perform asset-by-asset/partner-by-partner computation that the

partnership has already determined is unduly burdensome and costly. It is also likely that even if the Service were to undertake such a task, there would be no material increase in revenue.

The Committee believes the better course would be in the first instance to give these partnerships the opportunity to demonstrate that their allocation systems as applied in their particular circumstances are reasonable. It would not be unfair to place a greater burden on these partnerships, and, of course, these allocation systems are subject to the anti-abuse rule. However, as a matter of tax policy, fairness and administrability, it is inadvisable for the allocation systems of these partnerships to be declared to be per se invalid.

4. A Suggested Allocation System. Based upon informal conversations with Treasury representatives, the Committee believes the following allocation method (the “GA/LA Method”) would comply with the Temporary Regulations concerning securities partnerships.

Two memorandum accounts, a gain account (“GA”) and a loss account (“LA”), would be established on the books of the partnership for each partner and for each security. The initial balance in these accounts would be zero. As of the close of each fiscal period of the partnership, the following tax allocations and adjustments to the GA's and the LA’s would be made.

Step 1: The GA of each partner whose capital account had increased through an allocation of book profit for the fiscal period would be credited with the amount of such increase.

Step 2: The LA of each partner whose capital account had decreased through an allocation of book loss for the fiscal period would be credited with the amount of such decrease.

Step 3: The GA of any security that had increased in value from the beginning of the fiscal period to the end of the fiscal period (or in the case of a security sold during such fiscal period, from the beginning of such period through the date of sale) would be credited with the amount of such increase.

Step 4: The LA of any security that had decreased in value from the beginning of the fiscal period to the end of the fiscal period (or in the case of a security sold during such fiscal period, from the beginning of such period through the date of sale) would be credited with the amount of such decrease.

Step 5: With respect to any security that was sold during the fiscal period, the allocations described in (a) or (b) below, as applicable, would be made:

(a) In the case of a partnership electing to use the remedial allocation method:

Gain in an amount equal to the GA of the security in question (after adjustment for any change in value from the beginning of the

fiscal period through the date of sale pursuant to step (3) would be allocated among the partners with GAs pro rata in accordance with the relative balances in those GAs. Loss in an amount equal to the LA of such security (after adjustment for any change in value from the beginning of the fiscal period through the date of sale pursuant to step (4)) would be allocated among the partners with LAs pro rata in accordance with the relative balances in those LAs.

(b) In the case of partnerships using the traditional method: The net gain or net loss realized on the disposition of the security would be allocated among the partners pro rata in accordance to the relative balances in their GAs or LAs. If the security in question had both a GA and an LA, then an amount equal to the lesser of such security's GA or LA immediately prior to sale would be purged from both the GAs and the LAs of the partners by allocating as a charge to such accounts such amount pro rata in proportion to the relative balances in such accounts.

Step 6: Each partner's GA would be charged with any allocation of taxable gain to such partner.

Step 7: Each partner's LA would be charged with any allocation of taxable loss to such partner.

The Committee believes the GA/LA Method provides major relief from the complexities of the full property-by-property/partner-by-partner approach generally contemplated by the Final Regulations. However, this method is considerably more complicated than the more simplified system discussed below that the Committee understands is presently being used by a number of securities partnerships. [28]/

The Committee would support the Treasury's adoption of the GA/LA Method as a valid application of the aggregation rule so long as such adoption does not preclude the use of other reasonable aggregation methods. The Committee believes the GA/LA Method, when used in the remedial allocation mode, generally produces results that are more accurate than the simplified approach currently employed by many securities partnerships. Although the GA/LA Method includes operating rules for application of the ceiling rule that enables the GA/LA Method to work in conjunction with the traditional method (see step 5(b) above), the GA/LA Method is more suitable for use in conjunction with the remedial method. Accordingly, the Committee would not object if the Treasury were to permit the use of the GA/LA Method only upon the condition that remedial allocations be made. As demonstrated in the examples set forth below, the Committee believes the GA/LA Method does not lend itself to curative allocations. The conceptual reason for this is that in order to

[28]/ For example, a securities partnership with 100 partners and 1,000 securities positions would have to maintain at least 100,000 separate accounts in order to comply with the property-by-property/partner-by-partner approach. Under GA/LA method, such a partnership would have to maintain no more than 2,200 accounts (one GA and one LA for each partner and one GA and one LA for each security position). See Scharfstein, supra note 18, at 34-42. Under the more simplified approach described below, the partnership would have to maintain only 100 accounts--one each partner.

perform a proper curative allocation, one needs to know what the allocation would have been on a property-by- property/partner-by-partner basis had there not been any ceiling rule limitation. Inherent in the use of an aggregation system is the absence of the foregoing knowledge.

5. Examples of the GA/LA Method. The Committee believes that there should be a full explanation of the general principles underlying the aggregation rule for securities partnerships, since, as noted earlier, the Temporary Regulations do not really describe them. Moreover, the Committee strongly urges the Treasury to illuminate the operation of the aggregation rule for securities partnerships through the inclusion of some examples. Set forth below are some examples illustrating the Committee's understanding of how the GA/LA Method would operate.

Suppose A and B form partnership ABC and each contributes $100 cash. ABC purchases Security 1 for $200. A and B agree to share profits and losses 50% to A and 50% to B. After Security 1 has increased in value to $400, ABC admits C, who contributes $200, which is used to purchase Security 2. A, B and C agree to share profits and losses 33-⅓% to A, 33-⅓% to B and 33-⅓% to C. Assume that Security 1 then declines in value to $250 and then is sold for that amount, while the value of Security 2 remains at $200.

Under the GA/LA Method, a separate GA and LA would be maintained for each partner and for each security. Generally, the aggregate of the GAs and LAs of all the securities would equal the aggregate of the GAs and LAs of all the partners. In this example, the GAs and LAs up until the sale of Security 1 would be as follows:

ABC Accounts Immediately Prior to Sale of Security 1

	Each of A and B				C				Security 1		Security 2	
	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.
Organization Of AB	100	100	0	0					0	0		
Admission of C	100	--	100	--	--				200	--		
Interim Balances	200	100	100	0	200	200	0	0	200	0	0	
Security 1 Declines in Value to 230	(50)	--	--	50	(50)	--	--	50	--	150	--	--
Closing Balances	150	100	100	50	150	200	0	50	200	150	0	

In this example, Security 1, which has a GA of $200 and an LA of $150, is sold for an actual tax gain of $50. If the remedial allocation method is adopted, then an additional $150 of gain and $150 of loss would be deemed realized. The aggregate of $200 gain would be allocated to A and B pro rata in accordance with their GAs, and the $150 of loss would be allocated to A, B and C pro rata in accordance with their LAs. The allocations of gain to the partners reduce their GA balances, and the allocations of loss reduce their LA balances. Thus, the allocations would be as follows:

Allocation on Sale of Security 1 – Remedial Method

	Each of A and B				C				Security 1		Security 2	
	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.
Opening Balance	150	100	100	50	150	200	0	50	200	150	0	
Allocation of 200 Gain	--	100	(100)	--	--	--	--	--	(200)	--	--	--
Allocation of 150 Gain	--	(50)	--	(50)	--	(50)	0	(50)	--	(150)	0	
Closing Balances	150	150	0	0	150	150	0	0	0	0	0	

Alternatively, if the traditional method is chosen, the actual tax gain of $50 would be allocated to A and B in accordance with their GAs and no further allocations would be made. In order to preserve equality of the aggregate GAs and LAs of the partners with the aggregate GAs and LAs of the securities, as well as to give effect to the ceiling rule, the unused $150 GA

and $150 LA attributable to Security 1 should be applied to reduce the GAs and LAs of the partners in each case on a pro rata basis based upon the relative balances of their GAs and LAs, respectively.

Allocation on Sale of Security 1 – Traditional Method

		Each of A and B				C			Security 1		Security 2	
	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.
Opening Balance	150	100	100	50	150	200	0	50	200	150	0	
Allocation of Gain	--	25	(25)	--	--	--	--	--	(50)	--	--	--
Interim Balance	150	125	75	50	150	200	0	50	150	150	0	0
Elimination of GA and LA on Security 1	--	--	(75)	(50)	--	--	--	(50)	(150)	(150)	--	--
Closing Balance	150	125	0	0	150	200	0	0	0	0	0	0

If the traditional method with curative allocations is used, it is not clear how to achieve the proper result within the framework of the aggregation system. Although in this simplified example the theoretically proper curative allocation is obvious, in practice allocations must be determined mechanically based upon the GAs and LAs of the partners. One possibility would be not to eliminate the remaining $150 GA and $150 LA in the above example. This would produce a result similar, but not equivalent, to a curative allocation. For example, assume Security 2 appreciates to $500 and then is sold for that amount, producing a $300 tax gain.

Allocation of Gain on Sale of Security 2 – Actual Curative Method

	A		B		C	
	Book Cap. Acct.	Tax Cap. Acct.	Book Cap. Acct.	Tax Cap. Acct.	Book Cap. Acct.	Tax Cap. Acct.
Opening Balance	150	125	150	125	150	200
Gain on Security 2	100	125	100	125	100	50
Closing Balance	250	250	250	250	250	250

As the foregoing table demonstrates, the correct curative allocation is to allocate $125 of gain to each of A and B and $50 of gain to C, since that allocation would bring the book and tax capital accounts into alignment. However, since the GA/LA Method drives allocations off of the partners' GAs and LAs, the foregoing curative allocation cannot be deduced from the partners' GAs and LAs.

Allocation of Gain on Sale of Security 2 – Possible Curative Method under the GA/LA Method

	Each of A and B				C				Security 1		Security 2	
	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Book Cap. Acct.	Tax Cap. Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.	Gain Acct.	Loss Acct.
Opening Balance	150	125	75	50	150	200	0	50	150	150	0	0
Security 2 Appreciates to 500	100	--	100	--	100	--	100	--	--	--	300	--
Interim Balance	250	125	175	50	250	200	100	50	150	150	300	0
Security 2 is Sold (Tax Gain Allocated to Partners Pro Rate Based on Gas)	--	117	(117)	--	--	66	(66)	--	--	--	(300)	--
Closing Balance	250	242	58	50	250	266	34	50	150	150	0	0

As the table foregoing demonstrates, the GA/LA Method is not perfectly suited to curative allocations, although in most circumstances one would expect it to produce a reasonable approximation of the theoretically correct curative allocation (as in the foregoing example). While it might be possible to create operating rules for adjusting the GAs and LAs to fine tune the curative allocation, the Committee believes this would be an unnecessary complexity. The GA/LA Method works very well with the remedial method, so taxpayers desiring the closest matching of tax consequences to book consequences could elect to use that method.

6. Permit a Simpler Aggregation System to Qualify as a Reasonable Method. The Committee understands that there are two basic Section 704(c) allocation methods (with many subvariations) that are in prevalent use by securities partnerships today. One

method is the full asset-by- asset/partner-by-partner method generally contemplated by in the Final Regulations and is favored by many investors because it provides the closest matching of actual economic performance with tax consequences. Because the accounting for that method is fairly sophisticated and complex, many partnerships--including partnerships with assets in excess of $100 million--do not use this method.

The second common method is a method whereby unrealized gains and losses are netted so that the partnership does not keep separate track of unrealized gains and unrealized losses. Partners who have experienced net unrealized appreciation would have an unrealized gain account, while partners who have experienced unrealized loss would have an unrealized loss account. The net realized gain or loss of the partnership each year is allocated among the partners in proportion to their unrealized gain accounts and loss accounts, respectively. Because actual realized gains in any period may exceed the aggregate of the partners' unrealized gain accounts (because of unrealized loss positions), and vice versa, the excess realized gain is allocated to partners in accordance with some ratio defined in the partnership agreement, typically bottom line sharing ratios for the year in question.

The GA/LA Method is a refinement of the foregoing single unrealized account method. It is, however, considerably more complicated from an accounting perspective. Under the foregoing method, partnerships keep a book capital account and a single unrealized account for each partner. Net profit or loss of the partnership, for book purposes, can be determined simply by looking at the aggregate change in value of the partnership's assets during the period in question. Although each security of the partnership needs to be valued for purposes of making that

determination, no separate accounts need to be kept recording the period-to-period changes in the value of each security.

The GA/LA Method, while generally more accurate than the simpler approach (at least where the remedial allocation method is used), would involve substantial additional record keeping for securities partnerships. While not as complicated as the full partner-by- partner/asset-by-asset approach, this approach could nonetheless be a significant burden. Further, moving partnerships that are presently utilizing the single unrealized account method into any such new system raises tricky transitional questions. For example, in the GA/LA Method, how would one set up the initial balances in the GAs and LAs for each partner and each security?

The Committee believes that the single unrealized account method presently being used by many securities partnerships generally produces reasonable results. The Committee believes that this is especially true in situations where the allocation methods of these partnerships operate in a manner that results in the tax capital accounts ultimately equalizing with the book capital accounts, so that no permanent book/tax disparity can be created. It appears to the Committee, however, that the single unrealized account method, as presently in use, may not fully comply with the requirement in the Temporary Regulations that gains be aggregated separately from losses.

The Committee appreciates the Treasury's concern about the potential for abuse where partnerships do not separately account for gains and losses. On the other hand, the Committee does not believe it would be appropriate for the Section 704(c) regulations to declare per se invalid a non-abusive allocation

system presently in use by a large number of partnerships in the securities industry.

The Committee believes that there are several possible ways to deal with that concern. One approach would be to eliminate the requirement that gains be aggregated separately from losses, coupled with the addition of a description of an aggregation method the Treasury generally considers to be reasonable. While the Committee recognizes that eliminating the requirement to separately aggregate gains and losses poses greater risk of abuse, the Committee believes that, in the securities partnership area, the anti-abuse rule coupled with the limitation on the aggregation rule to reverse Section 704(c) allocations should be sufficient to protect the fisc.

A second, middle ground, alternative would be as follows. Partnerships complying with the requirement to separately aggregate gains and losses, [29]/ as well as all other requirements of the securities partnership aggregation regulations, would be treated as having a reasonable method under the regulations, subject to the anti-abuse rule. Partnerships meeting the requirements of the securities partnership aggregation regulations other than the separate aggregation of gains and losses requirement, would bear the burden of demonstrating that in their particular circumstances the method used was reasonable. These partnerships would not, however, have their allocations declared to be per se invalid simply because they did not separately aggregate gains and losses.

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[29]/ The Committee envisions that the final regulations will be more explicit on how this requirement can be met, e.g., through use of the GA/LA Method or other methods.

A third alternative would be to retain the requirement of separate aggregation of gains and losses and prescribe a method by which this requirement can be met that is simpler that the GA/LA Method. For example, the Treasury could require securities partnerships to allocate gains and losses on an "exploded" basis, i.e., in a manner designed to eliminate book and tax capital account disparities as quickly as possible, using actually realized gross gains and losses. That allocation method is illustrated by the following example.

Suppose A and B form partnership AB# with each contributing $100 in cash. Partnership AB purchases a security for $200, which appreciates in value to $400, whereupon C is admitted as a 1/3 partner in exchange for a contribution of $200 in cash. C's cash is used to purchase a second security, which later declines in value to $50. The capital accounts of the partners would be as follows that point:

	Each of A and B		C	
	Book Cap. Acct.	Tax Cap. Acct.	Book Cap. Acct.	Tax Cap. Acct.
Opening Balance	100	100		
Revaluation of security 1 upon the admission of C	100	--		
Admission of C	200	100	200	200
Revaluation upon decline in value of security 2	(50)	--	(50)	--
Closing Balance	150	100	150	200

Assume now that security 1 is sold at a $200 gain and security 2 is sold at a $150 loss. The net profit of the partnership is $50. However, while the partnership has a net profit, one of the partners, C, has experienced a book loss. The Service could require that $50 of the loss on security 2 be specially allocated to C. That would leave $100 of net bottom-line profit, which would be allocated $50 to each of A and B.

VI. Other Issues

There are certain other Section 704(c) issues that are not addressed by either the Final Regulations or the Temporary Regulations as to which guidance should be provided, either in the form of new regulations or a published ruling. Those issues are set forth below.

A. Guidance for Preexisting Partnerships

Section 704(c), as amended and made mandatory by the Tax Reform Act of 1984, was to be effective with respect to property that was contributed to a partnership after March 31, 1984. [30]/ The legislative history of the Tax Reform Act provides very little guidance as to how to apply Section 704(c), other than to suggest that partnerships may continue to rely on the then old Section 704(c)(2) regulations (i.e., the traditional method) until new regulations are proposed. [31]/ However, the Final Regulations and the Temporary Regulations are effective only with respect to property that was contributed to a partnership (or revalued) on or after December 21, 1993 (the date on which they were promulgated), [32]/ and there is a conspicuous silence in the

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[30]/ See P.L. 98-369, § 71(c). The statutory effective date refers only to property that is "contributed" and not to property that is revalued pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) (which made its first appearance as part of the final Section 704(b) regulations that were promulgated in 1985). However, Treas. Reg. § 1.704-1(b)(2)(iv)(f) itself provides that the book-tax difference attributable to revalued property must be taken into account "in the same manner as under Section 704(c)". See also Treas. Reg. §§ 1.704-l(b)(4)(i) and 1.704-3(a)(6)(i).

[31]/ See the Senate Report at 215; and H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 857 (1984) (the "Conference Report"). See also the Blue Book at 213.

[32]/ See Final Regulation § 1.704-3(f). Despite the cue from the legislative history, the Service chose to make the regulations effective when they were finalized, not when they were proposed.

Final Regulations and the Temporary Regulations as to what the law is for property contributed before that date. Thus, for partnerships to which property was contributed during this almost ten year gap period, there is very little guidance as to how to apply Section 704(c), even though its application is mandatory.

The Committee believes that there is an urgent need for additional guidance as to what the Section 704(c) law is with respect to partnerships to which property was contributed during this ten year gap period. Since such partnerships presumably will present the bulk of the Section 704(c) issues that are raised on audit during the next few years, it is in the interest of both the government and taxpayers that some additional guidance be provided on this transition rule issue. While the Committee recognizes that this is a difficult issue, it recommends that, at a minimum, guidance should be provided indicating that such gap period partnerships may rely on the principles of the Final Regulations and the Temporary Regulations (or the final version thereof).

The Committee makes the above recommendation for the following reasons. First, the transition rule issue in this case is much more significant than normal, since Section 704(c) is mandatory but not self-executing, yet almost ten years elapsed before any regulatory guidance was issued. Second, the Committee feels that it is unduly restrictive to leave such gap period partnerships with only the traditional method, which has long been criticized for the reasons discussed earlier, [33]/ was questioned in the legislative history of the Tax Reform Act

[33]/ See the discussion on pp. 8-10, supra.

of 1984 [34]/ and may not be used by partnerships subject to the Final Regulations in certain circumstances. [35]/ The Committee's perception is that many partnerships to which property was contributed during the ten year gap period have tried in good faith to apply Section 704(c) using methods other than the traditional method, especially curative allocations, in order to avoid the unfair and/or nonsensical tax results that the traditional method may produce. Third, the fisc should be reasonably protected under the Committee's recommendation, since a partnership relying on the Final and Temporary Regulations would have to be able to demonstrate compliance with the anti-abuse rule.

B. Interrelationship Between the Reasonable Method Requirement and the Anti-Abuse Rule

The Final Regulations state that Section 704(c) allocations "must be made using a reasonable method that is consistent with the purpose of section 704(c)". [36]/ The Final Regulations then generally sanction as reasonable the traditional method and the traditional method with curative allocations; the Temporary Regulations generally sanction as reasonable the remedial method.

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[34]/ All the committee reports on the Tax Reform Act of 1984 noted the limitations of the traditional method and suggested that the new Section 704(c) regulations should permit partnerships to make Section 704(c) allocations using new methods not permitted under the old Section 704(c)(2) regulations, such as curative allocations and allocations based on the aggregation of separate items of property. See the House Report at 1209-10; the Senate Report at 214-5; and the Conference Report at 857. See also the Blue Book at 213-4.

[35]/ See, e.g., Final Regulation § 1.704—3(b)(2) (Example 2).

[36]/ Final Regulation § 1.704-3(a)(1).

All Section 704(c) allocation methods, whether or not sanctioned by the Final or Temporary Regulations as generally reasonable, are subject to the general anti-abuse rule, which is somewhat similar to the substantiality requirement that applies for Section 704(b) purposes. [37]/ However, in contrast to the Section 704(b) regulations, where the substantiality test is clearly delineated as a separate test, the Section 704(c) regulations appear to blur the line between the requirement of using a reasonable method and the anti-abuse rule. That blurring results because the anti-abuse rule states that a Section 704(c) allocation system that substantially reduces the present value of the tax liabilities of the partners is "not reasonable". [38]/ This creates some confusion as to whether the anti-abuse rule is the exclusive test for reasonability or whether the anti-abuse rule is simply one component of a broader reasonability test, i.e., a necessary, but not sufficient, condition for any method to be treated as reasonable. Resolving this theoretical question is not necessarily of great practical importance. The Committee is concerned, however, that the status of allocation methods not strictly complying with all the requirements of the three enumerated Section 704(c) methods is not entirely clear.

For example, Final Regulation § 1.704-3(c) permits reasonable curative allocations over the remaining depreciable life of a property to the extent necessary to offset ceiling rule distortions. Unlike the Proposed Regulations, however, the Final Regulations do not permit catch-up curative allocations where the partnership does not have tax items sufficient to offset the ceiling rule in any particular year, unless the partnership

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[37]/ See Treas. Reg. § 1.704-l(b)(2)(iii).

[38]/ See also Temporary Regulation § 1.704-3T(d)(4), which indicates that the Service will not force a partnership to use the remedial method if its allocations are "not reasonable".

agreement provides that curative allocations are made over a reasonable period of time (such as the property's remaining economic useful life). Accordingly, the Final Regulations sanction as reasonable (i) curative allocations made over the remaining tax depreciable life of the property, but without catch-ups, and (ii) curative allocations made over the remaining economic useful life of the property with catch-ups. What, then, is the status of a curative allocation made over the remaining depreciable life of contributed property with catch-ups? The Final Regulations state that such an allocation system is "not reasonable". This could mean that either (i) it is per se unreasonable and, therefore, may not be defended on audit under any circumstance or (ii) it simply lacks the imprimatur of reasonableness otherwise conferred by the Regulations on curative allocations. The Committee believes that the latter interpretation is the correct one, and it recommends that this be confirmed.

The Committee believes that allocation methods similar to those described as reasonable in the regulations but failing to meet all the requirements of the regulations should stand on the same footing as allocation methods not described in the Regulations. In these cases, the partnership should be required to demonstrate that the allocation method in its particular case is reasonable and, further, that the anti-abuse rule is satisfied. The Committee believes the foregoing to be the correct interpretation of the Final Regulations and, accordingly, is not recommending any change in the regulations. It would be helpful, however, if that interpretation were confirmed by the Service in the ordinary course of issuing further guidance on the Section 704(c) regulations (e.g., in Revenue Rulings). As discussed earlier, this clarification would be most helpful in the securities partnership area, where the Committee believes there

will likely be many partnerships with reasonable nonabusive allocation methods that will not meet all the technical requirements of the regulations.

C. Determination of Fair Market Value

As the preceding discussion amply demonstrates, the Section 704(c) regulations prescribe detailed rules regarding the allocation of tax items attributable to property contributed to a partnership that has a difference between its fair market value and its tax basis at the time of contribution. However, the threshold determination that must be made in any particular case before those rules can be applied is what the fair market value of the contributed property is on the date of contribution. The fair market value of contributed property obviously is an inherently factual issue as to which reasonable people may differ in any particular case, which makes it a likely source of controversies on audit.

As currently drafted, the Section 704(c) regulations do not address the issue of how the fair market value of contributed property should be determined for Section 704(c) purposes. However, the Section 704(b) regulations do address that issue for capital account maintenance purposes, specifying that the fair market value that the partners assign to contributed property will be respected if (i) such value is reasonably agreed to by the partners in arm's length negotiations and (ii) the partners have "sufficiently adverse interests". [39]/ The legislative history of the Tax Reform Act of 1984 states that a similar standard should apply for Section 704(c) purposes. [40]/

[39]/ Treas. Reg. § 1.704-l(b)(2)(iv)(h).

[40]/ See the Senate Report at 214. See also the Blue Book at 213.

In order to provide some measure of certainty in the Section 704(c) valuation area and to insure consistency between Section 704(b) and Section 704(c) valuation issues, the Committee recommends that the Section 704(c) regulations expressly provide that the fair market value of contributed property, if determined in accordance with the standards set forth in the Section 704(b) valuation rule, will be respected for Section 704(c) purposes as well. It should be noted that the Section 704(b) valuation rule by its terms technically only applies to partnerships that rely on the complex capital account rules of Treasury Regulation § 1.704-1(b)(2) to validate their tax allocations; it does not apply to partnerships that rely on the interests of the partners in the partnership test under Treasury Regulation § 1.704-1(b)(3), as those partnerships are not required to maintain capital accounts for Section 704(b) purposes. [41]/ Nevertheless, the Committee recommends that the Section 704(c) regulations make clear that the Section 704(b) valuation rule may be relied upon by partnerships that rely on the interests of the partners in the partnership test if they can satisfy the applicable standards. Such a partnership would face a special burden in proving that the partners had "*sufficiently adverse interests*" for their valuation to be respected, since the value assigned to contributed property would not have potential economic consequences to the partners by affecting their capital account balances. However, such a partnership should still be able to satisfy that test by demonstrating that the value assigned to the contributed property for Section 704(c) purposes was the same as the value that the partners assigned to that property in determining their overall economic arrangement or that there were

[41]/ Unfortunately, such partnerships may not escape the clutches of the capital account rules where they hold contributed property, since Final Regulation § 1.704-3(a)(3)(i) requires that such partnerships maintain book capital accounts for Section 704(c) purposes.

adverse interests among the partners because the value assigned to the contributed property was expected to have a significant impact on their tax positions by affecting Section 704(c) allocations.

In addition to prescribing the rule described above, the Section 704(c) regulations should provide that in all events the value assigned to contributed property for Section 704(c) purposes must be the same as the value that is credited to the contributing partner's capital account if the partnership maintains capital accounts for its partners for Section 704(b) purposes and must otherwise be consistent with the economic arrangement of the partners.

D. Special Recapture Issues

Although the legislative history of Section 704(c) suggests that the Section 704(c) regulations should address the interrelationship between Section 704(c) and the recapture provisions of the Code (e.g., Sections 1245 and 1250), [42]/ the Final and Temporary Regulations do not address the subject. Thus, the only applicable law is that contained in the long-standing regulations under the recapture provisions, which indicate that recapture income generally should be allocated in the same proportions as the gain from the sale of the property is allocated. [43]/ As a result, even though Section 704(c) may prevent a partner that contributes property with built-in gain from shifting the amount of that gain to the other partners, there is a potential to accomplish what could loosely be described as “character shifting”. Consider the following simplified example:

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[42]/ See the Conference Report at 857. See also the Blue Book at 213.
[43]/ See Treas. Reg. §§ 1.1245-1(e)(2) and 1.1250-l(f).

Example (1). A and B form a partnership, with each having a 50% interest. A contributes production machinery with a fair market value of $100 and a tax basis of zero, and B contributes $100 in cash. Assume that A had previously claimed $80 of depreciation deductions with respect to the production machinery, all of which would have been recaptured as ordinary income under Section 1245 if A had sold the production machinery for $100. The partnership elects to use the traditional method of making Section 704(c) allocations, and it elects to depreciate its book basis in the machinery on a straight-line basis over five years in accordance with Treasury Regulation § 1.704-l(b)(2)(iv)(g)(3). Each year, the partnership's operating expenses equal its operating income. At the beginning of its third year (at which time the book basis of the machinery is $60), the partnership sells the machinery for $100, generating a $40 book gain and a $100 tax gain. Under the traditional method, the first $60 of tax gain would be allocated solely to A (reflecting the “built-in gain” at that time as determined under the Sale Rule) and the remaining $40 of tax gain would be allocated $20 to A and $20 to B. Under Treasury Regulation § 1.1245-1(e)(2), $16 of the tax gain allocable to B ($20 multiplied by the ratio that the recapture income of $80 bears to the total gain of $100) would be treated as ordinary income, even though B never received the benefit of any depreciation deductions with respect to the machinery. Thus, A would have shifted $16 of recapture income to B.

The right answer in the foregoing example obviously is that A should treat all the taxable gain allocable to him as recapture income, since that was the amount of recapture income inherent in the property at the time of contribution and no further recapture built up while the property was held by the partnership. Some partnership agreements provide for a special allocation of recapture income to try to produce that result as a fairness matter (or to avoid certain Section 751 problems that may be caused by the admission of new partners), but it is questionable whether such allocations are valid under Section 704(b) given that they generally lack economic effect. [44]/

The Committee recommends that guidance be provided requiring that recapture income inherent in contributed property at the time of contribution be taken into account under Section 704(c). In a simple case such as Example (1) above, that would mean that the recapture income realized at the partnership level should be specially allocated to the contributing partner as a Section 704(c) matter (without affecting capital accounts) to the extent that tax gain would otherwise be allocable to the

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[44]/ There are two possible reasons why such special allocations of recapture income may lack economic effect. First, since recapture is fundamentally a tax concept that has no directly corresponding book item, such special allocations of recapture income often are made solely as a tax matter, without affecting the book capital accounts of the partners or otherwise having any economic effect. Second, even where there is some type of special allocation of the recapture income on a book basis to drive a special allocation of recapture income on a tax basis, the special allocation on a book basis usually is limited to the amount of book gain that otherwise would have been allocated to the contributing partner to avoid distorting the economic arrangement of the parties. That limitation prevents the book special allocation from having any economic effect. It also should be noted that a full special allocation of recapture income on a book basis to drive a special allocation of recapture income on a tax basis often would not even be theoretically possible. The book analogue to recapture income on a tax basis would be the portion of the book gain on the sale of the property attributable to prior book depreciation deductions. However, the amount of book recapture income that is realized on the sale of contributed property often is less than the amount of recapture income on a tax basis, and it is unclear how the excess tax recapture income should be allocated in such cases.

contributing partner under Section 704(c), provided that the amount of the recapture income that is allocated to the contributing partner should not exceed the amount of recapture income inherent in the property at the time of contribution. [45]/

However, in most cases some refinement will be needed to deal with the fact that the partners of the partnership (including the contributing partner where there is no ceiling rule limitation) may be allocated depreciation deductions after the date of contribution that may result in still more recapture income being realized when the property is ultimately sold. To deal with that complication, the Committee recommends that the general rule be that recapture income realized on the sale of a property must be allocated by the partnership among all its partners to the extent that they have received tax depreciation deductions attributable to the property (which, in the case of the contributing partner, would include any depreciation deductions claimed prior to the contribution of the property), but in each case the amount of recapture income allocated to a particular partner may not exceed the amount of tax gain otherwise allocable to that partner under general Section 704(c) principles. That rule would cause the burden of the recapture income to be borne by the partners whose tax depreciation deductions are recaptured from an economic standpoint when the property is sold, subject to the effect of the limitation

[45]/ The amount of recapture income inherent in the property at the time of contribution should be computed assuming that the property were sold by the contributing partner for its original cost. It is arguable that the amount of recapture income should be limited to the amount of built-in gain at the time of contribution where the built-in gain is less, but that rule might result in some character shifting if the property appreciates in value after the contribution.

noted at the end of the preceding sentence. [46]/ It appears that it is not necessary to adopt a more elaborate first in/first out, last in/first out or pro rata rule, since the foregoing limitation seems to cause the allocation of recapture income to be the same under the Committee's proposal or any such alternative rule.

One additional refinement is needed where the partnership uses the traditional method with curative allocations or the remedial method. Consider the remedial method first. Since the remedial method results in a noncontributing partner being allocated notional tax depreciation that is functionally the same as actual tax depreciation, the notional tax depreciation should be treated as actual tax depreciation for purposes of determining the non-contributing partner's share of any recapture income that is realized by the partnership on the sale of the contributed property. While less obvious, the corresponding remedial allocation of ordinary income to the contributing partner is functionally the same as actual recapture income. Hence, such allocations should reduce the contributing partner's share of any recapture income that is realized by the partnership on the sale of the contributed property. Similar principles should apply in the case of curative allocations, subject to the curiosity that where depreciation deductions attributable to one asset are

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[46]/ As an illustration of the effect of that limitation, suppose that A and B form a partnership, with A contributing equipment that has a fair market value of $100, a tax basis of $50, built-in recapture of $50 and a remaining tax life of five years, and B contributing $100 of cash. Book income and loss are allocated 50% to A and 50% to B. The partnership uses the traditional method and, therefore, allocates the $10 of tax depreciation attributable to A's property during the first year 100% to B. At the beginning of the second year, the property is sold for its then book basis of $80. Under the traditional method, the $40 of tax gain from the sale (all of which consists of recapture income) would be allocated 100% to A. Since B would not be allocated any gain on a tax basis, the above limitation would dictate that B not be allocated any recapture income, even though all $10 of B's tax depreciation deductions (and only $30 of A's deductions) have been recaptured from an economic standpoint.

"borrowed" to make curative allocations with respect to a second asset, the recapture income related to those deductions would be triggered when the first asset is sold. [47]/

E. Section 708 Terminations

The Committee believes that special Section 704(c) concerns may arise in connection with a technical termination of a partnership pursuant to Section 708(b)(1)(B) that warrant the issuance of specific guidance. Under Section 708(b)(1)(B), when 50% or more of the capital and profits interests in a partnership are transferred within any 12-month period, the partnership is deemed to terminate. Under Treasury Regulation § 1.708-1(b)(1)(iv), the terminated partnership is deemed to have distributed its assets in kind to its partners, which are deemed to immediately contribute those assets to a new partnership. The assets that are deemed to have been distributed and then contributed effectively represent undivided interests in the properties of the terminated partnership. [48]/ The deemed contribution of those assets triggers the application of Section 704(c).

[47]/ The curative allocation of depreciation deductions attributable to the first asset would not increase the amount of recapture inherent in the second asset (since it would not affect the tax basis of the second asset), but such deductions would increase the amount of recapture inherent in the first asset.

[48]/ See, e.g., Private Letter Rulings 8540093 (July 12, 1985); 8217207 (Jan. 29, 1982); and 8130131 (Apr. 30, 1981).

A Section 708 termination can result in surprising, complex and often harsh consequences under Section 704(c), creating a trap for the unwary. That follows because the individual undivided interests that are deemed to have been contributed by each partner apparently are treated as separate items of property for Section 704(c) purposes. Compare the following two simplified examples:

> Example (2). A and B form a partnership, with each having a 50% interest. A contributes depreciable property with a fair market value of $100 and a tax basis of zero ("Property A"); B contributes similar depreciable property with a fair market value of $100 and a tax basis of zero ("Property B"). The partnership elects to use the traditional method of making Section 704(c) allocations, and it elects to depreciate its book basis in Property A and Property B on a straight-line basis over five years (which is the statutory recovery period for such assets). Each year, the partnership's operating expenses equal its operating income. Under the traditional method, there is no tax depreciation with respect to Property A or Property B to allocate under Section 704(c). Thus, neither A nor B would have any income or loss prior to the sale of the properties.
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> Example (3). Assume that the facts are the same as in Example (2), except that shortly after the partnership is formed, A sells his 50% interest to C for $100. That transaction causes a termination of the partnership under Section 708(b)(1)(B). The tax bases of the assets that are deemed to be distributed to C (a 50% undivided interest in Property A and a 50% undivided interest in Property B) are stepped up to $50 for the interest in Property A and $50 for the interest in Property B and will be recovered over five years in accordance with Section 168(i)(7)(B); the tax bases of the assets that are deemed to be distributed to B remain at zero. Under the traditional method, the $20 of tax depreciation attributable to C's undivided interests in Property A and B each year would be allocated $10 to C and $10 to B, since there would be no book-tax difference with respect to those properties.

> Consequently, B would capture half the tax benefits attributable to the step-up in the basis of the partnership's assets that was caused by C's purchase. [49]/

While the result in Example (3) is analogous to the result that would occur in the case of a real contribution of full basis property by one partner and zero basis property by another, it may not be anticipated by the parties in the Section 708 termination context. Such result could be mitigated by making curative or remedial allocations under Section 704(c), but in a real world partnership with many partners and many properties, those allocations could be orders of magnitude more complicated than the Section 704(c) allocations that may have been made before the termination. [50]/ As a general rule, the most equitable and straightforward way to deal with a Section 708 termination would be to apply the undivided interests method described below.

Under Section 704(c)(3) of the Internal Revenue Code of 1954, as in effect prior to the Tax Reform Act of 1984, partnerships that received contributions of undivided interests in the same properties could elect to allocate depreciation and gain or loss on the sale of those properties to put the partners in the same position they would have been in had the contributions not been made. Although the statutory allocation method for undivided interests was repealed by the Tax Reform Act of 1984, the question remains as to whether that method of allocating tax items attributable to undivided interests can still be used under Section 704(c). The preamble to the Final

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[49]/ In contrast, if C had purchased only a 49.9% interest from A, no termination of the partnership would have occurred and C would have been entitled to all the tax benefits resulting from any step-up in the tax basis of the partnership's assets resulting from a Section 754 election.

[50]/ In effect, the number of Section 704(c) assets that the partnership must keep track of would increase from the number of actually contributed (or revalued) properties that it owned before (which may have been zero) to up to a number equal to the product of the total number of properties that it owns and the number of partners that it has.

Regulations indicates that the Treasury considered including the undivided interests method as one of the specific Section 704(c) methods that is generally considered to be reasonable. However, according to the preamble, the Treasury rejected that idea because the undivided interests method "appears to be of very limited application", although it may be reasonable in "appropriate circumstances".

While the Committee agrees that real contributions of undivided interests in the same property are unusual, deemed contributions of undivided interests in the same property due to Section 708 terminations are not and they raise the concerns described above. Hence, the Committee recommends that guidance be issued specifically indicating that it generally would be reasonable for a "new" partnership resulting from a Section 708 termination to use the undivided interests method under Section 704(c).