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Profits-Only Interest in Exchange for Services

1

"The value of an interest in ... partnership capital ... transferred to a partner as compensation for services constitutes income to the partner under section 61."

Reg. 1.721-1(b)(1)

"To the extent that the value of such [PSP] interest is compensation for services rendered to the partnership it is a guaranteed payment for services under section 707(c)..."

Reg. 1.721-1(b)(2)

3

General Partners and Limited Partners are subject to SE tax on guaranteed payments for services

4

Profits Only Interests

Campbell (Tax Court 1990)

Campbell performed services involving the formation and syndication of three real estate limited partnerships, in exchange for profits-only interests in the partnerships.

Tax Court found that no authority exists to support different treatment for capital and profits interests received in exchange for services.

The Tax Court held that the profits interests were taxable upon receipt and valued from $15,000 to $25,000.

Campbell - 8th Cir. 1991

"Any predictions as to the ultimate success of the operations were speculative. ...[C]ampbell's profits interests ... were without fair market value at the time he received them..."

Tax Court Reversed

Do Not Assume that the Eighth Circuit Changed the View of the Tax Court

(outside of the 8th Circuit)

Or the IRS

Rev Proc 93-27

IRS Administrative Concession For Vested Profits Only Interest

Rev Proc 93-27

Profits Interest not taxable if NOT:

1) A substantially certain and predictable stream of income.

2) Disposed of within two years of receipt.

3) A limited partnership interest in a publicly traded partnership.

Profits Interest Definition

A partnership interest
other than
a capital interest.

Capital Interest Definition

A "capital interest is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership."

Example 1

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Vested
Profits Only Interest
(“Carried Interest”)

- Investor (I) and Developer (D) enter into a LLC/partnership (ID)
- Developer contributes $0
- Investor contributes $50 million

The LCC provides for liquidating distributions as follows:

3rd -- 20% to Developer [the promote (a "carried interest")], and 80% to Investor

Beginning Balance Sheet (in millions)

Assets		Capital	
Cash	50	Capital – I	50
		Capital – D	0
Assets	50	Capital	50

D's 20% "promote" is a safe-harbor profits only interest pursuant to Rev. Proc. 93-27.

(D gets zero on immediate liquidation)

The PSP invests all of the cash in real property and subsequently earns $20 mil. on the sale of property for $70 million ($70 - $50)

(in Yr. 1 for simplicity)

End of Year 1

	In Millions	I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	50	0	50

	In Millions	I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			70
	Book Income (4 – 3)			20

	In Millions	I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			70
	Book Income (4 – 3)			20
5:	70 Fict. Cash Dist.			
	1st 5 -- 10% Ret. -	+5		
	2nd 50– Cap. Recovery	+ 50		

	In Millions	I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			70
	Book Income (4 – 3)			20
5:	70 Fict. Cash Dist.			
	1st 5 -- 10% Ret. -	+5		
	2nd 50 -- Cap. Rec.	+ 50		
	3rd 15-- 80/20	+12	+3	
	Target Capital	67	3	

	In Millions	I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distrib.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			70
	Book Income (4 – 3)			20
5:	70 Fict. Cash Dist.			
	1st 5 -- 10% Ret. -	+5		
	2nd 50 – Cap. Recovery	+ 50		
	3rd 15 - 80/20	+12	+3	
	Target Capital*	67	3	
6:	Allocation (Step 5 – 3)	17	3	20

Final Result:

I - $17 mil.

D- $3 mil.

Example 2

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Patterned after *Scion*

ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, No. C.A. No. 5843-VCL, 2012 WL 1869416 (Del. Ch. May 16, 2012).

Begin with same facts as Example 1, but

I's lawyer reversed the order of the 2nd and 3rd clauses of the distribution provision

and

the property sells for $35 mil (not $70 mil.).

1st-- to Investor until Investor has received a 10% preferred return on its invested capital;

2nd to Investor until it has recovered its invested capital; and

No longer a “carried interest”

2nd -- 20% to Developer, and 80% to Investor

3rd, to Investor until it has recovered its invested capital.

End of Year 1

		I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			35
	Book Loss (4 – 3)			<15>

End of Year 1

		I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			35
	Book Income (4 – 3)			<15>
5:	$35 Fictional Cash			
	1st 5 -- 10% Ret. -	+ 5		
	2nd 30 -- 80/20	+24	+6	
	3rd $0 Ret. of Cap.	0	0	

End of Year 1

		I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			35
	Book Income (4 – 3)			<15>
5:	$35 Fictional Cash			
	1st 5 -- 10% Ret. -	+5		
	2nd 30 -- 80/20	+24	+6	
	3rd $0 Ret. of Cap.	0	0	
	Target Capital*	=29	=6	

End of Year 1

		I	D	Total
1:	Beginning Capital	50	0	50
2:	Contributions/Distribs.	0	0	
3:	Adjusted Beg. Capital	50	0	50
4:	Ending Total Capital			35
	Book Income (4 – 3)			<15>
5:	$35 Fictional Cash			
	1st 5 -- 10% Ret. -	+5		
	2nd 30 -- 80/20	+24	+6	
	3rd $0 Ret. of Cap.	0	0	
	Target Capital*	=29	=6	
6:	Allocation (Step 5 – 3)	<21>	6	<15>

Final Result:

I - <$21 mil.>
D- $6 mil.

What did D's attorney say upon reading the draft agreement by I's lawyer?

Fine work...lets do more deals

- The trial lasted four days and included nine fact witnesses, two expert witnesses, 300 documentary exhibits, and 25 deposition transcripts.
- The Delaware Chancery Court held in favor of Investor that the error was a scrivener's error.

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Partner's Share of Partnership Debt

41

A partner's distributive share of losses cannot exceed O.B. (Sec. 704(d))

The contributing partner’s beginning O.B. is the adjusted basis of contributed property (including money) to the contributing partner at the time of the contribution

Increase in a partner’s share of partnership debt is treated as contribution of money. (Section 752(a))

Decrease in a partner's share of partnership debt is treated as distribution of money. (Section 752(b))

Example (Not in Text)

- Bill and Carol each contribute $20,000 cash to BC general partnership.

- The partnership borrows $10,000 (recourse debt).

Balance Sheet

Assets (In Thousands)	Tax Basis	Book Basis	FMV
Cash	50	50	50
Total Assets	50	50	50
Rec. Debt	10	10	10
Capital:			
Bill (50%)	20	20	20
Carol (50%)	20	20	20
Total Capital	50	50	50

The share of recourse debt allocated to each partner hinges upon the economic risk of loss (EROL) test in sec. 752

EROL Test

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Assume all assets are worthless – financial Armageddon

Hypothetical Loss of <$50,000>

Balance Sheet Before Armageddon

Assets <u>(In Thousands)</u>	Tax Basis	Book Basis	FMV
Cash	50	50	50
Total Assets	50	50	50
Rec. Debt	10	10	10
Capital:			
Bill (50%)	20	20	20
Carol (50%)	20	20	20
Total Capital	50	50	50

After Financial Armageddon

Assets (In Thousands)	Tax Basis	Book Basis	FMV
Cash	0	0	0
Total Assets	0	0	0
Rec. Debt	10	10	10
Capital:			
Bill (50%)	<5>	<5>	<5>
Carol (50%)	<5>	<5>	<5>
Total Capital	0	0	0

Debt Share:

$5,000 to Bill

$5,000 to Carol

Outside Bases

Assets (In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	50	50	50	
Total Assets	50	50	50	
Rec. Debt	10	10	10	
Capital:				
Bill (50%)	20	20	20	25
Carol (50%)	20	20	20	25
Total Capital	50	50	50	

Loss allocation is driving debt allocation

What if the partnership agreement allocated depreciation disproportionately?

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Example 1

Begin with facts of Ex. 1 on Page 11

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Page 11
Ex. 1
Review

- Hal and Lori each contribute $50,000.
- PSP borrows $900,000 (recourse debt).
- The partnership purchases a building for $1,000,000.
- All items 50-50 except depreciation of 100% to Hal.

- Interest only on debt.
- Depreciation $50K per year.
- All gross income is equally offset by gross expenses (net zero) except for depreciation.

Upon Formation (In Thousands)

Building	1,000	Recourse Debt	900
		Capital – Hal	50
		Capital – Lori	50
Assets	1,000	Debt + Capital	1,000

1)The partners' capital accounts will be determined and maintained in accordance with Treasury Reg. 1.704-1(b)(2)(iv).
2)Distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership as set forth in Treasury Reg. 1.704-1(b)(2)(ii)(b)(2).
3)Any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership as set forth in Treasury Reg. 1.704(b)(2)(ii)(b)(3).

	Tax and Book Capital Accts	
	Hal	Lori
Formation	50,000	50,000
Yr. 1 Loss	-50,000	0
End of Yr. 1	0	50,000

Primary Test Met

End of Yr. 1 (In Thousands)

Building	950	Recourse Debt	900
		Capital – Hal	0
		Capital – Lori	50
Assets	950	Debt + Capital	950

Form 1065 K-1
Debt Share at Year End

K Partner's share of liabilities at year end:

Nonrecourse . . . . $ ____________

Qualified nonrecourse financing . $ ____________

Recourse . . . . $ ____________

EROL Test at Beg. of Yr. 2

Assume all assets are worthless – financial Armageddon

Hypothetical Loss of <$950,000> (<$475,000> each)

Beg. of Yr. 2 Following Hypothetical Armageddon (In Thousands)

Building	**0**	**Recourse Debt**	**900**
		Capital – Hal	**<475>**
		Capital – Lori	**<425>**
Assets	**0**	**Debt + Capital**	**0**

Hal: $0 - $475K = <475K>

Lori: $50K - $475K = <$425K>

Beg. of Yr. 2 (In Thousands) (End of Yr. 1)

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Building	950,000	Recourse Debt	900,000	O.B.
		Capital – Hal	0	$475,000
		Capital – Lori	50,000	$475,000
Assets	950,000	Debt + Capital	950,000	

Hal's Debt Share: $475,000

Lori's Debt Share: $425,000

Year 2

	Tax and Book Capital Accts	
	Hal	**Lori**
Formation	**50,000**	**50,000**
Yr. 1 Loss	**-50,000**	**0**
End of Yr. 1	**0**	**50,000**
Yr. 2 Loss	**-50,000**	**0**
Ending Cap.	**<50,000>**	**50,000**

Primary Test Met

Hal has a DRO

End of Yr. 2 (In Thousands)

Building	**900,000**	**Recourse Debt**	**900,000**
		Capital – Hal	**<50,000>**
		Capital – Lori	**50,000**
Assets	**900,000**	**Debt + Capital**	**900,000**

EROL Test at Beg. of Yr. 3

Assume all assets are worthless – financial Armageddon

Hypothetical Loss of <$900,000> (<$450,000> each)

Beg. of Yr. 3 Following Hypothetical Armageddon (In Thousands)

Building	**0**	**Recourse Debt**	**900**
		Capital – Hal	**<500>**
		Capital – Lori	**<400>**
Assets	**0**	**Debt + Capital**	**0**

Hal: <$50K> - $450K = <500K>

Lori: $50K - $450K = <$400K>

Beg. of Yr. 3 (In Thousands)

Building	900,000	Recourse Debt	900,000	O.B.
		Capital – Hal	<50,000>	$450,000
		Capital – Lori	50,000	$450,000
Assets	900,000	Debt + Capital	900,000	

Hal's Debt Share: $500,000

Lori's Debt Share: $400,000

In Yrs 1 thru 18, Hal is allocated <$900,000> (<50K> x 18) of actual net losses

Beg. Yr. 19 (In Thousands)

Building	100,000	Recourse Debt	900,000	Outside Basis
		Capital – Hal	<850,000>	50,000
		Capital – Lori	50,000	50,000
Assets	100,000	Debt + Capital	100,000	

Hal’s Debt Share: $900,000

Lori’s Debt Share: $0

In Year 20, Hal will lack sufficient O.B. to claim his <50K> loss allocation

Penske Truck Leasing Co., L.P.

"If, as a result of the application of Code Section 704(d), the federal income tax loss associated with an allocation of Losses allocated to a Partner ... cannot be claimed by such Partner for the taxable year during which such Losses arose, then such Losses may be reallocated ... but only to the extent such Partner consents to such reallocation, in the following manner and order: ...."

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Partner Share of Nonrecourse Debt

Reg. 1.752-3

Loss allocation does not control nonrecourse debt allocation.

Lender (not partners) bears the risk of loss.

Nonrecourse Debt Definition

A partnership debt is a nonrecourse debt to the extent that no partner or related person bears the economic risk of loss for that liability.

First Tier

Partners' Share Of
Minimum (Book) Gain

Second Tier

Partners' share of forward or reverse sec. 704(c) taxable gain if property is sold for relief of NR debt on the property

(eliminates sec. 731(a) gain)

Third Tier – Profit Share

(1) May be specified if consistent with significant item that has SEE; or

(2) Per Expected Allocation of Nonrecourse deductions; or

(3) Per remaining Sec. 704(c) built-in gain.

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Example 2

Tim and Beverly Form a 50-50 Partnership

- Tim contributes a building with an FMV of $200,000--basis $40,000--subject to a nonrecourse debt of $150,000.
- Beverly contributes $50,000 cash.
- Third Tier debt split 50-50 by agreement.
- Php uses traditional method of allocation under 704(c)

Tim's 1st Tier

Partners' Share Of Minimum (Book) Gain: $0

($150,000 NR debt - $200k land book basis)

Tim's 2nd Tier

Tim's share of taxable gain if property sold for NR debt: $110,000

($150K debt - $40K A.B.)

Tim's 3rd Tier

$40,000 (excess debt) x 50% = $20,000.

Tim's NR debt share on K-1 = $130,000 ($110,000 + $20,000)

Tim's O.B:	
Property's Adjusted Basis	$40,000
IRC Sec. 752(b) Reduction of Debt	-$150,000
Tier One	?
Tier Two	?
Tier Three	?
Tim's O.B.	= ?

Tim's O.B.:	
Property's Adjusted Basis	$40,000
IRC Sec. 752(b) Reduction of Debt	-$150,000
Tier One	+ $0
Tier Two	+ $110,000
Tier Three	+ $20,000
Tim's O.B.	= $20,000

Beverly’s O.B.:	
Cash contributed	$50,000
Tier One	+ $0
Tier Two	+ $0
Tier Three	+ $20,000
Beverly’s O.B.	= $70,000

Notice 2017-38 (July 7, 2017) –

Regulations Facing Extinction Per Executive Order 13789

https://www.irs.gov/pub/irs-drop/n-17-38.pdf

IRS Must I.D. Regs. that

1) Impose an undue financial burden on U.S. taxpayers;

2) add undue complexity to the Federal tax laws; or

3) exceed the statutory authority of the Internal Revenue Service (IRS).

By Sept. 18, 2017

IRS I.D.'d Eight Regs. that met "one of the first two requirements"

REG-163113-02 (8/4/16) Prop. Regs. 25.2701-2,-8, 25.2704-1, -2, -3, -4.

(attack market. and minority discounts)

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TD 9787 (10/5/2016)

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TD 9788; 1.752-2T (10/5/2016)

Notice 2017-38 Regulations (all 8)	Topic
§103 (REG–129067–15)	Definition of political subdivision Proposed regs (REG–129067–15 (2/23/16))
§337(d) (TD 9770)	Certain property transfers to RICs and REITs Final, temp and proposed regs - TD 9770 (6/8/16) REG–126452–15 (6/8/16)
§7602 (TD 9778)	Summons interview Final regs; removal of temp regs. TD 9778 (7/13/16)
§2704 (REG-163113-02)	Estate, GST and gift valuation Proposed regulations REG-163113-02 (8/4/16)
§752 (TD 9788)	Partnership recourse liabilities Final, temp and prop regs TD 9788 (10/5/16) REG-122855-15 (10/5/16)
§385 (TD 9790)	Treatment of certain corporate interest as stock or debt Final, temp and prop regs TD 9790 (10/21/16) Reg-130314-16 (10/21/16)
§987 (TD 9794)	Currency gain/loss for qualified business unit Final regs TD 9794 (12/8/16)
§367 (TD 9803)	Certain transfers of property to foreign corporations Final regs TD 9803 (12/16/16)

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Section 704(c) Tax Allocations

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704(c) Allocation Methods

Three Methods

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- Traditional Method
- The Curative Method
- The Remedial Method

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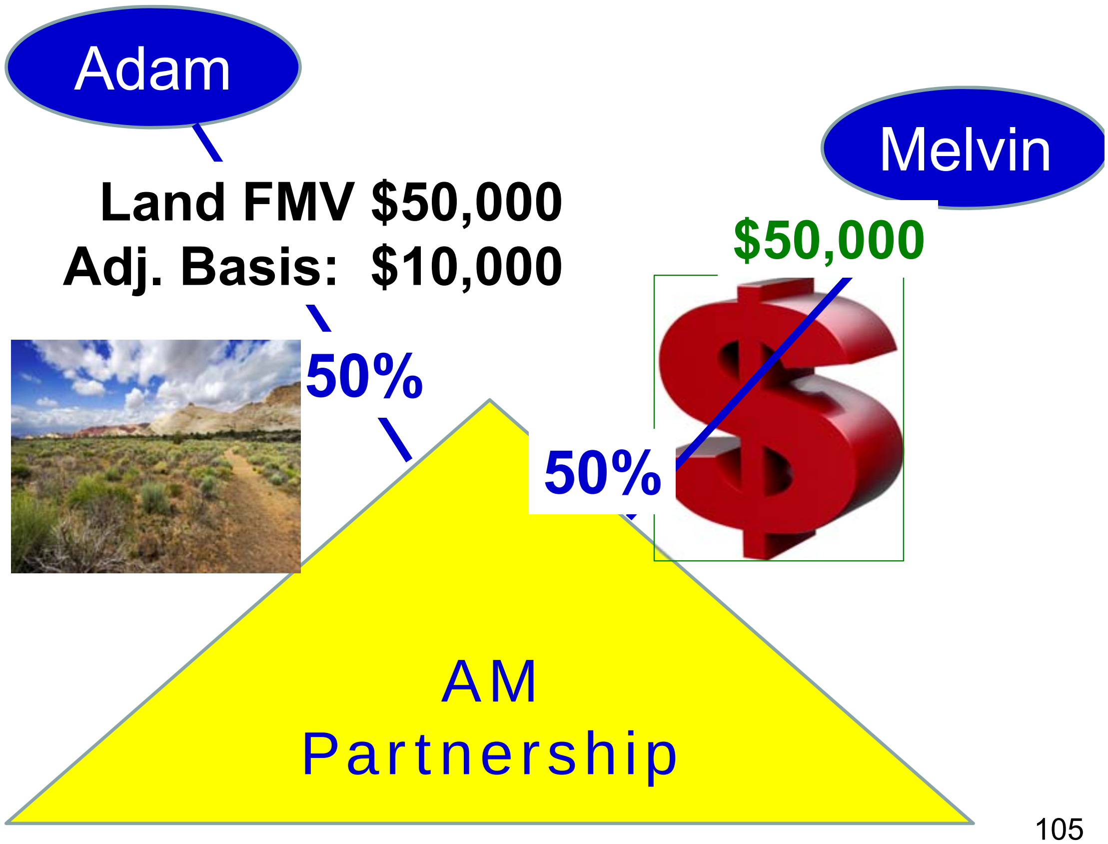
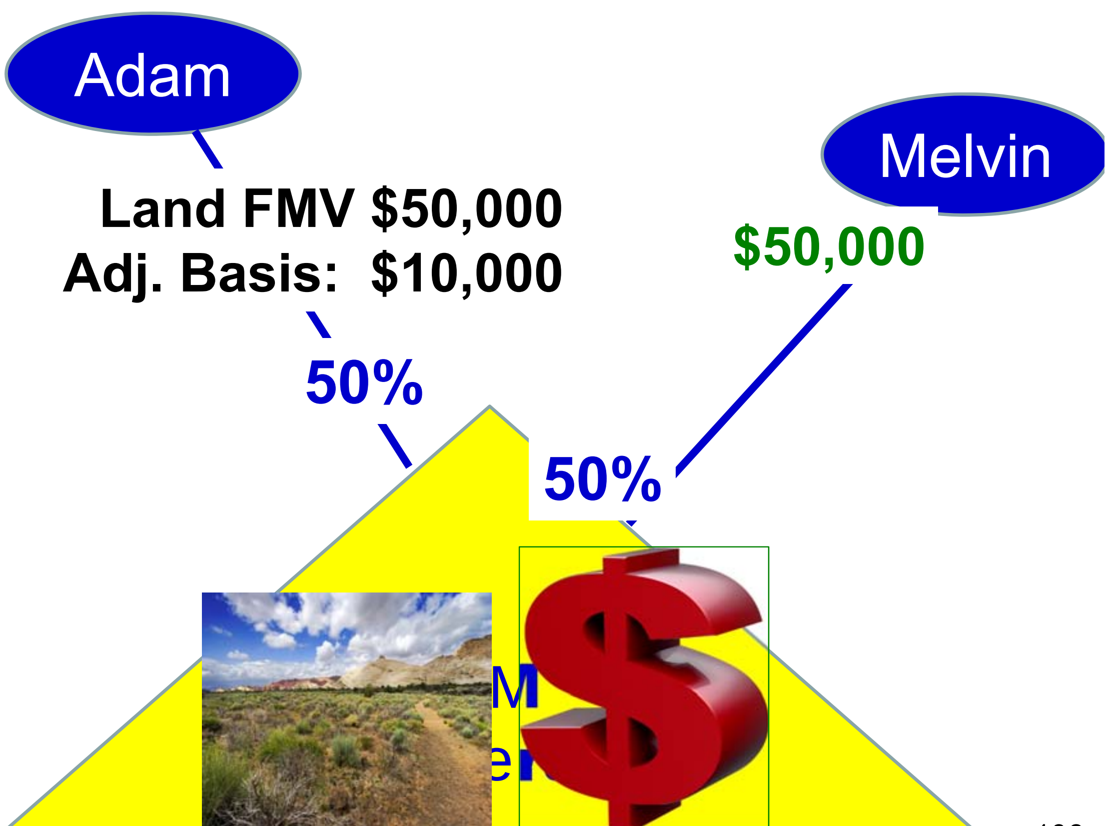
Example 2

704(c)
Traditional
Method


Adam
Melvin
Land FMV $50,000
Adj. Basis: $10,000
$50,000
50%
50%
AM
Partnership


Adam
Melvin
Land FMV $50,000
Adj. Basis: $10,000
$50,000
50%
50%

Balance Sheet After Formation

In Thousands

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash		50	50	
Land		50	50	
Total Assets		100	100	
Capital:				
Adam		50	50	
Melvin		50	50	
Total Cap.		100	100	

***"Book Value"** means, with respect to any Partnership asset, the adjusted basis of such asset for federal income tax purposes, except as follows:*

a) the initial Book Value of any Partnership asset contributed by a Partner to the Partnership shall be the gross Fair Market Value of such Partnership asset as of the date of such contribution;

Observation: Mandatory

Balance Sheet After Formation

In Thousands

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	50	50	50	
Land	10	50	50	
Total Assets	60	100	100	
Capital:				
Adam	10	50	50	10
Melvin	50	50	50	50
Total Cap.	60	100	100	

The Land is sold for $50,000

$0
Book Gain/Loss

($50,000 (sale price)-
$50,000 (book basis))

$40,000
Tax Gain

($50,000 (sale price)-
$10,000 (tax basis))

704(c) forces the entire tax gain to Adam (mandatory)

Tax Gain Allocation

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg. Bal.	10	50	50	50

No conflicts between the partners on these simple facts.

Target Method

	In Thousands	Adam	Mel	Total
1:	Beginning Capital	50	50	100
2:	Contributions/Distribs.			
3:	Adjusted Beg. Capital	50	50	100
4	Ending Total Capital			100
	Book Income <Loss>			0
5:	$100 Fict. Cash Dist.	+50	+50	

Target Method

	In Thousands	Adam	Mel	Total
1:	Beginning Capital	50	50	100
2:	Contributions/Distribs.			
3:	Adjusted Beg. Capital	50	50	100
4	Ending Total Capital			100
	Book Income <Loss>			0
5:	$100 Fict. Cash Dist.	+50	+50	
	Target Cap. (Year End)	=50	=50	
6:	Allocation (Step 5 – 3)	0	0	0

Target Method

	In Thousands	Adam	Mel	Total
1:	Beginning Capital	50	50	100
2:	Contributions/Distribs.			
3:	Adjusted Beg. Capital	50	50	100
4	Ending Total Capital			100
	Book Income <Loss>			0
5:	$100 Fict. Cash Dist.	+50	+50	
	Target Cap. (Year End)	=50	=50	
6:	Allocation (Step 5 – 3)	0	0	0
	Sec. 704(c) Tax Gain	+40	0	
	Taxable Income	=40	0	

Example 3

The Ceiling Rule With Traditional Method

The Land is sold for $30,000

<$20,000>

Book Loss

($30,000 (sale price)- $50,000 (book basis))

$20,000

Tax Gain

($30,000 (sale price)- $10,000 (tax basis))

All allocated to Adam (704(c))

Book Loss Allocation

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg. Bal.		50		50
Land Sale for 30K		-10		-10
End Bal.		40		40

Tax Gain Allocation

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg. Bal.	10	50	50	50
Land Sale for 30K	+20	-10	0	-10
End Bal.	30	40	50	40

Ceiling rule prevents Melvin from claiming a tax loss equal to his <$10,000> book & economic loss

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Example 4

Example (3) Continued to Liquidation

(shows the deferral of M's loss and A's gain)

Balance Sheet Before Liquidation

In Thousands

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	80	80	80	
Capital:				
Adam	30	40	40	30
Melvin	50	40	40	50
Total Cap.	80	80	80	

$80,000 Liquidating Distribution

	Adam	Melvin
Outside Basis	30,000	50,000
Cash Distributed	-40,000	-40,000

$10,000 Cap. Gain to Adam

	Adam	Melvin
Outside Basis	30,000	50,000
Cash Distributed	-40,000	-40,000
Cap. Gain (sec. 731)	$10,000	

<$10,000> Cap. Loss to Melvin

	Adam	Melvin
Outside Basis	30,000	50,000
Cash Distributed	-40,000	-40,000
Capital Gain	10,000	
Outside Basis		10,000
Capital Loss		<10,000>

Adam is pleased with the traditional method and likes the ceiling rule

If the land is an ordinary asset, then Adam has both deferred part of the built-in gain and partly converted it to capital gain

Exact opposite for Mel: ordinary loss is delayed and becomes a capital loss

If the land were a depreciable asset, the traditional method ceiling rule denies Mel full depreciation, but eventually allows a capital loss for the shortage.

Agreement language that mandates the traditional method (and ceiling rule):

LVP - Traditional Method Only

"Section 704(c) Method. LVP shall use, and shall cause any other entity in which LVP has a direct or indirect interest to use, the "traditional method" under Treasury Regulation Section 1.704-3(b) without curative allocations for purposes of making allocations under Section 704(c) of the Code or reverse Section 704(c) allocations with respect to the Contributed Interest and the Properties to take into account the book-tax disparities as of the effective time of the Contribution with respect to the Contributed Interest and the Properties."

Agreement language that provides maximum flexibility:

Managing Partner Decides

Internal Revenue Code Section 704(c). Tax items with respect to Company assets that are contributed to the Company [forward] with a Book Value that varies from its basis …will be allocated between the Partners for income tax purposes pursuant to Treasury Regulations promulgated under

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[IRC] *Section 704(c) so as to take into account such variation. The Company will account for such variation under any method approved under Code Section 704(c) and the applicable Treasury Regulations as chosen by the Managing Partner. If the Book Value of any Company asset is adjusted [reverse 704(c)] pursuant to the definition of "Book Value" herein, ….*

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Example 5

Traditional Method with Curative Allocation

Same as Example (3) --the Land is sold for $30,000--but the partners agree to use the traditional with curative method

Traditional Method

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg.	10	50	50	50
Land Sale	+20	-10	0	-10
Bal.	30	40	50	40

The same year the partnership incurred a <$20,000> capital loss on the sale of stock XYZ

Book Allocation of Stock Loss

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg.	10	50	50	50
Land Sale	+20	-10	0	-10
Bal.	30	40	50	40
Stock Sale		-10		-10
End.		30		30

Curative Allocation

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg.	10	50	50	50
Land Sale	+20	-10	0	-10
Bal.	30	40	50	40
Stock Sale		-10		-10
Stock Sale	0		-20	
End.	30	30	30	30

Melvin prefers the curative method

Agreement language that mandates the Traditional with Curative Method:

Items of Company taxable income, gain, loss and deduction with respect to any property contributed to the capital of the Company shall be allocated among the Members in accordance with Code Section 704(c) and the traditional method with curative allocations of Treasury Regulations Section 1.704-3(c), so as to take account of any variation....

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Example 6

Remedial Method

Same as Example (3) --the Land is sold for $30,000--but the partners agree to use the remedial method

Traditional Method

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg.	10	50	50	50
Land Sale	+20	-10	0	-10
Bal.	30	40	50	40

Remedial Allocation

In Thousands	Adam's Cap. Acct.		Melvin's Cap. Acct.	
	Tax	Book	Tax	Book
Beg.	10	50	50	50
Land Sale	+20	-10	0	-10
Bal.	30	40	50	40
Remedial* Allocation	+10		-10	
End.	40	40	40	40

*K-1 Items

Melvin likes the remedial method while Adam prefers the traditional method with the ceiling rule.

Capital Account Revaluations and “Reverse” Section 704(c) Allocations (optional)

“A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property…”
(Reg. 1.704-1(b)(2)(iv)(f))

The partnership agreement must require "that the partner' capital accounts" are adjusted "for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property" (Reg. 1.704-1(b)(2)(iv)(f)(3))

"The partnership agreement" must require "that the partners' distributive shares of … gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c)" (Reg. 1.704-1(b)(2)(iv)(f)(4))

So if the agreement mandates revaluation, then "reverse section 704(c) allocations", become mandatory

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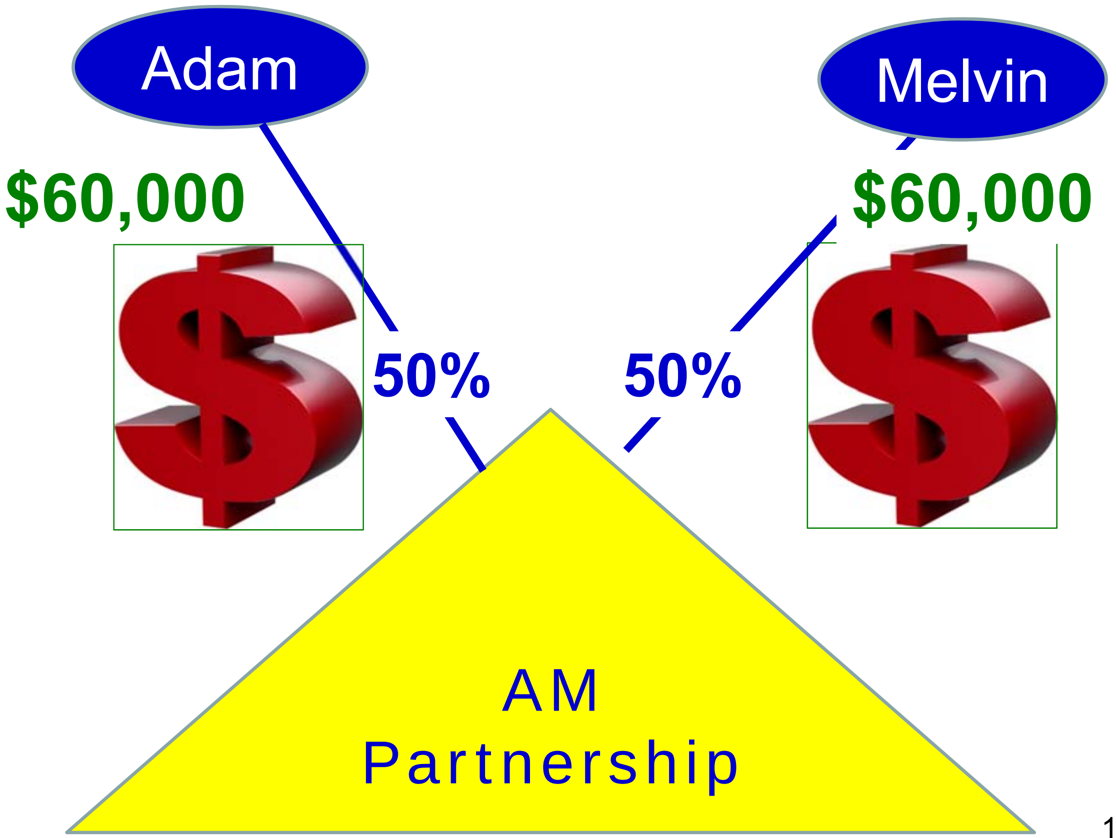
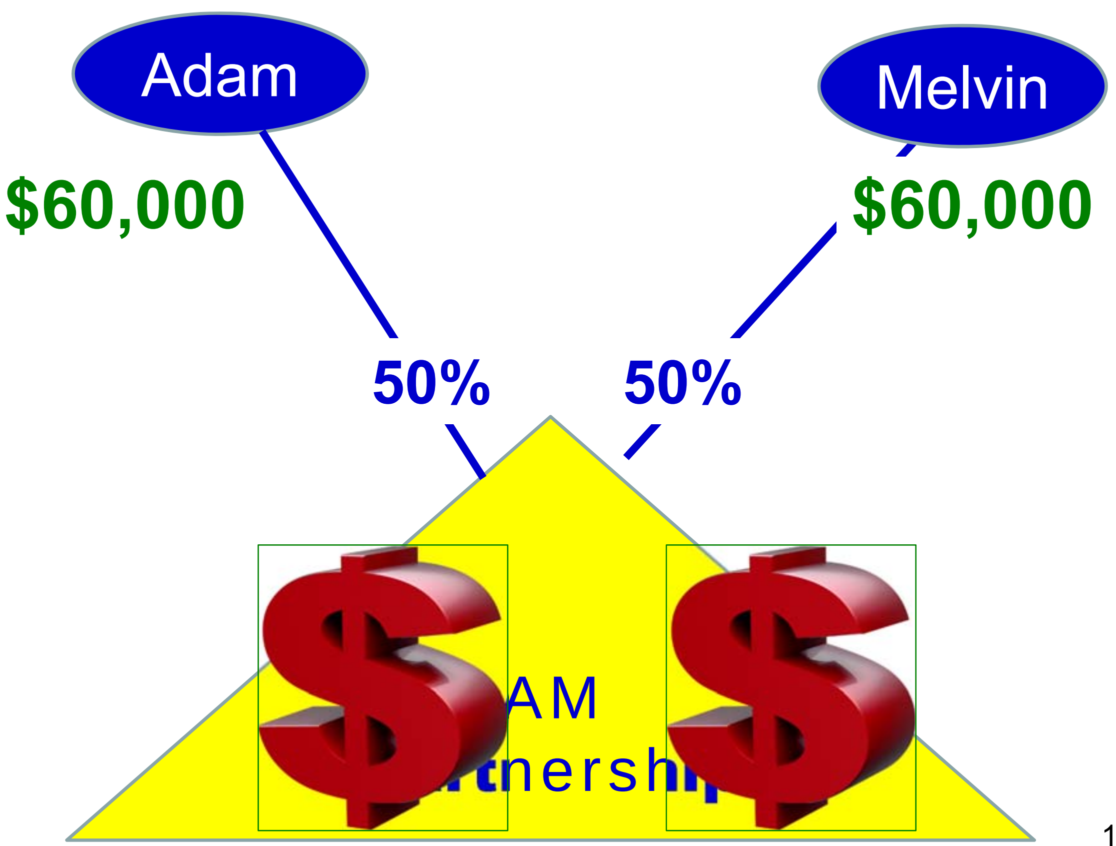
Example 7

Reverse 704(c) With Traditional Method


Adam
Melvin
$60,000
$60,000
50%
50%
AM
Partnership

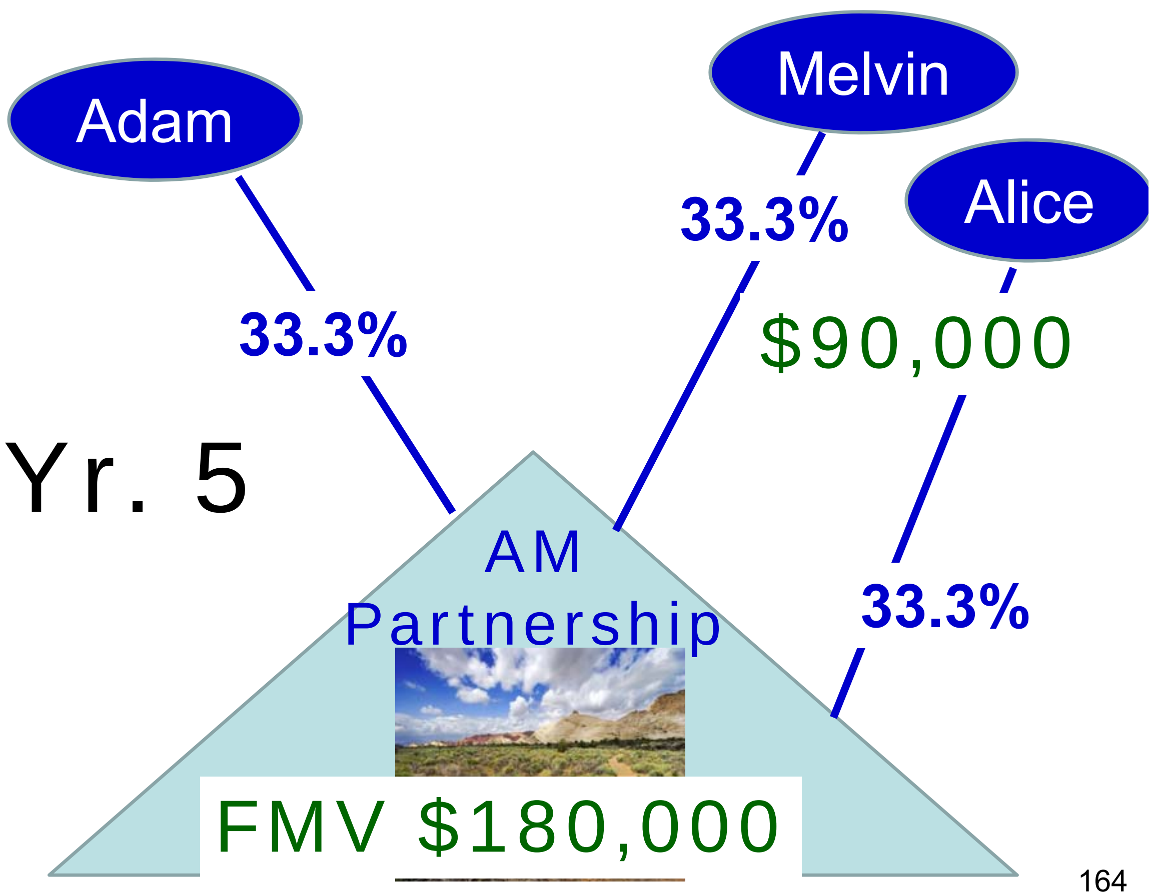

Adam
Melvin
$60,000
$60,000
50%
50%
AM

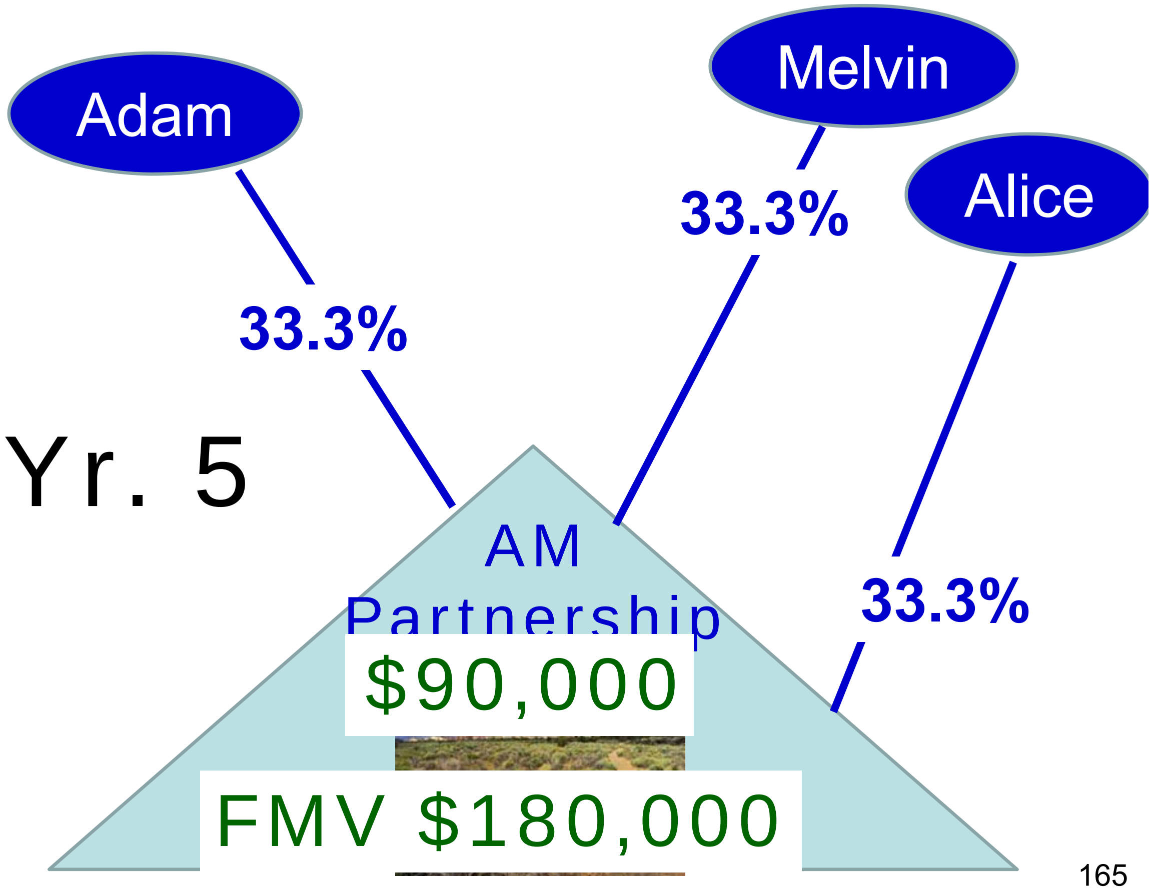
The partnership purchases land for $120,000 in Yr. 2 and it appreciates to $180,000 in Yr. 5

Year 5

Assets	Tax Basis	Book Basis	FMV	O.B.
Land	120	120	180	
Capital:				
Adam (50%)	60	60	90	60
Melvin (50%)	60	60	90	60
Total Capital	120	120	180	

Next, Alice contributes $90,000 cash for a 1/3 PSP Interest.





Capital Accounts are (optionally) Revalued

"Book Value" *means, with respect to any Partnership asset, the adjusted basis of such asset for federal income tax purposes, except as follows:*

a) *the initial Book Value of any Partnership asset contributed by a Partner to the Partnership shall be the gross Fair Market Value of such Partnership asset as of the date of such contribution;*

Observation: Required by IRC; a forward section 704(c).

b) *immediately prior to the distribution by the Partnership of any Partnership asset to a Partner, the Book Value of such asset shall be adjusted to its gross Fair Market Value as of the date of such distribution;*

Observation: Required by IRC. Book gain or loss is thus triggered, but normally not taxable gain or loss.

c) [optional per 704(c) regs.] *the Book Value of all Partnership assets shall be adjusted to equal their respective gross Fair Market Values, as reasonably determined by the Partners, as of the following times:*

i. the acquisition of an additional Partnership Interest in the Partnership by a new or existing Partner in consideration for more than a de minimis Capital Contribution;

ii. the distribution by the Partnership to a Partner of more than a de minimis amount of property (other than cash) as consideration for all or a part of such Partner's Partnership Interest in the Partnership; and

iii. the liquidation of the Partnership within the meaning of Treasury Regulations Section 1.704-1(b)(2)(ii)(g);

provided, that adjustments pursuant to clauses (i) and (ii) above need not be made if the Partners unanimously…. determine that such adjustment is not necessary or appropriate to reflect the relative economic interests of the Partners and that the absence of such adjustment does not adversely and disproportionately affect any Partner;

Thus, a reverse 704(c) with respect to Adam and Mel

After Revaluation of Cap. Accts.

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash		90	90	
Land		180	180	
Total Assets		270	270	
Capital:				
Alice (1/3)		90	90	90
Adam (1/3)		90	90	60
Mel (1/3)		90	90	60
Total Cap.		270	270	173

After Revaluation of Cap. Accts.

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	90	90	90	
Land	120	180	180	
Total Assets	210	270	270	
Capital:				
Alice (1/3)	90	90	90	90
Adam (1/3)	60	90	90	60
Mel (1/3)	60	90	90	60
Total Cap.	210	270	270	174

Next, the Land is sold for $180,000

$0

Book Gain/Loss

($180,000 (sale price) - $180,000 (book basis))

$60,000
Tax Gain
($180,000 (sale price) - $120,000 (tax basis))

Allocated 30K-30K to Adam and Mel (Reverse 704(c))

Ending Balance Sheet

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	270	270	270	
Capital:				
Alice (1/3)	90	90	90	90
Adam (1/3)	90	90	90	90
Mel (1/3)	90	90	90	90
Total Capital	270	270	270	

DeWind SWI – Traditional Method Mandated

For income tax purposes, each item of income, gain, loss, and deduction shall be allocable in the same manner such items are allocated for book purposes...; provided, however, that income, gain, loss and deductions with respect to property contributed to the Company by a Member or revalued pursuant to Treasury Regulation Section 1.704-1(b)(2)(iv)(f) shall be allocated ... using the traditional allocation method permitted by Treasury Regulation Section 1.704-3(b).

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Example 8

Same as Example (7) except no revaluation of book capital accounts but a special 704(b) allocation of built-in book and tax gain to Adam and Melvin

Tax and Book are Equal

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	90	90	90	
Land	120	120	180	
Total Assets	210	210	270	
Capital:				
Alice (1/3)	90	90	90	90
Adam (1/3)	60	60	90	60
Mel (1/3)	60	60	90	60
Total Cap	210	210	270	

Next, the Land is sold for $180,000

$60,000
Book & Tax Gain
($180,000 (sale price) - $120,000 (basis))

Tax and Book Gain is Allocated 30K-30K to Adam and Mel per Sec. 704(b)

Ending Balance Sheet

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	270	270	270	
Capital:				
Alice (1/3)	90	90	90	90
Adam (1/3)	90	90	90	90
Mel (1/3)	90	90	90	90
Total Capital	270	270	270	

Per sec. 1.704-1(b) (5), Example 14, (iv) (with similar facts), the allocation has substantial economic effect and thus satisfies both IRC sec. 704(c) principles and section 704(b).

Adam and Melvin assume the risk that gain sufficient to correct the capital account disparity may not be realized.

Example 9A

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No revaluation of capital accts, and no special allocation

All gains (and losses) are shared 1/3-1/3-1/3

A shift of $20K unrealized gain (true economic benefit) to Alice perhaps to entice Alice to contribute.

Following Alice's Contribution

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	90	90	90	
Land	120	120	180	
Total Assets	210	210	270	
Capital:				
Alice (1/3)	90	90	110	90
Adam (1/3)	60	60	80	60
Mel (1/3)	60	60	80	60
Total Cap	210	210	270	

There is no book/tax disparity thus no sec. 704(c) built-in gain -- sec. 704(c) allocation method is irrelevant

Is the shift of $20,000 of unrealized gain a taxable capital shift to Alice?

None of Adam or Mel's book capital account is being shifted to Alice so not a taxable capital shift. See CCA 201517006 (4/24/2015)

Next the Land is sold for $180,000: the tax and book gain of $60,000 is allocated 1/3-1/3-1/3: 20K-20K-20K

Ending Balance Sheet

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	270	270	270	
Capital:				
Alice (1/3)	110	110	110	110
Adam (1/3)	80	80	80	80
Mel (1/3)	80	80	80	80
Total Capital	270	270	270	

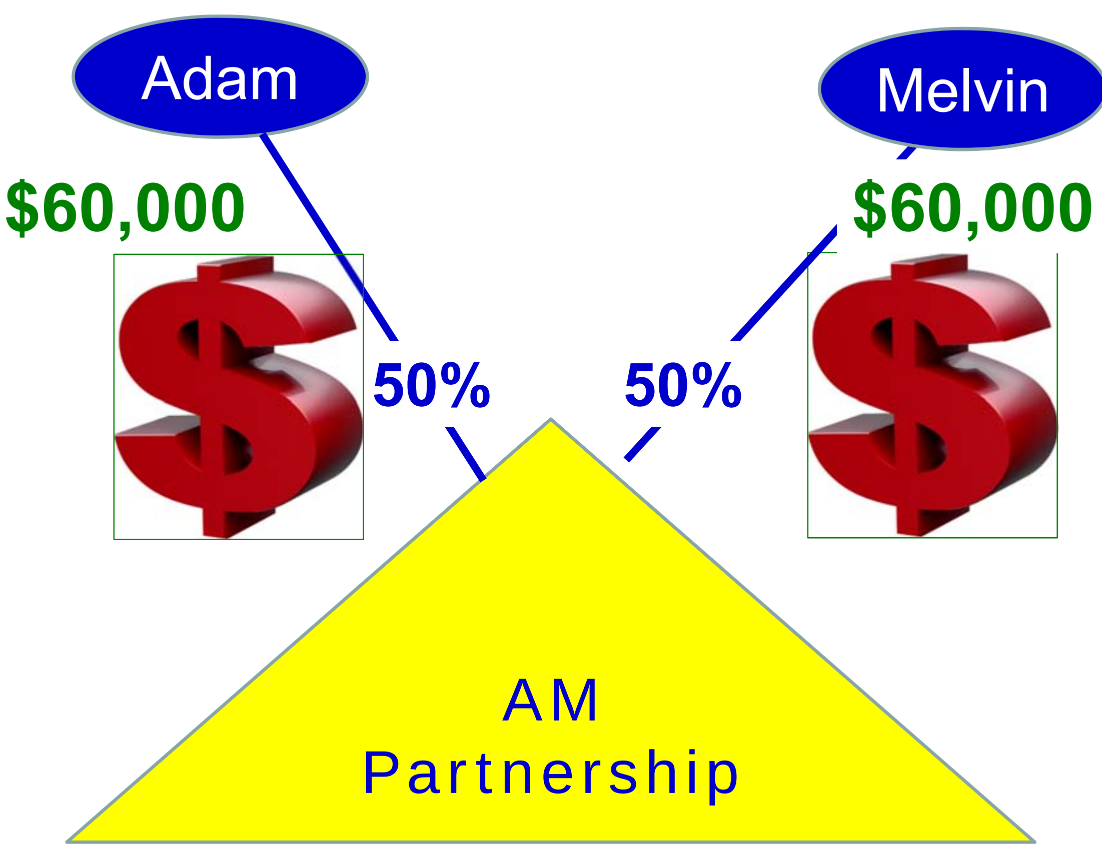
If liquidated, Alice receives $110,000 (tax free O.B. recovery)

The section 704(b) regs. indicate that this deal will be closely scrutinized

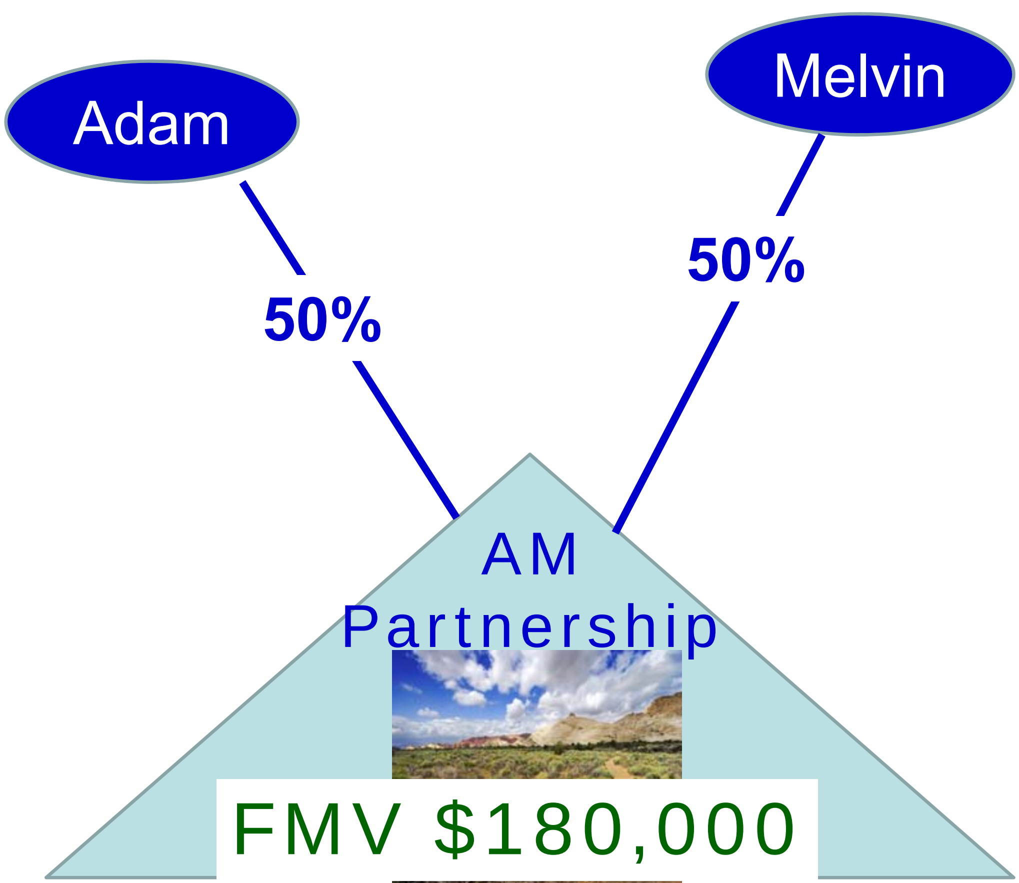
Example 9B

Same as Example 9A, except a Target Allocation (no revaluation)

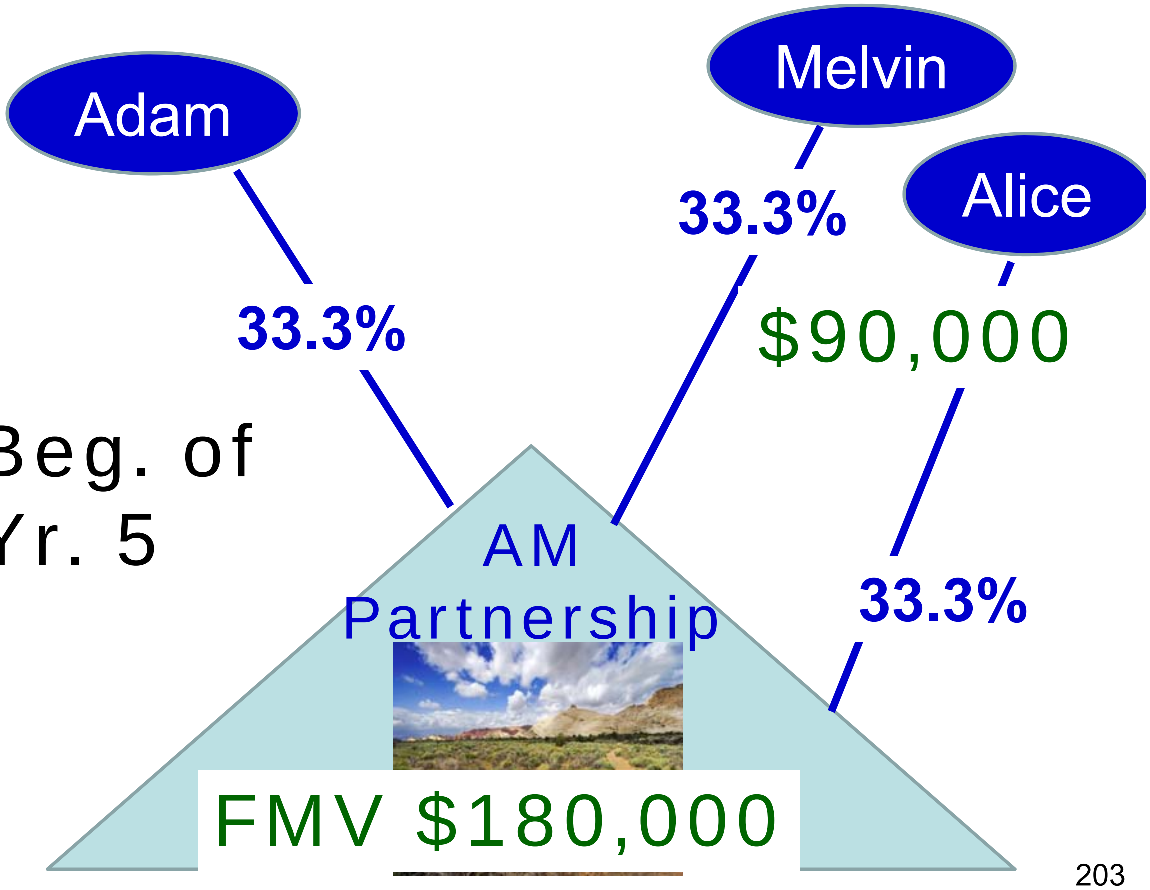
Illustrates self-corrective quality of Target Method



The partnership purchases land for $120,000 in Yr. 2 and it appreciates to $180,000 by Yr. 5



Beg. of Yr. 5



No Revaluation so Tax and Book are Equal

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	90	90	90	
Land	120	120	180	
Total Assets	210	210	270	
Capital:				
Alice (1/3)	90	90	90	90
Adam (1/3)	60	60	90	60
Mel (1/3)	60	60	90	60
Total Cap	210	210	270	

The land is sold for $180,000 so book and tax gain is $60,000 in Yr. 5 (the only income)

After the Land Sale for $180K

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	270	270	270	
Total Assets	270	270	270	
Capital:				
Alice (1/3)	?	?	?	?
Adam (1/3)	?	?	?	?
Melvin (1/3)	?	?	?	?
Total Capital	270	270	270	

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	90	60	60	210
2:	Contribs./Distribs.				
3:	Adjusted Beg. Cap.	90	60	60	210
4:	Ending Total Cap.				270
	Book Inc <Loss>				60

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	90	60	60	210
2:	Contribs./Distribs.				
3:	Adjusted Beg. Cap.	90	60	60	210
4:	Ending Total Cap.				270
	Book Inc <Loss>				60
5:	270 Fict. Dist. 1/3 each	+90	+90	+90	

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	90	60	60	210
2:	Contribs./Distribs.				
3:	Adjusted Beg. Cap.	90	60	60	210
4:	Ending Total Cap.				270
	Book Inc <Loss>				60
5:	270 Fict. Dist. 1/3 each	+90	+90	+90	
	Target Cap. (Year End)	=90	=90	=90	
6:	Allocation (5 – 3)	0	30	30	60

So the Target Method corrects the distortion caused by failure to revalue the book capital accounts.

But what if, instead of selling the land in Yr. 5, the PSP earns $120,000 operating profit (ordinary Income)

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	90	60	60	210
2:	Contribs. /Distribs.				
3:	Adjusted Beg. Cap.	90	60	60	210
4:	Ending Total Capital				330
	Book Income (4 -3)				120

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	90	60	60	210
2:	Contribs. /Distribs.				
3:	Adjusted Beg. Cap.	90	60	60	210
4:	Ending Total Capital				330
	Book Income (4 -3)				120
5:	$330 Cash, 1/3 Each	+110	+110	+110	

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	90	60	60	210
2:	Contribs. /Distribs.				
3:	Adjusted Beg. Cap.	90	60	60	210
4:	Ending Total Capital				330
	Book Income (4 -3)				120
5:	$330 Cash, 1/3 Each	+110	+110	+110	
	Target Capital	=110	=110	=110	
6:	Allocation (5 – 3)	20	50	50	120

The distortion is corrected, but with ordinary income instead of capital gain.

Revaluation and reverse 704(c) would preserve the capital gain treatment for Adam and Melvin on the extra $60,000.

Example 9C

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Same facts as Ex. 9A, but Hybrid Method and no sale of land until liquidation (which corrects the distortion).

Per the Partnership Agreement annual operating income, gain, losses, and deductions are specifically allocated (1/3, 1/3, 1/3)

Year 5 operating income is $120,000 and it is allocated $40K to each partner (1/3, 1/3, 1/3)

End of Year 5 Balance Sheet

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	210	210	210	
Land	120	120	180	
Total Assets	330	330	390	
Capital:				
Alice (1/3)	130	130	?	130
Adam (1/3)	100	100	?	100
Melvin (1/3)	100	100	?	100
Total Capital	330	330	390	

The Target Method upon liquidation of the partnership:

*4.4 **Allocations on Liquidation.** Notwithstanding any other provision of this Article __ to the contrary, upon the occurrence of the liquidation of the Partnership, all items of Partnership income, gain, loss and deduction shall be allocated among the Members so as to bring their respective Capital Account balances to the amounts and proportions necessary to make the distributions specified in Section 5 (Targeted Capital Account Balances).*

*5 **Distributions on Liquidation.** After the sale of assets, and payment of creditors, the remaining cash will be distributed 1/3, 1/3, 1/3 to each partner.*

In Year 6, the partnership sells the land for $180K and liquidates (no other income)

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	130	100	100	330
2:	Contribs./Distribs. except liquidating	0	0	0	0
3:	Adjusted Beg. Cap.	0	100	100	330
4:	Actual Pre-Liquid. Ending Capital				390
	Book Income (4 -3)				60

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	130	100	100	330
2:	Contribs./Distribs. except liquidating	0	0	0	0
3:	Adjusted Beg. Cap.	0	100	100	330
4:	Actual Pre-Liquid. Ending Capital				390
	Book Income (4 -3)				60
5:	390 Liq. Dist. 1/3 Each	+130	+130	+130	
	Target Cap. (Pre-Liquid)	=130	=130	=130	

	In Thousands	Alice	Adam	Mel	Total
1:	Beginning Capital	130	100	100	330
2:	Contribs./Distribs. except liquidating	0	0	0	0
3:	Adjusted Beg. Cap.	0	100	100	330
4:	Actual Pre-Liquid. Ending Capital				390
	Book Income (4 -3)				60
5:	390 Liq. Dist. 1/3 Each	+130	+130	+130	
	Target Cap. (Pre-Liquid)	=130	=130	=130	
6:	Allocation (5 – 3)	0	30	30	60

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Depreciable Property

"Book Depreciation" *means, with respect to any Partnership asset for each Fiscal Year, the Partnership's depreciation, amortization, or other cost recovery deductions determined for federal income tax purposes, except that if the Book Value of an asset differs from its adjusted tax basis at the beginning of such Fiscal Year, Book Depreciation shall be an amount which bears the same ratio to such beginning Book Value as the federal income tax depreciation, amortization, or other cost recovery deduction for such Fiscal Year bears to such beginning adjusted tax basis;*

provided, that if the adjusted basis for federal income tax purposes of an asset at the beginning of such Fiscal Year is zero and the Book Value of the asset is positive, Book Depreciation shall be determined with reference to such beginning Book Value using any permitted method selected by unanimous consent of the Partners in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)(g)(3).

Traditional Method

(with depreciable property)

"Noncontributing" partner is allocated tax depreciation up to the amount of the partner's book depreciation.

Book depreciation is calculated using the same method as tax (remaining recovery period).

Ceiling rule limits the noncontributing partner's tax depreciation allocation to the partnership's total tax depreciation on the contributed asset.

Traditional Method With Curative Allocation

(with depreciable property)

If a noncontributing partner is allocated less tax depreciation than book, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference

The partnership can alternatively use ordinary income to complete the curative allocation

Remedial Allocation Method

(with depreciable property)

Notional tax depreciation sufficient to correct the ceiling rule is allocated to the noncontributing partner and same amount is treated as income to the contributing partner.

Unique calculation of book depreciation:

1) Portion of book basis equal to the adjusted tax basis is recovered using the property's remaining recovery period.

2) The remaining book depreciation is calculated using the recovery period for newly purchased property.

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Example 12

Reverse 704(c) with Depreciation, Traditional Method and Revaluation.

- Abe and Bonnie form the AB equal LLC/tax partnership.
- Each partner contributes $2,250,000 and the partnership uses the $4,500,000 to purchase a residential rental real estate building on leased land.

- For simplicity, the building is depreciated over 30 years (instead of 27.5).
- Abe is the sole managing member of the LLC.

- 20 years transpire and each year the partnership earns zero net rental income (after depreciation), and generates cash flow each year equal to the depreciation deduction.

The adjusted basis of the building at the end of 20 years is $1,500,000, but the building has in fact appreciated in value to $6,000,000.

- At the beginning of Year 21, Cindy contributes $4,500,000 for a one-third interest in AB.

- The partnership revalues all of the book capital accounts (reg. 1.704-1(b)(2)(iv)(f)(5)).

The partnership uses the traditional method of section 704(c) allocation.

After Revaluation (In Thousands)

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	3,000	3,000	3,000	
Building	1,500	6,000	6,000	
Total Assets	4,500	9,000	9,000	
Capital:				
Abe (1/2)	2,250	4,500	4,500	2,250
Bonnie (1/2)	2,250	4,500	4,500	2,250
Total Capital	4,500	9,000	9,000	

Following Cindy's Contribution:

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	7,500	7,500	7,500	
Building	1,500	6,000	6,000	
Total Assets	9,000	13,500	13,500	
Capital:				
Abe (1/3)	2,250	4,500	4,500	2,250
Bonnie (1/3)	2,250	4,500	4,500	2,250
Cindy (1/3)	4,500	4,500	4,500	4,500
Total Capital	9,000	13,500	13,500	

- If the building were sold the next day, the tax gain of $4,500,000 ($6,000,000 (amount realized) minus $1,500,000 (adjusted tax basis of building) would be allocated 50-50 to Abe and Bonnie, each $2,250,000 per section 704(c) in “reverse”.

- $3,000,000 of the sale gain would be section 1250 capital gain (25% maximum rate), and the balance of $1,500,000, section 1231 gain (normally, 20% max. rate).

However, the building is not sold and it has 10 years remaining in its 30 year MACRS life.

Each partner's book depreciation, is $200,000 per year ($6,000,000 (book basis) ÷ 10 (remaining MACRS life) ÷ 3 (equal allocation))

Tax Depreciation Yrs 21 – 30

Year	Abe	Bonnie	Cindy
21	$0	$0	<$150,000>
22	$0	$0	<$150,000>
23	$0	$0	<$150,000>
24	$0	$0	<$150,000>
25	$0	$0	<$150,000>
26	$0	$0	<$150,000>
27	$0	$0	<$150,000>
28	$0	$0	<$150,000>
29	$0	$0	<$150,000>
30	$0	$0	<$150,000>
Totals	$0	$0	<$1,500,000>

Cindy is being allocated $50,000 too little tax depreciation per year for 10 years

($200,000 book minus $150,000 tax per Yr.)

End of Yr. 30

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	7,500	7,500	7,500	
Building	0	0	6,000	
Total Assets	7,500	7,500	13,500	
Capital:				
Abe (1/3)	2,250	2,500	4,500	3,000
Bonnie (1/3)	2,250	2,500	4,500	3,000
Cindy (1/3)	3,000	2,500	4,500	3,000
Total Capital	7,500	7,500	13,500	

If the building were sold for $6,000,000, the partnership would recognize a tax and book gain of $6,000,000.

Because the book and tax basis of the building are equal, no built-in gain remains to specially allocate to Abe and Bonnie under section 704(c). See reg. 1.704-3(b)(2) Example 1.

Following Sale and Before Liquidation:

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	13,500	13,500	13,500	
Capital:				
Abe (1/3)	4,250	4,500	4,500	4,250
Bonnie (1/3)	4,250	4,500	4,500	4,250
Cindy (1/3)	5,000	4,500	4,500	5,000
Total Capital	13,500	13,500	13,500	

Capital Gain or Loss per Sec. 731

	Cap. Gain <Loss>
Abe	$250,000
Bonnie	$250,000
Cindy	<$500,000*>

*Represent's Cindy's lost depreciation due to ceiling rule

The best deal for Abe and Bonnie!

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Example 13

Traditional Method with Curative Allocation

(via gross rent re-allocation)

The effect of the curative allocation is that Cindy experiences the same tax consequences that she would be entitled to if she were allowed MACRS depreciation of $50,000 (in addition to the $150,000) per year over the remaining 10 year MACRS life.

Abe and Bonnie each recognize $25,000 of additional income each year for 10 years.

End of Yr. 30

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	7,500	7,500	7,500	
Building	0	0	6,000	
Total Assets	7,500	7,500	13,500	
Capital:				
Abe (1/3)	2,500	2,500	4,500	2,500
Bonnie (1/3)	2,500	2,500	4,500	2,500
Cindy (1/3)	2,500	2,500	4,500	2,500
Total Capital	7,500	7,500	13,500	

If the building were sold for $6,000,000, each partner would be allocated $2,000,000 gain and no further gain or loss on liquidation

The best tax deal for Cindy!

Worst for Abe and Bonnie!

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Example 14

Remedial Method

Abe and Bonnie might agree to this as a compromise

Following Cindy's Contribution:

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	7,500	7,500	7,500	
Building	1,500	6,000	6,000	
Total Assets	9,000	13,500	13,500	
Capital:				
Abe (1/3)	2,250	4,500	4,500	2,250
Bonnie (1/3)	2,250	4,500	4,500	2,250
Cindy (1/3)	4,500	4,500	4,500	4,500
Total Capital	9,000	13,500	13,500	

Total tax depreciation in Years 21 through 30 is <$150,000> per year (<$300,000> remedial method book (Cindy's share is $300,000 ÷ 3 = $100,000 per year))

Tax Depreciation Allocation

Year	Abe	Bonnie	Cindy
21	<$25,000>	<$25,000>	<$100,000>
22	<$25,000>	<$25,000>	<$100,000>
23	<$25,000>	<$25,000>	<$100,000>
24	<$25,000>	<$25,000>	<$100,000>
25	<$25,000>	<$25,000>	<$100,000>
26	<$25,000>	<$25,000>	<$100,000>
27	<$25,000>	<$25,000>	<$100,000>
28	<$25,000>	<$25,000>	<$100,000>
29	<$25,000>	<$25,000>	<$100,000>
30	<$25,000>	<$25,000>	<$100,000>
Totals	<250,000>	<250,000>	<$1,000,000>

Remedial Allocations (Notional Tax Items)

Year	Abe	Bonnie	Cindy
31	25,000	25,000	<50,000>
32	25,000	25,000	<50,000>
33	25,000	25,000	<50,000>
…	…	…	…
50	25,000	25,000	<50,000>
Totals	$500,000	$500,000	<$1,000,000>

End of Yr. 50

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	7,500	7,500	7,500	
Building	0	0	6,000	
Total Assets	7,500	7,500	13,500	
Capital:				
Abe (1/3)	2,500	2,500	4,500	2,500
Bonnie (1/3)	2,500	2,500	4,500	2,500
Cindy (1/3)	2,500	2,500	4,500	2,500
Total Capital	7,500	7,500	13,500	

If the building were sold for $6,000,000, each partner would be allocated $2,000,000 gain and no further gain or loss on liquidation

Remedial method is not as good for Cindy as the Traditional with Curative (TC) Method because the remedial method extends the fix over an additional 20 years (30 (remedial) v. 10 (TC))

Remedial method a better tax deal for Abe and Bonnie (vs. traditional with curative allocation) because the additional income is deferred for 20 more years (30 (remedial) v. 10 (TC))

Example 15

Same as Ex. 12 but Without Revaluation

At the beginning of Year 21, Cindy contributes $4,500,000 for a one-third interest in AB.

Before Cindy Joins (No Revaluation) (In Thousands)

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	3,000	3,000	3,000	
Building	1,500	1,500	6,000	
Total Assets	4,500	4,500	9,000	
Capital:				
Abe (1/2)	2,250	2,250	4,500	2,250
Bonnie (1/2)	2,250	2,250	4,500	2,250
Total Capital	4,500	4,500	9,000	

The partnership does not revalue the capital accounts and does not compensate with a special sec. 704(b) allocation of built-in gain of $4.5 mil. to Abe and Bonnie

Abe and Bonnie are shifting $1,500,000 of unrealized built-in economic gain on the building to Cindy.

(likely a taxable gift if A and B are C's parents)

Following Cindy's Contribution:

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	7,500	7,500	7,500	
Building	1,500	1,500	6,000	
Total Assets	9,000	9,000	13,500	
Capital:				
Abe (1/3)	2,250	2,250	?	2,250
Bonnie (1/3)	2,250	2,250	?	2,250
Cindy (1/3)	4,500	4,500	?	4,500
Total Capital	9,000	9,000	13,500	

There is no book/tax disparity thus no sec. 704(c) built-in gain (due to the absence of a revaluation) – sec. 704(c) allocation method is irrelevant

- While $1,500,000 of unrealized economic gain is shifted to Cindy, there is no “capital shift”.
- None of Abe and Bonnie’s book capital account is being shifted to Cindy. See CCA 201517006 (4/24/2015)

If the building were sold the next day, the book and tax gain of $4,500,000 would be allocated $1,500,000 to each partner.

Following Building Sale:

Assets	Tax Basis	Book Basis	FMV	O.B.
Cash	13,500	13,500	13,500	
Capital:				
Abe (1/3)	3,750	3,750	3,750	3,750
Bonnie (1/3)	3,750	3,750	3,750	3,750
Cindy (1/3)	6,000	6,000	6,000	6,000
Total Capital	13,500	13,500	13,500	

No tax consequence on liquidation

What if depreciable section 704(c) built-in gain property (forward or reverse) is sold before the end of its recovery period?

With the traditional method, when section 704(c) depreciable property is sold before the end of its recovery period, remaining 704(c) built-in gain is the excess of its book basis over tax basis.

See Reg. 1.704-3(b)(2) Ex. 1