REPORT #776

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATION § 1.704-3
RELATING TO ALLOCATIONS UNDER SECTION 704(c)
OF THE INTERNAL REVENUE CODE

December 15, 1993

Table of Contents

TAX SECTION

New York State Bar Association

M E M O R A N D U M

December 15, 1993

TO: Leslie B. Samuels
Margaret Richardson

FROM: Peter C. Canellos

Enclosed is the report of the Partnerships Committee of the Tax Section dealing with proposed regulations under Section 704(c) of the Internal Revenue Code. The Report focuses on two key issues, the standards for determining whether an allocation method under Section 704(c) is unreasonable and the aggregation of assets for purposes of making Section 704(c) allocations. In addition, the Report comments briefly on several other significant issues.

The Report suggests certain changes in the proposed regulations to deal with these issues. In the alternative, certain of our concerns could be addressed through revenue rulings or notices in the event that the proposed regulations are finalized in their current form.

If you have any questions regarding the report or issues raised therein please call Joel Scharfstein or myself.

Enclosure

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REPORT ON PROPOSED REGULATION § 1.704-3
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OF THE INTERNAL REVENUE CODE

December 15, 1993

Report on Proposed Regulation § 1.704-3
Relating to Allocations under Section 704(c)
of the Internal Revenue Code

This Report[1] expresses the views of the Tax Section of the New York State Bar Association on certain key aspects of the proposed Section 704(c) regulations. In general, we believe that the proposed regulations represent a reasonable and constructive approach and that the Treasury Department and the Internal Revenue Service should be commended for both the substance and style of the proposed regulations.

Our comments focus primarily on two issues, the standards for determining whether an allocation method is unreasonable and the aggregation of assets. Comments are also included on the application of Section 704(c) to multiple contributions, the application of Section 704(c) principles to liabilities, and the "same type" requirement for curative allocations.

Unreasonable Allocations.

In general the proposed regulations provide that Section 704(c) allocations can be made using any reasonable method consistent with the purposes of Section 704(c). The regulations outline three methods, the traditional method, the traditional method with curative allocations and the deferred sale method, as examples of reasonable allocation methods. The regulations provide that a method that would otherwise be considered reasonable will not be so considered if "the contribution of

[1] Joel Scharfstein drafted this report. Helpful comments were received from Peter C. Canellos, Stephen L. Millman, Richard L. Reinhold and Michael L. Schler.

property and the allocation of tax items are made with a view to reducing substantially the partners' aggregate overall tax liability and without affecting the amounts to which each partner is economically entitled on the partnership's books.” If an allocation is found unreasonable the Service may make adjustments as needed to result in a reasonable method.

The proposed regulations give two examples of allocations which would be considered unreasonable under the anti-abuse rule, one involving use of the traditional method and one involving use of the traditional method with curative allocations. However, the scope of the rule is impossible to gauge from the examples. Neither the text nor the examples indicate what alternative approaches would be reasonable or what the touchstone for “abuse” is. This is especially critical because a substantial part of the tax effect illustrated by the examples results not from the choice of method (at least as between the traditional method and the traditional method with curative allocations) but from the requirements of the Section 704(b) regulations as to how depreciation is to be computed.[2]

We recommend that the anti-abuse rule be clarified to provide taxpayers with a usable indication as to what constitutes abuse and that the examples be supplemented to indicate what methods would be considered reasonable in each case. In addition, a safe harbor method should be prescribed, and a method or standards for determining correct allocations if a partnership's

[2] For book purposes, property must be depreciated by the partnership over its remaining tax depreciation period even if the property at the time of contribution if purchased would be depreciated over a much longer period. Thus in each example there is substantially more book depreciation in the year in question than if the property had been purchased at its fair market value.

chosen method is found to be unreasonable should be added. We suggest the deferred sale approach as a safe harbor.

Absence of Abuse. The anti-abuse rule of the proposed regulations appears not to apply in cases where all of the interests in a partnership are held by partners having generally the same tax situation. Presumably the anti-abuse rule would not have applied to either of the partnerships in the examples illustrating unreasonable allocations if each partner was fully taxable at the same rates on its allocable share of partnership income. It would be helpful if the final regulations confirmed this by example or otherwise. The final regulations should also indicate whether, in this context, the tax effect of an allocation on a partner should be determined on the basis of its actual effect or on the basis of the effect anticipated at the time the allocation method was chosen.

Aggregation of Assets

In general, the proposed Regulations require that Section 704(c) be applied on a property by property basis. A narrow exception is provided under which multiple properties, other than real estate, may be aggregated (i.e., treated as a single property for Section 704(c) purposes) if they are contributed by the same partner in the same taxable year and are in the same "general asset account." Although the proposed regulations do not define the term "general asset account," the reference is presumably to general asset accounts established pursuant to regulations under Section 168(i)(4). Proposed regulations under that section generally provide that assets may be included in a general asset account only if they all have the same asset class, have the same depreciation method, have the same applicable recovery period, have the same applicable convention and are placed in service (presumably by the contributing partner) in the same taxable year.

We believe that this prohibition of the proposed regulations on the aggregation of assets is overly restrictive. This prohibition is at variance with the otherwise flexible approach of the proposed regulations permitting a partnership to adopt any reasonable method or combination of methods that is consistent with the purposes of Section 704(c), subject to an anti abuse rule. While aggregation of assets may present a potential for abuse, non abusive aggregations of assets should be eligible for treatment as a component of a reasonable method.

The ability to aggregate assets can be of great importance in bringing the complexity of administering Section 704(c) to manageable levels in cases where many assets are involved. We are particularly concerned with the level of complexity under a mandated asset by asset approach where an ongoing business comprising numerous assets is contributed to a partnership. A similar, and in many instances even more burdensome, potential for complexity arises in applying the "principles of Section 704(c)" to cases where there are frequent withdrawals from or admissions to an existing partnership which has numerous assets and the partnership elects to re value its assets pursuant to Reg 1.704-l(b)(2)(iv)(f). Partnerships formed to invest in marketable securities and commodities, which the preamble to the proposal regulations solicits comments on, are only one of the contexts where this issue arises.

The ability to aggregate not only simplifies the calculation process, but in many cases involving a business with many assets it, together with an appropriate corresponding change to the Section 704(b) regulations (as discussed below) would avoid the need for an asset by asset determination of fair market value. In many cases the valuation of a contributed or existing partnership business which forms the basis of the economic deal among the parties is based on a determination of the fair market value of the business as a whole (for example using discounted cash flows) and the partners' capital accounts are established on that basis, not by separate valuation of what may be thousands of individual assets. Requiring individual asset valuations solely for purposes of applying Section 704(b) and (c) imposes an unnecessary and unwarranted burden and encourages arbitrary valuations.

The current Section 704(b) regulations generally require that the initial book value of each asset be separately determined and that book depreciation be synchronized with tax depreciation by computing it separately for each asset as the product of the tax depreciation and the ratio of book value to tax basis. In order to obtain the benefits of aggregation for Section 704(c) purposes without sacrificing the book/tax synchronization that currently exits, the Section 704(b) regulations would also have to be amended to permit a corresponding aggregation of assets for purposes of computing book depreciation and book gain and loss.[3]

Reasonable Methods of Aggregation. In addition to not specifically prohibiting asset aggregation as a reasonable method, the final regulations should provide comfort that certain asset aggregations will generally be considered reasonable, subject to the general anti abuse rule. That comfort should be

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[3] Book depreciation with respect to an aggregation of assets for a given year would be computed as the product of the aggregate tax depreciation with respect to such assets for the year times the ratio of the aggregate fair market value of such assets at the time of contribution to the aggregate adjusted tax bases of such assets at the time of contribution.

provided for broader aggregations of assets than are now permitted under the proposed regulations. For example, specific sanction might be provided for the aggregation of all of the assets of a business contributed in a single transaction which have same applicable recovery period (or alternatively which are in the same Section 1060 asset class), as well as for the corresponding aggregation of assets in the reverse Section 704 (c) case where a partner is admitted to a partnership which has an existing business.

Multiple Contributors.

The proposed regulations do not include any special rules for cases where there are multiple contributors of property. Application of Section 704(c) in that context, including the case where the contributions consist solely of undivided interests in property,[4] can be particularly complex. In such contexts, the final regulations should include rules to make the application of Section 704(c) more manageable. One approach would be to generally allow a netting of book-tax differences on contributed property to the extent that the ratio of book value

[4] This includes the case of deemed contributions of undivided interests in property resulting from a deemed termination of a partnership under Section 708(b)(1)(B).

to tax value of the contributed properties is the same,[5] subject to the general anti-abuse rule.[6]

Application of Section 704(c) to Liabilities.

The proposed regulations address the Section 704(c) consequences of differences between book value and tax basis of assets contributed to a partnership. When a business is contributed to a partnership the capital accounts established by the partners are based not only on a valuation of the assets contributed but also of the assumed liabilities, both contingent and non contingent. The settlement of such liabilities at amounts which differ from the values at which they were reflected in computing the capital accounts can result in significant book-tax disparities, and corresponding misallocations of taxable income and deduction. The proposed regulations should indicate the extent to which Section 704(c) principles should or would apply to liabilities that are reflected in capital accounts at values that differ from their tax basis (i.e., “adjusted issue price”.)

For example consider a contribution of property worth $100X to a partnership in connection with which the partnership assumes a liability with a stated value of 70X, valued by the partners at 60X (because, for example, interest on the liability

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5 Under this approach Section 704(c) tax adjustments would generally not be required if A contributed property with a market value of 100X and a tax basis of SOX and B contributed property with a market value of 300X and a tax basis of 150X for a 25% and 75% interest, respectively, in a partnership; since the ratio of book to tax ratio in each case is 50%. If the basis of B's property was only 100X, the approach could be applied by treating B as having made two contributions, one of property with a value of 200X and a basis of 100X and the second of property with a value of 100X and a basis of zero and then netting A's contribution and B's “first” contribution. Section 704(c) would then only be applied with respect to B's “second” contribution

6 The ability to net different types of assets should be coordinated with the rules on aggregation discussed above.

is substantially below the market rate). Accordingly, the contributing partner receives a 40X capital account with respect to its net contribution and profits and losses are computed by reference to the value of the liability rather than its tax basis (tax basis is 70X). If the liability is subsequently settled by the partnership for 60X, then there will be no book income but there will be 10X of cancellation of indebtedness income for tax purposes, which will have to be allocated in some manner. If the 1OX is treated under Section 704(c) as “built in gain” it would all be allocable to the contributing partner, but otherwise the manner in which it would be allocated is unclear. A similar example is the case where property worth 100X is contributed to a partnership subject to a contingent liability valued by the partners at 60X.[7]

Curative Allocations-Same Type Requirement.

The proposed regulations provide that a curative allocation is reasonable only if it is made using tax items that would have the same effect on the partners as the tax items affected by the ceiling rule. The final regulations should provide guidance on how the effect of a curative allocation on the partners would be determined. The proposed regulations are unclear as to whether the effect of curative allocations is to be determined on the basis of actual effects on the partners, anticipated effects on the partners or on the basis of the classification of specific types of income as being per se different. If the effect on the partners is determined in whole or in part by reference to actual or anticipated effects on the partners consideration should be given to accommodating small

[7] For a discussion of the application of Section 704(c) principal liabilities in the partnership context see the New York State Bar Association's report on “Certain Issues Relating to Troubled Partnerships”, dated June 28, 1993.

variations in effect or providing that the effect need only be substantially the same.