Let's Rethink Partnership Contributed Property

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In this article, Ravichandran evaluates section 704(c) to illustrate the difficulties of partnership tax, and he proposes an alternative to simplify the tax law.

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I. Introduction

To be more direct, let's repeal section 704(c) and simplify partnerships at the same time. Partnership tax reform seems inevitable, and a bold option is worth considering. The possibility that we could live without section 704(c) might surprise practitioners who work with partnerships. But in fact, taking a close look at the history of the section and how it operates makes one wonder why we ever chose to live with it.[1]

Section 704(c) does not advance any clearly desirable policy objective on its own. Rather, it reflects a hodgepodge of different competing aims, some intended to be favorable to taxpayers and others to the government, while also attempting to preserve flexibility. Further, as a practical effect of its regulations, section 704(c) arises in nearly all partnerships. Yet the rules themselves are unintuitive and difficult to apply in simple cases and do not even try to address complicated situations. In other words, it is a system of questionable administrability and effectiveness. That should warrant reexamination.

This article proceeds in three parts. First, it examines the current state of the law, identifying some (but necessarily not all) of the issues leading to so much complexity. Second, it reviews the history of section 704(c) to see what the drafters and reformers of the section had in mind. Third, it considers reform proposals, including repeal and mandatory remedial allocations.

II. Where Are We?

For those who don't regularly practice in the area, a reminder: Section 704(c) is one of the only instances not related to a deliberate subsidy in which Congress has specifically mandated that tax items be allocated without regard to economics. It has two main purposes. First, when property is contributed with built-in gain, section 704(c) attempts to allocate the built-in gain back to the contributing partner. Second, when property has a tax basis that is less than fair market value, section 704(c) tries to disproportionately allocate tax depreciation to the *noncontributing* partner, to reduce the difference between each partner's basis in its partnership interest and the partner's share of the partnership's basis in its assets.

Although seemingly addressing narrow issues, section 704(c) matters are in fact omnipresent in most partnerships. This is because many partnerships are formed with contributed property rather than cash. But the more significant reason is that the regulations provide that section 704(c) principles apply when a partnership revalues its assets for book purposes as a result of various events, including the admission of a new partner or a non-pro-rata redemption of an existing partner.[2] In that case, there is a difference between book value and tax basis that reflects similar issues as those for built-in gain property. These are common events for partnerships, so even when a partnership isn't formed by property contributions, section 704(c) will likely become relevant.

The discussions below offer a deeper dive into how section 704(c) operates. This is not intended to be comprehensive. Rather, it is to help those less familiar with section 704(c) understand why it raises so many difficult issues and to identify how section 704(c) illustrates issues common to partnership tax.

A. Section 704(c) Methods

Section 704(c) commands that, under regulations, "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." The result — taking into account the variation — is not optional, and the method for doing so is supplied by the regulations.

As is customary in examining partnership questions, a simple illustration is helpful.

Example 1. Suppose A and B form a 50/50 partnership. A contributes a machine worth $10,000 and with a full tax basis of $10,000. B contributes commercial real estate worth $10,000 but with no tax basis. Suppose also that each property depreciates on a straight-line basis over 10 years and that all other items in the partnership wash out.

After the first year, there has been $2,000 of economic depreciation: $1,000 from the machine and $1,000 from the real estate. But there has been only $1,000 of tax depreciation, all of which is from the full-basis machine. Thus, there is the variation between basis in the property and its FMV. How should that variation and corresponding tax depreciation be allocated? The regulations provide three methods.[3]

Under the traditional method, A would be allocated a disproportionate amount of the tax depreciation on the real estate contributed by B, up to the amount of A's share of the economic depreciation on that property.[4] This latter limit is referred to as the "ceiling rule."[5] On the facts of Example 1, the traditional method has no effect. The property B contributed has no tax depreciation at all, so there is nothing to disproportionately allocate. This is the case even though the property that A contributed has full basis and even though B is being allocated its 50 percent share of the tax depreciation on that property.[6]

The second method — the traditional method with curative allocations, or "curatives" — is the same as the traditional method except that other actual tax items of the partnership (besides just those from the section 704(c) property itself) can be allocated to the noncontributing partner.[7] So on the facts of Example 1, A would be reallocated the tax depreciation on the machine it contributed that otherwise would be allocated to B. As a result, A is allocated all $1,000 of tax depreciation: $500 as its pro rata share of the machine and a curative allocation of $500 for the machine that otherwise would have been allocated to B.

The final method is the remedial method, which really is a version of the deferred sales method discussed below.[8] Under the remedial method, the section 704(c) real estate contributed by B gives rise to a "remedial" asset. This asset has an FMV and tax basis equal to the difference between the actual FMV and tax basis of the property upon its contribution. On the simplified facts, the remedial asset has a value and basis equal to the entire FMV of the property because it was contributed with no basis.

The remedial asset then is depreciated, and the portion allocable to the noncontributing partner results in an actual depreciation deduction to that partner and an equal income item to the contributing partner. Thus, on the facts of Example 1, A is allocated remedial deductions from the real estate that B contributed, and B is allocated the same amount of remedial income ($500, in each case, to reflect A's 50 percent share of the remedial asset). On these simplified facts, the net result of the remedial method is identical to that of the curative method. This is because the remedial income allocated to B is offset by B's share of tax deductions from the machine contributed by A.

Under more complex facts, however, the remedial method does not always produce the same result as the curative method. There may be insufficient actual tax items elsewhere in the partnership to support a full curative allocation. But even if there are, the fictional remedial asset is subject to a fresh depreciation period.[9] As a consequence, it will generally produce less book depreciation per year and thus less tax depreciation.

Moreover, section 704(c) methods are inherently artificial. Suppose, for example, the real estate is sold for $10,000 at the very beginning of year 2. One might think that all $10,000 of gain should be allocated to B because the property has not actually suffered any net depreciation since its contribution, but that is not the rule. For purposes of applying section 704(c), the book value is $9,000, and the amount of gain to be allocated under section 704(c) (the difference between book and tax basis) is only $9,000. The additional $1,000 of gain is not subject to section 704(c).

Although this discussion is not offered to demonstrate complexity, even these basic rules are hardly straightforward. It is easy to imagine how quickly things can become difficult as even small differences creep in — multiple properties, multiple partners, different depreciation schedules. In fact, the regulations encourage complexity because they mandate that allocations be made separately for each section 704(c) property.[10] This is why the real-world application of section 704(c) is far more complicated than the already complicated hypothetical examples tax advisers invent merely to illustrate the rule.

B. Multiple Layers

One of the most common sources of complexity is the occurrence of multiple section 704(c) layers. This, too, is best illustrated by a simplified example.

Example 2. Suppose A and B form a 50/50 partnership (AB). A contributes property with a value of $1,000 and a basis of $400. The property depreciates on a straight-line basis over 10 years. B contributes $1,000 cash. Assume AB elects the traditional method. In the first year, A's property depreciates by $100, but there is only $40 of tax depreciation. Under the traditional method, all of the $40 of depreciation is allocated to B.

At the beginning of the next year, C contributes $2,500 cash for a 50 percent interest in what is now ABC. C's contribution reflects a sudden and unexpected economic appreciation in A's property, which is now worth $1,500. The traditional method is used for this layer also.

A's property is now subject to two section 704(c) layers. The first is a forward section 704(c) layer (forward because it arises as the result of a contribution of appreciated property) reflecting the original value-basis difference of $600, which has now been reduced to $540. The second is a reverse section 704(c) layer (reverse because it arises as a result of property appreciation within the partnership) reflecting the current value-basis difference of $1,140. It is clear under the regulations that both these layers exist, but there is still only $360 of tax basis and $40 of annual tax depreciation.

How is this depreciation allocated? One approach is to allocate first to the "newest" layer, in which case all $40 would be allocated to C. A second approach would be to allocate to the "oldest" layer, in which case B would be allocated $40 of depreciation. A third might be a proportionate approach of some kind. Choices for the proportion could include the relative amount of built-in gain in each layer or relative shares of economic depreciation. Ultimately, neither the regulations nor any other guidance provides specific direction on this. Presumably, the IRS would respect any reasonable method.

In fact, the regulations add complexity by providing that taxpayers may select different methods for each section 704(c) layer.[11] Thus, one could elect the remedial method for the new layer even if the traditional method was used for the old layer.

A discussion of the full magnitude of problems can be found in other complete articles devoted to this topic.[12] As a sampling, however, consider the following questions:

- Suppose the traditional method was used for the original layer, but the curative method is used for the new layer. Is the allocation to B in the original layer a tax item that can be specifically allocated to C for its layer?
- How is the remedial method applied to the second layer if the traditional method is applied to the first? The remedial method assumes that existing basis is allocated pro rata among the partners; however, if the traditional method is applied to the first layer, this existing basis could be allocated entirely to B.
- Can a remedial item for one layer be used as a curative item for another layer?
- Does the rule that a different method may be used for each layer also mean that a different method to allocate between layers may be used for each new layer?

The correct conceptual answer is probably to determine the hypothetical section 704(c) allocation for each layer as if it were the only section 704(c) layer giving rise to an allocation and to then select a reasonable method to allocate the tax items that do exist among those layers. But in any event, no method appears compelled by the regulations.

C. Tiered Partnerships

The application of section 704(c) to partnership tiers is another source of substantial complexity and uncertainty.[13] This section of the article describes a few of the more significant issues. Example 3 illustrates one of them.

Example 3. Assume the same facts as in Example 2, but instead of C contributing property to partnership AB, suppose AB and C form a new partnership (X) to which AB contributes its property (including the depreciable property with a value-basis difference) and C contributes its property.

Because AB contributed property that was subject to section 704(c) to X, AB's interest in X is itself section 704(c) property.[14] Moreover, the depreciable property is *also* section 704(c) property in the hands of X. The net effect is that, at the level of X, tax depreciation will be allocated to C — the noncontributing partner — up to the amount of C's economic depreciation. On the facts of Example 3, all of X's tax depreciation will be allocated to C. However, if X allocated any remaining depreciation to AB, that depreciation would presumably be allocated to B to reflect that AB's interest in X is subject to section 704(c) and that A contributed section 704(c) property to AB.

Notably, this is a potentially different result from what would happen if C had directly become a partner in AB. In that case, depending on the method applied, B and C could have shared in the special allocation of tax depreciation. That there is such a different result based on a relatively minor difference is generally undesirable because it works as both a trap for the unwary and a planning opportunity for the well advised.

A further variation on this example considers whether AB can cure the lack of tax depreciation flowing from X. For example, could AB make curative or remedial allocations to B to the extent that actual depreciation deductions from X were less than B's share of economic depreciation? There is no clear answer.[15] From a section 704(c) policy perspective, it certainly advances the purpose of the section to permit allocations that reduce value-basis disparities, but the relevant regulatory language is fundamentally ambiguous.[16]

It comes as no surprise that this uncertainty might also be used for planning purposes. For example, if AB elected the remedial method but changed its mind, it could ensure that X elects the traditional method. AB then could take the position that its remedial allocation does not apply to interests in X, effectively undoing its remedial allocation. This is another instance in which tiered partnerships can be used to achieve results that are unavailable to a single partnership with multiple section 704(c) layers.[17]

Another set of significant issues arises with reverse section 704(c) layers. Under current regulations, a lower-tier partnership is not necessarily required to revalue its assets, even when an interest in that partnership *is* required to be revalued.[18] This occurs in two common cases: (1) if a new partner joins an upper-tier partnership that owns an appreciated interest in a lower-tier partnership, and (2) when a person transfers an interest in a partnership to another partnership.[19] In both cases, the interest in the lower-tier partnership is revalued to FMV, but the lower-tier partnership is not required to revalue its own assets.

The practical upshot is that there will be no section 704(c) tax items flowing up from the lower-tier partnership to permit the upper-tier partnership to make the appropriate section 704(c) allocations. Indeed, if desired, taxpayers can rely on this principle to almost turn off section 704(c), as discussed later, in Section III.D.3.

In fact, even when a simultaneous book-up may occur (for example, if the upper-tier partnership contributes the new partner's cash to the lower-tier partnership in exchange for an additional interest), it is not always clear that any section 704(c) items from the lower-tier partnership can be allocated at the level of the upper-tier partnership. The relevant regulations apply by their terms only to property that was subject to section 704(c) at the time of its contribution.[20] Accordingly, it is unclear whether and how the rule would apply to reverse 704(c) layers.

D. Specific Examples

This section of the article now turns from conceptual examples of complexity and uncertainty to specific ones.

1. Antiabuse, reconciling subsections 704(c) and (b).

The simplest example of section 704(c) is when tax gain on property sold by a partnership is specially allocated back to the contributor to the extent the gain accrued before the property's transfer to the partnership. However, these same facts can also demonstrate a flaw with the section 704(c) rules.

Example 4. Suppose A and B form partnership AB with A contributing cash and B contributing property with an FMV of $10,000 but only $1,000 of tax basis. Suppose also that the property has only one year of remaining life for tax depreciation purposes, even though its actual economic life is substantially longer, and in fact, that the property is expected to maintain its economic value for the foreseeable future.

Now assume AB adopts the traditional method for the contributed property. In year 1, the full amount of the book value is depreciated. This reflects the one-year remaining usable life for tax purposes. As a result of the full depreciation, the asset is no longer a section 704(c) asset (because its book value does not differ from its tax basis). In year 2, the property is sold for $10,000 (reflecting the lack of economic depreciation). Because the asset is no longer a section 704(c) asset, AB allocates the resulting $10,000 of tax gain 50/50 to A and B.

In certain circumstances — such as if A had expiring net operating losses — this transaction might be viewed as abusive.[21] Thus, the regulations provide that in this case, use of the traditional method is unreasonable and therefore violates the antiabuse rule specific to section 704(c).[22] AB must use another method under which, presumably, B would have been allocated all the gain, so A would not have used any of its NOLs.

This problem is wholly artificial, as is the need for an antiabuse rule. The problem arises not because of section 704(c) at all but rather because the 704(b) accounting rules require a carryover of a noneconomic depreciation period and further assume that capital accounts best reflect the current financial condition of the partnership, and the section 704(c) rules follow that fiction. The fact that the depreciation period is noneconomic is often outside subchapter K entirely. Further, it is unclear if the purported abuse is even an abuse. There is no general rule prohibiting the use of preexisting losses to offset gains or income from a partnership.[23] Indeed, any noneconomic depreciation on a section 704(c) asset can shift gain from the contributing partner to the noncontributing partner as the section 704(c) layer burns off.

In fact, this uncertainty renders the scope of the antiabuse rule unclear.[24] For example, are these facts abusive if A has no NOLs at all so that the effect of the noneconomic depreciation is merely to cause gain to be shared 50/50? On the other hand, does the application of the antiabuse rule *require* that all gain be allocated to B? What if instead the partnership applies a section 704(c) method of its own invention that reflects a more economic depreciation schedule, in effect permitting gain to be shared as true depreciation occurs? The regulations appear to permit this, so long as no notional items are invented.[25]

Fundamentally, how does one evaluate whether a rule that exists solely to permit noneconomic tax allocations is abusive? The typical abuse evaluation compares business or real-world outcomes with tax outcomes in search of a disparity. But section 704(c) is *only* about the tax world; by definition, there is no nontax consequence to section 704(c) allocations.

These issues are not merely of academic interest. In one recent instance, a major corporation engaged in a transaction with a foreign affiliate, the effect of which was to shift built-in gain to the foreign affiliate. This result occurred because the corporation deliberately planned into the traditional method and relied on the distortions caused by the ceiling rule.[26] The IRS, in a field service announcement, appeared to take the position that the corporation's method ran afoul of the antiabuse rule. To my knowledge, no court has decided on the merits of these arguments.

2. Securities partnerships, stuffing.

The examples above hint at the complexity that might be involved if there are numerous properties subject to section 704(c). This is the exact issue hedge funds and other securities partnerships face. These partnerships are permitted to mark their assets to FMV on a constant basis without regard to the typical events that must occur before a revaluation is permitted.[27] As a consequence, they have numerous section 704(c) layers with FMVs that differ from tax basis.

The section 704(c) regulations provide special relief for securities partnerships. These partnerships are permitted to aggregate section 704(c) assets and layers under one of two netting approaches.[28] The basic effect of these rules is to permit securities partnerships to share built-in gain among partners on an aggregate basis as and when the underlying assets are sold.

However, even the application of this relief is not clear. Thus, there is a common market practice known as the stuffing allocation. Under this allocation, a withdrawing partner is "stuffed" with all the tax gain on assets sold by the partnership up to the difference between the partner's withdrawal proceeds and outside basis. The withdrawing partner is indifferent to this allocation because any tax gain allocated to it reduces tax gain on withdrawal. The other partners, meanwhile, benefit by deferring the tax gain with which the withdrawing partner is stuffed.

The validity of the stuffing allocation is not clear and has engendered significant debate.[29] If the stuffing allocation is valid, it has the effect of deferring government revenue. If the stuffing allocation is invalid, the fact that it is not clearly invalid means taxpayers will continue to use it until its invalidity is made plain. In either case, the stuffing allocation demonstrates one of the key themes of this article: The complexity of section 704(c) requires uncertainty, and uncertainty can benefit taxpayers, too.

3. Publicly traded partnerships and fungibility.

Publicly traded partnerships are particularly sensitive to potential section 704(c) issues. PTPs generally have section 704(c) layers, either because historic pre-initial public offering partners contributed built-in gain property or because of revaluation events (including in connection with the IPO itself). The principle of section 704(c) is to allocate tax items to specific partners and not others and, moreover, to require current partners to step into the shoes of partners they purchased from. However, public interests in an entity must be fungible — that is, equivalent for all economic purposes — with one another to be freely tradeable.[30] The tax treatment of an interest cannot be particularized and depend on the historic ownership of the interest. Thus, section 704(c) is incompatible with the notion of a PTP.

PTPs manage this issue in two primary ways. The first is by making a section 754 election for the partnership in conjunction with a remedial method allocation for all section 704(c) property.[31] The basic effect is that the section 743(b) amortization offsets, dollar for dollar, all remedial income allocated to the partner for any section 704(c) layer. In this way, each interest in the partnership is fungible because no net amount of income or loss is allocated as a result of section 704(c).[32] I understand that master limited partnerships generally rely on this method to achieve fungibility.

This method may not be desirable in all cases, however. The section 754 election can be cumbersome to administer, and the remedial method may require some historic continuing partners to recognize gain on a current basis. The alternative method is to use tiered entities. In the simplest form, a PTP may hold nothing but stock in corporations. Although there may be a section 704(c) layer for this stock, the PTP will never sell it, and the corporations' income does not flow up to the PTP partners. So section 704(c) will never be relevant.

A more complicated version of this approach is when the lower-tier entity itself is a partnership. In that case, it is necessary to ensure that the PTP did not itself contribute section 704(c) property to the lower-tier partnership. As discussed earlier, although the regulations require contributed property to be tracked through tiers of partnerships, there is no similar requirement that a section 704(c) revaluation event at the upper-tier partnership level be tracked through partnership tiers. Thus, if the PTP never contributed appreciated property to the lower-tier partnership, any section 704(c) layer at the PTP level will also not be relevant. I understand that most fund manager IPOs relied on this method to achieve fungibility.

Interestingly, in this latter case, purchasers of PTP units will bear taxes owed on historic appreciation. This is because any gain recognized by the lower-tier partnership will be shared proportionately at the level of the PTP. The upshot is that purchasers may have a worse outcome because they pay upfront tax on historic appreciation and may not be able to offset any increased basis against this tax. Meanwhile, historic partners are able to continue to defer tax on any appreciation exceeding their proportionate share. Practically, this would be an unusual scenario since it would primarily arise if the PTP sold its historic assets and then did not liquidate. In any event, as far as I am aware, however, this feature did not engender meaningful objection, suggesting that strict adherence to section 704(c) concepts in all cases is not a commercial imperative.

E. Some Concluding Remarks

Section 704(c) is a complexity force multiplier. Whatever complexity the underlying business transaction has will inevitably be made worse by the overlay of section 704(c).

Perhaps the best example of this complexity is that the IRS asked for community assistance addressing 19 questions regarding section 704(c) issues involving multiple layers, partnership mergers, divisions, and tiers.[33] Although some questions were highly technical, others were fundamental. The IRS issued this ask in 2009, 25 years after the enactment of modern section 704(c). Now an additional 16 years later, no substantial guidance project has ever been issued on these topics.[34] In other words, nearly 45 years after the 1984 code and 75 since the 1954 code, baseline questions for section 704(c) remain unanswered.

Moreover, section 704(c) issues do not merely exist on tax returns; they must be explained to the actual participants in the transaction, who rarely have any background in tax, much less one in complex partnership tax issues. These conversations rarely go well. There is nothing intuitive about section 704(c) and thus no basis to work to the right answer.

Code provisions also have to be administered. I don't know exactly how the IRS tries to administer section 704(c), but its reported struggles administering partnerships generally suggest that it is not easily able to do so.[35] And the fact that section 704(c) issues are pervasive likely interferes with the IRS's ability to administer other aspects of the partnership rules.

Of course, in the U.S. tax system, taxpayers are also responsible for administering section 704(c). But the story is not much better here. Only sophisticated taxpayers (and their advisers) have the time and resources necessary to disentangle a section 704(c) issue. And even then, the only reasons to do so are for either commercial negotiations or tax planning. Other taxpayers just give it their best shot.

Indeed, most negotiated section 704(c) issues are solved through complex modeling. Parties then bargain over the dollars and cents. As discussed below, there is something rather ironic about this practice when it is considered in light of the history of section 704(c). Theorizers worked diligently to come up with the right answer or reduce potential tax basis disparities. Yet, in the real world, no one knows or cares a great deal what the right answer or tax basis is; they just look to the numbers.

In nonnegotiated contexts and even in negotiated ones, parties frequently elect to use the traditional method. This is because assets often have a tax basis of zero, so the ceiling rule ensures that no section 704(c) allocations need to be made unless an asset is sold. Even then, if the asset is depreciable and held for a meaningful period of time, the section 704(c) layer eventually will disappear and any gain that does arise will be shared pro rata (which is what most partners expect anyway). Meanwhile, discerning the outcome from an alternative method is viewed as too cumbersome and, to the extent reliant on projections, possibly too unreliable.

This is hardly an encouraging state of affairs. Most often, parties simply try to avoid section 704(c). But sometimes they can't, and it interferes with a business transaction, necessitating a convoluted solution to circumvent it. And in still other arbitrary cases, section 704(c) affirmatively creates tax planning opportunities. All the while, the IRS probably cannot administer it, and most taxpayers don't bother to. Thus, section 704(c) is alternatively ignored, exploited, misunderstood, and avoided.

III. How Did We Get Here?

Given all these issues, why do we even have section 704(c)? As it turns out, not for any particularly good reason. Section 704(c) was first enacted as part of the 1954 code and related tax reforms and was further amended in 1984. In each case, substantial American Law Institute (ALI) projects preceded the relevant statutory provisions and clearly influenced them. This section of the article recounts that history.

A. The 1954 ALI Proposal

Before the 1954 code, much of partnership law was deeply unsettled and little of it was codified.[36] In 1954, ALI undertook a substantial project to codify and work to settle partnership law.[37] The project required resolving problems across virtually all the partnership tax space. Of all of these issues, however, even ALI observed, “Probably no other problem has seemed as difficult of resolution as that of the proper treatment of depreciation and gains and losses in respect of contributed property.”[38]

The ALI project examined three solutions to the problem.[39] The first was a deferred sales method.[40] The basic idea would be to treat the contribution as producing a sale as of the date of contribution but deferring the tax until a realization event occurred. ALI rejected the idea in 1954 because of concerns about valuation, its extreme complexity when applied to depreciation and depletion, and perceived fairness issues.[41] The deferred sales method was revisited later, and this article discusses the method in greater detail in connection with that discussion further below.

The second and third solutions, which I refer to as the substituted basis approach and the transferred basis approach, respectively, each provided that the partnership would allocate tax items based on its carryover basis in the property it received without any special allocation to address issues caused by basis-value disparities.[42] The difference between the two was that, in the substituted basis approach, each partner’s basis in its partnership interest would reflect the basis of the property contributed by that partner to the partnership.[43] That is the same as current law. In contrast, in the transferred basis approach, each partner’s basis in its partnership interest would equal its share of the aggregate basis of all property contributed to the partnership.[44]

In both cases, however, the partnership would take the contributed property with a substituted basis, and all further allocations of gain, loss, or depreciation would be shared as the relevant economic gain, loss, or depreciation was shared. As ALI acknowledged, this approach had the advantage of simplicity and avoided “the complexities and uncertainties involved in attempting to allocate, as between the partners, depreciation, depletion, gain or loss” under the deferred sales method.[45]

The 1954 ALI project recommended the transferred basis approach, with a partnership election to follow the deferred sales method.[46] There were two main reasons for the transferred basis approach. The first was that the approach ensured a partner did not need to separately track its basis in its partnership interest because there was exact parity between the partner’s inside and outside bases in the partnership. The second was that, as compared with the substituted basis approach, the shift of built-in gain under the transferred basis approach occurred as of the formation of the partnership. Thus, it would be easier for parties to reflect that shift in determining the economics of the partnership.

ALI's recommendation reflected several key assumptions. First was that the majority of partnerships would be small businesses, for whom administrative simplicity was itself a substantial benefit.[47] The transferred basis approach is the absolute simplest in this regard, because it not only eliminates special allocations at the partnership level but also ensures that there is no need to separately track outside and inside basis. Second was that substantial basis-value disparities would be relatively rare.[48] Third, ALI believed there generally should not be a large fiscal consequence of allocation method, so partners should be left with the flexibility to approach the issue however they wanted.

In other words, partners could negotiate the economic deal to reflect the tax detriment to the noncontributing partner upon formation or elect into a deferred sales method to manage the tax issue over time.[49] Indeed, the project's view was, "Since this aspect of the tax treatment of contributed property relates essentially to the relationship between the partners, rather than to an issue between the Treasury and the partners, the paramount consideration should be a set of rules permitting sufficient flexibility in consummating partnership agreements."[50]

To put it more simply, the very first group to seriously examine the problem actually *rejected* section 704(c) entirely. Its preferred approach would have permitted only two options: an immediate basis correction upon partnership formation or a deferred sale. In no case would special allocations of tax items be permitted *at the partnership level*. And the same group acknowledged that, to the extent this produced unexpected or undesirable tax results, the parties could handle that through bargaining.

B. The 1954 Code

The 1954 code effectively adopted ALI's recommendation but with the substituted basis approach instead of the transferred basis approach.[51] Thus, the default rule was that partnerships would allocate tax gain or loss on contributed property in the same manner as the overall allocation of economic gain or loss. The 1954 code also adopted ALI's electivity, permitting the partnership to elect to specially allocate gain or loss to account for the variation between the FMV and tax basis of contributed property.[52] The 1954 code did not, however, adopt the deferred sales method.

Interestingly, when the legislation was introduced by the House, electivity was *not* permitted. Instead, the House rule *required* that tax items for contributed property be allocated in the same manner as all other items.[53] The House Ways and Means Committee report explained that the proposal was "adopted in the interest of simplification of the partnership provisions."[54] The report acknowledged that some partners might be in a worse or better tax position as a result of the rule but that this would be unwound upon exit.

It was the Senate that added the rule permitting the partnership to account for variations between FMV and basis.[55] No particular reason was offered for this change, although one might assume it was motivated by the desire to promote flexibility. At the same time, the Senate included a limitation on the use of any method by setting forth in the legislative history that "in any case, however, the total gain, loss or depreciation allocated to the partners may not differ from the amount of gain or loss realized by the partnership, or the depreciation or depletion allowable to it."[56] Thus, the Senate effectively mandated the modern traditional method and viewed the ceiling rule as a protection against abusing the flexibility granted to partnerships. Further, this language effectively rejected the deferred sales method, since that method necessarily would involve the creation of tax items not actually recognized in the transaction.

Neither the Senate nor House proposals, nor any legislative history, contemplated any cost to the government. Instead, the proposals and the legislative history were concerned with the consequences to the partners. Thus it appears reasonable to assume that Congress, like ALI, viewed the section 704(c) issue primarily as one between the partners and not the government.

In this regard, it is understandable why Congress might have tolerated special tax allocations. The difference between inside and outside basis could have been viewed as an inadvertent artifice of tax accounting that partners could fix if they wanted to. If Congress did not believe there was any cost to the government, naturally there would be no objection to fixing this quirk.

C. The 1984 ALI Proposals

Thirty years of experience warranted a reappraisal of section 704(c), which ALI undertook as part of its 1984 federal income tax project. ALI formally adopted and presented its subchapter K proposals in 1982.[57] In these proposals, ALI once again considered the deferred sales method.

Under the deferred sales method, a partner that contributed appreciated property to the partnership would be treated as selling that property to the partnership.[58] The partnership would take the property with a basis equal to its FMV, and it would use that basis for all subsequent purposes, such as sales and depreciation. However, the contributing partner would not realize gain on the sale until a triggering event occurred.[59] This preserved deferral upon the contribution.

Notably, the incurrence of depreciation was a triggering event.[60] Thus, for depreciable property, the contributing partner would recognize gain as the property depreciated. Meanwhile, the partnership would depreciate the property from a full FMV basis. The practical effect of this proposal was a combination of the traditional method and the remedial method.[61]

If, before the deemed sale, the contributed property had sufficient tax depreciation so that the noncontributing partner could be disproportionately allocated an amount of tax depreciation equal to its economic depreciation, the effect of the deemed sales method would be for that allocation to occur. The contributing partner would recognize correspondingly reduced tax depreciation. This is functionally identical to the traditional method, in which the ceiling rule does not apply.

On the other hand, if the contributed property had insufficient tax depreciation before the deemed sale, the noncontributing partner still would be allocated tax depreciation equal to its full amount of economic depreciation under the deferred sales method. The contributing partner would recognize a corresponding amount of gain. This is functionally identical to the remedial method, in which notional items of tax depreciation and income are invented to ensure that there is a proper net allocation of depreciation to the noncontributing partner.

ALI identified the "most important" difficulty with this approach as valuation, particularly when the partners might otherwise be indifferent to valuation.[62] ALI posited as an example a two-person equal partnership in which both persons contributed zero-basis property, with only one asset being depreciable. In that case, the partner contributing the depreciable asset would like to understate its value to minimize recognition of deferred gain as the building depreciates, while there is no incentive to properly state the value for the nondepreciable asset (especially if it will not be sold for a long time).

ALI observed that even in cases in which relative value may be easier to determine, such as when one or more partners contribute cash, there might be valuation problems among multiple properties.[63] Further, in complex partnerships, it may be difficult to determine relative value if partners have varying interests in partnership profits and property. And, as always, some property might be particularly difficult to value in any case. Although not directly referenced, presumably the government could be whipsawed when one of the partners might actually prefer to recognize gain (for example, when a contributing partner deliberately overstates value in order to recognize expiring losses). Thus, the valuation issue presented problems for both the partners and, potentially, the government.

ALI also identified complexity as a significant concern.[64] The first form of complexity was the obvious problem that the deferred sales method placed a substantial accounting burden on the partnership. For nonamortizing property, the deferred sale upon contribution would need to be tracked somehow over the life of the partnership, and for amortizing or depreciable property, it would need to be tracked over the remaining amortization or depreciation period. This would necessarily be cumbersome for various reasons.

The second complexity was the reverse section 704(c) allocation problem.[65] Suppose a new partner is admitted to a preexisting partnership whose assets have appreciated in value. Should the deferred sales method apply here so that the preexisting partners recognize gain on the appreciation transferred to the new partner?[66] As the ALI report mentions, such a rule would be necessary to protect the main rule for a contributing partner, because otherwise the rule could be avoided through planning. However, the rule would necessarily also become extremely complex for partnerships with substantial appreciated property and many partners.

Ultimately, ALI chose not to recommend the approach for the reasons discussed above. Its conclusion is worth quoting in full:

> The question is a difficult one and to some extent its resolution depends more on empirical factors than on pure logic. If, because of the ease with which gain or loss on contributed property can be shifted between partners, such shifting is being broadly used to gain tax advantage, a rule to prevent such shifting may be appropriate. If, on the other hand, such shifting generally occurs only because of valuation uncertainty or a

> desire by taxpayers to avoid the additional complexity which a section 704(c)(2) allocation agreement entails, then the adoption of a rule similar to the deferred-sale approach described above seems unwise.[67]

In other words, ALI acknowledged a shift from considering the theoretically correct answer — if one even existed — to a practical one. It also acknowledged that it might be worth reevaluating section 704(c) if the section works in a manner adverse to the collection of revenue.

D. The 1984 Code

In 1984, Congress made section 704(c) mandatory.[68] That is, partnerships are *affirmatively required* to specially allocate tax items to reduce the disparity between the FMV of contributed property and its tax basis.

In the legislative history introducing the change, the Ways and Means Committee illustrated the need for the change by focusing on built-in loss:

> For example, if partner A contributes property with a basis of $200 and a value of $100 while partner B contributes $100 in cash to a partnership, and the initial capital accounts of the partners are set at $100 (the fair market value of their contributions), some taxpayers contend that absent specific allocations of loss under the partnership agreement, a subsequent sale of the property for $100 would result in an allocation of $50 loss to each partner, thereby shifting $50 of loss from A to B. The shifting of the loss could be effective so long as the partnership remained in existence; however, the pre-contribution loss would be effectively reallocated to the contributing partner if the partnership were liquidated.[69]

The committee expressed some hesitancy about whether a similar problem might arise for gain property: "Some taxpayers contend that a similar shifting of gain can be accomplished in the case of a contribution of appreciated property to a partnership."[70] At the same time, the committee speculated about circumstances in which the special allocation of gain might artificially shift tax consequences:

> This is particularly important since the various partners may have different tax positions. For example, a partner to whom gain could be shifted in the absence of the bill's provisions could be tax-exempt, could have a lower marginal rate than the contributing partner, or could have expiring net operating losses.[71]

The Senate Finance Committee copied the Ways and Means Committee's example and rationale. However, in an intriguing repeat of the history to the 1954 code, it went on to encourage electivity again:

> It is anticipated that the regulations will permit partners to agree to a more rapid elimination of disparities between the value and the adjusted basis of contributed

> property (determined at the time of contribution) among partners than required by the new rules by substituting items not described in section 704(c) for items described in section 704(c) and vice versa, provided that there is no tax avoidance potential . . . [and for] the difference between the adjusted basis and the fair market value to be eliminated more slowly than required by the new rules through allocations solely of gain or loss on the disposition of such properties (without requiring special allocations of depreciation or depletion).[72]

In other words, the Finance Committee once again permitted taxpayers options to account for section 704(c) property. And incredibly, it permitted optionality in *both* directions: more quickly than the traditional method by explicitly encouraging regulations to provide for the curative method and more slowly by *not* specially allocating depreciation.

The final piece of legislative history is the conference committee report. This report reflected much more hesitancy about whether the change was really necessary, merely stating that "it generally is thought that a portion of the built-in gain or loss that would have been realized by the contribution partner if he had sold the property may be shifted to other partners."[73]

Even more significantly, the conference report explicitly identified Congress's concern about the potential, significant complexity and once again emphasized the possibility of excluding from section 704(c) allocations of depreciation and the like:

> The conferees are concerned with complexities that may arise in applying this new rule to allocations of depreciation and depletion. . . . The conferees intend that [the Senate Finance Committee report] be read as illustrative of, rather than as a limitation on, the Secretary's authority to provide reasonable rules as long as no abuse potential is present. For example, the conferees recognize that the Secretary may decide to require taxpayers to allocate only the built-in gain or loss on contributed property under new section 704(c) and permit allocations of depreciation, depletion, or similar items with respect to such property, to be governed by section 704(b), provided this flexibility is not likely to result in the contributing partner avoiding the effect of the allocation of built-in gain or loss (such as when the property is expected to be held by the partnership until it has little, if any, fair market value).[74]

Regardless of whether Congress believed the problem was worth solving, the conference report boldly stated that, as a result of the change, "it will not be possible to shift built-in gain or loss from the contributing partner to the other partners."[75]

E. Conclusion

This is the strange journey of modern section 704(c). The first group to think about the problem rejected modern section 704(c) entirely. It was added as an optional way to help taxpayers resolve basis issues related to contributed property. Then it was made mandatory because the optional approach was prone to abuse. Yet even when the provision was made mandatory, Congress could not wean itself off electivity. Nor could it clearly set forth what theoretical problem needed to be solved. Indeed, Congress expressed appropriate trepidation that the complexity of the system might outweigh any benefits.

Conceptually, however, there is a distinct evolution. Initially, those groups approaching the issue viewed it as a matter purely among partners without significant government interest. The natural mindset was to provide an option for partners to resolve the problem, if indeed there was one, and to consider what might be the right theoretical answer. Over time, the approach became much more practical. The focus was on whether section 704(c) was in fact costless to the government.

It is striking, however, that over the entire course of this evolution, no explicit consideration was given to how the IRS might administer the rule. This is surprising, since a partnership's allocation of taxable income or loss to its partners is what the IRS is ultimately always auditing. Practically, this means the IRS must work its way through section 704(c) allocations even when administering unrelated partnership provisions.[76] Moreover, Congress did not consider that permitting electivity might be detrimental to the government. And, of course, electivity also compounds the complexity in administering the rule.

Several themes appear consistently — acknowledgement of the difficulty of the problem, as well as a commitment to electivity. But the focus changed also. The 1954 proposals tried to achieve the right theoretical answer while minimizing taxpayer burden. In contrast, the 1984 proposals worked toward protecting the government from perceived taxpayer abuse. And some important principles were absent entirely, such as whether the IRS could administer the rule.

IV. Where Might We Go?

To go forward, this article suggests we go *back*. Namely, to the House's proposal in 1954: Tax items regarding contributed property *must* be allocated among the partners in accordance with their share of partnership gains or losses.[77] No electivity is permitted, and there are no special tax allocations toward (or, in the case of depreciation or amortization, away from) a contributing partner to reduce basis disparities. More broadly, it is a natural culmination in the evolution of section 704(c) — dispensing entirely with the theoretical and focusing solely on the practical.

Importantly, the 1984 legislative history foresaw the potential for immense complexity and subtly questioned whether it might be appropriate. Experience suggests the answer is "probably not." Meanwhile, the virtues the House identified with the original proposal deserve more merit than first appreciated. It is simple. It is understandable. It is not elective. And it is *administrable*. The IRS need not evaluate tax allocations under both the section 704(b) and section 704(c) regimes. And neither taxpayers nor tax practitioners need waste precious resources on section 704(c) issues.

To be clear, this article does not suggest we go all the way back. As noted, the proposal is not to repeal section 704(c)(1)(C), related to the importation of built-in loss, or to repeal the mixing bowl rules in sections 704(c)(1)(B) and 737. It also does not suggest we remove section 721(c), giving

Treasury the authority to police transfers of property to partnerships with foreign partners. Indeed, if the proposal is adopted, Treasury might decide to exercise this authority more broadly than it has.

A. Further Evaluation of the Proposal

1. The benefits.

One can appreciate the virtue of the proposed system by seeing how it handles the issues identified above. In the first instance, the contribution of property to a partnership would not require separate consideration of the effects of section 704(c) and, if those effects are undesirable, consideration of how to avoid them. Indeed, for most small partnerships, people generally assume they share the tax effects of whatever is contributed, so there would be an intuitive alignment between the tax law and the formation of the average partnership.

More difficult issues under the current regime largely disappear. Multiple layers are not relevant on their own; instead, new partners can bargain over the correct outcome with preexisting partners. It is already routine to "diligence" asset basis in any reasonably sophisticated transaction, and it would be far easier to negotiate solely on the basis of this preexisting asset basis without layering on any corrective effects of section 704(c).

Similarly, handling tiered partnerships no longer requires looking through partnership layers — a notoriously difficult exercise. Each allocation can be evaluated on its own merits at each partnership tier. Although an upper-tier partnership might, in its own allocations, take into account that it contributed appreciated property to a lower-tier partnership, it would not need to depend on the lower-tier allocation method. Moreover, the standard would be the same for multiple layers and multitier partnerships, further reducing unnecessary planning.

What follows from all this is the primary virtue of the proposal: It lets parties focus on, and bargain for, what they care about — their post-tax economics. Because there is no section 704(c) overlay, parties can negotiate for the tax results they want regarding contributed property.

Consider the case in which a new partner is admitted to a preexisting partnership that has appreciated in value. Under current law, when a new partner is admitted, the allocation of built-in gain in the existing partnership property must be accomplished through section 704(c). This is because the admittance is a book-up event and therefore creates a section 704(c) layer that is allocated back to the existing partners. This is a nuisance to track and explain to partners, if they even understand the issue, and there is even a trap for the unwary in that a sophisticated new partner may try to use the remedial or curative method to allocate to itself depreciation or amortization.

The proposal solves that problem because the parties need not deal with section 704(c) at all. The vast majority of partnerships can just diligence tax basis, assume the gain will be shared roughly pro rata, and reflect that in the deal economics. Some partnerships may negotiate appropriate allocations to reflect their desired economics, such as an allocation of precontribution value (and gain) to the contributor or preexisting partners, akin to multitier waterfalls that exist today. To be clear, partnerships would not be permitted to make special allocations solely to address basis disparities along the lines of former section 704(c)(2) allocation agreements. Rather, these allocations would need to be tested for economic substance under principles similar to those for other allocations.[78]

In any case, any of these results might accord with what the participants want to achieve, and they are all made much easier than under current law. Indeed, under current law, for depreciable or amortizable property, the difference between value and basis is reduced over time as the property is depreciated or amortized for book purposes. The net result is that even preserving an allocation of initial built-in gain to a contributing partner is not straightforward.[79] That the current law does not easily achieve this result is especially unfortunate because it is the intuitive result most parties would expect in perhaps the most common of partnerships — in which a capital partner contributes property that is operated by a service partner.[80]

Conversely, for depreciation and amortization, many parties expect existing depreciation on contributed property to be allocated solely to the contributing partner. Yet this is the exact *opposite* of the result under current section 704(c) in which depreciation and amortization are shifted *away* from the contributing partner. The proposal would permit parties to retain this allocation (or even have a pro rata sharing) if so desired.

Thus, this proposal permits intuitive, commercial results that are easy to understand and administer while permitting taxpayers flexibility to ensure their tax results follow the economics. Parties can bargain with more confidence and speed because the starting point for negotiations is more familiar and does not require substantial development by advisers to even approach the problem.

2. The costs.

No approach is perfect, of course, and there must be trade-offs to this simplicity.

The first issue is simply that this approach necessarily perpetuates inside-outside basis differences. But on this count, there are two responses. First, it doesn't really matter. The inside-outside basis concern identified in 1954 was an administrative one — reducing bookkeeping for smaller partnerships. In today's world, tracking tax basis at two different levels is routine and trivial. Second, the current system doesn't solve the problem either, since there is no mandatory elimination of inside-outside basis disparities in all cases, and even when there is, the elimination takes time to occur. In other words, we already have to live with a system in which there are endemic inside-outside basis differences. By getting rid of section 704(c), we can at least ease the burden of parties figuring out what these differences might be as they try to understand the tax consequences of their transactions.

The second issue is that this approach clearly permits the allocation of precontribution gain away from the contributing partner. In cases in which there is no cost to the fisc, the parties can just bargain over the issue and consider appropriate allocations of income or gain. But in some cases, there could be a cost to the fisc if a high-tax partner shifts precontribution gain to a low-tax partner.

One immediate question is whether this should be policed at all. Although intuitive, notably, ALI and Congress only alluded to this as a specific problem for section 704(c) to solve and even then only depending on whether there was in fact a problem. Moreover, although different for many reasons, in the corporate context (whether "S" or "C"), built-in gain on transferred property is necessarily and unavoidably shared (or at least not fully borne by the transferor).[81] Thus, it may be reasonable to conclude that bona fide partnerships do not result in the shifting of precontribution gain frequently enough to warrant further rules.

Alternatively, either because of a substantial cost in the case of bona fide partnership, or perhaps a belief that policing the bona fides of a partnership for this issue would not be easily administrable, a special rule to address the issue might be needed. The nature of the rule would reflect the circumstances warranting it, but the partnership rules already include some concepts that could be easily adapted.

For example, the mixing bowl rules apply only to transactions occurring within seven years of a contribution. Meanwhile, the section 704(b) regulations include a general prohibition when there is a superior tax result for one partner with a strong likelihood no other partner does substantially worse, as well as specific concepts of transitory and shifting allocations that are impermissible because they produce superior tax results without affecting economics.[82] Thus, one can imagine a rule that disallows the allocation of a substantial amount of gain of property contributed by a high-tax partner to a low-tax partner within a period of time following the contribution absent a bona fide business transaction giving rise to the allocation.

The IRS could further administer this rule with presumptions — again, similar to rules already in the regulations for other cases. For example, the IRS could provide that gain allocations occurring within two years to a lower-tax partner are presumed to be disallowed, similar to the disguised sale rules under section 707. Conversely, the IRS could provide that gain allocations are presumed to have a bona fide business purpose if only an insubstantial amount of gain is allocated to low-tax partners and gain is otherwise allocated pro rata. Further, the IRS could require reporting in circumstances in which contributed property is sold soon after contribution and gain is allocated to a low-tax or tax-indifferent partner.[83]

Although possibly more administratively involved, in each case, the IRS and taxpayers are able to focus directly on the unwanted result — the allocation of tax gain to a low-tax partner — rather than an artificial, complex regime that only sometimes actually addresses this result. And, as mentioned, it is not even clear this would be more administratively involved than sorting through the application of the current section 704(c) rules in every partnership.

Although the same general approach can be taken for depreciation and amortization of contributed property, this depreciation and amortization is already allocated *away* from the contributing partner under current law.[84] Thus, it is not necessarily clear what special rule would be needed if tax items could be allocated more to the contributing partner and less to others, although presumably it would be beneficial to police the cases in which low-tax partners allocate amortization and depreciation to high-tax partners.[85]

3. Revenue.

It is also important to consider the effect of the proposal on revenue. I am unaware of any attempted recent study on the effect of this proposal or anything similar. Indeed, any such study would be quite complicated and likely require access to confidential taxpayer return data. However, the data available make a strong case that the effect would likely be minimal and perhaps even positive.

As a first step, consider the revenue increase associated with the changes in 1984. The anticipated cumulative revenue increase from section 704(c) was projected at $390 million.[86] While no small sum, all tax reforms in the bill collectively were expected to raise $54 billion over the same period.[87] So the section 704(c) change amounted to seven-tenths of 1 percent of the anticipated revenue raise. Note also that the Deficit Reduction Act of 1984 was not the largest tax increase of the period. For comparison, the 1982 Tax Equity and Fiscal Responsibility Act was expected to raise $189 billion over the same period.[88] Taking these two revenue amounts together, the section 704(c) change amounted to less than one-fifth of 1 percent of the total revenue raised.[89] Thus, on a relative basis, the revenue effect of section 704(c) was exceedingly small.

Moreover, the revenue estimate in 1984 reflected a change from an elective approach to a mandatory one. In other words, we should assume that taxpayers were electing into section 704(c) only when favorable to do so. Thus, the 1984 revenue estimate did *not* compare the mandatory section 704(c) method with a different mandatory method. In effect, it measured the revenue raised from turning off electivity.

In fact, the new section 704(c) did not even fully turn off electivity because taxpayers can choose among different methods. As an example, property contributed with zero basis is actually treated *better* under the new law than the old one. Under the old law, only the traditional method was available; since there is no tax depreciation at all, the ceiling rule would mean no tax deductions for the noncontributing partner. Under the new law, taxpayers can elect into curatives or remedial allocations when advantageous or otherwise default to the traditional method and make no allocations at all. It is not clear that the revenue estimate accounted for this.[90]

Finally, the revenue estimate also reflected the fact that section 704(c) was also made to apply to built-in loss on a mandatory basis — a point observed by the House report. This aspect would not change under this article's proposal because section 704(c)(1)(C) would remain in the code. Similarly, the proposal would not eliminate section 721(c), so Treasury would retain authority to address abuses in situations involving foreign partners.

All taken together, it seems reasonable to believe that the actual revenue effect of removing section 704(c) would not be significant. It is important to emphasize again that the proposal provides *no* electivity. As a result, while some taxpayers may do better because built-in gain is allocated to others, others may very well do worse for the same reason.

Importantly, all of this is without considering the overall revenue effects from easing administration. Congress and presidents already have been willing to treat as revenue the anticipated proceeds of increased enforcement.[91] This proposal is similar: It both frees up IRS resources from enforcing section 704(c) and simplifies partnership issues so the IRS can better focus on enforcing what remains. It seems reasonable to assume this too would have positive revenue effects.

Finally, it is worth considering the effect of the proposal on partnership formation — one of the original concerns of the 1954 ALI proposal and relevant today because of dynamic scoring. Here, one might observe that the proposal resembles the approach for S corporations. Under the S corporation rules, tax items for contributed property must clearly be shared among the shareholders. It is not even possible to specially allocate limited economics to account for basis-value mismatches because S corporations can have only a single class of shares. Moreover, taxpayers must separately track inside and outside basis. Nevertheless, S corporations remain among the most popular business entities, suggesting that this problem is not generally a significant impediment to business formation. In other words, to the extent business formation is taken into account in dynamic scoring, the effect there also should be minimal.

4. Encumbered property.

One significant technical problem with the article's proposal is the treatment of a contribution of encumbered property. Under current law, the transfer of encumbered property to a partnership does not result in immediate gain, even though the partnership is now liable for the debt.[92] Section 704(c) plays a critical role in this result because the debt is allocated back to the contributor as a result of their section 704(c) allocations for the property.[93]

The relevant rules are outside the scope of this article, but at a high level, debt encumbering a property must be allocated to the contributing partner to the extent of any section 704(c) gain that would arise if the property were disposed of for liability relief. Indeed, in another example of electivity compounding complexity, the amount of the debt allocation itself can turn on the partnership's decision about the section 704(c) method.[94] This is because, in the first case, the amount of section 704(c) gain itself turns on whether the remedial method or traditional method is used. When the traditional method is used, only the difference between the amount of the liability and tax basis is allocated (since the ceiling rule would limit the allocation of gain). In contrast, if the remedial method is used, the remedial income allocated to the contributing partner also results in a liability allocation to the contributing partner.[95]

Similar principles apply to the amount of the remaining liability not allocated under the preceding rules. Although no longer necessary to avoid the recognition of gain upon contribution, taxpayers are permitted to elect different methods to allocate the remaining liabilities. These methods can take into account the effect of section 704(c), either because of gain allocable to the contributing partner or depreciation allocated to the noncontributing partner.

In any case, the contributor's gain is deferred until the section 704(c) layer burns off over time, and then it can often remain deferred to the extent of the contributor's interest in the partnership.[96] Removing section 704(c) from the code, without further relief, would practically require immediate gain recognition on the transfer of encumbered property to a partnership. This is because the debt presumably would be allocated on the basis of relative profits under section 752, so the contributing partner would be treated as relieved of a portion (which might be a very large portion) of the transferred liabilities.[97] This would give rise to either a disguised sale or a deemed distribution, both of which would produce gain.[98]

No doubt, some might consider this an appropriate result. The partner has, after all, been relieved of some of its liabilities. Outside the partnership context, relief of liabilities clearly results in gain.[99] For those persuaded by this rationale, this is in fact an additional reason to remove section 704(c).

However, others might be concerned by this result because it is inconsistent with years of partnership practice and might be viewed as impeding partnership formations. In this case, some relief would be necessary.

In my view, the circumstance of encumbered property is the precise scenario in which the deferred sales method works extremely well. In the first place, valuation issues are considerably reduced because the face amount of the liability is known and therefore sets the sales price. Moreover, the gain could either be picked up over the remaining term of the debt or stay deferred so long as the debt remains outstanding (including, perhaps, through refinancings) and the asset remains with the partnership. But in any case, administrability is made considerably simpler because the debt acts an objective measure of both timing and amount.

B. The Wyden Approach — All Remedial Method

In a 2021 proposal for partnership tax reform, then-Finance Committee Chair Ron Wyden, D-Ore., suggested replacing section 704(c) with mandatory use of the remedial method.[100] As mentioned above, the remedial method itself is merely a version of the deferred sales method the 1954 ALI project considered and rejected.[101] Its reasons for rejection remain equally valid.

The first and most significant point is that use of the remedial method effectively repeals section 721 for contributed property that is depreciable or amortizable. In lieu of a nonrecognition rule, section 721 becomes an installment sale rule, in which gain is recognized based on the depreciation period of the property.

It is important to recognize that *goodwill* would also be subject to this rule. The section 197 regulations clearly provide that goodwill that is contributed to a partnership but subject to the remedial method is amortized, even if acquired from a potentially related person.[102] Even worse, this applies to section 704(c) layers created by book-ups. Thus, this change would subject appreciated goodwill to current taxation upon contribution as well as upon virtually any book-up event.[103] That is, when new partners contributed capital to existing partnerships, or existing partnership engaged in non-pro-rata redemptions, all the goodwill of the business would effectively be deemed sold and start producing gain or loss.

This would be a truly remarkable change. Requiring gain recognition in the case of reverse 704(c) layers to noncontributing partners when the asset itself has not actually been transferred at all arguably violates the principles of realization. And to the extent it does not, requiring this type of immediate and unexpected taxation is likely to discourage productive business investment.

Although somewhat minor by comparison to the foregoing, mandatory use of the remedial method would be extremely cumbersome and costly to administer. This would be the case for taxpayers, who would incur additional costs in hiring advisers to explain the rules and provide the proper computations. But it would also burden the IRS, which would need to sort through all these computations to determine their accuracy, in addition to the wholly separate section 704(b) regime and wealth of other partnership issues.

It is also not obvious that mandatory use of the remedial method would benefit Treasury in all cases, at least versus this article's proposal. As an example, suppose a contributing partner has otherwise unusable NOLs. That partner would *prefer* remedial allocations of income items, and in practice, the remedial method would effectively transfer the NOL to the other partners.

In concept, of course, the Wyden proposal could be modified to exclude goodwill (and perhaps other long-lived assets) from its scope. But, as mentioned, goodwill is often the predominant amortizable asset for a business, so excluding goodwill would result in even more complexity because different section 704(c) rules would apply for different assets. It is hard to see how this could ultimately make things better.

Put another way, the Wyden proposal identifies the right issue — effectively removing Section 704(c) — but offers the wrong solution. The Wyden proposal would be fundamentally inconsistent with the current tax system, would impose substantial costs on taxpayers, and could harm the IRS's administration of partnerships even further. Because of these issues, it is unlikely the proposal would lead to increased revenue, but even if it did, it is improbable the revenue raise would outweigh the costs of the proposal.

C. A Third Possibility — No Sharing of Precontribution Items

A third possibility is to reject the notion of a partnership entirely for contributed property. In this case, all precontribution gain would be allocated to the contributor, and any existing depreciation or amortization would similarly only be allocated back the contributor. Only partnership items allocated with cash or future appreciation in contributed property could be shared. Although I am unaware of any formal proposal suggesting this, it shares some of the virtues identified herein in that it is not elective and is intuitively simple.

As compared with this article's proposal, it offers more legal simplicity for the IRS, since there is no need to evaluate whether an allocation of precontribution items meets the standards for disallowance. But it comes with two substantial costs. First, it affirmatively prohibits taxpayers from allocating precontribution items in their desired manner. While parties might typically be able to reflect this in the economics, they may not in all cases, and it is somewhat inconsistent with the flexibility notion underlying partnerships.

Second, much of the administrative complexity identified for the current section 704(c) would need to remain because both the IRS and taxpayers would need to track the allocations being made for contributed property, since they will necessarily not be shared in accordance with other items.

Further, it would be necessary to directly address the relationship between this rule and the fact that most property amortizes or depreciates for section 704(b) purposes. Thus, for example, should all the initial gain on depreciable property be mandatorily allocated back to the contributor, or should this allocation reduce over time as the property is depreciated for section 704(b) purposes? If the latter, should this depreciation reflect the remaining tax life of the property, a new tax life, or some other method?

This would all follow through to reverse section 704(c) layers, which also would be subject to the same rules. Managing these mandatory section 704(c) allocations to existing partners in the case of new contributions or redemptions would likely be exceedingly cumbersome. Tiered partnerships would also present difficult issues because it would be necessary to track property across tiers of partnerships or otherwise permit planning around the rule through the use of tiers of partnerships.

The upshot is that this approach would solve electivity and, as compared with the Wyden proposal, realization-related issues in many cases, but it would not generally solve complexity. Further, because the sharing of precontribution gain is not itself necessarily problematic, the mandatory complexity seems especially inadvisable.

V. Conclusion

Fundamentally, removing section 704(c) allows the tax system (taxpayers, advisers, and the IRS) to administer what actually matters — the allocation of tax income and gain — without also having to contend with the effects of artificial (and arbitrary) tax-only allocations. Indeed, the underlying principle that there is an economic deal apart from the tax deal is itself questionable. Parties care about post-tax outcomes, and tax inevitably enters into deal negotiations.

This is especially true as partnerships continue to proliferate in both use and complexity. Unnecessary legal complexity is an impediment to tax administration. Taxpayers and practitioners need not expend effort trying to apply these rules to business transactions they intend to undertake. Meanwhile, the IRS need not waste resources attempting to audit or solve intractable problems.

One consideration this article leaves for the future is whether the subchapter K architecture itself ought to be transformed. Indeed, if section 704(c) is repealed, some transformation is necessary because so many other subchapter K provisions, including the main allocation rules, assume that section 704(c) handles all book-tax disparity issues. In any case, rather than a complex superstructure of allocation principles that broadly hope to snuff out abuse (not always successfully), Treasury and the IRS might consider an approach that generally requires disclosure and investigation of the circumstances that are most likely to be abusive.

Of course, there is no need to overpromise — the approach proposed in this article certainly has nonobvious flaws and issues that would need to be addressed. But so does the current approach.

With all the uncertainty and complexity in section 704(c) even after 75 years, maybe it's time to try something new.

FOOTNOTES

[1] Section 704(c)(1)(A) is what most people think of when they think of section 704(c), and it is shorter to say section 704(c), so this article continues to use the term "section 704(c)" throughout. This article is not about the mixing bowl rules of section 704(c)(1)(B) or the built-in loss rules of section 704(c)(1)(C).

[2] Reg. section 1.704-3(a)(6).

[3] Reg. section 1.704-3(a)-(d).

[4] Reg. section 1.704-3(b).

[5] *Id.*

[6] Indeed, A's property is not subject to section 704(c) at all because it was contributed with a basis equal to value.

[7] Reg. section 1.704-3(c).

[8] Reg. section 1.704-3(d).

[9] Reg. section 1.704-3(d)(2).

[10] Reg. section 1.704-3(a)(2). There are exceptions for properties of similar type contributed in the same transaction.

[11] Reg. section 1.704-3(a)(6) ("Partnerships are not required to use the same allocation method for reverse 704(c) allocations as for contributed property, even if at the time of the revaluation the property is already subject to 704(c) and [reg. section 1.704-3(a)].").

[12] *See* Blake D. Rubin and Andrea R. Macintosh, "Exploring the Outer Limits of the 704(c) Partnership Built-In Gain Rule (Part 3)," 89 *J. Tax'n* 271 (1998).

[13] For a helpful discussion of tax issues related to tiered partnerships, see Gary R. Huffman and Barksdale Hortenstine, "Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships," 86 *Tax Mag.* 179 (2008).

[14] Reg. section 1.704-3(a)(9).

[15] Huffman and Hortenstine, *supra* note 13, at 196.

[16] *Id.*

[17] This planning is somewhat of a one-way street. If AB elects the traditional method, and X elects the remedial method, it seems that remedial items would only offset C's lost depreciation. Presumably, all such remedial items ultimately would be allocated to A. In other words, the lost depreciation to B as a result of the traditional method could not be rectified through a remedial method election at the lowertier partnership level.

[18] Reg. section 1.704-3(a)(6).

[19] It is clear that the interests in the lower-tier partnership are section 704(c) property in the hands of the transferee partnership. However, the lower-tier partnership's appreciated property is not itself section 704(c) property.

[20] Reg. section 1.704-3(a)(9).

[21] *See* reg. section 1.704-3(b)(2), Example 2.

[22] Reg. section 1.704-3(a)(10).

[23] By contrast, a corporation that acquires control of a target corporation generally may not use its preexisting NOLs to offset gains recognized for target property for a period of five years after the acquisition. Section 384.

[24] *See generally* Stephen L. Gordon, "Understanding the Scope of the Section 704(c) Anti-Abuse Rule," Tax Forum Paper No. 666 (2015).

[25] Reg. section 1.704-3(a) (providing that methods other than the traditional method, the traditional method with curative allocations, and the remedial method "may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss or deduction independent of allocations affecting book capital accounts.").

[26] *See* FAA 20204201F.

[27] In practice, hedge funds would likely mark to market frequently, even under those rules, because hedge funds permit partners to withdraw interests relatively often, and redemptions are a clear book-up event.

[28] Reg. section 1.704-3(e)(3).

[29] *See*, *e.g.*, Andrew W. Needham, "The Problem With Stuffing Allocations," *Tax Notes*, Nov. 18, 2013, p. 737.

[30] Interests in an entity must be traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof for the entity to be a PTP for tax purposes. *See* reg. section 1.7704-1(a)-(c).

[31] Although section 743(b) adjustments typically are amortized over the period for newly purchased property, a special rule permits partnerships to use the remaining life of property subject to section 704(c) solely to the extent the section 743(b) basis step-up is attributable to the section 704(c) gain. Reg. section 1.743-1(j)(4)(i)(B)(2). One express purpose of this rule was to permit PTPs to achieve fungibility. REG-209682-94.

[32] Because any remedial income is offset by an appropriate amount of depreciation or amortization, the holder's basis also does not change.

[33] *See* Notice 2009-70, 2009-34 IRB 255. This article refrains from discussing section 704(c) issues arising in mergers and divisions, but many of the same themes are present there also.

[34] The New York State Bar Association Tax Section issued a report in response to this request that exceeded 100 pages. *See* NYSBA Tax Section, "Report on the Request for Comments to Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships" (Jan. 22, 2010).

[35] The Treasury Inspector General for Tax Administration recently reported that only a tiny fraction of partnerships are audited. TIGTA, "Centralized Partnership Audit Regime Rules Have Been Implemented; However, Initial No-Change Rates Are High and Measurable Goals Have Not Been Established," No. 2022-30-020, at 11 (Mar. 17, 2022).

[36] J. Paul Jackson et al., "A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners — American Law Institute Draft," 9 *Tax. L. Rev.* 109, 112 (1954) (1954 ALI report).

[37] *See generally id.*

[38] ALI, "Income Tax Project — Preliminary Draft No. 71," at 195 (1951).

[39] The ALI project assumed, as does this article, that partnership contributions should not result in the recognition of gain or loss and thus, as a consequence, the partnership should take contributed property with a carryover basis. *See* 1954 ALI report, *supra* note 36, at 119.

[40] *Id.* at 120-123.

[41] *Id.*

[42] *Id.* at 124-129. The 1954 ALI report refers to these as the "entity approach" and the "aggregate approach." To avoid confusion, this article does not use those terms. They have become defining concepts in the partnership space, and the sense in which the 1954 ALI report uses the terms is not quite the same as their modern connotation.

[43] *Id.* at 124.

[44] *Id.* at 127.

[45] *Id.* at 125.

[46] *Id.* at 129.

[47] *Id.* at 129-130.

[48] *Id.* at 125.

[49] *Id.* at 129-131.

[50] *Id.* at 132-133.

[51] Section 704(c)(1) (as in effect before the Deficit Reduction Act of 1984, P.L. 98-369).

[52] Section 704(c)(2) (as in effect before the Deficit Reduction Act of 1984, P.L. 98-369).

[53] Internal Revenue Code of 1954, H.R. 8300, 83rd Cong. (1954) (as reported by the Ways and Means Committee) (providing that in determining a partner's distributive share, tax items "arising with respect to contributed property . . . shall be allocated among the partners in the same manner as items arising with respect to any other property acquired by the partnership").

[54] H.R. Rep. No. 83-1337, at A223 (1954).

[55] Internal Revenue Code of 1954, H.R. 8300, 83rd Cong. (1954) (as reported by the Finance Committee).

[56] S. Rep. No. 83-1622, at 381 (1954).

[57] *See* ALI, "Federal Income Tax Project Subchapter K: Proposals on the Taxation of Partners" (1984) (1984 ALI project).

[58] *Id.* at 129.

[59] *Id.*

60 *Id.*

61 Leaving aside the different depreciation periods applicable to traditional method depreciation versus remedial method depreciation.

62 1984 ALI project, *supra* note 57, at 131.

63 *Id.* at 133.

64 *Id.* at 136-138.

65 *Id.* at 136.

66 If the deferred sales method does apply on these facts, the preexisting partners will realize the appreciation on the partnership assets in a separate deferred gain account. Those partners will recognize the appreciation over time as triggering events occur.

67 1984 ALI project, *supra* note 57, at 140.

68 *See* Deficit Reduction Act of 1984, P.L. 98-369, section 71(c).

69 H.R. Rep. No. 98-432, pt. 2, at 1208-1209 (1984).

70 *Id.* at 1209.

71 *Id.*

72 S. Rep. No. 98-169, at 214-215 (1984).

73 H.R. Rep. No. 98-861, at 854 (1984) (Conf. Rep.).

74 *Id.* at 857.

75 *Id.* at 855.

76 In concept, some of these issues might be mitigated now that the IRS also requires separate statements of section 704(b) capital accounts. It remains to be seen, however, whether the additional data make things easier or, as often happens, harder. *See* IR-2020-240 (announcing revised instructions to Form 1065, "U.S. Return of Partnership Income," requiring partnerships to calculate partner capital accounts using the transactional basis approach for the tax basis method) ("The revised instructions are part of a larger effort by the agency to improve the quality of the information reported by partnerships to the IRS and furnished to partners to facilitate increased compliance.").

[77] Treasury, too, has recently looked to the past for section 704(c) solutions. The proposed corporate alternative minimum tax regulations would apply the deferred sales method to contributed property. Prop. reg. section 1.56A-20(c)(1).

[78] Of course, these principles would need to be adapted if section 704(c) were repealed, since the current section 704(b) regulations assume all matters related to book-tax disparities are addressed under 704(c).

[79] A special provision of the curative method permits partnerships to effectively preserve any economic depreciation that is not accompanied by tax depreciation to be reversed with a curative allocation upon sale. *See* reg. section 1.704-3(c)(2)(iii)(B). The fact that the regulations require this awfully cumbersome approach to get to the answer that is most sensible is a good illustration that the section 704(c) rules have "lost the plot."

[80] Admittedly, in simple cases, the same result might obtain as a result of the operation of the section 704(b) rules and the (presumed) service partner's participation in profits only above the FMV of the property contributed by the capital partner.

[81] As with partnerships, there is a separate set of substantial limitations on the importance of built-in losses. Section 362(e).

[82] Reg. section 1.704-1(b)(2)(iii).

[83] This, too, reflects an approach the IRS has taken with the disguised sale rules. Although obviously addressing very different circumstances, the overall approach of safe harbors and presumptions combined with reporting was recently proposed by the IRS in the spinoff context. *See* REG-112261-24.

[84] And because only actual tax basis could produce amortization or depreciation, no artificial tax items would be created.

[85] One aspect of depreciation outside the scope of this article is whether the partnership's depreciation period should begin anew or instead continue throughout the remaining period of the underlying property. Resetting the depreciation period (and effectively requiring the remaining basis to be depreciated over a longer time) generally is inconsistent with Congress's desire to subsidize investment through accelerated depreciation. On the other hand, the new depreciation period might be consistent with the notion that the partnership is a "new" user of the property, and it may also alleviate abuse that could occur if substantial tax basis that depreciates quickly can be allocated. Most likely, it will require experience in an alternative system for Congress to determine whether taxpayers can combine the subsidy with the partnership provisions in an inappropriate way.

[86] Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84, at 216 (1985).

[87] *Id.* at 1235.

[88] JCT, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," JCS-38-82, at 454 (1983).

[89] The data presented by the JCT bluebook refer to the 1984-1987 period collectively, which made use of the period convenient. In fairness, the section 704(c) change was expected to produce a vanishingly small amount of revenue in 1984. I have not analyzed whether other provisions were also unusually small in 1984. Even if they were not, however, the revenue raise in 1988 was $240 million, which would only marginally adjust the numbers in the text. *See supra* note 84.

[90] This is especially significant because much amortization revolves around goodwill, which generally has zero basis.

[91] *See*, *e.g.*, Congressional Budget Office, "Estimated Budgetary Effects of H.R. 5376, the Inflation Reduction Act of 2022, as Amended in the Nature of a Substitute (ERN 22335) and Posted on the Website of the Senate Majority Leader on July 27, 2022," at 14 (Aug. 3, 2022) (estimating that increased funding for tax enforcement activities under the Inflation Reduction Act will raise $203.7 billion of revenue between fiscal years 2022 and 2031).

[92] *See* section 752. Under this section, any increase in a partner's share of partnership liabilities, including an increase resulting from the partnership's assumption of the partner's liabilities, is a deemed contribution of cash to the partnership by the partner. Cash contributions increase a partner's outside basis. Section 722. *But see* reg. section 1.707-5 (providing that a section 752 deemed cash distribution is taxed as a disguised sale when the liability is not a qualified liability as defined in the reg. section 1.707-5 regulations).

[93] Reg. section 1.752-3(a)(2).

[94] *See* Rev. Rul. 95-41, 1995-1 C.B. 132.

[95] Remedial income can arise as a result of book loss on the property in a hypothetical sale for solely liability relief. The curative method is effectively treated the same as the traditional method, since there is no guarantee that curative items would be available in the year of sale.

[96] Reg. section 1.752-3(a)(3).

[97] If this article's proposal is adopted and the parties negotiate for all precontribution gain to be allocated back to the contributing partner, one might be able to rely on this principle to allocate the liability back to the contributing partner also, thereby avoiding immediate gain recognition.

[98] *See* reg. section 1.707-5(a)(1) (providing that a section 752 deemed cash distribution is taxed as a disguised sale when the liability is not a qualified liability as defined in the reg. section 1.707-5 regulations); *see also* sections 752(b), 722, and 731(a)(1) (providing, collectively, that any decrease in a partner's share of partnership liabilities is a deemed distribution of cash that reduces the partner's outside basis but that any deemed distribution that would decrease the partner's outside basis

below zero is gain to the partner to the extent the deemed distribution is greater than the partner's outside basis).

[99] Section 108(a).

[100] *See* Finance Committee release, "Wyden Unveils Proposal to Close Loopholes Allowing Wealthy Investors, Mega-Corporations to Use Partnerships to Avoid Paying Tax" (Sept. 10, 2021).

[101] Notably, Treasury's initial section 704(c) proposed regulations proposed the deferred sales method rather than the remedial method. *See* Notice of Proposed Rulemaking, 57 F.R. 61345 (Dec. 24, 1992), and T.D. 8501 (describing the remedial method as a simpler version of the deferred sales method).

[102] Reg. section 1.197-2(g)(4)(ii).

[103] Indeed, this is one of the main deficiencies ALI identified in 1984 with the deferred sales method.

END FOOTNOTES