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Partnership Allocation Regs. Affect Contributions of Property

by Robert W. Wood • San Francisco

The manner in which gain or loss is allocated among partners on contributions of appreciated or depreciated property to a partnership has always been an issue of some importance. Far from merely affecting real estate projects (perhaps the paradigm for the partnership vehicle), such contributions have also affected joint ventures among corporate partners. The basic premise of Section 704(c) is that tax allocations in a partnership should take into account the historic tax bases of the contributing partners.

At the end of 1993, the Service issued final regulations under Section 704, dealing with allocations to reflect built-in gain or loss on property contributions. These final rules generally take the position set out in the proposed regulations issued in December 1992. Thus, if a partner contributes property to a partnership, the partnership can use any reasonable method of making allocations so that the contributing partner receives the tax burdens and benefits of any built-in gain or loss on the property.

Two reasonable methods of allocation are described in the final regulations: (1) the traditional method; and (2) the traditional method with curative allocations. A third method, the remedial allocation method, is also discussed as a reasonable method, and is the subject of separate temporary regulations discussed below.

Consistency Requirement

While the final regulations allow a partnership to use different allocation methods for different items of Section 704(c) property (as long as all such allocation methods are reasonable), the allocation method used for any item of Section 704(c) property must be consistently applied to that item of property by both the partnership and the partners from year to year. Furthermore, the overall method or combination of allocation methods used by the partnership must be reasonable under the facts and circumstances. In cases where the partnership's allocations are not reasonable, the Service

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can make adjustments, regardless of the provisions of the actual partnership agreement.

Antiabuse Rule

The final regulations state that an allocation method (or a combination of methods) is not considered reasonable if the contribution or other relevant event and the allocations regarding the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. Accordingly, time value of money principles are relevant.

Curative Allocations

Under the final regulations, curative allocations are considered reasonable only if they conform to certain limits. They may not exceed the amount needed to offset the effect of the ceiling rule. (The "ceiling rule" provides that the total amount of depreciation, depletion, gain, or loss that can be allocated is limited to the amount realized by the partnership for tax purposes.) The period over which the allocations are made is also a factor in determining whether the allocations will be considered reasonable. So-called "make-ups" of curative allocations are generally not permitted.

For example, if a partnership does not have sufficient tax items to fully offset the effect of the ceiling rule in one year, the partnership might determine to make a curative allocation in the following tax year. Although the proposed regulations had allowed such make-up allocations, the final regulations generally do not.

A curative allocation will not be considered reasonable to the extent the allocation exceeds the amount necessary to offset the effect of the ceiling rule for the current tax year. A curative allocation on disposition of the property also will not be considered reasonable to the extent it exceeds the amount needed to offset the effect of the ceiling rule for a prior year. However, a partnership may make curative allocations in a tax year to offset the effect of the ceiling rule for a prior tax year if they are made over a reasonable period of time (*e.g.*, over the economic life of the property), and if they are provided for under the partnership agreement in effect for the year of the contribution.

De Minimis Rule

A partnership can disregard the application of Section 704(c) to a partner's contribution of property in a single year if (1) for the items of contributed property (measured in the aggregate), the fair market value of the property does not differ from the adjusted tax basis by more than 15% of the latter, and (2) the total disparity for all properties contributed by that partner in that year did not exceed \$20,000. The *de minimis* rule in the proposed regulations had allowed separate testing of each contributed asset, rather than testing the items of contributed property in the aggregate, with a \$15,000 cap on the disparity.

Remedial Allocations under Temp. Regs.

A separate set of temporary regulations was issued under Section 704 regarding remedial allocation methods. The proposed regulations released in December 1992 had included a deferred sale method as one of the allocation methods deemed reasonable. The temporary regulations revise the deferred sale method, and call it the "remedial allocation method."

Remedial allocations are defined as tax allocations of income or gain created by the partnership that are offset by tax allocations of loss or deduction created by the partnership. Remedial allocations are in addition to other allocations made by a part-

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nership, and have no effect on the partnership book capital accounts. If the ceiling rule results in a book allocation to a noncontributing partner that differs from the corresponding tax allocation, the temporary regulations call for the partnership to make a remedial allocation of income, gain, loss, or deduction to the noncontributing partner equal to the full amount of the limitation caused by the ceiling rule, and an offsetting remedial allocation of deduction, loss, gain, or income to the contributing partner.

A remedial allocation is reasonable only to the extent it equals the amount needed to offset the effect of the ceiling rule for that year, and only if it has the same effect on each partner's tax liability as the item limited by the ceiling rule. Furthermore, remedial allocations are subject to the general antiabuse rule (discussed above) in the final regulations.

Securities and Similar Investments

The temporary regulations also deal with securities and similar investments owned by a partnership. The temporary rules call for certain partnerships to aggregate securities and similar investments for purposes of making allocations under Section 704(c). ■