Partnership Book-Ups

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In Rev. Proc. 2009-70, the IRS asked for guidance regarding the proper allocation of partnership built-in gain. This article offers two sets of three recommendations. The first set proposes technical modifications to the computation of allowable book-ups to ensure that the values ascribed to partnership assets correspond with objectively verifiable values. The second set of recommendations proposes more radical changes to the allocation of built-in gain when book-ups are triggered by distributions of partnership property to ensure that tax allocations properly correspond to economic sharing of gains and losses.

Section 704(c)(1)(A) governs the taxation of unrealized appreciation and loss in property contributed to a partnership. The principles underlying section 704(c)(1)(A) also apply to property held by a partnership when additional property is contributed to the venture or existing property is distributed in exchange for a partnership interest. In Notice 2009-70, 2009-2 C.B. 255, *Doc 2009-18291*, *2009 TNT 154-6*, the Service solicited comments on the proper application of section 704(c)(1)(A) to contributed property and on the application of section 704(c)(1)(A) principles in appropriate circumstances to existing property of a partnership.[1]

Part A responds to Notice 2009-70 with three technical changes to the application of section 704(c) principles, each of which will better conform the application of section 704(c) principles to economic reality. The first two technical proposals limit the ability of a partnership to exploit section 704(c) principles when doing so would be inconsistent with the economic arrangement among the partners or would emasculate the alternate test for economic effect under section 704(b). The third technical proposal expands the use of section 704(c) principles when their use would allow the books of a partnership to more closely reflect the economics underlying the partners' economic positions.

Part B proposes three broad changes to the application of section 704(c) principles to partnership dispositions and distributions. In many cases, the existing rules allow the partial sale of a partnership interest or a partnership distribution to shift the recognition of income among partners in ways that are easily manipulated. The proposals offered in Part B will in most situations eliminate the shifting of income resulting from these transactions, thereby making it harder to exploit partnership dispositions and distributions in tax minimizing ways.

The contribution of property to a partnership is tax free to all the partners,[2] and the contributing partner's adjusted basis in the property carries over to the partnership.[3] Thus, any unrealized gain or loss in contributed property goes unrecognized at the time of contribution but is preserved until eventual disposition of the property by the partnership.[4] Section 704(c)(1)(A) requires the partnership to ''take account of the variation of the basis of the property to the partnership and its fair market value at the time of contribution,'' a rule that has come to mean that any built-in gain or loss in contributed property must be allocated to the contributing partner when that built-in gain or loss eventually is recognized by the partnership.[5]

When an existing partnership wishes to acquire property in exchange for an interest in the venture, it has two economically equivalent ways to structure the transaction. First, it simply can accept the new property and issue a partnership interest to the contributor. If the transaction is structured in this way, the property contributed by the new partner will be captured by section 704(c)(1)(A), but there will be no other tax consequences to the transaction.

Second, a new partnership could be created by a simultaneous contribution of all of the assets of the old partnership along with a contribution of the new property, thereby giving the continuing partners only an indirect interest in the new, lower-tier entity. If the transaction is structured in this way, the old assets of the existing partnership as well as the new property will be

[1]For other responses to Notice 2009-70, see Monte A. Jackel, ''A Response to Notice 2009-70,'' *Tax Notes*, Sept. 14, 2009, p. 1133, *Doc 2009-19260*, *2009 TNT 175-9*; New York State Bar Association Tax Section, ''Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships,'' *Doc 2010-1728*, *2010 TNT 16-22*.

[2]Section 721(a).

[3]Section 723.

[4]If the contributing partner exits the partnership before a taxable disposition of the contributed property by the partner, the unrealized appreciation or loss in the contributed property will be recognized on the exit. *See* section 722. An inside basis adjustment can ensure that this gain is not recognized a second time when the property is sold by the venture. *See* section 743(b).

[5]*See, e.g.*, reg. section 1.704-3(b)(1).

captured by section 704(c)(1)(A) because both the old and new properties are contributed to the newly created, lower-tier partnership.

Because section 704(c)(1)(A) constrains the manner in which partnership income can be allocated among the partners, its reach usually is avoided if avoidance can be managed at low cost. In the simple example presented above, the application of section 704(c)(1)(A) to the property already held by the old partnership can be avoided by using the first structure rather than the second, and so a new, lower-tier partnership rarely is used for the acquisition of property by a partnership. But because the two structures are economically identical, they ought to be taxed the same and be subjected to the same tax constraints. In recognition of this fact, current tax regulations generally require that section 704(c)(1)(A) principles be applied to the property of an existing partnership when it acquires new property (including cash or services) in exchange for an interest in the venture, just as if a lower-tier partnership were formed.[6] When such section 704(c)(1)(A) principles apply to the existing assets of a partnership, we say that the variation between the adjusted basis of the partnership's assets and the fair market value of those assets at the time of the transaction creates a ''reverse 704(c) layer.'' The literal application of section 704(c)(1)(A) to property actually contributed to a partnership creates what is called a ''forward 704(c) layer.''

Reverse section 704(c) layers can arise other than in connection with the contribution of property to an existing partnership. When cash or property is distributed from a partnership to a partner, the nondistributee partners should see an increase in their relative shares of the venture from then on. As a result, the partnership must be careful to distinguish between unrealized appreciation in its assets accruing before the distribution (shared among the partners in their predistribution ratios) and that accruing after the distribution (shared among the partners in their postdistribution ratios). This is accomplished by restating the value of the partnership's assets to fair market values immediately before the distribution and then adjusting each partner's capital account by his share of the variation between the value at which the assets have been carried on the books of the venture immediately before the distribution and the fair market value of the assets on the date of distribution. This is called a ''book-up'' by the partnership of its assets, although as a technical matter loss assets will in fact be booked *down* to current fair market value as part of a ''book-up.''

In Notice 2009-70, the Service requested comments on the proper application of section 704(c)(1)(A). The impetus for Notice 2009-70 was the reaction by many tax advisers to proposed regulations detailing the tax consequences of a partnership merger.[7] When assets are contributed to a partnership in circumstances giving rise to a merger as defined in current regulations, assets not actually transferred are sometimes treated under the proposed regulations as if they had been transferred, giving rise to a forward section 704(c) layer despite the absence of an actual contribution of the property.[8] The application of section 704(c)(1)(A) to such constructive contributions is further complicated by the approach of these proposed regulations which treats some but not all of the forward section 704(c) layer as a reverse section 704(c) layer.[9] I am no fan of this hypothetical and inconsistent treatment of partnership property in the context of a merger,[10] but Notice 2009-70 requested that comments on the weakness of the overall treatment of partnership mergers not be offered.

While the clear focus of Notice 2009-70 was on the forward and reverse section 704(c) layers created by partnership mergers as well as on related issues arising in the context of tiered partnerships, Notice 2009-70 also sought comment on at least one of the more basic issues underlying the application of section 704(c)(1)(A) principles, asking: ''Should any changes be made to the events . . . which allow for a revaluation of assets? Should additional events be added?'' I took this as an invitation to comment on the underlying structure of reverse section 704(c) layers and proffered six proposals to the government. The discussion that follows is based on those proposals.

A. Technical Proposals Relating to Book-Ups

1. No selective revaluations.[11] Reg. section 1.704-1(b)(2)(iv)(f) provides in part that a ''partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books.'' This regulation does not make clear whether all of the partnership's assets must be revalued or if the partnership is permitted to revalue less than all of its assets. This ambiguity should be resolved: The resolution proposed here is that a partnership should be permitted to revalue all of its assets but not only some of its assets.

A revaluation of partnership assets can affect the allocation of partnership tax items in two important ways.[12] First, for allocation of tax items subject to the

[6]*See* reg. section 1.704-1(b)(2)(iv)(f) and -3(a)(6).

[7]*See* prop. reg. section 1.704-4(c)(4)(ii) (Aug. 22, 2007).

[8]*See, e.g.*, reg. section 1.706-1(c)(5), Example 2 (recharacterization of direction of merger).

[9]*See* prop. reg. section 1.704-4(c)(4)(ii)(A)-(B); *see also* prop. reg. section 1.704-4(c)(4)(F), Example 3.

[10]*See* Howard E. Abrams, ''Section 704(c) Gain in Partnership Mergers,'' *Business Entities* 34 (May-June 2004).

[11]I would like to thank Alexander Wu, Yale Law School class of 2010, for first calling this issue to my attention and for his review of portions of these proposals.

[12]A revaluation of partnership assets also can affect the allocation of partnership liabilities. For example, nonrecourse partnership liabilities are allocated among the partners as they share partnership profits, first as they share partnership minimum gain, then as they share partnership minimum section 704(c) gain, and then as they share residual gain. For purposes of the first-tier allocation, minimum gain is defined to equal the excess of nonrecourse indebtedness over the book value of partnership property. Accordingly, a revaluation of partnership assets (and the resulting restatement of capital accounts) shifts

(Footnote continued on next page.)

alternate test for economic effect, no loss may be allocated to a partner to the extent such loss would drive the partner's capital account more negative than the partner's limited deficit restoration obligation, if any.[13] Accordingly, positive revaluations permit greater allocation of loss to a partner having only a limited capital account deficit restoration obligation. Second, if the capital account of a partner having only a limited deficit restoration obligation becomes more negative than the partner's limited deficit restoration obligation, items of partnership income must be allocated as quickly as possible to restore the partner's capital account to the maximum amount of the partner's limited deficit restoration obligation (represented by a "qualified income offset" provision in the partnership agreement).[14] Thus, negative revaluations may trigger the qualified income offset provision of a partnership agreement.

If partners are permitted to revalue less than all of the partnership's assets, the partners can manipulate their capital account balances to allocate partnership tax items in a manner inconsistent with economic effect. Consider the P partnership owning two capital assets, Asset No. 1 having current book value and adjusted basis of $500 and current fair market value of $800 along and Asset No. 2 having current book value and adjusted basis of $500 and current fair market value of $200. Assume further that the partnership's assets are encumbered by a liability of $100, allocable under section 752 equally between X and Y. Finally, assume that X and Y are equal partners, each has a capital account of $450 and an outside basis of $500, and neither has any deficit capital account deficit restoration obligation.[15]

On these facts, satisfaction of the alternate test for economic effect precludes an allocation of loss to either partner in excess of $450 until both capital accounts have been reduced to zero.[16] However, suppose Z now contributes cash of $900 in exchange for a 50 percent interest in the venture, with X and Y reducing their shares to 25 percent each. If the partnership is permitted to revalue only Asset No. 1 on the admission of Z, then X and Y will increase their capital accounts by $150 each,[17] thereby increasing the loss that can be allocated to either partner from $450 to $600. However, if both of the partnership's assets had been revalued, there would be no net change to the capital accounts of X and Y and so no increase in the allowable loss that could be allocated to either partner. Allowing the partnership to revalue only the assets with unrealized appreciation emasculates the central limitation of the alternate test for economic effect, namely that losses should be allocable to the partner who bears the risk of diminution in value.[18]

As this example shows, permitting a partnership to revalue only selected assets offers the possibility that capital account balances will be manipulated to avoid the limitations imposed by the alternate test for economic effect. Because such manipulation arises from adjusting capital accounts in ways that are unrelated to economic reality, it should not be permitted. Accordingly, reg. section 1.704-1(b)(2)(iv)(f) should be amended to provide that if a partnership elects to revalue its assets, it must revalue *all* of its assets.[19]

2. Pro rata contributions and distributions should not justify a book-up. Current regulations permit the revaluation of partnership assets and restatement of capital accounts on the occurrence of specified conditions. While the rationale for permitting the revaluation of partnership assets is not expressed in the regulation itself, it can be inferred from the events which trigger such revaluations. As currently written, reg. section 1.704-1(b)(2)(iv)(f) authorizes a revaluation of partnership assets immediately before the occurrence of any one of three events: (1) a contribution of more than a de minimis amount of money or other property to the partnership as consideration for an interest in the venture; (2) a distribution of more than a de minimis amount of money or other property to a partner as consideration for an interest in the venture (including in connection with a liquidation of the partnership as a whole); and (3) a contribution of services to the partnership as consideration for an interest in the venture.[20] What these events have in common is a market transaction from which the value of the partnership's assets can be determined.

Consider, for example, the contribution of property to a partnership in exchange for an interest in the venture by someone who is not a partner immediately before the transaction. If, for example, the incoming transferor

allocation of liabilities from tier 1 to tier 2 and so potentially affects the allocation of partnership liabilities.

[13]Reg. section 1.704-1(b)(2)(ii)(d).

[14]*See* reg. section 1.704-1(b)(2)(ii)(d)(3).

[15]That is, aggregate capital accounts equal the book value of the partnership's assets less partnership debt, and aggregate outside basis equals aggregate inside basis.

[16]No amount of deduction in excess of $450 can be allocated to either partner until both capital accounts are zero even if either or both partners have agreed to restore a capital account deficit in favor of the lender (but not in favor of the other partner). *See generally* Abrams, "Partnership COD Income and Other Debt Issues," *Tax Notes*, Feb. 15, 2010, p. 845, *Doc 2010-1507*, or *2010 TNT 30-5*. The result does not change if the debt is nonrecourse.

[17]The contribution of capital by Z permits the partnership to revalue its assets and restate capital accounts *immediately before* the contribution by Z. Reg. section 1.704-1(b)(2)(iv)(f)(5); reg. section 1.704-1(b)(5), Example 14. Accordingly, the restatement of capital accounts does not affect Z.

[18]If either X or Y is allocated a loss in excess of $450 and then the partnership's assets are sold for less than book value, the excess loss could result in a negative capital account balance for the partner despite the absence of a partner deficit restoration obligation.

[19]The regulations might allow, for simplicity, that a partnership can elect to exclude from its revaluation any goodwill of the venture carried with zero book value. Goodwill may be especially difficult to value, and failing to include goodwill having zero book value in the valuation process cannot lead to the inappropriate overstatement of a partner's capital account because such goodwill can never give rise to a book loss.

[20]Also, a partnership may revalue its assets under generally accepted industry accounting practices if substantially all of its assets (excluding money) consist of financial assets "that are readily tradable on an established securities market."

contributes $1,000 for a one-quarter interest in the venture, then, if the partners are dealing at arm's length, the value of the partnership's assets immediately after the contribution should equal $4,000. Further, because the incoming partner contributed $1,000, we can infer that the value of the assets of the venture immediately before the contribution equaled $3,000. Similarly, if an existing partner having a one-third interest in the venture contributes $1,000 to increase her share of future profits to one-half, then the value of the partnership's assets should have equaled $3,000 immediately before the contribution.[21]

Because the triggering transactions specified in reg. section 1.704-1(b)(2)(iv)(f) are transactions having economic significance independent of their tax consequences, they ensure that values assigned to a partnership's assets correspond to an objective determination of those values. Linking capital account revaluations to objectively determined values ensures that tax allocations correspond with economic reality because the value of partnership capital accounts balances affects the manner in which partnership gains and losses may be allocated among partners.

If contributions are made to the partnership *other than in proportion to existing capital*, the effect of the contribution on the partners' interests in future income should provide an objective mechanism for determining the current value of the partnership's assets. For example, suppose X, Y, and Z are equal partners in the XYZ partnership. X and Y each agree to contribute an additional $100 to the venture in exchange for an increase in future profits from one-third to 40 percent. Assuming the partners are dealing at arm's length, the value of the partnership's assets immediately before the cash contributions of X and Y should be $300.[22] As a result, the values ascribed to the partnership's assets as part of an optional asset revaluation triggered by the contribution can be tested against this objective measure.

However, if contributions are made by all of the partners in proportion to existing capital, then future shares of partnership income should be unaffected by the contributions. As a result, such pro rata contributions do not provide an objective measure for determining the value of the partnership's assets. Accordingly, if the events triggering an optional revaluation of partnership assets are limited to transactions implicitly valuing the partnership's assets, a pro rata contribution should not be such a triggering event.

It may be that the language of the current regulations reaches this result. As currently written, reg. section 1.704-1(b)(2)(iv)(f)(5)(i) provides that a contribution to the partnership of more than a de minimis amount of money or property triggers an optional revaluation of the partnership's assets if the contribution is in "consideration for an interest in the venture." Arguably, a pro rata contribution does not constitute consideration for an "interest in the venture" because the partners maintain their relative interests in the venture. Equally true, however, is that each partner increases his absolute interest in the venture, and the language in the current regulation does not make clear whether it speaks to relative or absolute interests. Because a change in absolute but not relative interest in the venture does not provide an objective valuation of the partnership's assets, reg. section 1.704-1(b)(2)(iv)(f)(5)(i) should be amended to provide that a contribution of more than a de minimis amount of money or property to the partnership triggers an optional revaluation of the partnership's assets only if the contribution is in exchange for a new or increased relative interest in the venture. The same issue arises with pro rata distributions under reg. section 1.704-1(b)(2)(iv)(f)(5)(ii), and a parallel change to that regulation should be made as well.

3. Sale of a partnership interest should permit a book-up. As described above in section (II)(A)(2), current regulations permit the revaluation of partnership assets and a restatement of capital accounts upon the occurrence of market transactions from which the value of the partnership's assets can be determined. Consistent with this approach, the list of transactions triggering a permissible partnership revaluation of its assets should be expanded to include a taxable, arm's-length sale or exchange of a partnership interest.

Consider the following example. P, Q, and R are equal partners in the PQR limited liability company (taxable as a partnership) with capital accounts and outside bases of $2,000 each. R sells her partnership interest in an arm's-length transaction to S for $2,400. Because S is purchasing a one-third interest in the venture for $2,400, the total value of the partnership's assets should equal $7,200. Accordingly, a revaluation of the partnership assets to $7,200 should be authorized for the same reasons that revaluations are authorized when cash or property is contributed to or distributed from a partnership. Under current law, the inside basis of the partnership's assets can be increased to reflect the full $2,400 paid by S.[23] Nonetheless, current law does not permit a change to the book value of the partnership's assets.[24]

A revaluation of partnership assets in this example is particularly important for the purchasing partner (that is, for S). If S does not have an obligation to contribute additional funds to the venture, then under the alternate test for economic effect no allocation of loss can be made to S in excess of S's capital account.[25] S's capital account is equal to $2,000 because, under existing authority, the

[21]If the partners are dealing at arm's length, then the contributing partner's precontribution share of one-quarter of the venture plus $1,000 equals one-half of the postcontribution value of the venture. If the precontribution value of the partner's assets equaled $3,000, then a one-third share equaled $1,000, and that amount plus $1,000 equals one-half of the postcontribution $4,000 value of the assets.

[22]If the assets of the venture are worth $300 immediately before the contributions by X and Y, then the assets of the venture are worth $500 immediately after, and a 40 percent interest in $500 equals $200, the same as $100 plus a one-third interest in $300.

[23]Section 743(b); *see* reg. section 1.743-1(b).

[24]Reg. section 1.704-1(b)(2)(iv)(m)(2).

[25]Reg. section 1.704-1(b)(2)(d)(3).

transferee of a partnership interest takes the capital account of the transferor.[26] Here, that means S's capital account equals $2,000 and, as a result, no more than $2,000 of partnership loss can be allocated to S.

This $2,000 loss limitation is, on these facts, wholly artificial. S's economic investment in the venture equals S's purchase price of $2,400. If the partnership's assets decline to zero, S's investment will become worthless and S should be entitled to a deduction equal to S's investment; that is, to $2,400. Further, assuming neither P nor Q can be required to contribute additional funds to the partnership, the maximum loss that can be allocated to P and to Q under the alternate test for economic effect is $2,000 each.[27] Thus, there will be a tax loss of $6,400 but a book loss of only $6,000, seemingly precluding $400 of the tax loss from being allocated to *any* partner. While there might be a way to read into existing regulations some mechanism for allocating this tax loss,[28] surely the right result is most easily reached by allowing the partnership to revalue the partnership's property and restate capital accounts when S purchases R's partnership interest in an arm's-length transaction. Accordingly, reg. section 1.704-1(b)(2)(iv)(f)(5) should be amended to authorize the revaluation of property on a taxable transfer of an interest in the venture.

B. Transfers of Built-In Gain

1. Transfer of built-in gain should not be 'proportional' to the value of an interest transferred. If a partner transfers his partnership interest, the transferor's capital account in the partnership carries over to the transferee.[29] As a result, any built-in gain in partnership property must be allocated to the transferee as it would have been allocated to the transferor.[30] If only a portion of a partnership interest is transferred, then the capital account of the transferor "that is attributable to the transferred interest" must be carried over to the transferee.[31] Regarding the transfer of less than the entire partnership interest, current regulations provide that "the share of built-in gain . . . *proportionate to the interest transferred* must be allocated to the transferee partner."[32] No further guidance is provided concerning the determination of built-in gain "proportionate to" the transferred portion of a partnership interest.

If a portion of a partnership interest is sold in an arm's-length transaction, the proportion of the transferor's share of built-in gain *seemingly* should equal the fair market value of the transferred portion as compared with the fair market value of the transferor's entire partnership interest immediately before the sale.[33] In many circumstances, this allocation will yield a proper result. But in some circumstances this allocation will overallocate built-in gain to the transferee and so will shift too much built-in gain away from the transferor.

Consider the following example.[34] X and Y each contributes $100 to the XY partnership in exchange for a 50 percent interest in profits and losses. The partnership agreement provides that partnership assets will be revalued and partnership capital accounts will be restated as provided in reg. section 1.704-1(b)(2)(iv). The partnership purchases two nondepreciable assets, Blackacre and Whiteacre, for $100 each. After Blackacre increases in value to $240 and Whiteacre increases in value to $280, Blackacre is distributed to X in a nonliquidating distribution and the partnership agreement is amended to allocate future profits 7 percent to X and 93 percent to Y.[35] After these events, the partnership books stand as follows:

	X		Y	
	CA	**OB**	**CA**	**OB**
Cash contributions	$100	$100	$100	$100
Book-up of Blackacre	$70	$0	$70	$0
Book-up of Whiteacre	$90	$0	$90	$0
Distribution of Blackacre	($240)	($100)	$0	$0
	$20	$0	$260	$100

The partnership now owns only Whiteacre with a current fair market value of $280. X's interest is worth $20 and Y's interest is worth $260. Suppose at this point that X sells one-half of his partnership interest to Z for its current fair market value of $10. X recognizes a gain of $10 on the sale. If Z takes on one-half of X's share of the built-in gain in Whiteacre, then when Whiteacre is sold, the taxable gain of $180 will be allocated $45 to X, $90 to Y, and $45 to Z. This cannot be the proper result: X should not be able to avoid $45 of built-in gain by recognizing only $10 of income on the sale to Z. If Z is a low-bracket taxpayer (in the extreme case, a zero-bracket taxpayer

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[26]Reg. section 1.704-1(b)(2)(iv)(*l*).

[27]Reg. section 1.704-1(b)(2)(d)(3).

[28]*See* reg. section 1.704-1(b)(4)(i) (allocations to reflect revaluations), 1.704-1(b)(2)(iv)(q) (adjustments where guidance is lacking).

[29]Reg. section 1.704-1(b)(2)(iv)(*l*).

[30]Reg. section 1.704-3(a)(7). While this regulation also provides that built-in loss must be allocated to the transferee as it would have been allocated to the transferor, the loss portion of this rule has been significantly limited by enactment of section 704(c)(1)(C) as part of the American Jobs Recovery Act of 2004. The comments made herein do not speak to issues raised by section 704(c)(1)(C).

[31]Reg. section 1.704-1(b)(2)(iv)(*l*).

[32]Reg. section 1.704-3(a)(7) (emphasis added).

[33]*See* Eric Sloan, Judd Sher, Matthew Sullivan, and Julia Trossen, "Order in the Court: Why Ordering Matters in Partnership Transactions," *Tax Notes*, Aug. 27, 2007, p. 765, *Doc 2007-18483*, or *2007 TNT 167-38*. I have criticized some of the results reached in their article in ways consistent with the discussion herein. *See* Abrams, *supra* note 15; Abrams, "Now You See It, Now You Don't: Exiting a Partnership and Making Gain Disappear," 50 *Tax Mgmt. Mem*. 75 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1374125 as Emory Public Law Research Paper No. 9-58; and Abrams, "Dispositions and Partial Dispositions of a Partnership Interest," 11 *J. of Passthrough Entities* 31 (2008).

[34]This example is based on Abrams, "The Section 734(b) Basis Adjustment Needs Repair," 57 *Tax Lawyer* 343, 362-364 (2004).

[35]These postdistribution shares of profits and loss are included for completeness but play no role in the analysis.

such as an exempt organization), the sale permanently reduces the tax burden imposed on the gain accruing to and enjoyed by X.

If the partnership has an election under section 754 in effect or makes such an election for the year of the sale, the sale from X to Z produces even more objectionable results. If such an election is in effect, then Z is entitled to an inside basis adjustment under section 743(b)(1) equal to "the excess of the basis to [Z] of his interest in the partnership over [Z's] proportionate share of the adjusted basis of the partnership property." Under existing regulations, the amount of this excess equals $45.[36] Accordingly, if the partnership then sells Whiteacre, there will be a taxable gain to X of $45, to Y of $90, and nothing to Z. That is, at a cost of $10 of income recognition to X on the sale to Z, one-quarter ($45) of the appreciation in Whiteacre escapes taxation.[37]

A more sensible result would be that only $10 (rather than one-half, or $45) of X's share of the built-in gain in Whiteacre shifts to Z. If that is true, then when Whiteacre is sold by the partnership after Z joins the venture, X will be taxed on $80 of the built-in gain on that sale. This $80 of gain recognized by X, along with the $10 recognized by X on the sale of one-half of X's partnership interest to Z, is the full $90 that was booked into X's capital account when Whiteacre was revalued. Further, if an election under section 754 is in effect, Z will report no gain or loss from the partnership's sale of Whiteacre, again a proper result because Whiteacre did not change in value after Z's purchase of one-half of X's partnership interest.

Z's initial capital account equals that portion of X's pretransfer capital account balance "that is attributable to the transferred interest."[38] In this example, immediately before the sale from X to Z, X's claim on the value of the partnership's asset equaled $20. Because Z purchased one-half of X's interest in the venture, Z's share of the venture must equal one-half of $20, or $10. That must be the initial value of Z's capital account regardless of how much built-in tax gain is treated as shifting from X to Z. My proposal simply limits Z's share of the built-in gain to the value of Z's interest in the venture.

The need for a nuanced determination of the amount of built-in gain shifting to a transferee also can arise following a leveraged partnership distribution. Consider the following example. P and Q own 60 percent and 40 percent of the profits of PQ-LLC,[39] a limited liability company electing to be taxed as a partnership. The partnership owns a single, nondepreciable asset with inside basis and book value of $0 and fair market value of $2,000. In a year in which the partnership has an election under section 754 in effect, the partnership borrows $500 from a third-party lender, with 60 percent of the debt guaranteed by P and 40 percent of the debt guaranteed by Q. The $500 loan proceeds are distributed to the partners in proportion to their guarantees. After this series of transactions, the books of the venture read as follows:

	P		Q	
	CA	OB	CA	OB
Initial values	$0	$0	$0	$0
Borrowing	$0	$300	$0	$200
Distribution	($300)	($300)	($200)	($200)
	($300)	$0	($200)	$0

At this point, the partnership owns a single asset with inside basis of zero and fair market value of $2,000, encumbered by a debt of $500. P's share of the partnership's $1,500 equity is $900 while Q's share is $600. If the partnership sells its remaining asset for its fair market value of $2,000, the gain of $2,000 will be allocated $1,200 to P and $800 to Q. Thus, each partner's share of the partnership's built-in gain exceeds the fair market value of the partner's interest in the venture.

Suppose that Q now sells one-half of his interest to R for its fair market value of $300 and that R does not guarantee repayment of any of the partnership's debt. Q recognizes a gain of $300 on the sale and Q's outside basis equals $300. If the portion of built-in gain shifting to Q is equal to the relative value of the partnership interest acquired from Q, then one-half of Q's share — that is, $400 — of built-in gain shifts to R. Because Q recognized only $300 of gain on the sale to R, this represents too great a shift to R and, just as in the XYZ example above, offers a tax minimization possibility for the selling partner.

As before, a more sensible result is reached if the share of built-in gain shifting to the purchaser (that is, to R) equals the gain recognized by the seller (that is, by Q) on the sale of the partnership interest. Here, that means only $300 of Q's built-in gain should shift to R, leaving $500 of built-in gain remaining with Q. This result further ensures that a section 754 election by the partnership cannot be used to make partnership gain disappear.

Consistent with this determination of the amount of built-in gain that shifts to R, R's capital account balance must equal $0. Because R has purchased one-half of Q's

[36]Z's proportionate share of the adjusted basis of the partnership property equals the amount of cash that Z would receive on liquidation of the partnership following a sale of Whiteacre for its book value (that is, $10), less the taxable gain that would be allocable to Z on that sale. *See* reg. section 1.743-1(d). If Z takes on one-half of X's share of the built-in gain in Whiteacre, then the taxable gain that would be allocable to Z on the sale of Whiteacre is $45, so that Z's share of the partnership's adjusted basis in its assets equals $10 less $45, or negative $35. The amount of the basis adjustment in favor of Z is then the excess of Z's outside basis ($10) over that share of inside basis (-$35), and $10 minus negative $35 equals $45. *See generally* Richard L. Doernberg, Howard E. Abrams, and Don A. Leatherman, *Federal Income Taxation of Corporations and Partnerships*, 786-789 (4th ed. 2009).

[37]"Escapes taxation" is an overstatement. Because X avoids $35 of gain recognition when Whiteacre is sold by the partnership, X's outside basis will be $35 lower than if that gain had not been avoided. Accordingly, the gain will reappear if X exits the venture in a taxable transaction or will result in a reduced asset basis if X should receive distributions of partnership property. The avoided gain will be eliminated in its entirety only if X dies before recognizing the gain in some other form.

[38]Reg. section 1.704-1(b)(2)(iv)(*l*).

[39]This example is taken from Abrams, *supra* note 15.

interest in the partnership, R must be entitled to receive one-half of what formerly would have been Q's share of the value of the partnership's assets. As indicated above, that share was $600 so that R's share must be one-half of $600, or $300. R's initial capital balance therefore must equal $0 (and Q's capital account balance must remain negative $200) so that each will have a capital account balance of $300 after the partnership sells its asset.

The analysis becomes slightly more complex when a partner makes a transfer of a portion of the partnership interest in a tax-free transaction such as a transaction described in section 351 or section 721. For example, reconsider the XYZ example above but assume that X does not sell half his partnership interest but rather contributes it to a partnership, say to the N Partnership. If half of X's built-in gain is treated as shifting to N as a result of the transfer, then once again an election under section 754 will allow some of X's gain to escape taxation: the amount of the outside basis adjustment under section 743(b) in favor of N will be $35,[40] thus shielding $35 of the unrealized appreciation in Whiteacre from recognition when Whiteacre is sold by the partnership.

If, as proposed above, unrealized appreciation shifts to N only to the extent that X recognizes gain on the transfer, then no built-in gain would shift to N. But that is not the right outcome in this case because a tax-free transfer of property in a carryover basis transaction is supposed to shift gain from the transferor to the transferee; more specifically, it is supposed to shift an amount of gain equal to the excess of the fair market value of the transferred property over the adjusted basis of that property in the hands of the transferor.[41] Applying this rule, $10 of X's gain should be transferred to N by reason of the tax-free transfer.

If $10 of built-in gain is transferred to N, then a sale by the partnership of Whiteacre for its book value of $280 yields a taxable gain to the partnership of $180, of which $80 is allocable to X, $90 is allocable to Y, and $10 is allocable to N. This result makes sense: X transferred an asset to N having a zero basis and a fair market value of $10, and so N ultimately reports $10 of income allocable to the transferred asset. Further, N's inside basis adjustment under section 743(b) equals $0, so no appreciation escapes taxation. If more than $10 of built-in gain had shifted from X to N, then that excess built-in gain would be excluded from taxation on disposition of the partnership's asset as a consequence of a section 743(b) adjustment triggered by the transfer from X to N.

Each of the examples presented so far has involved a transferor partner having a zero basis in his partnership interest, but the same analysis applies if the transferor partner has a positive outside basis. Consider, for example, the following variation on the PQ example discussed above. P and Q own 60 percent and 40 percent of the profits of PQ-LLC, a limited liability company electing to be taxed as a partnership. The partnership owns a single, nondepreciable asset with inside basis and book value of $0 and fair market value of $2,000. In a year in which the partnership has an election under section 754 in effect, the partnership borrows $500 from a third-party lender, with 60 percent of the debt guaranteed by P and 40 percent of the debt guaranteed by Q. Four hundred dollars of the $500 loan proceeds are then distributed to the partners in proportion to their guarantees. After this series of transactions, the books of the venture read as follows:

	P		Q	
	CA	OB	CA	OB
Initial values	$0	$0	$0	$0
Borrowing	$0	$300	$0	$200
Distribution	($240)	($240)	($160)	($160)
	($240)	$60	($160)	$40

At this point, the partnership owns cash of $100 along with an asset with inside basis of zero and fair market value of $2,000, encumbered by a debt of $500. P's share of the partnership's $1,600 equity is $960 while Q's share is $640. If the partnership sells its asset for fair market value of $2,000, the gain of $2,000 will be allocated $1,200 to P and $800 to Q. If the partnership were then to liquidate, its cash of $2,100 would pay off the debt of $500, and the remainder would be distributed $960 to P and $640 to Q.

Suppose the partnership does not sell its asset but rather Q sells one-half of his interest to R for its fair market value of $320. Assuming, as before, that R does not guarantee repayment of any of the partnership's debt, Q recognizes a gain of $320 on the sale[42] and R's outside basis equals $320. If, as proposed above, the portion of built-in gain shifting to R is set equal to the amount of gain recognized on the sale by Q, then $320 of built-in gain should shift to R. R's capital account should start at $0 (the amount paid by R less R's share of the unrealized appreciation in the partnership's property) and Q's capital account deficit balance should remain at negative $160 after the sale to R (because no positive or negative amount moved from Q to R). When the partnership sells its asset for $2,000, R's capital account will increase by $320 from $0 to $320 and Q's capital account will increase by $480 from negative $160 to positive $320, showing that Q and R each own half of the partnership interest formerly owned by Q alone.

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[40]Because the transfer from X to N is a carryover basis transaction, the allocation of the inside basis adjustment is made under a different set of rules. *See* reg. section 1.755-1(b)(1)(i). However, the *amount* of the adjustment does not change; *see* reg. section 1.743-1(b). Further, on the facts of this example, even the allocation of the basis adjustment would be unchanged. *See* reg. section 1.755-1(b)(5).

[41]*See* section 1015(a); *Taft v. Bowers*, 278 U.S. 470 (1929).

[42]*See* Rev. Rul. 84-53, 1984-1 C.B. 159. If, under Rev. Rul. 84-53, the gain recognized by Q on the sale were only $300, then only $300 of built-in gain should shift to R. In this case, R would take an initial capital account of $20 (the amount paid by R less R's share of the unrealized book appreciation in the partnership's asset) and Q's capital account would decline from negative $160 to negative $180 (because $20 was shifted to R).

In conclusion, new regulations should be promulgated under section 704(b) and (c) providing that the amount of built-in gain that shifts to the transferee on the transfer of a portion of a partnership interest should not necessarily be proportional to the value of the interest transferred but rather should be determined by the amount of gain that is recognized by the transferor on the transaction. In the case of a tax-free transfer, the transferee should pick up only so much of the built-in gain as equals the excess of the value of the interest transferred over the transferee's adjusted basis in the acquired interest.

2. Book-up gain and loss should be allocated exclusively to the distributee. Reconsider the first XY example above in which X and Y each contributes $100 to the XY partnership in exchange for a 50 percent interest in profits and losses. The partnership agreement provides that partnership assets will be revalued and partnership capital accounts will be restated as provided in reg. section 1.704-1(b)(2)(iv)(f)-(g). The partnership purchases two nondepreciable assets, Blackacre and Whiteacre, for $100 each. After Blackacre increases in value to $240 and Whiteacre increases in value to $280, Blackacre is distributed to X in a nonliquidating distribution and the partnership agreement is amended to allocate future profits 7 percent to X and 93 percent to Y. After these events, the partnership books stand as follows:

	X		Y	
	CA	OB	CA	OB
Cash contributions	$100	$100	$100	$100
Book-up of Blackacre	$70	$0	$70	$0
Book-up of Whiteacre	$90	$0	$90	$0
Distribution of Blackacre	($240)	($100)	$0	$0
	$20	$0	$260	$100

The partnership now owns only Whiteacre with a current fair market value of $280. X's interest is worth $20 and Y's interest is worth $260. If the partnership sells Whiteacre for its fair market value of $280, there will be a taxable gain of $180, allocable $90 to X and $90 to Y. Thus, the books of the venture will become:

	X		Y	
	CA	OB	CA	OB
Prior values	$20	$0	$260	$100
Sale of Whiteacre	$0	$90	$0	$90
	$20	$90	$260	$190

The partnership owns $280 in cash, and if that cash were distributed in a final, liquidating distribution it would go $20 to X and $260 to Y. On such a final distribution, X would recognize a taxable loss of $70 and Y would recognize a taxable gain in the same amount. Recognition of gains and losses on a final liquidation of cash is the hallmark of a failure of economic effect because it means that tax allocations were not made consistently with the manner in which the associated economic benefits and burdens were shared among the partners during the life of the partnership.[43]

On the book-up of Blackacre immediately prior to its distribution to X, each partner's capital account was increased by one-half of the $140 unrealized appreciation in that asset. When a partnership asset is revalued and the partners' capital accounts are restated, unrealized appreciation in the asset is booked into the capital accounts as the partners have agreed to share gain from the asset.[44] When that tax gain ultimately is recognized by the partnership, it must be allocated among the partners as they shared the capital account increases.[45]

However, the distribution of Blackacre to X precludes that tax allocation: once Blackacre is distributed to X, only X can recognize gain when Blackacre is sold because only X owns the property. Accordingly, although the $140 of appreciation was allocated equally between X and Y (and was booked equally into their capital accounts), X will be taxed on the full $140 appreciation when X eventually sells the property. Thus, the sharing of the economic gain in Blackacre (reflected in the partners' capital accounts) is not matched by the allocation of tax gain from Blackacre (allocated entirely to X). It is this mismatch that causes the tax gains and losses on the liquidation of the partnership.

The solution to this problem is to skew the book allocation of the gain in Whiteacre in a way that offsets the mismatch in the gain in Blackacre. Reconsider the facts of this example but assume that all of the unrealized appreciation in Blackacre (the distributed property) is allocated to X (the distributee partner) and that an offsetting amount of unrealized appreciation is allocated to Y on the predistribution book-up. That gives the following:

	X		Y	
	CA	OB	CA	OB
Cash contributions	$100	$100	$100	$100
Book-up of Blackacre	$140	$0	$0	$0
Offsetting book-up of Whiteacre	$0	$0	$140	$0
Remainder book-up of Whiteacre	$20	$0	$20	$0
Distribution of Blackacre	($240)	($100)	$0	$0
	$20	$0	$260	$100

The totals remain the same but the way in which the totals are reached is very different. Now, gain from the distributed property has been allocated solely to the distributee partner (that is, to X, the partner who necessarily will recognize that gain when the property is sold). And an offsetting amount of gain in undistributed property has been allocated to Y, the nondistributee partner. These allocations of the book gain in the partnership's

[43]*See* reg. section 1.704-1(b)(2)(ii)(b); reg. section 1.704-1(b)(5), Example 1(iv)-(v).
[44]Reg. section 1.704-1(b)(2)(iv)(f)(2).
[45]Reg. section 1.704-1(b)(2)(iv)(f)(4).

assets ensure that book allocations will match tax allocations, both regarding property distributed to X and regarding property retained by the partnership.[46] Note that an important consequence of this set of book allocations is that when Whiteacre is sold by the partnership, almost all of the taxable gain will be includable by Y.[47]

These allocations may not be effective under current law. Section 704(b) provides that allocations as agreed to by the partners will be effective for tax purposes only if they have ''substantial economic effect.'' Under current regulations, partnership allocations have ''substantial economic effect'' only if (1) they are consistent with the underlying economic arrangement of the partners[48] and (2) there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax considerations.[49] The proposed allocations are consistent with the economic arrangement among the partners (indeed, as discussed below, I believe they are the only set of allocations consistent with the economic arrangement among the partners), but arguably (although, I believe, incorrectly) they might be thought not to affect the dollar amounts received by the partners.

A set of allocations cannot fail the substantiality test in a vacuum. Instead, a set of allocations can fail the substantiality test only if it reduces the aggregate tax liability of the partners without changing substantially the dollar amounts that the partners will receive *as compared with another valid set of allocations that better reflects the partners' interests in the partnership*.[50] The argument that my proposed allocations fail the substantiality test is clear: because these proposed allocations do not change the capital account totals as compared with a straight 50-50 allocation of book gain from each partnership asset, they do not affect the dollar amount any partner will received *as compared with straight 50-50 allocations*. But, as discussed below, it is the straight 50-50 allocations that should be subject to challenge because they do not allocate book income consistently with the recognition of partnership taxable income.

When partnership property is distributed to a partner, the property must be revalued to current fair market value immediately before the distribution.[51] Any difference between the value of the property as carried on the books of the partnership before the revaluation and the fair market value of the property at that time is allocated among the partners as they would share that gain (or loss) if the property were sold rather than distributed.[52] While the partnership agreement may specify each partner's share of such book gain or loss, those specifications must have ''substantial economic effect.''[53]

Regardless of the manner of allocating the revaluation book gain or loss, the tax gain or loss will in fact be reported by the distributee partner alone because, once the property is distributed, only the owner of property reports taxable gain or loss from the disposition of property. That is, the distribution of the property forces all unrealized appreciation or loss to the distributee partner. Accordingly, because book gains (or losses) and tax gains (or losses) must be allocated consistently with one another to satisfy the requirement of economic effect,[54] the revaluation book gain or loss should be allocated exclusively to the distributee partner.[55]

In the XY example above, Blackacre is distributed to X. Immediately before the distribution, Blackacre is carried on the books of the partnership at $100. Because Blackacre is worth $240 at the time of the distribution, $140 of unrealized book gain must be allocated between the partners, and those allocations add to their capital accounts. Regardless of how that book gain is allocated following the revaluation, the associated tax gain will be includible to X in full because it is X alone who holds the property once it has been distributed. Accordingly, the *only* allocation of the book gain that will be consistent with the eventual allocation of the tax gain is to allocate all of the book gain to X.

Because this allocation of book gain to X will increase X's capital account balance, it will increase the amount X is entitled to receive on a liquidation of X's interest in the

[46]This example involves a nonliquidating distribution of property. In a nonliquidating distribution, the distributee partner's basis in the distributed asset generally will equal the partnership's adjusted basis in the asset immediately before the distribution (section 732(a)(1)); and in no event will it be greater, *see* section 732(a)(2). If a distribution is made in liquidation of a partner's interest in the venture, then the distributee partner's basis in the distributed assets can exceed the partnership's adjusted basis in the distributed assets. *See* section 732(b). In such circumstances, the amount of tax gain recognized by the distributee partner on sale of the asset will produce less tax gain than would have been recognized if the asset had been sold by the partnership rather than distributed, and the prior distribution by the partnership will have triggered a basis reduction under section 734(b)(2). The amount of built-in gain in undistributed assets properly allocable to the nondistributee partners will then have to be coordinated with the rules of section 734(b). Such coordination seems beyond the scope of Notice 2009-70 and so is not proposed herein. In the absence of such coordination, this proposal and the next might properly be limited to nonliquidating distributions.

[47]If the undistributed property is depreciable or amortizable, then the proposed allocations will also affect the allocation of tax depreciation or amortization among the partners.

[48]Reg. section 1.704-1(b)(2)(ii)(a).

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

[50]*See, e.g.*, reg. section 1.704-1(b)(5), Example 7(i) (disallowing a special allocation of exempt income as lacking substantiality when compared with a straight 50-50 sharing).

[51]Reg. section 1.704-1(b)(2)(iv)(e)(1).

[52]*Id*; *see also* reg. section 1.704-1(b)(2)(iv)(f)-(g).

[53]Section 704(b)(2).

[54]Reg. section 1.704-1(b)(2)(ii)(a) (second sentence).

[55]Usually, when book items and tax items are not recognized simultaneously, allocations of book gains and losses are constrained only by the ''substantial economic effect'' test, and then the associated tax items are made consistently with the prior book allocations. *See, e.g.*, reg. section 1.704-1(b)(5), Example 14(i). But when unrealized book gain and loss from the revaluation of distributed property is made, it must follow the subsequent tax gain rather than lead it because the distribution forces allocation of the tax gain to the distributee partner.

venture.[56] Accordingly, unless the partners have agreed to a disproportionate economic relationship, an offsetting allocation of unrealized book gain must be made to Y's capital account to ensure the aggregate allocations fully reflect the equal economic relationship between the partners. In the XY example, this is accomplished by allocating the first $140 of unrealized book gain from Whiteacre to Y. This disproportionate allocation of book gain from Whiteacre to offset the disproportionate allocation of gain in Blackacre arising from the distribution is virtually identical to the section 704(c) "traditional method with curative allocations" recovery method.[57] In this context, as in the more conventional context in which curative allocations are used to correct imbalances caused by the ceiling limitation, such curative allocations ensure that book allocations and tax allocations are consistent.[58]

A constraint should be placed on the partnership's ability to allocate to the nondistributee partners unrealized gain or loss in undistributed assets to offset the disproportionate allocation to the distributee partner of gains or losses in distributed property. In the absence of the distribution, the nondistributee partners would share in the unrealized book gain or loss in the distributed asset.[59] To make-up for that share of gain or loss, book gain or loss from undistributed assets should be allowed as long as the offsetting allocation is expected to have substantially the same effect on each partner's tax liability as the gain from the distributed property would have had if that property had been sold rather than distributed. This limitation ensures that the distribution of property by a partnership cannot be used to allocate items by character in violation of the limitations imposed by the "substantiality" regulations[60] and is taken virtually word for word from the existing regulations applicable to use of the section 704(c) "traditional method with curative allocations" recovery method.[61]

It is possible that when appreciated property is distributed by a partnership to a partner, the unrealized appreciation in the partnership's remaining assets is insufficient to offset the effect of the distribution on the nondistributee partners. This is akin, under existing regulations, to the use of curative allocations when there is insufficient partnership income or loss with which to effect a cure.[62] If a distribution is made in such circumstances, the offsetting allocation of unrealized book income to the nondistributee partners might be deferred (as can happen in the case of certain optional basis adjustments; see reg. section 1.755-1(c)(4)), replaced with disproportionate allocations of taxable income or loss from partnership operations, or simply left uncorrected (as can be the case with curative allocations; see reg. section 1.704-3(c)(3)(i)). But it would be peculiar at best to leave in place the current regime that fails in *all* cases because there might be occasions that cannot immediately be corrected in full.

In conclusion, when appreciated property is distributed by a partnership to a partner in a nonliquidating distribution, built-in book gain in the distributed asset should be allocated exclusively to the distributee partner and, to the extent necessary to ensure consistency with the economic arrangement among the partners, an offsetting portion of built-in gain in undistributed assets should be allocated to the nondistributee partner.

3. Book gain in distributed property should be reallocated to the distributee. Reconsider the XY example above in which X and Y each contributes $100 to the XY partnership in exchange for a 50 percent interest in profits and losses. The partnership owns two nondepreciable assets, Blackacre and Whiteacre, each with a cost basis to the partnership of $100. After Blackacre increases in value to $240 and Whiteacre increases in value to $280, Blackacre is distributed to X in a nonliquidating distribution and the partnership agreement is amended to allocate future profits 7 percent to X and 93 percent to Y. However, assume that the assets of the partnership are carried on the books of the venture at current fair market value because they had been revalued based on some event described in reg. section 1.704-1(b)(2)(iv)(f).[63] Accordingly, the books of the venture should read:

	X		Y	
	CA	**OB**	**CA**	**OB**
Cash contributions	$100	$100	$100	$100
Book-up of Blackacre	$70	$0	$70	$0
Book-up of Whiteacre	$90	$0	$90	$0
	$260	$100	$260	$100

Assume that the partnership now distributes Blackacre to X in a nonliquidating distribution. Under section 732(a)(1), X will take an adjusted basis in Blackacre of $100. As a result, all $140 of the unrealized appreciation in Blackacre will be taxed to X on disposition of the asset even though only half of that gain was allocated to X when held by the partnership. This is the issue discussed immediately above, and the solution should remain the

[56]*See* reg. section 1.704-1(b)(2)(ii)(b)(2) (general test for economic effect), and -1(b)(2)(ii)(d)(1) (alternate test for economic effect).

[57]*See* reg. section 1.704-3(c).

[58]As a theoretical matter, the "remedial allocation" section 704(c) recovery method also could be used in his context. *See* Abrams, "The Section 734(b) Basis Adjustment Needs Repair," 57 *Tax L. Rev*. 343, 357-364 (2004). However, application of remedial allocation principles in this context would cause distributions of appreciated property to be taxable events to nondistributee partners, an outcome inconsistent with existing section 731(a).

[59]This sharing is determined, under section 704(b), by reference to the partnership agreement subject to the requirement of substantial economic effect.

[60]*See* reg. section 1.704-1(b)(2)(iii)(b).

[61]Reg. section 1.704-3(c)(3)(iii)(A).

[62]*See* reg. section 1.704-3(c)(1).

[63]For example, one partner might have made a contribution of cash that was then used to pay deductible expenses, and this deduction was allocated to the partner contributing the cash. *See, e.g.*, Rev. Rul. 99-43, 1999-2 C.B. 506.

same: X should be allocated all of the unrealized appreciation in Blackacre for book purposes because the distribution forces X to recognize all of the unrealized appreciation for tax purposes.

However, because the values of the assets of the venture were restated to fair market values before the distribution, the unrealized appreciation in Blackacre and Whiteacre was allocated according to the partners' general interests in gains and losses: that is, 50 percent to each partner. As a result, the partners cannot disproportionately allocate unrealized book appreciation in the distributed asset to X and an offsetting amount of unrealized book appreciation in the undistributed asset to Y because there is no unrealized book appreciation to allocate to either partner at the time of the distribution.

The partners should be required (certainly, at least, allowed) to retroactively reallocate the appreciation in Whiteacre and Blackacre. That will not change their predistribution capital accounts or outside bases, but it will affect the sharing of taxable gain when Whiteacre is sold by the partnership. Indeed, that is the only change that will result from this proposal, but it is an important change because it ensures that X will not be overtaxed nor Y undertaxed as a consequence of the distribution. The partnership's tax gain from Whiteacre, when Whiteacre is sold by the partnership, should be allocated not $90 to each partner but rather $20 to X and $160 to Y, thus forcing disproportionate taxable income from Whiteacre to substitute for the $70 of gain from Blackacre that was allocated to Y for book purposes but which Y will never recognize for tax purposes because of the distribution of Blackacre to X.

Because reverse-section 704(c) layers caused by the revaluation of partnership assets do not appear in the code, there should be no statutory limitation on the government's ability to promulgate new regulations that provide for the retroactive reallocation of unrealized book gain and loss if such reallocations, as discussed above, are made to ensure that book allocations are consistent with postdistribution allocations of taxable gain and loss. But if newly promulgated regulations authorize the shifting of a forward section 704(c) layer to offset the skewing of tax allocations arising from the distribution of appreciated partnership property,[64] one reasonably might question whether such regulations are inconsistent with section 704(c). For the following reasons, I believe such regulations would be consistent with section 704(c) and so even forward section 704(c) layers should be used to address the inconsistency between book and tax allocations otherwise resulting from the distribution of appreciated property.

First, section 704(c)(1)(A) simply requires that regulations ''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 absence of further statutory detail along with the generic ''take account'' language vests broad discretion in the government. We know, for example, that while built-in taxable gain generally should be allocable to the contributing partner when contributed property is sold by the partnership, disparate book and tax allocations of depreciation can substitute for such taxable gain.[65] Allocating precontribution gain to a noncontributing partner in exchange for an offsetting share of other gain similarly should be allowable.[66]

Second, the legislative history of what is now section 704(c)(1)(A) contemplated and authorized the exchange of built-in gain for other, equivalent gain.[67] Although this legislative history cautions that such an exchange of section 704(c) for other gain should be permitted only ''provided there is no tax avoidance potential,'' that stricture surely would not be violated by regulations that authorize an exchange of built-in gain for other gain only when necessary to ensure that tax allocations correspond with book allocations if appreciated property is distributed by a partnership.

In conclusion, book gain equal to the built-in tax gain in distributed property should be allocated to the distributee partner, and if this rearranges a prior allocation of book gain, an appropriate reallocation of gain in undistributed property should be made.

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[64]For example, one or both of the assets owned by the XY partnership might have been contributed to the partnership with built-in gain at the time of the contribution. To avoid implicating sections 704(c)(1)(B) and 737, assume that any such contribution was made more than seven years before the distribution of any partnership assets.

[65]*See, e.g.*, reg. section 1.704-3(b)(2), Example 1.

[66]Of course, if contributed property is distributed within seven years of contribution, application of section 704(c)(1)(B) may eliminate the precontribution gain that otherwise would be taxed to the distributee; *see* section 704(c)(1)(B)(iii) (eliminating the need for a subsequent offset).

[67]H.R. Rep. No. 432 (pt. 2), 98th Cong., 2d Sess. 1209 (1984).