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The Fundamentals of Section 704(c) – Understanding Partnership Book-Tax Differences

Tuesday, October 25, 2022

3:15 – 4:15 pm

Moderator

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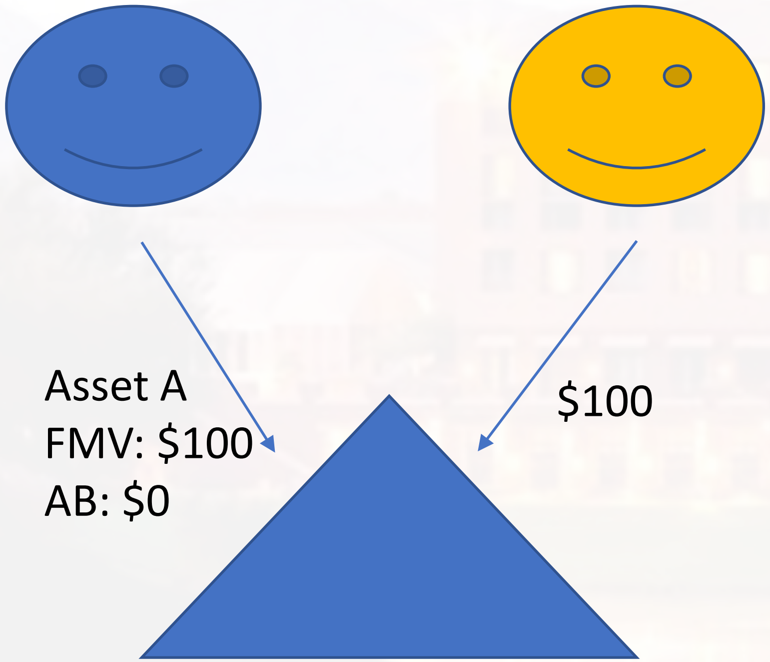
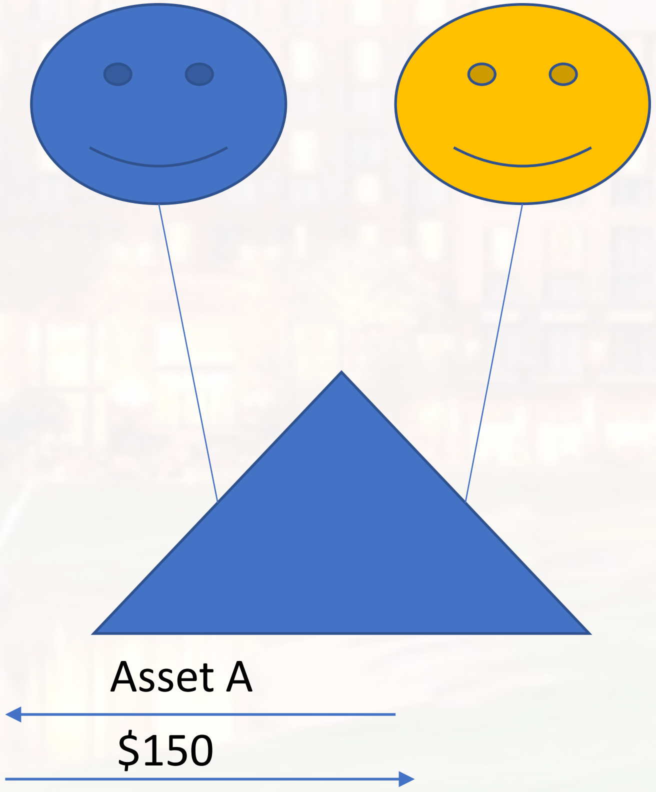
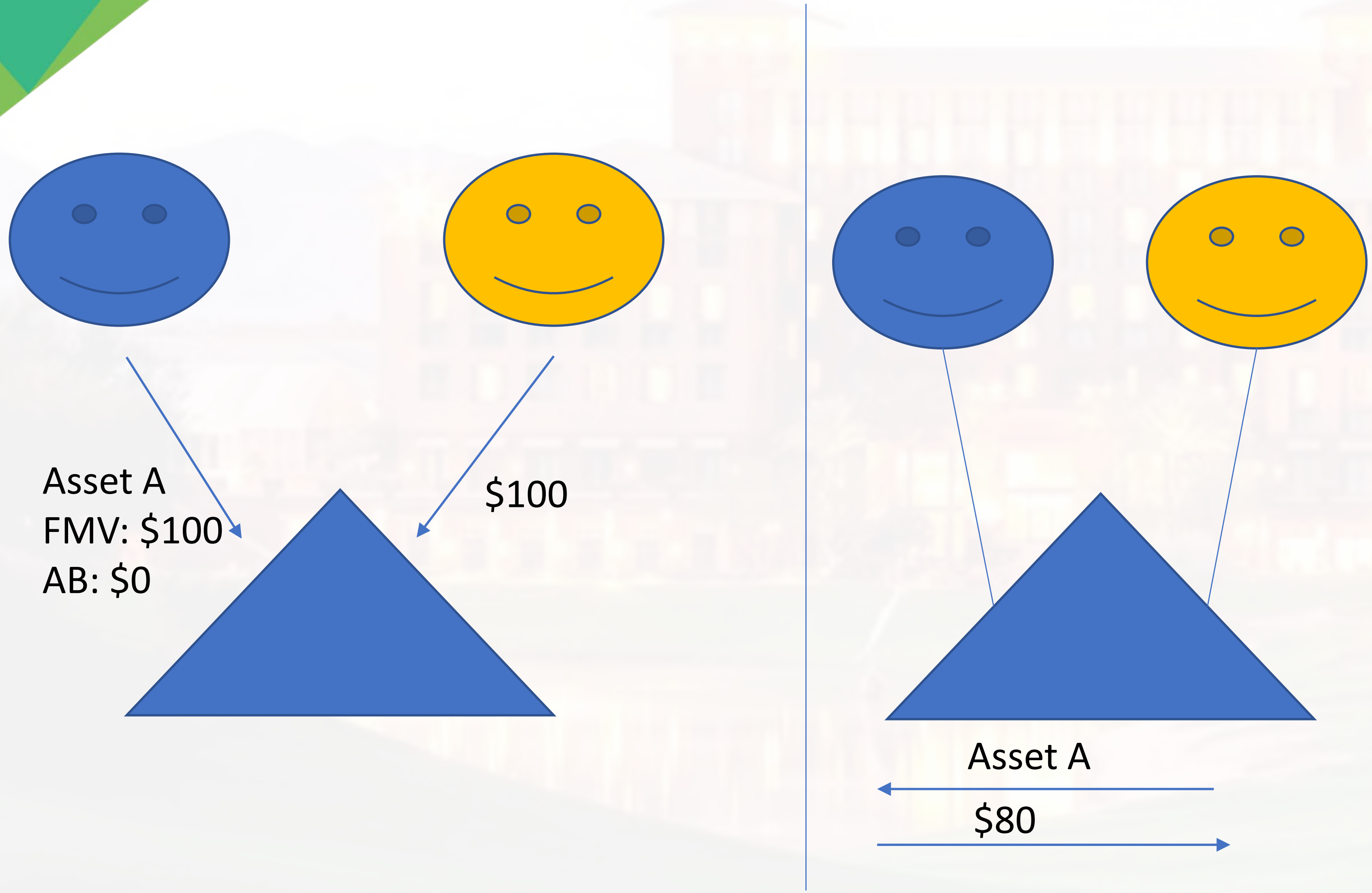
SECTION 704(c) BASIC CONCEPT





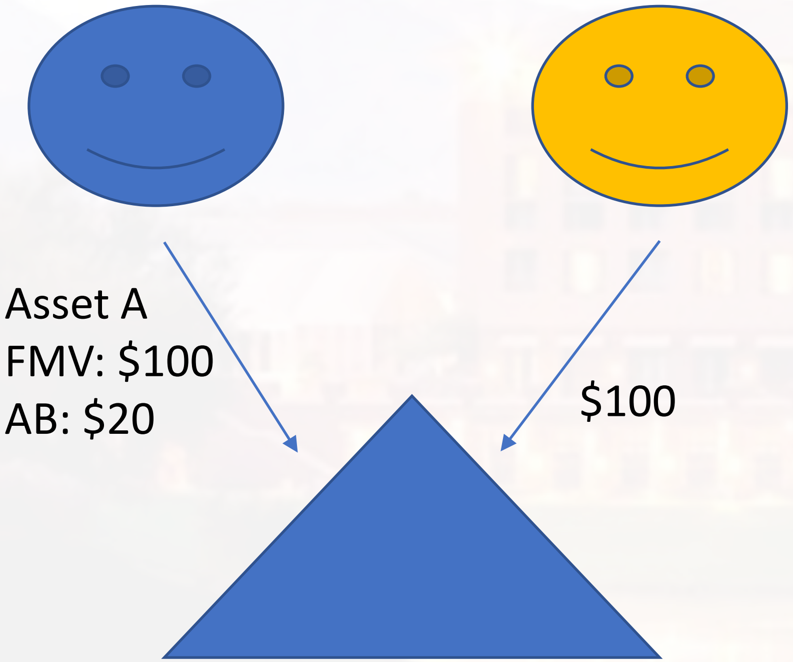
- How should the $150 of gain on Asset A be taxed?
- Section 704(c)(1)(A) makes Blue responsible for difference between FMV and basis at time of contribution.
- Blue is taxed on the $100 of pre-contribution gain.
- Blue and Yellow share the $50 of post-contribution gain.
- “Tax follows Book” for Yellow.

SECTION 704(c) – Ceiling Rule



- Partnership sells Asset A for $80. This is a “book” loss of $20, but a tax gain of $80.
- How does “tax follow book” for Yellow?
- Traditional Method - Yellow does receive a tax loss to match book.
- Curative Method – Other tax items are allocated between Yellow and Blue to give Yellow the right amount.
- Remedial Method -- Artificial $10 loss is created for Yellow and an artificial $10 gain is created for Blue.

SECTION 704(c) – Application to Depreciation



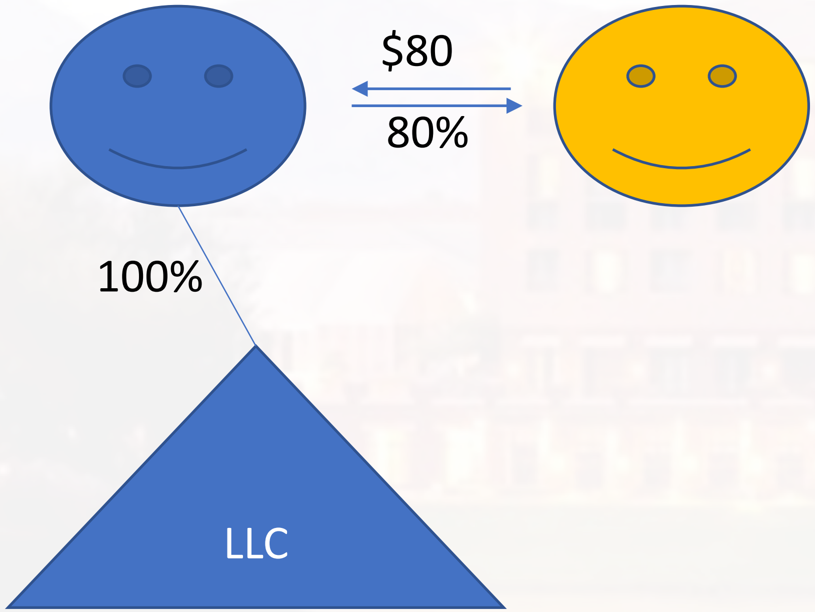
Asset A has two years of straight line recovery left on its five year period.

- We still have the “tax follows book” rule for Yellow.
- Here, Asset A is worth $100, so Yellow would expect to get $50 of depreciation deductions. However, there are only $20 of available depreciation. Those deductions will be allocated to B, but that still leaves B short $30 of depreciation deductions.
- Traditional Method - Yellow does not receive a tax deduction to match book.
- Curative Method – Other tax items are allocated between Yellow and Blue to give Yellow the right amount.
- Remedial Method – Actual basis recovered over, remaining two year period. $80 built-in gain recovered over five year period ($16 year). Yellow’s “book” is $13 for first two years and $8 for next three years. “Remedial” items created to match Yellow’s shortfall.
- What if Asset A had a basis of $60 on contribution?

SECTION 704(c) – Reflexive vs. Thoughtful

- Cash contributors should always ask for remedials
  - Is there insufficient tax to follow book?
  - What is the expected holding period?
  - What is the appetite for deductions?
- Property Contributors should always resist remedials
  - Am I worse off because of remedial allocations?
  - Are remedial allocations worse than another alternative?
- Think about winning the term sheet
  - Preliminary modeling
  - Knowing the profiles

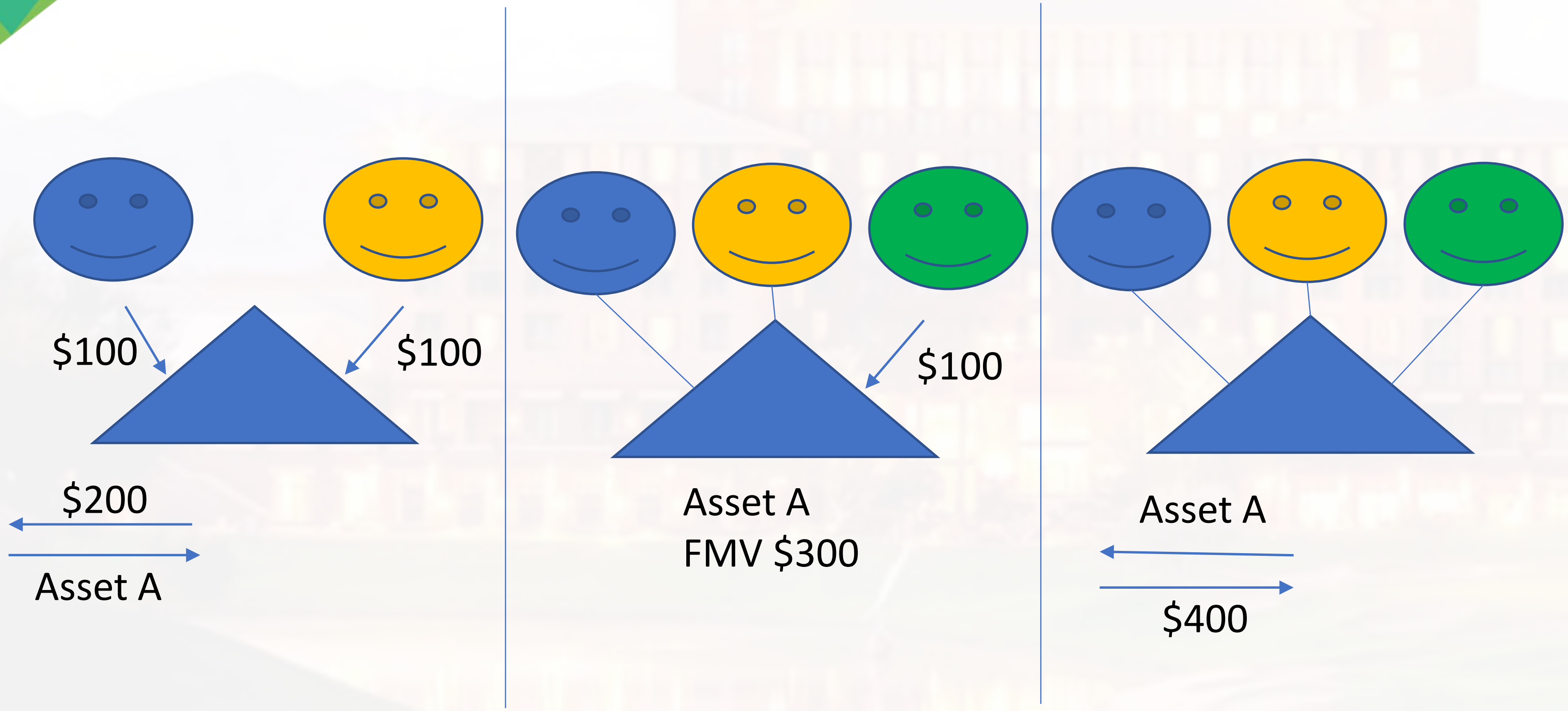
SECTION 704(c) – Rollover Scenario



Asset A
FMV: $100
AB: $0

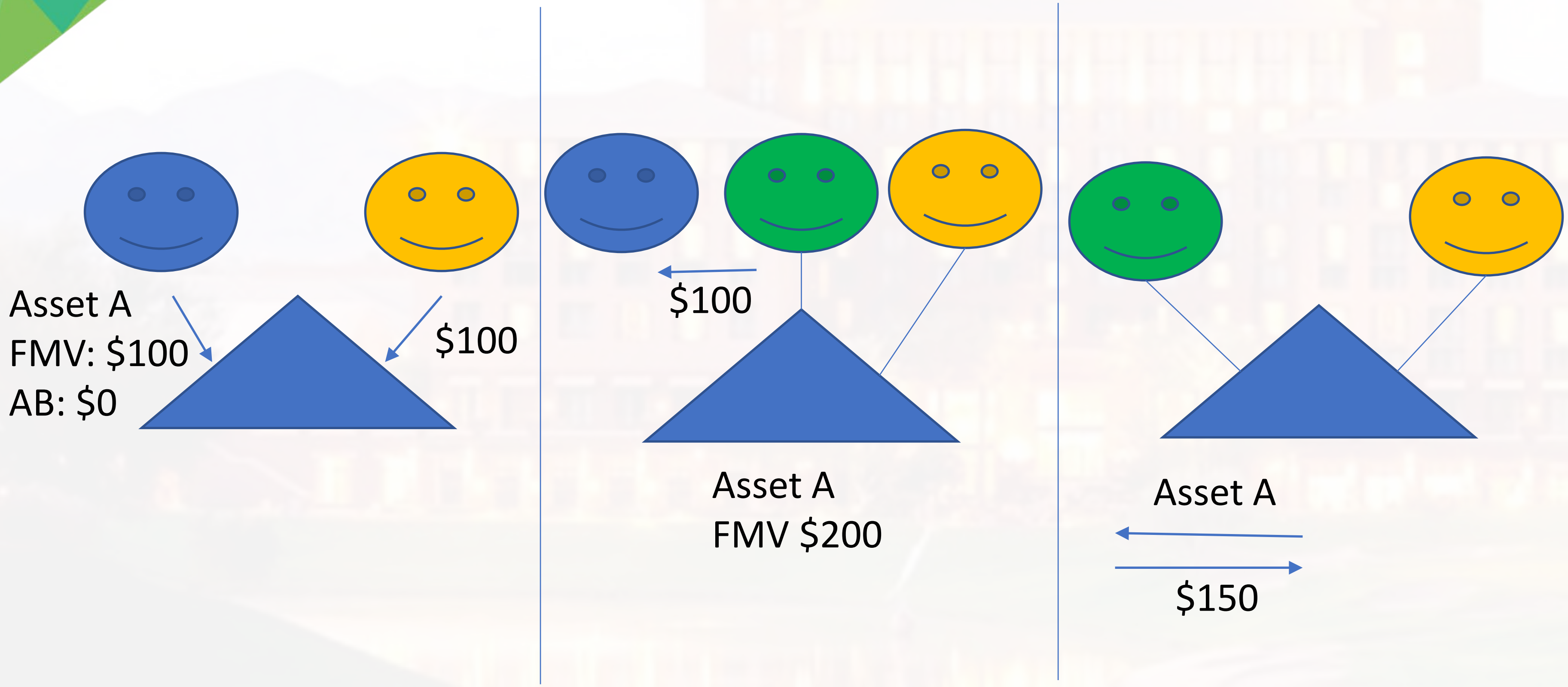
- When Yellow buys 80% of Blue's LLC, Yellow is treated as buying 80% of the assets.
- Yellow is then deemed to contribute its high-basis assets to the partnership while Blue contributes the remaining 20% of low-basis assets to the partnership.
- Yellow will receive $16 of book depreciation on the 20% low-basis assets, and so will routinely ask for remedial allocations which result in $16 of taxable income to Blue.
- From Yellow's perspective, Blue is receiving 20% of the depreciation from Blue's high-basis assets, so the remedial allocations are appropriate.
- For Blue, the $16 of remedial income would be offset by the $16 actual depreciation.
- This is not a question of fairness, it is a question of deal leverage and desired outcomes.

REVERSE SECTION 704(c) Allocations



- Asset A is sold for $400, which results in $200 gain.
- Green's book gain is only 25% of $100, so Green should only be allocated $25 of tax gain.
- The remaining $175 of tax gain should be split between Blue and Yellow.
- What if Blue had contributed Asset A with a $50 basis and a $200 FMV?

SECTION 1.704-3(a)(7) “Step in the Shoes”



- Asset A is sold for $150 with $150 of gain.
- Yellow’s book gain is $25, and so Yellow is allocated $25 of taxable gain.
- Green inherits Blue’s responsibility for the $100 of built-in gain.
- If there is a section 754 election, Green is neutral to stepping into Blue’s shoes.

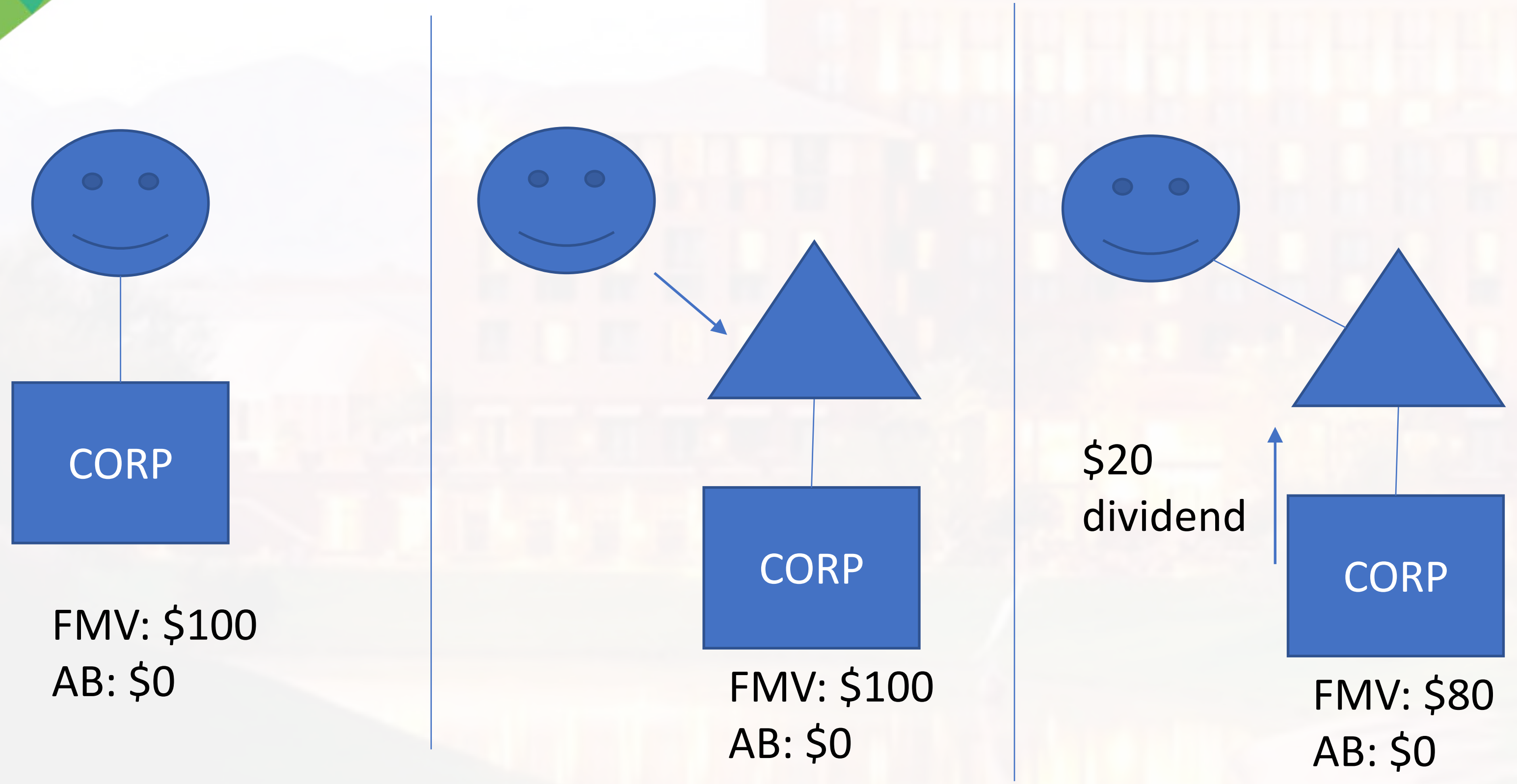
SECTION 704(c)(1)(C) – Built-in Loss

- Historically, the section 704(c) rules applied to built-in loss property as well.

- This was perceived as creating abusive situations because buyers could step into the shoes of a seller's built-in loss.

- Section 704(c)(1)(C) now treats a built-in loss as an external item that is reserved for the contributing partner.

Section 704(c) – What is a built-in item?

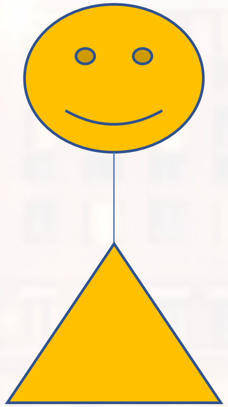


- The shares in CORP are a built-in gain item to Blue.
- What about the dividend?
- What about “booking up” when value is based on discounted cash flows?

Section 704(c) – How to Approach

Blue will invest $200 in LLC for a 50% interest

$200



Equipment – FMV $40, AB $19
Goodwill – FMV $160, AB $0

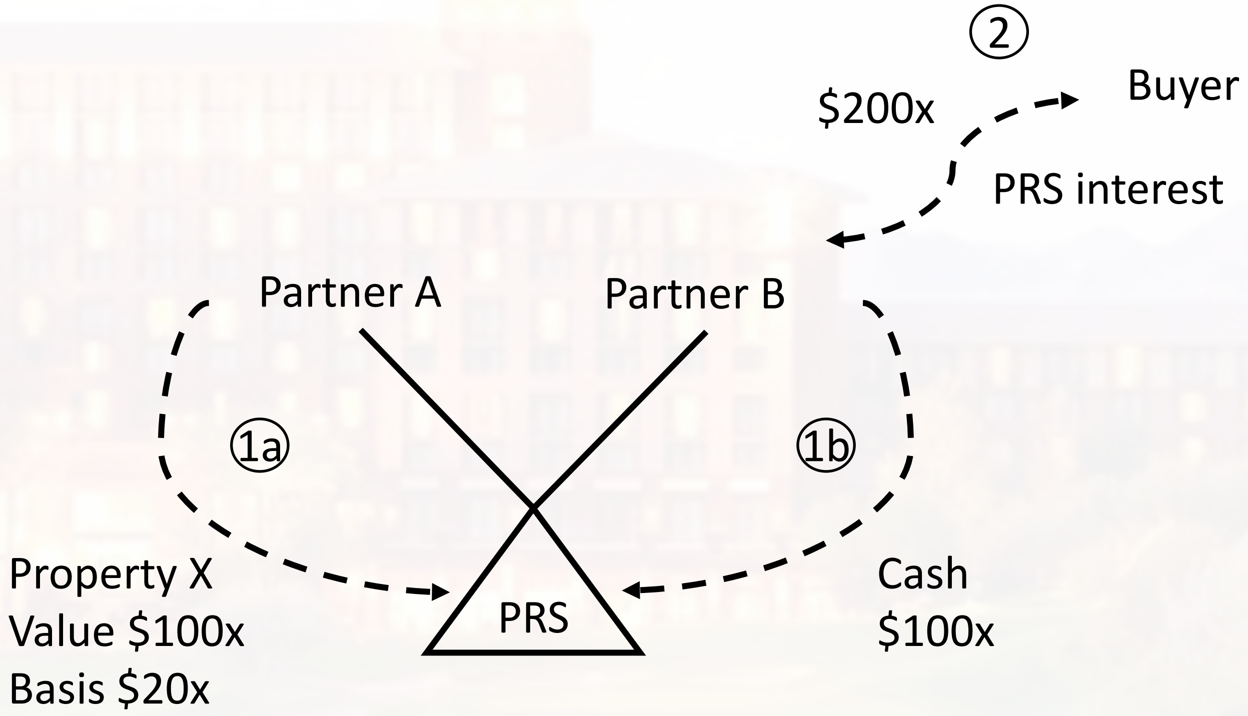
- Does all of Yellow's equipment have proportionate built-in gain? Section 704(c) applies on an asset-by-asset basis (with limited aggregation).
- Is there any concern that Yellow's goodwill could be be considered tainted for purposes of the anti-churning rules? If so, Blue should consider remedial allocations.
- What if Blue is contributing built-in gain assets instead of cash?

Section 704(c) – Additional Considerations

- The traditional, curative, and remedial methods are only examples of “reasonable” methods. It is possible to use alternative methods. Consider “keep your own” approach (PLR 9829016).
- Section 704(c) anti-abuse rule.
- Section 704(c)(1)(B) and Section 737 “Mixing Bowl” rules.

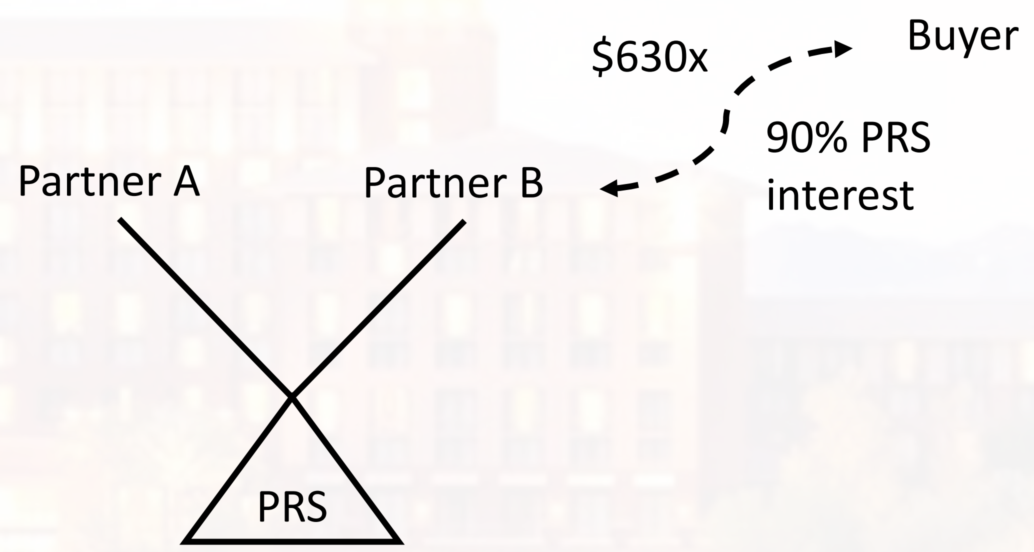
Sale of Partnership Interest (Example 1)

- Partner A and Partner B form PRS.
  - Partner A contributes Property X with value of $100x and basis of $20x.
  - Partner B contributes cash of $100x, which PRS uses to acquire Property Y.
  - PRS adopts traditional method under Section 704(c).
- The value of PRS increases from $200x to $400x.
  - Property X has value of $200x, Section 704(b) basis of $80x, and tax basis of $16x.
  - Property Y has value of $200x, Section 704(b) basis of $100x, and tax basis of $80x.
- Buyer purchases Partner B’s interest for $200x.
  - PRS makes Section 754 election and Buyer gets Section 743(b) adjustment.
  - Does Buyer care that PRS originally adopted traditional method with respect to Property X?



Sale of Partnership Interest (Example 2)

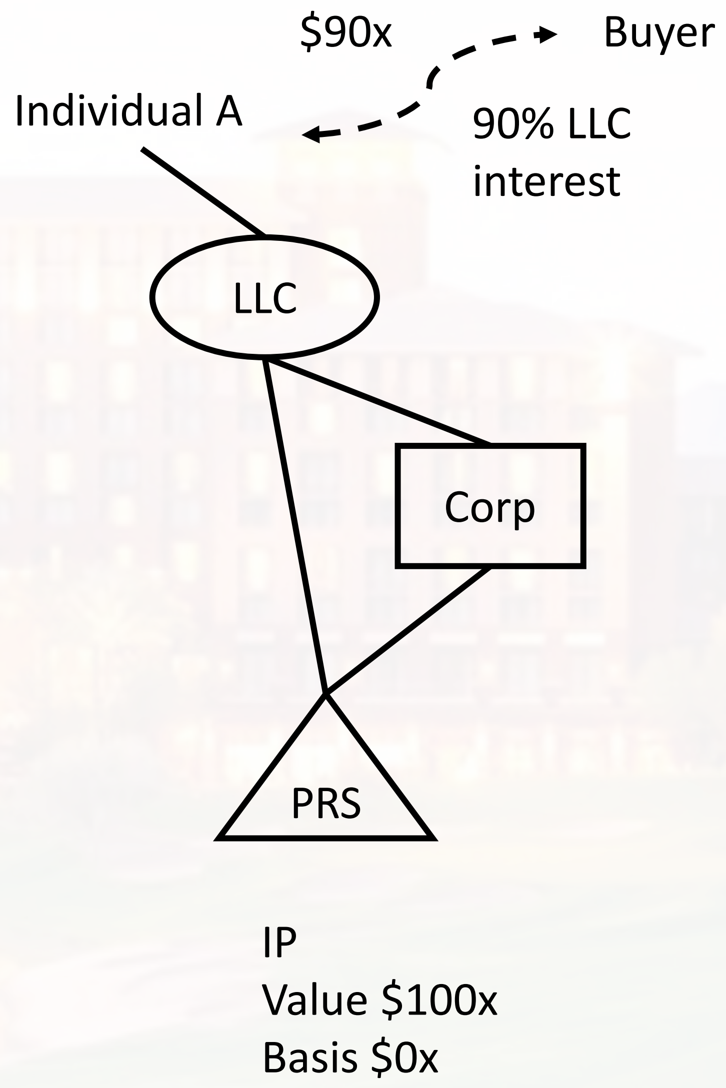
- Partner A and Partner B own, respectively, 10% and 90% of PRS.
- PRS holds two assets:
    - IP with value of $500x and basis of zero.
    - Tangible property with value of $200x and basis of $50x.
- Buyer acquires Partner B's 90% interest for $630x.
    - PRS makes a Section 754 election and Buyer receives Section 743(b) adjustment.
- PRS recaps so that Buyer has a preferred interest and Partner has a common interest.
    - Buyer is entitled to a return of capital and 10% preferred return.
    - Partner A then receives a catch up distribution.
    - Thereafter distributions are pro rata.
- Does Buyer (or Partner A) care about Section 704(c) methods?



Tangible property	IP
Value $200x	Value $500x
Basis $50x	Basis $0x

Sale of Partnership Interest (Example 3)

- Individual A owns 100% of disregarded LLC.
- LLC owns 100% of Corp.
- LLC owns 99% of PRS and Corp owns 1% of PRS.
- PRS holds property consisting of IP with value of $100x and basis of zero.
- Buyer purchases 90% of LLC from Individual A for $90x.
- PRS makes a Section 754 election.
- Does Buyer care about Section 704(c) methods?



Transfer of Section 704(c) property to LTP

- Partner A and Partner B form PRS
  - Partner A contributes Property X with value of $100x and basis of $50x
  - Partner B contributes cash of $100x, which PRS uses to acquire Property Y.
  - PRS contributes both Property X and Property Y to disregarded LLC.
  - PRS adopts traditional method under Section 704(c).
- The value of PRS increases from $200x to $400x.
  - Property X has value of $200x, Section 704(b) basis of $80x, and tax basis of $40x.
  - Property Y has value of $200x, Section 704(b) basis of $100x, and tax basis of $80x.
- Investor contributes $400x to LLC for a 50% interest.
  - Will this transaction impact Partner B's Section 704(c) situation at PRS?
  - What if PRS had originally adopted the remedial allocation method with respect to Partner A's contribution of Property X?