

Revaluations Revisited: Partnership Allocations and the Demise of the Ceiling Rule

The idea for this article began with a challenge from a client. He was setting up a hedge fund, where allocations of gains and losses would be made twice a year based on changes in net asset value. Accordingly, unrealized as well as realized gains and losses were to be reflected in these allocations. Also, on those allocation dates, investors would acquire or redeem interests in the fund. The percentage interest in the fund that would be issued or redeemed would be based on the net asset value at that time.

I explained that under arrangements of these types, any unrealized gains and losses that were reflected in net asset value would have to be allocated for tax purposes, when realized, in accordance with the percentage interests of the investors at the times when those gains and losses accrued, although if an asset had both gains and losses in different accrual periods, something called the “ceiling rule” could affect those allocations. I dutifully drafted language for the partnership agreement requiring these tax allocations to be made in accordance with the principles of the relevant provisions of the partnership tax regulations.

The client was dissatisfied. Not being a tax lawyer himself, he had no idea what those principles were. He reasoned, understandably enough, that there ought to be a mechanical approach to the allocations that could be expressed in a formula, whether expressed in words or in mathematical terms.

After some effort, I was able to provide language that specified how the allocations were to be performed, without any reference to the tax regulations. That language incorporated the operation of the ceiling rule, which was a mandatory feature of the tax law at that time. As a drafting matter, it was a case of first impression, as I had never

seen an example of a tax allocation clause with such a self-contained verbal formula, nor have I since.

The first version of this article was published in *The Tax Lawyer* under the title “Partnership Revaluations.”¹ Years later, the relevant tax regulations were amended to allow partners to mitigate the effect of the ceiling rule by providing curative or remedial allocations. So I rewrote the article with curative and remedial allocations reflected in additional drafting examples. The revised article was also published in *The Tax Lawyer*, with the title “Revaluations Revisited.” Since then, the article has been updated and reprinted in the Practising Law Institute’s annual compendium on partnership taxation. The version here reflects updates through early 2012.

Although these drafting examples have been readily available to practitioners for years, they have never caught on. A principal reason for this, I believe, is the popularity of “stuffing” allocations, which preferentially allocate gain to investors that are cashing out, and therefore recognizing gain anyway. It is difficult to square these allocations with a principled reading of the regulations, but until the IRS affirmatively indicates that it will not respect stuffing allocations, they will continue to remain attractive.

Even if the drafting examples are not used, they nonetheless provide insight into how the regulations work. In particular, they also indicate the circumstances in which the allocation method preserves fungibility of interests, and also shed light on how the choice of methods affects the complexity of the allocation computations. Interestingly, the “exact” methods are some respects conceptually simpler than the “simplified” methods offered by the regulations for investment partnerships.

¹ See *infra* note 3.

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I. INTRODUCTION

The regulations under Section 704 include detailed rules for maintaining partners' capital accounts to ensure that the allocation of the partnership's taxable income and loss among the partners will be respected for federal income tax purposes.² Yet complying with these rules can be difficult and confusing for a partnership that must "revalue" its capital accounts to give effect to the business arrangements among the partners. These revaluations may be a routine event, particularly for investment partnerships, which typically revalue at the end of each year and upon any change in partnership interests.

This article explains how investment partnerships can comply with the revaluation rules. Regulations issued in the late 1990s permit these partnerships to use curative allocations and aggregate approaches to minimize distortions of income and simplify computations.³ Although the regulations address the most serious deficiencies of prior law, they persist in failing to state clearly how taxable income is to be allocated in the context of a revaluation. Instead, the regulations make general reference to Section 704(c) principles, which are illuminated, but only to a limited extent, by numerical examples. This article seeks to remedy that failing by showing, with drafting examples, what investment partnerships must actually do. Finally, the article briefly explores how these rules might be applied by other types of partnerships to depreciable property.

² I.R.C. § 704. Similar issues may arise under foreign and state income taxes, but these are beyond the scope of this article.

³ For a discussion of this topic before the current regulations were issued, see Stephen B. Land, *Partnership Revaluations*, 43 TAX LAW. 33 (1989).

II. OVERVIEW OF SECTION 704(C) PRINCIPLES

The partnership allocation regulations contemplate that a partnership will maintain capital accounts for each partner, credit each account for amounts contributed by the partner and for the partner's share of taxable gains and other items of income, debit each account for distributions to the partner and for the partner's share of taxable losses and other deductions, make liquidating distributions on the basis of capital account balances, and recover any capital account deficits from partners upon liquidation.⁴ When capital accounts are maintained in this manner, the allocations of the partnership's items of taxable income or loss generally have economic effect because they determine what each partner will ultimately receive from the partnership upon its liquidation.⁵

Section 704(c) requires⁶ a partnership to use special rules when allocating depreciation, gain or loss from contributed property. Under the capital account rules, a contributing partner's capital account must be increased by the fair market value of the contributed property, regardless of its tax basis.⁷ In allocating any subsequent depreciation, gain or loss, the special rules require the partnership to "take account of" any increase or decrease⁸ in the value of the asset that occurred

⁴ Treas. Reg. § 1.704-1(b)(2)(ii)(b).

⁵ Some deductions cannot have economic effect because the associated economic loss is not borne by any partner. An example is depreciation of an asset with an adjusted basis that is less than the amount of nonrecourse debt secured by the asset. *See infra* Part III.D (p. 395).

⁶ The Tax Reform Act of 1984, Pub. L. No. 98-369, § 71 (a), 98 Stat. 494, 589, made the previously elective rule mandatory.

⁷ Treas. Reg. § 1.704-1(b)(2)(iv)(b), (d)(f).

⁸ I will use "increase" and "decrease" to refer to changes in asset value whether or not realized for tax purposes, and "gain" and "loss" to refer only to realized gains or losses.

while it was in the hands of the contributing partner before it was contributed to the partnership.⁹

For example, if the contributing partner buys an asset for 50, contributes it to the partnership when the asset is worth 100, and the partnership sells it for 125, then the first 50 of gain must be allocated to the contributing partner, and the remaining 25 of gain is allocated among all of the partners in the same manner that this gain would have been allocated if the partnership had purchased the asset for 100.

If instead the asset declined in value to 75 after it was contributed to the partnership, the partnership would have taxable gain of only 25 to allocate: an amount realized of 75 minus the tax basis of 50. The partnership's total gain would be smaller than the unrealized increase in value at the time the asset was contributed. In such a case, the amount of gain that can be allocated to the contributing partner has traditionally been limited by the "ceiling rule" to the partnership's total realized gain, leaving no gain or loss to be allocated to the noncontributing partners.¹⁰ This result fails to allocate to the noncontributing partners any of the 25 of economic loss that the partnership has sustained.

After criticism of the ceiling rule for the distortions of this type that it causes,¹¹ the Treasury issued regulations that permit partnerships to use curative or remedial allocations to correct for these distortions. In this example, a curative allocation would take 25 of unrelated gain that otherwise would have been allocated to all the partners, and would allocate it to the contributing partner, so that the contributing partner is allocated a full 50 of gain, and all the partners

⁹ Treas. Reg. §§ 1.704-1(b)(2)(iv)(d)(3), -3(a)(1).

¹⁰ See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(iii). The ceiling rule can also apply to depreciation, as discussed *infra* in Part VIII.A (p. 454).

¹¹ See N.Y. ST. BA. ASS'N TAX SEC., *Comments Relating to Proposed Regulations To Be Issued Pursuant to Sections 704(c), 707(a)(2) and 752*, at 11–21 (1985).

enjoy the tax benefit of the 25 post-contribution loss by the curative allocation of 25 of gain away from them.¹²

Curative allocations are effective only when there is sufficient unrelated gain or loss that can be reallocated to offset the effects of the ceiling rule. To deal with this shortcoming, the regulations also permit partnerships to use a remedial method, under which the partnership creates notional items of gain or loss in equal amounts, and specially allocates these notional items to offset the effects of the ceiling rule.¹³

Adjustments similar to those required under Section 704(c) are required if a partnership revalues its capital accounts upon the admission of a new partner.¹⁴ Such a revaluation will generally be necessary either to preserve the interests of the continuing partners in any unrealized increases in the value of the partnership's assets, or to protect the new partner from bearing the burden of any unrealized decreases. In the revaluation, the partnership adjusts the book value of

¹² Treas. Reg. § 1.704-3(c).

¹³ Treas. Reg. § 1.704-3(d).

¹⁴ The regulations permit revaluations upon the change of an interest of a partner in the partnership as a result of a contribution by or distribution to that partner, an issuance of a noncompensatory partnership option, or a grant of a partnership interest in exchange for services. In addition, "investment partnerships" are permitted to revalue on other occasions under generally accepted industry accounting practices. Treas. Reg. § 1.704-1(b)(2)(iv)(j)(5). For this purpose, a partnership is an investment partnership if substantially all of its noncash assets consist of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. These investment partnerships typically revalue at the end of each fiscal year regardless of whether any distributions or contributions are made at that time. Revaluations are also required upon the exercise of a noncompensatory partnership option. Treas. Reg. § 1.704-1(b)(2)(iv)(i)(I).

The Treasury Department has proposed regulations that would extend the permitted revaluation events to include a change in the manner in which partnership items are allocated, or a revaluation of an upper- or lower-tier partnership. Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(j), 79 Fed. Reg. 65,151, 65,159 (Nov. 3, 2014). In addition, the proposed regulations would *require* a revaluation upon a distribution of property in exchange for a partnership interest, if the partnership owns "hot assets" subject to ordinary income treatment under Code Section 751. Prop. Treas. Reg. § 1.751-1(b)(2)(iv), 79 Fed. Reg. 65,160–61 (Nov. 3, 2014).

each partnership asset to its fair market value. A corresponding adjustment to the partnership's capital is allocated among the partners in the way that the built-in gain or loss in each asset would have been allocated if the asset had been sold on that date.¹⁵ After the revaluation, the combined capital accounts of the partners are equal to the fair market value of the partnership's capital. Thus, if a new partner contributes funds in exchange for an interest in the partnership, the new partner's share of the partnership's book capital will be equal to the share of the partnership's equity value represented by the new partner's contributed funds.

A revaluation upon the admission of a new partner can be thought of as a contribution by the continuing partners of their interests in the partnership's assets, along with the contribution of the new partner, to a "new" partnership.¹⁶ Assuming that the new partner contributes cash, it is the continuing partners that have contributed assets that may have increased or decreased in value before this notional contribution to the new partnership. Accordingly, the regulations apply the principles of Section 704(c) to allocations of subsequent depreciation or of gains and losses attributable to these assets.¹⁷ These post-revaluation allocations are sometimes referred to as "reverse" Section 704(c) allocations.

One result of this treatment of revaluations is that Section 704(c) principles apply far more broadly now than when Section 704(c) was first enacted in 1954.¹⁸ Originally, Section 704(c) applied only to contributed property, and only if the partnership elected to have it apply. Section 71(a) of the Tax Reform Act of 1984¹⁹ eliminated the elective feature, so that Section 704(c) applies to all contributed property. The

¹⁵ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(2).

¹⁶ See Howard E. Abrams, *Partnership Book-Ups*, 127 TAX NOTES 435 (Apr. 28, 2010).

¹⁷ Treas. Reg. §§ 1.704-1(b)(2)(iv)(f), -1(b)(4)(i), -3(a)(6)(i).

¹⁸ I.R.C. § 704(c)(2)(1954).

¹⁹ See *supra* note 6.

regulations now apply Section 704(c) principles to any partnership subject to a revaluation, even if all contributions to the partnership are made in cash. Moreover, while a Section 704(c) adjustment need be applied to contributed property only once, partnership revaluations can occur many times before the partnership sells a revalued asset.

A number of problems arise when Section 704(c) principles are applied in this broader context. First, it is unclear how these principles apply to partnerships whose allocations are not completely “linear.” I will call an allocation of a partnership item linear if multiplying the item by a factor, which may be negative, does not change each partner’s percentage share of the item. If each partner is entitled to the same percentage share of partnership income, regardless of whether that income is \$1,000, or \$2,000, or \$1 million, or negative \$1 million, then the allocation is linear. An allocation can be linear even if it is not in proportion to invested capital or the partner’s share of net asset value. For example, an allocation of 20% of all partnership profits or losses to the general partner is a linear allocation even if the general partner has provided only 1% of the partnership’s investment. If, however, the general partner is allocated 20% of profits but only 1% of losses, the allocation is nonlinear.²⁰

All of the examples in the Section 704(c) regulations apply Section 704(c) principles in the context of contributed property rather than a revaluation, except for the last two examples, which deal with aggregate approaches for revaluations of securities partnerships.²¹ The Section 704(b) partnership allocation regulations offer two examples

²⁰ The allocations to the general partner of a limited partnership are often nonlinear because the general partner may have a different share of losses than of profits, or because the general partner’s share may escalate after the limited partners have received distributions equal to their investment, or have realized a target rate of return. By contrast, unless the partnership has several classes of limited partnership units, allocations of items of profit or loss among the limited partners will typically be linear, so that a partner owning two limited partnership units always receives twice as large a portion of any item allocated among limited partners as a partner owning one unit.

²¹ Treas. Reg. §§ 1.704-3(b)(2), 1.704-3(c)(4), 1.704-3(d)(7), 1.704-3(e)(3)(ix).

dealing with revaluations.²² Both of these examples are lengthy and complicated, even though each deals only with a single revaluation of a partnership with linear allocations. Indeed, each example in both sets of regulations deals with a partnership in which all allocations of book income²³ are not only linear but are equal among the partners. The regulations offer no guidance on the tax consequences of a revaluation for a partnership with nonlinear allocations.

A second problem arises from the application of Section 704(c) principles on an asset-by-asset basis. In the context of contributed property, Section 704(c) principles affect only the assets contributed. In the context of a revaluation, however, these principles affect *all* of the partnership's assets, which can create a serious accounting burden. The asset-by-asset tracking becomes even more burdensome when a partnership undergoes multiple revaluations. The regulations address multiple revaluations in the context of applying aggregate methods to investment partnerships,²⁴ but are silent on the issue of how multiple revaluations are applied on an asset-by-asset basis.

Further complications arise upon transfers or redemptions of partnership interests. The partnership can elect to adjust the tax basis of its assets to reflect gain or loss recognized by the selling or redeeming partner,²⁵ raising questions about how these adjustments affect the application of Section 704(c) principles to revalued partnership assets.

Investment partnerships face all of these problems. The allocations to the general partner are likely to be nonlinear. Revaluations are

²² Treas. Reg. § 1.704-1(b)(5), Exs. (14) and (18).

²³ As used here, "book" items refer to items of partnership income or capital that are used by the partnership to determine the capital accounts that govern a partner's interest in the partnership, including the partner's rights upon a liquidation of the partnership. For partnerships with contributed or revalued property, these book items will generally differ from the corresponding tax items because the book items will reflect unrealized increases or decreases in value. Also, as used here, "book income" and "taxable income" can be positive or negative. "Profits" and "gains" will be used to refer to items of positive income only.

²⁴ Treas. Reg. § 1.704-3(e)(3)(ix).

²⁵ I.R.C. §§ 734, 743, 754.

routinely made whenever a partner receives a non pro rata distribution or invests additional funds, and in any event at the close of each year. Transfers and redemptions happen regularly. To investment partnerships, revaluations are a regular fact of life, not an isolated event. For these reasons, the discussion below focuses primarily on revaluations in the context of an investment partnership.

For simplicity, our investment partnership is assumed to invest only in marketable securities and to have expenses equal to net investment income apart from gains and losses from the sales of these securities. It operates as an open end investment company, where partners are able to acquire new units of limited partnership interests or redeem units at a price based on the net asset value of the partnership. Changes in the net asset value of the partnership arise solely from increases and decreases in the value of its securities, and the only tax items that need to be allocated are realized gains and losses from the sale of securities. Typically, the partnership determines book income by reference to changes in the net asset value, which takes into account both realized and unrealized increases and decreases in the value of the partnership's assets.

The allocation of such an investment partnership's book income is, logically, prior to the tax allocation.²⁶ The net asset value of the partnership is determined when a partner acquires a new interest from the partnership or redeems a partnership interest, and at the end of the partnership's taxable year. The partnership's capital accounts are revalued on each of these dates, and the book income to be allocated for each allocation period ending on a revaluation date is the change in the partnership's net asset value since the last revaluation date. This change in net asset value is measured after taking into account contri-

²⁶ This is in contrast to the usual situation where "book" follows "tax" because of the general requirement of the regulations that tax allocations determine capital account changes and ultimate entitlements upon liquidation. Where the organizers of the partnership have a particular economic outcome in mind, the tax lawyer may be required to perform some "reverse engineering" to come up with tax allocations that have that outcome as their economic effect.

butions or distributions at the beginning of the allocation period but before taking into account contributions or distributions at the end of the allocation period.

The general partner's share of this book income may be determined by a nonlinear formula that provides the intended performance-based compensation. For example, the general partner might be entitled to 20 percent of any increases in net asset value in excess of a 7 percent target rate of return. Such a formula will cause the general partner's share of book profits to increase as the level of book profits increases. To deal with the vagaries of periodic accounting, it may be necessary to cause the general partner to bear a disproportionate amount of subsequent losses to offset profits that were previously allocated in a disproportionate manner to the general partner. Also, the general partner's disproportionate share of profits often does not take effect until prior losses have been recouped.

The computations of the general partner's share can be made on the basis of overall fund performance, or they can be calculated separately for each investor or even for each investment made by a particular investor. If the general partner's share is based on overall fund performance, then after this share has been determined, the balance is allocated linearly among the limited partnership interests.²⁷ If the general partner's share is determined separately for each investor or each investment, a tentative allocation is made linearly among the limited partners, and then an appropriate portion of each limited partner's profit is reallocated to the general partner.

The following sections explore some of the problems faced by such an investment partnership as it performs revaluations.

²⁷ There can, of course, be multiple classes of general as well as limited partners, and the allocations among the classes may be nonlinear. The discussion here will assume a single general partner.

III. ALLOCATION OF REALIZED AND UNREALIZED ITEMS

Even in the period before the first revaluation, an allocation of book income based on changes in net asset value does not itself determine how taxable income should be allocated. If taxable income were precisely equal to book income, it would be natural, and perhaps necessary, to allocate both the same way. In general, of course, they will not be equal, because unrealized increases and decreases in value enter into the calculation of book income only. Indeed, book and taxable income might even have opposite “polarity”: a partnership with a book profit might realize a net taxable loss, and a partnership with a book loss might realize a net taxable gain. If the partnership’s book allocations are linear, the disparity between book income and taxable income poses no problem because each partner has the same percentage interest in all partnership items. Accordingly, a partner’s allocated percentage of the partnership’s taxable income should be the same as the partner’s allocated percentage of the partnership’s book income.

Difficulties arise when the partnership’s book allocations are nonlinear. Even the simplest nonlinear case, where the sharing of book losses is different from the sharing of book profits, poses a conundrum if there is a book profit but a taxable loss: Is the taxable loss to be shared in accordance with the percentages for book profits or for book losses? In this and other cases involving nonlinear allocations, the book allocation does not itself determine the tax allocation. Whatever choice is made, the partnership’s allocation of taxable gain or loss has no nontax effect because the economic arrangements among the partners are already fully defined by the allocation of changes in net asset value.

The answer cannot be found by recourse to Section 704(c) principles either. Section 704(c) principles apply only *after* a revaluation has occurred, when gains or losses are realized on assets acquired before the revaluation. While the allocation of taxable gains and losses before

the revaluation may affect the way Section 704(c) principles apply afterwards, a partnership that has not yet been revalued is not within the scope of the partnership allocation regulations that import Section 704(c) principles.

Partnership agreements for investment partnerships rarely make the tax allocations clear. Such an agreement may include a clause stating that allocations of realized gains and losses are to be made in proportion to book allocations, to cash distributions, to capital accounts, or simply “in accordance with” the book allocations, whatever that means. Usually there is a clause reciting that Section 704(c) principles will apply after a revaluation, without articulating what these principles are. There might also be a clause authorizing the general partner to vary the tax allocations in any manner deemed necessary or desirable to reflect properly the business deal.

Given the intense focus on tax allocations in tax shelters and other tax-motivated partnerships, it is surprising how little thought is often given to tax allocations in “economic deals” that are offered on the basis of their pretax returns. Even tax allocations that have no effect on book capital accounts affect a partner’s annual cash flow. To be sure, a tax allocation that does not affect book capital accounts affects only the timing of the partner’s income, not its cumulative amount. Over the life of the investment, a partner’s cumulative taxable gain or loss will be tied to the partner’s economic gain or loss, regardless of how these tax allocations are made. Few taxpayers, however, are indifferent to the timing of their taxable income.

The practical consequence of vague or discretionary tax allocations is to put the burden of decision, and the risk of partner dissatisfaction, on the general partner, or more likely, on the partnership’s accountant. Unlike the attorney who drafted the partnership agreement, the accountant cannot duck the issue: numbers must appear on the Schedules K-1 that identify each partner’s share of partnership income, for reporting to the partners and to the IRS. It is worth exploring, therefore, what choices, if any, partners in an in-

vestment partnership have in allocating taxable gains and losses. Several alternatives come to mind.

A. *Ignore-The-Book Approach*

Using the ignore-the-book approach, one disregards the actual level of book income and allocates taxable income in the same manner that book income would have been allocated had book income been equal to the actual level of taxable income. Thus, if there is a book profit and a taxable loss, the taxable loss is allocated in the same manner that a book loss of the same amount would have been allocated, and the actual allocation of the book profit is disregarded.

For example, suppose the general partner receives 20% of book profits but only 1% of book losses, and the partnership has 500 of net book income but 100 of net taxable loss, the difference being attributable to 600 of unrealized increases in value. Using the ignore-the-book method, only 1% of the net taxable loss would be allocated to the general partner, because that is how book income would have been allocated if book income had been equal to the 100 of taxable loss.

The ignore-the-book approach might make sense if there were no revaluation at the end of the year. In that event, however, book income and taxable income would be the same because book income would not reflect the 600 of unrealized increases in value. If there were no revaluation, the unrealized increases in value would affect the partners' capital accounts only when reflected in realized gains, and they could be allocated at that time.

If there is a revaluation, however, the partners' capital accounts are affected as much by unrealized increases and decreases in value as by realized gains and losses. Consequently, the ignore-the-book approach appears inconsistent with the presence of a revaluation. If the general partner is allocated 100 of the net book income (20% of 500) and 1 of net taxable loss (1% of 100), then out of the 600 of unrealized increase in value, 101 has in effect been allocated to the general

partner and 499 to the limited partners. Thus, in this example, the ignore-the-book approach allocates to the general partner 1% of the net taxable loss and 17% of the unrealized increase in value. It is hard to see a justification for these differing percentages, when both realized and unrealized items are taken into account in the same way in determining capital account balances.

B. *Proportion-To-Cash Approach*

Under the proportion-to-cash approach, taxable income is allocated in proportion to cash distributions. This approach, used by many partnerships, is incomplete for partnerships that do not make annual cash distributions, and its logic is obscure when the approach is used to allocate tax losses. The proportion-to-cash approach is most workable for a partnership, such as a law firm, that regularly has positive taxable income and annually distributes an amount roughly equal to this income. In such a case, the approach is appealing because it allocates tax liability in accordance with each partner's ability to pay out of partnership income.

Over the life of a partnership its taxable income should equal its net cash flow (after adjustments for tax-exempt income, nondeductible expenditures, and the like). The proportion-to-cash approach, however, will not generally allocate taxable income to each partner in proportion to the partner's cash distributions over an extended period of time because each year's cash distributions will carry varying amounts of taxable income. Even a partnership with linear allocations and no revaluations can suffer this problem if cash distributions vary among partners over time. For example, a partner will receive an allocation of too much taxable income in relation to cash received if the partner receives a disproportionate amount of cash in a year when the partnership's taxable income is high in relation to its distributed cash. Despite its surface plausibility, the proportion-to-cash approach does

not generally provide an equitable allocation of an investment partnership's tax burden and will not be discussed further here.

C. Proportion-To-Book Approach

The proportion-to-book approach allocates all increases and decreases in value in the same proportions as the allocation of book income. A realized gain or loss is allocated in the same way that the underlying increase or decrease in value is allocated. In the first allocation period, the proportion-to-book approach causes book and taxable income to be allocated in the same proportions, regardless of their polarity.

If the partnership has a book profit but a taxable loss, the proportion-to-book approach allocates the taxable loss in accordance with the allocation of the book profit. Each partner's economic benefit from the book profit allocation is therefore magnified by the tax benefit of the taxable loss allocation. In the example described above under the ignore-the-book method, the general partner would be allocated 20 of the net taxable loss (20% of 100) in accordance with the allocation to the general partner of 20% of the partnership's net book income. Of the 600 of unrealized increases in value, 120 (20% of 600) would be allocated to the general partner.

The tables are turned if the partnership has a book loss and a taxable gain. Now, insult is added to injury: the partner with the greatest economic loss pays the most tax. Although this result and the result in the preceding example might appear troubling to some, the justification in both cases is that each partner is allocated the same percentage of realized and unrealized items.

For a partnership that revalues at the end of every year, a partner's capital account is affected by all increases and decreases in value, whether or not realized for tax purposes. There is no obvious reason to allocate unrealized increases and decreases in value in a manner different from the allocation of realized gains and losses. As discussed

below, a uniform allocation of unrealized and realized items is much simpler to administer after one or more revaluations. The proportion-to-book method is therefore particularly attractive for investment partnerships.

D. *Anything Goes Approach*

Because the revaluation at the end of the year determines the economic interests of the partners, taking into account both realized and unrealized items, the allocation of taxable income or loss cannot itself have any economic effect. Therefore, the usual justification for respecting the agreement of the partners is absent. Nothing in the regulations, however, specifically mandates that realized and unrealized items must be allocated in the same way in the period leading up to a revaluation; and if no revaluation occurs, there is no need to allocate unrealized items at all. Because the only tax consequence specified by the regulations is the application of Section 704(c) principles to gains and losses realized after the revaluation, the regulations could be read to imply that any agreement of the partners will be respected in allocating taxable gains and losses before the revaluation, regardless of the method chosen.

Such a flexible attitude would be consistent with the regulations for allocating deductions attributable to nonrecourse liabilities, such as depreciation of the cost of property financed with nonrecourse debt. Any economic loss associated with this depreciation will be borne by the lender, not the partner, to the extent that the value of the property drops below the outstanding debt balance. In this circumstance, no allocation of these deductions can have substantial economic effect, which the regulations frankly admit.²⁸ The regulations state a general rule that these deductions must be allocated in accordance with the partners' overall interests in the partnership, a standard which is un-

²⁸ Treas. Reg. § 1.704-2(b)(1).

certain for many partnerships with nonlinear allocations, and which purports to give the partners no discretion.²⁹ Yet this general rule is swallowed up by an exception that will deem *any* agreed allocations of these deductions to be in accordance with the partners' interests in the partnership, provided only that the allocations are consistent with some other significant item relating to the property, and the effect of the allocation is reversed over time by an offsetting allocation of income used to repay the nonrecourse debt.³⁰

Under the most flexible interpretation, a partnership would be free to allocate realized gains and losses any way it wants, provided that unrealized increases and decreases in value are allocated in a manner which, when combined with the allocation of realized gains and losses, results in capital account balances that tally with the results of the revaluation. This approach might even permit a partnership to separately allocate realized gains and losses from particular assets, perhaps by allocating short-term capital gains to some partners and long-term capital gains to others.

It is hard to imagine the Internal Revenue Service allowing this sort of thing to go unchallenged, particularly if, as one might expect, the realized gains and losses are specially allocated in a manner that reduces the aggregate tax liabilities of the partners, taking into account the tax circumstances of each partner, such as being tax-exempt or having capital loss carryforwards. The requirement that allocations have an economic effect which is "substantial" has been applied in the regulations to preclude special allocations that have offsetting effects on capital account balances.³¹ For example, a special allocation of Section 1231 loss to a partner in a Section 1231 loss position, or of tax-exempt income to a partner in a higher marginal tax bracket, or of foreign-source income to a foreign partner, will not be treated as hav-

²⁹ *Id.*

³⁰ Treas. Reg. § 1.704-2(b)(2), (e)(2).

³¹ Treas. Reg. § 1.704-1(b)(2)(iii)(b).

ing substantial economic effect if, in each case, the economic effect of the allocation is offset by a special allocation of other items.³²

The most popular *ad hoc* approach to revaluations appears to be the use of “stuffing” allocations that give priority in allocating gains to withdrawing partners who will recognize the gains anyway. These stuffing allocations have never been explicitly approved or condemned by the Service, and in the absence of any direct pronouncements on the issue taxpayers have been drawn to their user-friendly results.³³ While arguments have been made in support of these allocations,³⁴ the Service could legitimately be concerned with allocations that have no substantial economic effect and serve to postpone recognition of gain by continuing partners.³⁵

A concern with substantiality of economic effect may seem a bit fussy when applied to allocations, such as pre-revaluation allocations of realized gains and losses, that admittedly have no economic effect at all. Yet there hardly seems to be any policy reason to give the partners wide-open discretion to allocate tax items solely to reduce their aggregate tax liabilities. Although the regulations do not expressly address the allocation of realized and unrealized items before a revaluation, the regulations do state that an allocation to a partner of “bottom line” taxable income and loss shall be treated as an allocation to the partner of the same share of each component of the bottom line allocation.³⁶ Allocations based on net asset value are similar to bottom line allocations of taxable income and losses, and it would

³² Treas. Reg. § 1.704-1(b)(5), Exs. (6), (7)(ii), and (10)(ii).

³³ See N.Y. ST. BA. ASS'N TAX SEC., *Report on Aggregation Issues Facing Securities Partnerships under Subchapter K 35* (2010); Terence Floyd Cuff, *The Section 704(c)(1)(A) Regulations*, 6 PRACTISING LAW INSTITUTE, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2008, at 855–57.

³⁴ See Brian E. Ladin, James M. Lowy, and William S. Woods, II, *Hedge Fund Stuffing Allocations: A Path Through the Maze*, 121 TAX NOTES 925 (Nov. 25, 2008).

³⁵ See Andrew W. Needham, *The Problem with Stuffing Allocations*, 141 TAX NOTES 737 (Nov. 18, 2013).

³⁶ Treas. Reg. § 1.704-1(b)(1)(vii).

make sense to apply a similar rule here. Such a rule would mandate the proportion-to-book approach for any investment partnership that makes book allocations on the basis of overall changes in net asset value. For this reason, and because of its relative computational simplicity, the discussion that follows will focus primarily on partnerships that use the proportion-to-book approach to allocate realized and unrealized gains and losses.

IV. AFTER A SINGLE REVALUATION

After a revaluation, the regulations provide that taxable gain or loss from property subject to a revaluation must be allocated among the partners in a manner that “takes account” of the increase or decrease in value before the revaluation, just as taxable gain or loss on the sale of contributed property is allocated under Section 704(c) in a manner that takes account of the increase or decrease in value before the property was contributed.³⁷ While examples in the regulations³⁸ illustrate the application of Section 704(c) principles, including the ceiling rule, the regulations fail to explain outright what Section 704(c) principles require in the context of a revaluation. Such an explanation is attempted here. These principles are explained first in the “traditional” context, where the ceiling rule applies, and then in the context of curative and remedial allocations.

A. *Traditional Method*

Consider what happens when a partnership sells an asset immediately after its first revaluation at a price equal to its revalued amount. Gain or loss on such a sale should be allocated based on the allocation of the asset’s increase or decrease in value before the revaluation, because none of the gain or loss is attributable to an increase or decrease in value after the revaluation. In this case, the allocation of *realized* gain or loss after the revaluation is governed by the allocation of *unrealized* increases and decreases in value before the revaluation.

If a new partner is admitted on the revaluation date, Section 704(c) principles have traditionally required that gain or loss on the sale of a revalued asset be allocated to the new partner to the extent of

³⁷ See *supra* note 17.

³⁸ See *supra* notes 21 and 22.

the new partner's share of the book increases and decreases in value since the revaluation date³⁹ and that the remaining gain or loss, if any, be allocated among the continuing partners.⁴⁰ How that remaining gain or loss is allocated among the continuing partners depends on how the increases and decreases in the asset's value were allocated for the periods before and after the revaluation. If these increases and decreases were allocated among the continuing partners in the same proportions before and after the revaluation, the remaining gain or loss should be allocated in the same manner. In such a case, each of the continuing partners will have a net increase if there is remaining gain after taking into account the new partner's share. Each will have a net decrease if there is remaining loss.

If increases and decreases in value are allocated among the continuing partners in different proportions before and after the revaluation, Section 704(c) principles require that gain on a revalued asset be allocated among partners with an allocated net increase in value, and that loss be allocated among partners with a net decrease in value. Such an allocation can be performed using the following procedure:

- (1) Allocate the increase or decrease in the value of the asset before the revaluation among the continuing partners.
- (2) Allocate the increase or decrease in the value of the asset after the revaluation among the continuing partners and the new partner.
- (3) For each partner, sum the increases or decreases allocated to that partner in steps one and two.

³⁹ In this exposition, the ceiling rule is implicit in limiting to the partnership's gain or loss the amount allocated to the new partner. The scope of the ceiling rule is quite broad in this context, because it applies whenever an appreciated asset decreases in value after a revaluation, or a depreciated asset increases in value. *Cf.* Treas. Reg. § 1.704-3(b)(2), Ex. (1).

⁴⁰ Treas. Reg. § 1.704-1(b)(5), Exs. (14)(i) and (18)(iv).

- (4) If the asset is sold at a gain, allocate the gain among partners with a net increase in step three, in proportion to the net increase.
- (5) If the asset is sold at a loss, allocate the loss among partners with a net decrease in step three, in proportion to the net decrease.

This procedure is consistent with the traditional method examples contained in the regulations, which deal with the admission of a new partner by a partnership that has linear allocations. In these examples, realized gain or loss is allocated first to the new partner in proportion to the new partner's share of book increases or decreases, and the balance is allocated among the continuing partners.⁴¹

To confirm that this result is replicated under the procedure outlined above, three possible situations must be considered. First, the new partner's share of the book increase may exceed the partnership's realized gain. In this case, the continuing partners will have a net decrease, and all of the realized gain will be allocated to the new partner, the total amount being limited by the ceiling rule.⁴² Second, the partnership's realized gain may exceed the new partner's share of the book increase, both being positive. The continuing partners will have a net increase, and no partner will have a net decrease; so the allocation of realized gain in proportion to the net increase will give each partner, including the new partner, that partner's allocated net increase. Finally, the new partner may suffer a book decrease. If this occurs, only the continuing partners will have a net increase, and none of the gain will be allocated to the new partner under the procedure outlined above. Parallel possibilities exist for a realized loss. In each case, the proce-

⁴¹ Treas. Reg. §§ 1.704-1(b)(5), Exs. (14) and (18); -3(b)(2), Ex. (1).

⁴² One commentator has suggested that reverse Section 704(c) allocations are not applicable in this context, because the partnership has realized a gain but the revaluation adjustment was negative. Richard W. Harris, *Federal Taxation of Partnership Asset Revaluations*, 14 VA. TAX REV. 257, 314 (1994). He admits that this interpretation produces serious distortions in the context of an example dealing with a partnership with nonlinear allocations.

cedure outlined above applies Section 704(c) principles in a manner consistent with the examples in the regulations.⁴³

The procedure also works when the sharing of book income among partners varies from one allocation period to the next because of nonlinear allocations or some other reason. Indeed, it is to accommodate varying allocations of book income based on net asset value, which reflects unrealized as well as realized items, that the regulations permit investment partnerships with marketable securities to revalue capital accounts at the end of each year in accordance with industry practice.⁴⁴ The procedure described above allocates gain or loss in a way that takes into account pre-revaluation increases and decreases in value, regardless of whether a new partner is admitted.

The allocation of pre-revaluation increases and decreases in value in step one of the procedure outlined above depends upon the approach used by the partnership to allocate taxable income before the revaluation. Absent a reason for distinguishing among assets, a partner's percentage share of an asset's pre-revaluation increase or decrease in value should be equal to the difference between the partner's share of book and taxable income divided by the difference between the partnership's book and taxable income for the period before the revaluation.

The application of this procedure to particular assets can be illustrated using the partnership discussed in the preceding section, in which the general partner is allocated 20 percent of book profits but only 1% of book losses (with no clawbacks), and the partnership has net book income of 500 and a net taxable loss of 100 in its first year. Suppose that in the second year there is a net book loss of 250 and net taxable income of 400, of which 200 represents the realization of increases in value that occurred during the first year. If an asset with 100 of unrealized increase in value at the end of the first year is sold

⁴³ See *supra* note 41.

⁴⁴ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii).

during the second year at a taxable gain of 125, then 100 of this gain must be allocated in accordance with the sharing of unrealized gains and losses during the first year, and the balance in accordance with the sharing of realized gains and losses during the second year.

If the partnership used the ignore-the-book-approach, 17% of the first 100 of gain would be allocated to the general partner, because 17% (101 out of 600) of the unrealized increase in value during the first period was allocated to the general partner. The remaining 25 of taxable gain would be allocated in accordance with the sharing of book profits, so that the general partner would be allocated 5 (20% of 25) of the remaining gain, for an aggregate amount of 22 out of the total 125 gain.

Under the proportion-to-book approach, the general partner would be allocated 20% of the 100 gain attributable to increases in value during the first year, but would be allocated only 1% of the remaining 25 of gain because the partnership suffered a book loss in the second year. It can be seen immediately that the general partner's share of unrealized changes in asset value is 20% in the first year using the proportion-to-book approach. Under the ignore-the-book approach, however, this share must be computed by adding the amount of realized losses that are allocated 1% to the general partner (1) to the general partner's total share of book increase in value during the first year (100), and dividing the sum (101) by the first year's unrealized increases in value (600) to arrive at the general partner's 17% share. The proportion-to-book approach is much simpler, and this simplicity becomes even more apparent in the context of multiple revaluations.

B. *Curative Allocations*

When the ceiling rule is applied strictly on an asset-by-asset basis, without further adjustments, some increases and decreases in value will never be reflected in a partner's taxable income until the partner's interest in the partnership is liquidated. The overstatement of one

partner's taxable income will be matched by a corresponding understatement of another's. Because the gains and losses are difficult to predict in advance, the ceiling rule typically creates more of a problem of fairness among partners than a threat to the fisc. Its effects are particularly arbitrary in the context of investment partnerships because these partnerships seem more like aggregates and less like entities than partnerships that conduct active businesses.

The ceiling rule exists out of respect for the partnership as an entity, which has only so much gain or loss to allocate among its partners. It does no violence to the entity concept, however, to allocate to a group of partners more gain or loss on the sale of a particular asset than the partnership's gain or loss on that asset, if the partnership has other gains or losses to spare that can make up the difference. The regulations permit partnerships to make reasonable "curative" allocations using these spare gains and losses to reduce or eliminate the effect of the ceiling rule.⁴⁵

In determining whether curative allocations are reasonable, the regulations impose limitations on amount, timing, and character. The amount of the curative allocation can be no more than necessary to offset the effects of the ceiling rule.⁴⁶ The period of time over which the curative allocation is made may not be unreasonably fast; but this limitation appears to apply to curative allocations relating to depreciation rather than gains and losses from sales of property.⁴⁷ Finally, the character of the item subject to the curative allocation must be of a character that is expected to have substantially the same tax effect on each partner as the item limited by the ceiling rule.⁴⁸ For investment partnerships, this limitation suggests that short-term and long-term capital gains must be treated separately, so that a special allocation of

⁴⁵ Treas. Reg. § 1.704-3(c)(1).

⁴⁶ Treas. Reg. § 1.704-3(c)(3)(i).

⁴⁷ Treas. Reg. §§ 1.704-3(c)(3)(ii); -3(c)(4), Ex. (3).

⁴⁸ Treas. Reg. § 1.704-3(c)(3)(iii).

short-term capital gain may not be used to offset the effect of the ceiling rule on a long-term capital gain.

Except for these limitations, the regulations have little to say about how a curative allocation should be done. Each of the examples in the regulations deals with a partnership that has more than enough income of a suitable character to offset fully the effects of the ceiling rule.⁴⁹ No guidance is given if there is only enough income to offset partially these effects: which partner's allocation is "cured" first? Curative allocations have no effect on partners' book capital accounts, and therefore do not have economic effect. Their only consequences are tax consequences. If the partners are free to decide what they want, they may choose a manner that reduces their overall tax liabilities. The choice may require some negotiations among the partners, since an allocation that reduces their overall tax liabilities might increase the tax liabilities of particular partners. Leaving the matter to the general partner's discretion may raise questions of fiduciary duties and conflicts of interest if the amounts involved are material.

Like many recent tax regulations, the Section 704(c) regulations contain an anti-abuse rule, which provides that a partnership's choice of an allocation method for contributed or revalued property is not reasonable if it is made with a view to shifting the tax consequences of built-in gain or loss in a manner that substantially reduces the present value of the partners' aggregate tax liability.⁵⁰ The regulations offer two examples illustrating when a choice of an allocation method is unreasonable; both deal with allocations of depreciation on property that has only one year of tax depreciation left when contributed to the partnership, but a much longer remaining useful life.⁵¹ These examples have little relevance to investment partnerships, and leave open the question what, if any, restrictions apply to the manner in which in-

⁴⁹ Treas. Reg. § 1.704-3(c)(4).

⁵⁰ See *infra* Part V.D (p. 421).

⁵¹ See *infra* notes 73–74

vestment partnerships may apply curative allocations to offset the effects of the ceiling rule on gains and losses from investments.

This question whether there are restrictions on these curative allocations is similar to the question, discussed earlier,⁵² whether there are restrictions on how a partnership allocates realized and unrealized gains and losses before a revaluation. Regardless of whether any such restrictions exist in the tax law, the partners can avoid difficult questions about the equitable allocation of the tax burden if the partnership agreement specifies unambiguously how curative allocations are to be made.

If there were no ceiling rule, each partner's share of realized gain or loss on the disposition of an asset would be equal to sum of the partner's share of the increase or decrease in value of the asset before and after the revaluation. Because of the ceiling rule, the allocation procedure described above under the traditional method allocates gains to partners with a net increase, in proportion to the net increase, and allocates losses to partners with a net decrease, in proportion to the decrease. When the ceiling rule applies, some partners have net increases that exceed the gains allocated to them, while other partners have net decreases that exceed the losses allocated to them. A systematic curative allocation would take all of the realized gains from each class of assets (such as capital assets held for more than one year) and allocate these gains in the aggregate among all partners with net increases in value from these assets, taking into account each partner's share of the asset's increase or decrease in value before and after the revaluation. Realized losses from each such class would be similarly allocated among partners with net decreases in value from these assets. A virtue of this procedure is that it can be generalized to assets subject to multiple revaluations, as discussed below.⁵³

⁵² See *supra* Part III.D (p. 395).

⁵³ See *infra* Part V.B (p. 415).

C. Remedial Allocations

Curative allocations are not cure-alls. They are subject to the risk that there will not be enough gain or loss to do a complete curative allocation. To address this concern, the regulations offer the “remedial method,” in which the partnership creates equal and offsetting amounts of notional gain and loss, and allocates these among the partners to eliminate completely the effects of the ceiling rule. One might question the authority of the Service to issue regulations allowing partnerships to create these notional items, but the Service believes that the legislative history to the 1984 Act provides broad authority to permit allocations that correct ceiling rule distortions.⁵⁴ It is hard to imagine, however, a circumstance in which this authority would be questioned, since the use of the remedial allocation rule is purely elective. Although the anti-abuse rule in the regulations authorizes the Service to force a partnership not to use a method that is unreasonable,⁵⁵ this authority cannot be exercised so as to require a partnership to use the remedial method.⁵⁶

Despite the potential for complexity that arises from the creation of notional items, the remedial method is the simplest method in terms of its outcome: on the disposition of an asset, gain is allocated to those partners whose share of increases or decreases in value before and after the revaluation is a net increase, and loss is allocated to those partners whose share is a net decrease. Regrettably, the regulations express the operation of the remedial method in a more cumbersome manner. They direct the partnership to allocate gains and losses first under the traditional method, to identify ceiling rule disparities, and then to create the notional items to eliminate those

⁵⁴ T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994); H.R. REP. NO. 98-432 (Part 2) 1209 (1984).

⁵⁵ See *infra* note 70.

⁵⁶ Treas. Reg. § 1.704-3(d)(5)(ii).

disparities.⁵⁷ It is hard to see why investment partnerships allocating gains and losses from revalued investments need to go through the motions of calculating the amounts that would have been allocated under the traditional method, when the end result under the remedial method can be determined directly from the allocations of increases and decreases in value of these investments.

For an investment partnership, the virtues of the remedial method are compelling. Under the traditional method, the ceiling rule misallocates income in an arbitrary and unpredictable manner. The effectiveness of curative allocations is contingent on there being enough gains and losses to reallocate. The remedial method is simplest in concept and in computation, provided the Service does not require the partnership to distinguish specifically between the amounts allocated under the traditional method and the notional items created to offset the effects of the ceiling rule. The advantages of the remedial rule are even more pronounced when allocating gain or loss from property that has been revalued more than once.

⁵⁷ Treas. Reg. § 1.704-3(d)(1). Not surprisingly, the regulations describe the rule as it applies to contributed property, leaving it to the taxpayer to figure out how the rule is intended to apply to revalued property. *See* Treas. Reg. § 1.704-3(a)(6)(i).

V. MULTIPLE REVALUATIONS

When property is contributed to a partnership, Section 704(c) applies only once. Precontribution changes in value are accounted for separately from postcontribution changes in value, but there is no need for any further separate accounting. In contrast, although property is contributed only once, it can be revalued many times. Section 704(c) principles require separate accounting for changes in value during each allocation period in which the asset is held.⁵⁸ While the details of computation might seem overwhelming, there are algorithms for handling the calculations that can be programmed on a computer. These algorithms can be set out in the partnership agreement under any of the methods permitted by the Section 704(c) regulations, as shown in the drafting examples given below.

A. *Traditional Method*

If the value of an asset on successive revaluation dates consistently increases or decreases, no new issues arise. Each partner's share of the gain or loss is the sum of the increases or decreases in the value of the asset allocated to that partner in each allocation period. In these cases, the ceiling rule does not apply.

⁵⁸ In Notice 2009-70, 2009-34 I.R.B. 255, the IRS requested comments on the treatment of multiple revaluations, including the circumstances in which multiple "layers" of revaluation adjustments should be collapsed and netted. The discussion here assumes that, apart from the aggregate approaches discussed *infra* in Part VI (p. 430), each layer should be given effect prior to the application of the ceiling rule. See Monte A. Jackel, *A Response to Notice 2009-70*, 124 TAX NOTES 1133, 1136-37 (Sept. 14, 2009); N.Y. ST. BA. ASS'N TAX SEC., *Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships* 20-25 (2010) (recommending separate tracking except in *de minimis* situations). The IRS has proposed regulations that would prohibit netting, but has requested comments on when netting might be appropriate to reduce administrative burdens, e.g., for small partnerships. Prop. Treas. Reg. § 1.703-3(a)(6)(i), 79 Fed. Reg. 3042, 3054, 3056 (Jan. 16, 2014).

Where the ceiling rule does apply, however, it becomes necessary to decide which increases and decreases are offset first by the ceiling rule. One might attempt to generalize the approach taken in the regulations' examples by giving priority to the newest partners first.⁵⁹ Gain or loss would be allocated to the newest partner to the extent of that partner's allocated increase or decrease since the most recent revaluation. Any remaining gain or loss would be allocated to the second-newest partner to the extent of that partner's allocated increase or decrease since the second-most recent revaluation. This recursive method quickly becomes complicated as the number of revaluations increases. It is also incomplete because it only prescribes the treatment for revaluations that result from the admission of a new partner. Revaluations can also result from the retirement of a partner or a realignment of the interests of continuing partners, and investment partnerships may revalue annually or more often without any contribution or distribution of funds.⁶⁰

A more direct approach that avoids the complexity and incompleteness of the recursive method is to apply the proportion-to-book approach to multiple revaluations in the same way that it is applied to a single revaluation. Gains are allocated among partners with a net increase attributable to that asset for all allocation periods in which the asset was held, and losses are allocated among partners with a net decrease.

Even with the possibility of multiple revaluations, the proportion-to-book approach can be succinctly stated in a partnership agreement in a formula that does not require a reference to Section 704(c) principles. Here is a sample clause:

⁵⁹ See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(iii). In I.R.S. Priv. Ltr. Rul. 2008-29-023 (July 18, 2008), the Service blessed the use of such a "LIFO" method of allocating gains through multiple revaluations, but under facts that did not seem to implicate the ceiling rule. See also Deborah Fields, *IRS Ruling Offers Insight on Determining 'Appropriate Adjustment' Under Section 704(c) for Partnerships in Partial Recognition Transactions*, BNA DAILY TAX REP. (Nov. 12, 2008).

⁶⁰ See *supra* note 14 and accompanying text.

- (a) The partnership shall allocate taxable gain or loss from the disposition of an asset to each partner whose net cumulative share of increases and decreases in market value of the asset is an increase (in the case of a gain) or a decrease (in the case of a loss), in proportion to the increase or decrease.
- (b) The increase or decrease in market value of each asset during the portion of each allocation period in which the partnership held the asset shall be allocated in accordance with the allocation of the increase or decrease in the net asset value of the partnership for that allocation period.

The allocation applies regardless of whether the holding period of the asset spans a revaluation, and the ceiling rule is implicit in the formula.

With multiple revaluations, the proportion-to-book approach no longer ensures that the newest partner will be allocated all of the realized gain or loss up to that partner's share of the increases and decreases since the last revaluation. Because of prior shifts among continuing partners, including new partners that were admitted before the most recent revaluation, it is possible that some continuing partners will have a net increase attributable to an asset even though the new partner also has an increase that exceeds the partnership's realized gain. In such a case, the proportion-to-book approach requires the new partner to share the realized gain with any continuing partners that had a net increase. This result does not conflict with existing regulations and is more consistent with the intent of Section 704(c) principles than allocating all of the gain to the new partner, because the proportion-to-book approach allocates the taxable gain among all of the partners that have derived an economic gain from that asset.

Although the traditional method is often seen as unduly complex when applied on an asset-by-asset basis to investment partnerships, the separate tracking of assets can be made fairly straightforward using the proportion-to-book approach. The apparent complexity arises

from the need to keep track of each partner's percentage interest in increases and decreases in value for each asset during each allocation period. As a general matter, this requires working with a large three-dimensional array of data, with dimensions for partners, assets, and allocation periods. One can visualize this data entered into a spreadsheet workbook, with a separate worksheet for each allocation period, and on each sheet a row for each partner and a column for each asset. A cell in the workbook would show the row partner's share of the increase or decrease in the column asset for the worksheet allocation period.

The proportion-to-book approach simplifies matters greatly because each partner has a fixed percentage interest in the increases and decreases in value of each asset during any particular allocation period. Consequently, the computation only requires two two-dimensional arrays, or matrices,⁶¹ containing a much smaller quantity of data.

The first of these two-dimensional arrays is a partner matrix, with one row for each partner and one column for each allocation period. Each cell shows the percentage of book income allocated to a particular partner in an allocation period. The proportion-to-book approach uses this percentage to determine the partner's share of increases and decreases in each asset during that allocation period. The second array is an asset matrix, with one row for each allocation period and one column for each partnership asset. Each cell in the second matrix shows the change in value of a particular asset during an allocation period. Note that this second matrix records changes rather than levels of value, changes being what ultimately determine gain or loss.

⁶¹ A "matrix" is a two-dimensional array of numbers, essentially a rectangular table. Such a matrix can be treated as a mathematical object in its own right, and a branch of mathematics known as matrix algebra prescribes rules for adding, subtracting, multiplying and dividing matrices. Although the principal applications of matrix algebra are in physics, such as the matrix mechanics of quantum theory, matrix algebra can also bring order to otherwise knotty problems of tax accounting. *See, e.g.,* Stephen B. Land, *Strange Loops and Tangled Hierarchies*, 49 TAX L. REV. 53, 75 (1993), *reprinted in* STEPHEN B. LAND, PAPERS ON TAXATION, VOL. 1, at 200–01 (2013).

Both matrices contain zeroes in cells for allocation periods that precede the admission or follow the retirement of a partner, or precede the purchase or follow the sale of an asset.

The first step in allocating realized gains and losses is to multiply the two matrices. The product is an allocation matrix that has a row for each partner and a column for each asset. Each cell of the allocation matrix shows a partner's share of the total increases and decreases in value for an asset.⁶² In computing a cell of the allocation matrix, the relevant partner's percentage for each allocation period is applied to the change in value of the relevant asset for that period. The results are added together to get the total economic gain or loss attributable to that partner from that asset over all allocation periods in which the partner was a member of the partnership and the asset was held by the partnership. Matrix multiplication is tedious to do by hand, but spreadsheet programs contain a built-in function that performs these calculations automatically.

In the example below, the general partner receives a 20% allocation in years with a net increase in value, and no allocation in years with a net decrease in value. The limited partners share the remaining gain or loss equally. Limited partner Z enters the partnership at the beginning of year two, and asset A is sold during year two. The contribution of each asset to each partner's economic gain or loss is shown in the allocation matrix. Thus, X's share of the increases and decreases in the value of asset A, is 16.67 [(40% x 50) + (33.33% x -10) + (33.33% x 0)].

If there were no ceiling rule, computing each partner's allocated gain or loss in an allocation period would simply be a matter of adding up the partner's row of the allocation matrix, taking into account only

⁶² Under the standard rules for matrix multiplication, this cell is the "dot product" of the partner's row of the partner matrix with the asset's column of the asset matrix. A dot product of two sequences of numbers is computed by multiplying each element of the first sequence by the corresponding element of the second sequence, and adding together the products.

the columns for assets sold during that allocation period.⁶³ Thus, in the example above, the sale of asset *A* in the second year would cause a gain of 10 to be allocated to the general partner, a gain of 16.67 to be allocated to limited partners *X* and *Y*, and a loss of 3.33 to be allocated to limited partner *Z*. Because the traditional method respects the ceiling rule,⁶⁴ the partnership's gain of 40 on the sale of asset *A* is allocated only among partners with positive cells in that asset's column of the allocation matrix, in proportion to the cell balances, resulting in an allocation of 9.23 of this gain to the general partner, and 15.38 each to limited partners *X* and *Y*.

<i>Partner Matrix</i>	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>
General Partner	20.0%	0.0%	20.0%
Limited Partner <i>X</i>	40.0%	33.3%	26.7%
Limited Partner <i>Y</i>	40.0%	33.3%	26.7%
Limited Partner <i>Z</i>	0.0%	33.3%	26.7%

<i>Asset Matrix</i>	<i>Asset A</i>	<i>Asset B</i>	<i>Asset C</i>
Year 1	50	20	0
Year 2	-10	5	-15
Year 3	0	-5	10

<i>Allocation Matrix</i>	<i>Asset A</i>	<i>Asset B</i>	<i>Asset C</i>
General Partner	10.00	3.00	2.00
Limited Partner <i>X</i>	16.67	8.33	-2.33
Limited Partner <i>Y</i>	16.67	8.33	-2.33
Limited Partner <i>Z</i>	-3.33	0.33	-2.33

⁶³ This approach was rejected by the Service in Rev. Rul. 75-458, 1975-2 C.B. 258, because of its failure to observe the ceiling rule. *But see infra* Part V.C (p. 420).

⁶⁴ *Cf.* Treas. Reg. § 1.704-1(b)(5), Ex. (18)(x)–(xii).

B. *Curative Allocations*

Curative allocations can be applied to assets that are sold after multiple revaluations by using the same methodology that was used after a single revaluation: the partnership's gross gains from all assets sold during the year in a particular class (such as capital assets held for more than one year) are allocated to partners with an aggregate net increase from those assets, taking into account their shares of net increases and decreases over each of the allocation periods in which the asset was held by the partnership. Similarly, gross losses from assets in a particular class are allocated to partners with aggregate net decreases from those assets.

In general, the sum of the partners' net increases and decreases attributable to the assets sold in any period will be equal to the partnership's overall net gain or loss for that period. I will refer to this relationship between the partners' aggregate net increases and decreases, and the partnership's overall net gain or loss, as the "allocation equation." The allocation equation holds because the partnership's gain or loss on each asset sold is the sum of increases and decreases in value that have been allocated among the partners.

If the partnership's gross gains are smaller than the sum of the net increases of the partners having net increases, it follows that the partnership's gross losses will also be smaller than the sum of the net decreases of those partners having net decreases. Indeed, the allocation equation mandates that the shortfall on the gain side will be equal to the shortfall on the loss side. In this case, no complete curative allocation is possible: the partnership does not have enough gains and losses to allocate to the proper partners. The best that can be done is to allocate the partnership's gross gains among the partners with net increases, in proportion thereto, and to allocate the gross losses similarly among the partners with net decreases.

If the partnership's gross gains are greater than the sum of the net increases of the partners having net increases, however, it similarly

follows that the partnership's gross losses will be greater than the sum of the net decreases of the partners having net decreases. Again, the allocation equation mandates that the excess on the gain side will be equal to the excess on the loss side. In this situation, complete curative allocations are possible because the partnership can allocate gross gains to the partners with net increases, up to the amount of the aggregate net increases, and can allocate gross losses to the partners with net decreases. Any gain remaining after this allocation is equal to the remaining loss; the two can be offset by allocating the gain in the same manner as the loss.

If we are serious about curative allocations, however, these remaining gains or losses need not go to waste. They can be used to offset ceiling rule disparities that arose in earlier allocation periods. Although the regulations generally restrict the use of curative allocations to offset the effects of the ceiling rule in the current year only, curative allocations on a disposition of property can be used to offset the effects of the ceiling rule in earlier years.⁶⁵

To accomplish this, a memorandum "ceiling rule" account can be established for each partner, showing for each allocation period the cumulative amount of gain or loss that would have been allocated to that partner but for the operation of the ceiling rule. For allocation periods in which a complete curative allocation is not possible, each partner's ceiling rule account is increased or decreased by the difference between the partner's allocated net increase or decrease attributable to assets sold in that period, and the amount of partnership gain or loss allocated to that partner. If in a subsequent period a complete curative allocation is possible and there are excess gains and losses, the excess gains can be allocated among partners with positive ceiling rule account balances, and the excess losses among partners with negative ceiling rule account balances. The amount of excess

⁶⁵ Treas. Reg. § 1.704-3(c)(3)(i).

gains and losses so allocated to each partner reduces the positive or negative balance of the partner's ceiling rule account.

The use of a single ceiling rule account assumes that all gains and losses are fungible. Different types of gain, however, may have different tax effects for different partners, the most common distinction being that between short-term and long-term capital gains. Similarly, for a partnership with both United States and foreign partners, gains from United States real property interests and gains from passive foreign investment company stock will have distinctive tax effects on some but not all partners.

The regulations address this lack of fungibility by requiring that the item subject to the curative allocation be expected to have substantially the same effect on each partner's tax liability as the item limited by the ceiling rule.⁶⁶ For a contributed asset, the regulations state that this expectation is measured when the asset is contributed and becomes subject to an allocation specifically stated in the partnership agreement.⁶⁷ If, however, the partnership agreement is not specific as to the manner of allocation, the expectation is measured when the asset is sold and the gain or loss is actually allocated. This is one of the few instances in the partnership allocation regulations where tax consequences may differ depending on whether an allocation is specifically set forth in the partnership agreement. Presumably, however, the common approach of authorizing the general partner to make curative allocations in its discretion would not satisfy this requirement of specificity.

An investment partnership that expects to incur gains and losses of different types, which may have varying tax effects among its partners, can limit its curative allocations by maintaining a separate ceiling rule account for each type of gain or loss. Here is a sample clause:

⁶⁶ Treas. Reg. § 1.704-3(c)(3)(iii)(A).

⁶⁷ Treas. Reg. § 1.704-3(c)(3)(iii)(B).

- (a) The partnership's total taxable gains and losses in each class from the disposition of assets during each allocation period shall be allocated:
 - (i) first, among the partners whose combined net cumulative share of the increases and decreases in market value of the assets is a net increase (in the case of gains) or a net decrease (in the case of losses), in proportion to, and to the extent of, the increase or decrease;
 - (ii) second, among the partners whose ceiling rule account balances for that class are positive (in the case of gains) or negative (in the case of losses), in proportion to, and to the extent of, these balances; and
 - (iii) third, among all partners in accordance with the allocation of the increase or decrease in net asset value for the allocation period [or any other arbitrary method, because gains and losses allocated to each partner under this clause will be equal].
- (b) The increase or decrease in market value of each asset during the portion of each allocation period in which the partnership held the asset shall be allocated in accordance with the allocation of the increase or decrease in the net asset value of the partnership for that allocation period.
- (c) The partnership shall maintain a ceiling rule account for each partner with respect to each of the following classes of gain and loss:
 - (i) Short-term capital gains;
 - (ii) Long-term capital gains;
 - (iii) [other categories as appropriate]

- (d) The ceiling rule account for each partner with respect to each class of gain and loss shall be initially zero and shall be:
 - (i) increased by
 - (A) the amount, if any, by which the partner's combined net cumulative share of increases and decreases in market value of assets disposed of during the allocation period is an increase that exceeds the gains of that class allocated to the partner under paragraph (a)(i), and
 - (B) losses of that class allocated to the partner under paragraph (a)(ii); and
 - (ii) decreased by
 - (A) the amount, if any, by which the partner's combined net cumulative share of increases and decreases in market value of assets disposed of during the allocation period is a decrease that exceeds the losses of that class allocated to the partner under paragraph (a)(i), and
 - (B) gains of that class allocated to the partner under paragraph (a)(ii).

This formulation fulfills the most stringent demands for specificity, but its complexity is daunting. The only merit of curative allocations is that they offset some of the distortions of the ceiling rule without creating notional tax items. The avoidance of notional tax items has a substantial cost in the form of this complexity.

C. *Remedial Method*

The remedial method is simplest of all. Each partner's share of gain or loss on the sale of an asset is the sum of the partner's shares of the increases and decreases in the asset's value during each allocation period. Under the proportion-to-book approach, these shares of gain and loss can be read directly off the allocation matrix that is described above under the discussion of the traditional method. Provided there is no need to separately identify the portion of the "notional" gain or loss allocated to each partner (as opposed to "real" gain or loss of the partnership), the remedial method requires less computation than the traditional method, since there is no need for further calculations on the allocation matrix to give effect to the ceiling rule.

If there were a need to separately state the real and notional components of each partner's allocated gain or loss, the partnership would have to perform the allocations under both the traditional method and the remedial method. The real component of each partner's gain or loss would be the amount allocated under the traditional method, and the notional component would be the difference between the amounts allocated under the two methods. Separate reporting of these real and notional components would cause the remedial method to require more computation than the traditional method, but it is hard to see what is gained by requiring any such separate reporting.

The remedial method can be specified in the partnership agreement as follows:

- (a) Each partner shall be allocated taxable gain or loss from the disposition of an asset in an amount equal to the partner's net cumulative share of increases and decreases in market value of the asset.
- (b) The increase or decrease in market value of each asset during the portion of each allocation period in which the partnership held the asset shall be allocated in accordance

with the allocation of the increase or decrease in the net asset value of the partnership for that allocation period.

Comparing this formulation with the clauses necessary to implement curative allocations shows the relative simplicity of the remedial method.

D. *Choice of Methods*

The Section 704(c) regulations permit a partnership to use any reasonable method to allocate gain or loss on the sale of an asset after a revaluation so as to take into account differences between the tax basis and book value of the asset, and the regulations state that the three methods described above will generally be considered reasonable.⁶⁸ The regulations state that other methods may be reasonable in appropriate circumstances.⁶⁹ This flexibility is circumscribed, however, by an anti-abuse rule: a method will not be considered reasonable if the revaluation and resulting tax allocations 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 aggregate tax liability of its direct or indirect partners.⁷⁰

There is something puzzling about an anti-abuse rule that prevents taxpayers from making a tax election to reduce tax liability. The choice of allocation method has no consequences other than tax conse-

⁶⁸ Treas. Reg. § 1.704-3(a)(1).

⁶⁹ *Id.* The preamble to the final regulations refers to two other methods, which may be reasonable under appropriate circumstances, but are not included in the final regulations because they apply only in limited circumstances. Under the first of these methods, all allocations with respect to contributions of undivided interests in property are made to the contributing partners as if the property had not been contributed to the partnership. Under the second method, said to be used in the oil and gas industry, all depletion and depreciation with respect to contributed property is allocated to the contributing partner. T.D. 8500, 58 Fed. Reg. 67,676 (Dec. 22, 1993). Neither method appears to be relevant to investment partnerships.

⁷⁰ Treas. Reg. § 1.704-3(a)(10).

quences; one might therefore expect the partners to want to choose whichever method reduces their aggregate tax liability. Taken to its literal extreme, the anti-abuse rule could have the absurd effect of forcing partnerships to adopt the method that produces the *highest* aggregate tax liability,⁷¹ although the regulations expressly disavow this interpretation.⁷²

The examples in the regulations shed some light on what the drafters of the anti-abuse rule had in mind. Both examples deal with a contributed asset that has only one year remaining in its cost recovery schedule, but a significantly longer useful life. One example states that the traditional method is unreasonable when applied to a sale of the asset after it has been fully depreciated, where the traditional method has the effect of shifting the tax on pre-contribution gain to a partner with expiring loss carryforwards.⁷³ The other example states that curative allocations are unreasonable where they have the effect of giving the noncontributing partner an enhanced write-off of its investment over a period substantially shorter than the remaining useful life of the property.⁷⁴ These examples leave the distinct impression that the Treasury's concern is the use of the ceiling rule or curative allocations to exploit aspects of the depreciation rules in the partnership context.⁷⁵

The ceiling rule itself artificially shifts taxable income from one partner to another, so the traditional rule might arguably be viewed as unreasonable whenever it is used to shift taxable income to a partner

⁷¹ A partnership will not be forced to use the remedial method, however, even if it creates the highest aggregate tax liability, because the Service will not force a partnership to create notional tax items. *See supra* note 56.

⁷² "An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability." Treas. Reg. § 1.704-3(a)(1).

⁷³ Treas. Reg. § 1.704-3(b)(2), Ex. (2).

⁷⁴ Treas. Reg. § 1.704-3(c)(4), Ex. (3).

⁷⁵ *See infra* Part VIII.B (p. 458); Laura E. Cunningham, *The Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 92, 120–25 (1996).

that is exempt from federal income tax or subject to tax at a lower rate. For an investment partnership, however, the only occasions for the application of the ceiling rule is where post-revaluation changes in value move in the opposite direction from pre-revaluation changes in value. In general, it will be impossible to predict the direction of post-revaluation changes in value for any particular asset, and therefore it will be hard for the Service to assert that the revaluation and subsequent choice of method were made with a view to reducing the partners' aggregate tax liability.

One case where post-revaluation changes in value are predictable is where the partnership holds a market discount bond. If a partnership with partners not subject to federal income tax owns bonds purchased at par but trading at a discount because of a general rise in interest rates, then the partnership could admit a partner subject to tax at the highest marginal rate and revalue the bonds down to their trading values. When the bonds are redeemed at par, there will be no gain or loss at the partnership level, and if the partnership chooses the traditional method the new partner's post-revaluation share of that gain will not be subject to tax.

While this example indicates that on some occasions the traditional method might be unreasonable, both curative allocations and the remedial method should generally be reasonable for an investment partnership. For these partnerships, which have no depreciable property, any improper shifting of built-in gain or loss is caused by the ceiling rule itself; attempts by the partnership to restrict or eliminate the effects of the ceiling rule can only bring the tax allocations in closer alignment with economic income. While the remedial method is the most reliable in this regard, the Service cannot fault a partnership for going no further than curative allocations to offset the effects of the ceiling rule, since the regulations expressly state that a partnership will not be required to use the remedial method.⁷⁶

⁷⁶ See *supra* note 56.

Because the remedial method completely eliminates the effects of the ceiling rule, some commentators on the Section 704(c) regulations have suggested that the remedial method be a safe harbor choice that could not be attacked under the anti-abuse rule.⁷⁷ The Treasury rejected this approach, apparently because it identified circumstances in which the remedial method could produce inappropriate tax results through shifts in the *character* of the income realized by particular partners, even though the *amount* of income allocated to each partner was proper.⁷⁸ For example, suppose a partnership owns stock of a controlled foreign corporation with built-in gain that would be dividend income under Section 1248 if the partnership sold the stock. Instead of such a sale, the partnership first admits a new partner, revalues the stock up to its fair market value, and then causes the corporation to distribute its accumulated income, allocating the resulting dividend among all of its partners, including the new partner. The partnership then sells the stock at no gain, because the distribution reduced the value of the stock to an amount equal to its basis. In its preamble to the temporary regulations that first offered the remedial method, the Treasury Department stated, in a similar example involving contributed property, that the use of the remedial method to allocate a capital gain to the original partners, and a corresponding loss to the new partner, would not be a reasonable use of the remedial method if the contribution (or revaluation), the dividend distribution and the remedial allocation were made with a view to reducing the partners' aggregate tax liabilities.⁷⁹ The use of the remedial method by an investment partnership should be unassailable, however, if the notional

⁷⁷ See T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 27, 1994).

⁷⁸ See T.D. 8501, 58 Fed. Reg. 67,684, 67,685–86 (Dec. 22, 1993).

⁷⁹ *Id.* This example is baffling, since similar results could have been achieved under any of the allocation methods, and the abuse, if there is one, might be better addressed under the general partnership anti-abuse rule of Treas. Reg. § 1.701-2. See also Gregory J. Marich, Barksdale Hortenstine & Barksdale Penick, *The Remedial Allocation Method: A Viable Cure for the Ceiling Rule*, 65 TAX NOTES 1267, 1288 (Dec. 7, 1994).

items created are of the same character as the unrealized increases and decreases in value that would be recognized by partners absent the ceiling rule.

E. Mixtures of Methods

The regulations explicitly state that a partnership is not required to use the same allocation method for reverse Section 704(c) allocations each time the partnership revalues its property.⁸⁰ Presumably this means that a partnership can, if it so chooses, use the traditional method for its first revaluation, apply curative allocations to its second revaluation, and use the remedial method for its third revaluation, if the choice of allocation method in each case satisfies the general standard of reasonableness set forth in the regulations.⁸¹

It is hard to see why an investment partnership would want to vary its choice of method. A partnership might choose the traditional method if it were leery of creating notional items, and wanted to avoid the complexities of curative allocations. A partnership might choose curative allocations if it wanted to minimize the effects of the ceiling rule without creating notional items. A partnership might choose the remedial method for its simplicity and fairness in avoiding the arbitrary shifts in income caused by the ceiling rule. These preferences are unlikely to shift from one revaluation to the next.

More perplexing is trying to determine how the computations would work. When a particular method is chosen for a revaluation, it applies to all assets held by the partnership at that time. If an asset has been subject to multiple revaluations, and the partnership has purported to elect different methods for some of these revaluations, some intractable questions quickly arise. For example, if partners whose shares of increases and decreases in the asset's value are a net

⁸⁰ Treas. Reg. § 1.704-3(a)(6)(i).

⁸¹ Treas. Reg. § 1.704-3(a)(10).

increase have an aggregate net increase that exceeds the partnership's gain on the asset (and therefore other partners have a cumulative net decrease), then the ceiling rule would apply if the partnership had applied the traditional method throughout. But if the partnership has elected the traditional method for some revaluations and the remedial method for others, it is unclear how much the partnership is entitled to create notional items of gain or loss to offset the effects of the ceiling rule.⁸² Likewise, if the partnership has elected to use curative allocations for some, but not all, revaluations, it is unclear how much of the partnership's gross gains and losses can be used for curative allocations. Even if these questions could be answered, the computations would be significantly more complex, because the partnership could not use the allocation matrix as the starting point for its allocations. Each cell of the allocation collapses a partner's cumulative net increases and decreases from a particular asset into a single number, but the result of electing differing methods is that increases and decreases from various allocation periods must be handled differently.

Given these imponderables, it is difficult to imagine what the drafters of the regulations intended in permitting a partnership to use differing methods for successive revaluations. A more coherent alternative would have been to permit a partnership to use different methods for assets sold in different allocation periods. For example, the partnership might use the traditional method for all assets sold in one year, and the remedial method for all assets sold in the next. A more liberal approach would permit a partnership to elect differing methods for each asset sold within a particular allocation period; this approach would be consistent with the flexibility already given to partnerships to elect differing methods for each contributed asset.⁸³

⁸² See Blake D. Rubin & Andrea Macintosh Whiteway, *Exploring the Outer Limits of Section 704(c)(1)(A)*, 7 PRACTISING LAW INSTITUTE, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2008, ch. 88, at 94–100.

⁸³ Treas. Reg. § 1.704-3(a)(2).

Once a method is elected for an asset, however, the partnership would be required to apply that method to each revaluation of that asset.

F. *Revaluations of Contributed Assets*

Since a revaluation applies to all assets owned by the partnership at the time of the revaluation, including contributed assets, it is possible for gain or loss on the sale of a contributed asset to be subject to both Section 704(c) and reverse Section 704(c) allocations. The regulations contemplate this possibility, and state that a partnership need not use the same method for the two types of allocations, even when both are being applied to the same asset.⁸⁴ None of the examples in the regulations deal with revaluations of contributed property, and consequently there is no specific guidance on how the calculations are to be made.⁸⁵

Despite the lack of guidance, it is fairly straightforward to construct plausible procedures for allocating gain or loss from contributed and revalued assets, at least if the partnership has chosen a consistent method for both. Under each method, any pre-contribution increases or decreases in value would be added to the contributing partner's share of post-contribution increases and decreases in value shown in the allocation matrix. If the partnership elects the traditional method, gain or loss would then be allocated, as before, among those partners with net increases (if a gain) or net decreases (if a loss) in proportion to the net increases or decreases. If the partnership elects to use curative allocations, then gross gains and losses are allocated among partners with overall net increases or decreases, just as with non-

⁸⁴ Treas. Reg. § 1.704-3(a)(6)(i).

⁸⁵ In I.R.S. Priv. Ltr. Rul. 2008-29-023, *supra* note 59, the Service approved a "LIFO" method that gave precedence to recognizing revaluation gains over prior pre-contribution gain. The facts of that ruling did not implicate the ceiling rule, and the approach is difficult to generalize, since it would require a methodology for allocating ceiling rule effects (and any curative allocations) among the LIFO layers.

contributed assets. If the partnership uses the remedial method, then the pre-contribution increase or decrease in value is simply added to that partner's gain or loss as shown on the allocation matrix, and no additional computation is necessary.

One can also construct procedures for allocating gain or loss where the partnership has elected one method for pre-contribution increases and decreases in value but a different method for post-contribution increases and decreases in value. First, an allocation of post-contribution increase and decrease in value would be determined, using the method chosen by the partnership for revaluations, in amounts equal to the gain or loss that would be allocated to each partner if the partnership's basis were its value on the date of contribution. Then the actual gain or loss would be allocated, using the method chosen by the partnership for the contribution, by treating each partner's share of post-contribution increases and decreases in value, as determined in the first step, as the post-contribution amounts to be taken into account in this second step.

These procedures assume that a downwards revaluation does not cancel out an upwards adjustment when the property was contributed, and vice versa. There is support for the contrary view in the language of the regulations, which apply Section 704(c) principles to built-in gains and losses on contribution, but provide further that these built-in gains and losses are reduced by subsequent decreases in the difference between book value and tax basis.⁸⁶ Imagine, for example, an asset with a tax basis of 50 that is worth 100 when contributed, but declines to 50 at the time of a subsequent revaluation. After that revaluation, the book value and the tax basis of the asset are equal. If the asset is then sold for, say, 75, the procedures described above would apply regular and reverse Section 704(c) allocations by looking to each partner's share of the increases and decreases in the asset's value that occurred before the contribution, after the contribution but

⁸⁶ Treas. Reg. § 1.704-3(a)(3)(ii).

before the revaluation, and after the revaluation. Yet if the book value and tax basis are equal, it could be argued that no Section 704(c) allocations are required or even permitted.⁸⁷ The principal drawback of this interpretation is that it allows adjustments on contributions and revaluations to undermine each other, producing distortions that cannot be corrected by an appropriate choice of allocation method. A better approach would be to apply both regular and reverse Section 704(c) allocations to situations of this type, which will potentially trigger the application of the ceiling rule, but will give partnerships the flexibility to offset the ceiling rule's effects with curative allocations or notional items.

⁸⁷ See Barksdale Hortenstine & Gregory J. Marich, *An Analysis of the Rules Governing Partnership Allocations with Respect to Contributed Properties: The Final Regulations under Section 704(c)*, 3 PRACTISING LAW INSTITUTE, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 1999, at 645–46; Harris, *supra* note 42, at 307.

VI. AGGREGATE METHODS

The allocations required by separate asset accounting under the regulations can be quite detailed for a partnership with numerous assets and frequent revaluations. The partners may prefer a simpler, more understandable method of allocating gains and losses to a more complicated method that is theoretically more sound. Unless the simplification creates opportunities for tax avoidance, there is no reason for the tax law not to permit a partnership to use any reasonable method that effectively eliminates disparities between book and tax accounts over time.

In the past, much of the complexity of separate asset accounting was attributable to the ceiling rule. Ironically, the initial justification for the ceiling rule appears to have been to avoid the complexity that was perceived to result from allocating to a contributing partner more gain than was realized by the partnership.⁸⁸ Now that the ceiling rule has been made essentially elective, and partnerships can avail themselves of the relatively simple remedial method, the computations required by separate asset accounting have become less burdensome. In a further move towards simplicity, the regulations permit the use of aggregate methods, but only for securities partnerships.

A. *Securities Partnerships*

The Section 704(c) regulations permit securities partnerships to aggregate gains and losses from qualified financial assets using any reasonable method.⁸⁹ Qualified financial assets include any personal property that is actively traded on an established financial market for

⁸⁸ See Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 TAX LAW REV. 627, 636 (1986).

⁸⁹ Treas. Reg. § 1.704-3(e)(3)(i).

purposes of the straddle rules.⁹⁰ A partnership is an eligible securities partnership if it is either (i) registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, or (ii) revalues at least annually and holds qualified financial assets with a fair market value at least equal to 90 percent of the fair market value of the partnership's non-cash assets. For some partnerships,⁹¹ the universe of qualified financial assets is expanded to include qualifying interests in other partnerships.⁹²

A partnership may use an aggregate method only if all book allocations are made in proportion to book capital accounts, except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership. This requirement could unreasonably deprive some investment partnerships of the benefits of an aggregate method. For example, an investment partnership might allocate a portion of the carried interest to an affiliate of a partner performing management or advisory services. Also, some investing partners, such as persons affiliated with the investment manager, might be permitted to invest without being burdened by the carried interest. Even more common are arrangements where the spe-

⁹⁰ Treas. Reg. §§ 1.704-3(e)(3)(ii)(A), 1.1092(d)-1. Registered management companies can treat a variety of financial assets as qualified financial assets, even if not actively traded. Treas. Reg. § 1.704-3(e)(3)(ii)(B).

⁹¹ To qualify, the partnership must meet some additional requirements. First, it must revalue at least four times annually. In addition, it must reasonably expect, as of the beginning of the first year in which it seeks to qualify, (a) to have at least ten unrelated partners at all times during the year, and (b) to make at least 200 trades of qualified financial assets during the year, the aggregate value of which will comprise at least half of the book value of the partnership's assets. Rev. Proc. 2007-59, 2007-2 C.B. 582 (2007).

⁹² Either the partnership interest must be traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof, or the following requirements must be satisfied: (i) the interest constitutes less than 10 percent of the capital and profits of the issuer, (ii) the investing partnership does not actively or materially participate in the management or operations of the issuer, and (iii) the interest constitutes less than 5 percent of the book value of the investing partnership's assets as of the beginning of the year. *Id.*

cial allocation to the investment manager is calculated separately for each investor. For example, if the investment manager is entitled to 20 percent of increases in value in excess of a target rate of 7 percent, the extent to which this target rate is exceeded will vary for different investors who acquired partnership interests at different points in time. If the regulations are strictly construed, partnerships with these types of allocations will not be permitted to use an aggregate method.

When the aggregate methods were first made available in temporary regulations, the Service acknowledged that there were different ways of defining a securities partnership and invited comments on this issue.⁹³ One possibility noted by the Service looks to the number of accounting entries that would be required under an asset-by-asset method. In the final regulations, the Service relaxed some of the requirements of the temporary regulations, including the elimination of a diversification requirement, but retained the restriction on allocations.⁹⁴ This restriction makes aggregate methods unavailable to some partnerships simply because of features of their book allocations that have no bearing on the appropriateness of aggregate methods. An investment partnership that is 90 percent invested in qualified assets and revalues at least annually should be permitted to use an aggregate method for those assets, regardless of its book allocations.⁹⁵

B. Full Netting Method

The regulations provide that a securities partnership can use any reasonable approach for aggregating gains and losses,⁹⁶ and offer two

⁹³ T.D. 8501, 58 Fed. Reg. 67,684 (Dec. 22, 1993).

⁹⁴ T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

⁹⁵ See N.Y. ST. BA. ASS'N TAX SEC., *Report on Aggregation Issues Facing Securities Partnerships Under Subchapter K 18–23* (2010) (recommending that eligibility be broadened, by applying a standard based on the anticipated burden of separate tracking, as reflected in the expected number of expected revaluations, assets, and partners)

⁹⁶ Treas. Reg. § 1.704-3(e)(3)(i).

approaches that will generally be considered reasonable.⁹⁷ Both of these approaches depart from the separate asset tracking of the regulations by treating all unrealized gains or losses as a sort of fungible inventory, to be reported under accounting conventions, just as FIFO and LIFO are used to report income from real inventory. Instead of tracking the partners' interests in each asset separately, the gaps between the partners' book and tax capital accounts are measured at the end of each allocation period, and a portion of the partnership's gains or losses is used to close these gaps.

In implementing an aggregate method, the principal question is the extent to which current-period gains and losses will be used to close the gaps between book and tax capital accounts. Under the "full netting" method, the partnership's realized gains and losses for each period are netted, and the overall net gain or loss is allocated to partners with a positive (in the case of a net gain) or negative (in the case of a net loss) difference between the partner's book and tax accounts.

While the regulations are quite explicit in describing this method, the description is incomplete in that it deals only with the circumstances in which the net overall gain or loss is smaller than the gaps between partners' book and tax account balances that need to be closed. In these circumstances, the method is clear: allocate the overall gain or loss to partners with gaps of the right polarity, in proportion to the size of the gaps. What is less clear is what to do with any leftover net gain or loss. This point is to some degree addressed by the examples in the regulations illustrating the aggregate approach, which are the only examples in the regulations that apply Section 704(c) principles in the context of revaluations. In the example dealing with

⁹⁷ Treas. Reg. § 1.704-3(e)(3)(iv) and (v). The regulations provide no support for the apparently popular practice of allocating as much gain as possible to a retiring partner, who would have to recognize the gain anyway. Instead, the continuing partners must seek whatever relief is available from basis adjustments to the partnership's assets under Section 734. *See supra* notes 33–34 and accompanying text.

the full netting approach,⁹⁸ there is leftover net loss after eliminating the gap of the only partner with a tax account in excess of the book account, and this leftover loss is allocated among all of the partners in accordance with the percentages for sharing book items for the allocation period in which the sale occurs. These percentages are applied even though the net loss may be attributable to decreases in value that occurred in prior allocation periods, when the sharing percentages were different. This is actually the case in the example offered by the regulations, which allocates a portion of the leftover loss to a new partner, even though the net loss is attributable to an asset on which half of the decreases in value occurred before that partner was admitted.

The allocation of leftover net gain or loss is arbitrary because it not only lacks substantial economic effect, but actually *increases* gaps between book and tax capital accounts. This result is unavoidable: once the gaps are closed, the allocation of any further gains and losses can only cause the gaps to open up again. Still, one could imagine more nuanced approaches. Before the allocation of leftover net gain or loss, the full netting approach only closes gaps of the right polarity: if there is a net loss, the allocation of the net loss can only close the gaps of partners with a negative gap (tax capital account in excess of book capital account). The positive gaps of other partners will be untouched. An approach that minimizes overall book/tax disparities might allocate leftover loss first to partners with the smallest positive gaps. This refinement seems hardly worth the candle, however, for an aggregate method that values simplicity over refinement.

Although the example in the regulations addresses the treatment of leftover net gain or loss, it does so only in the context of a partnership with equal, linear allocations of book items. A partnership with nonlinear allocations could apply the same approach, by allocating leftover net gain or loss in proportion to the sharing of book items for

⁹⁸ Treas. Reg. § 1.704-3(e)(3)(ix), Ex. (2).

the allocation period in which the sale occurs. Here is sample drafting language:

- (a) The partnership's total gains and losses from the disposition of assets during each allocation period shall be netted, and the net amount allocated:
 - (i) first, among the partners whose revaluation account balances (after taking into account the allocation of any increases or decreases in net asset value for the allocation period) are positive (in the case of a net gain) or negative (in the case of a net loss), in proportion to, and to the extent of, these balances; and
 - (ii) second, among all partners in accordance with the allocation of the increase or decrease in net asset value for the allocation period.
- (b) Each partner's revaluation account shall be initially zero and shall be:
 - (i) increased by
 - (A) the partner's share of any increase in net asset value for the allocation period; and
 - (B) any losses allocated to the partner under paragraph (a); and
 - (ii) decreased by
 - (A) the partner's share of any decrease in net asset value for the allocation period; and
 - (B) any gains allocated to the partner under paragraph (a).

Because of the netting, the full netting method will generally fail to close the gaps between partners' book and tax accounts as quickly as a strict asset-by-asset method. For example, a partnership might realize gains attributable to assets owned at the beginning of the period, but some or all of these gains might be offset by losses on assets acquired

and sold during the period. Also, the amount of taxable income used to close positive gaps will be reduced by any net decreases from assets sold during the period, but those net decreases may be economically attributable under an asset-by-asset method to partners with negative gaps. Instead of being used to close these negative gaps, these net decreases will reduce the amount of gain available to close positive gaps. Similar possibilities exist when taxable losses are used to close negative gaps.

It is also possible, but much less likely, that the full netting method will close gaps faster than the asset-by-asset method. For example, a portion of taxable income might be allocated to partners with positive gaps based on net increases from assets sold that are economically attributable to partners with negative gaps. On the whole, however, the distortions that arise under the full netting method will tend to slow the closing of gaps. For this reason a partnership that seeks to have its tax allocations reflect economic accruals will find the full netting method to be an inadequate substitute for an asset-by-asset method. The netting overly restricts the allocation of gains and losses back to the partners that earned them.

C. Partial Netting Method

A far more powerful alternative is the “partial netting” method. Under this variant, the partnership’s aggregate gains are used to close positive gaps, and aggregate losses are used to close negative gaps. Otherwise, this method works in the same manner as the full netting method, including the allocation of leftover gains and losses.

Here is a sample clause implementing the partial netting method:

- (a) The partnership’s total gains and losses from the disposition of assets during each allocation period shall each be allocated:
 - (i) first, among the partners whose revaluation account balances (after taking into account the allocation of

- any increases or decreases in net asset value for the allocation period) are positive (in the case of gains) or negative (in the case of losses), in proportion to, and to the extent of, these balances; and
- (ii) second, among all partners in accordance with the allocation of the increase or decrease in net asset value for the allocation period.
- (b) Each partner's revaluation account shall be initially zero and shall be:
- (i) increased by
 - (A) the partner's share of any increase in net asset value for the allocation period; and
 - (B) any losses allocated to the partner under paragraph (a); and
 - (ii) decreased by
 - (A) the partner's share of any decrease in net asset value for the allocation period; and
 - (B) any gains allocated to the partner under paragraph (a).

This variant avoids most of the occasions for netting that cause the full netting method to be too slow, and the few occasions that remain are sanctioned by the ceiling rule (*e.g.*, gross gains might be diminished by decreases in value after the beginning of the current allocation period from previously appreciated assets). The partial netting method is susceptible, however, to distortions that cause it to close gaps too fast. For example, it is likely that some gross gains will be economically attributable to partners with negative gaps, but these gains will be used to speed the closing of positive gaps.

Although the partial netting method will usually close gaps faster than the asset-by-asset method, it stays within the ceiling rule. As a consequence, it merely allocates realized gains of the partnership to partners with net increases in value, and losses to partners with net decreases, even though the gains may have been derived from differ-

ent partnership assets. To the extent that the partial netting method is faster than an asset-by-asset method, partners receiving accelerated allocations of gains and losses lose the benefits, or detriments, of deferring gains and losses until the assets that gave rise to them are sold. Except under a rigorous aggregate concept of the partnership, it is not clear that partners have any right or obligation to have this deferral.

D. How Much Simpler?

Now that investment partnerships are no longer shackled by the ceiling rule, they can enjoy the relative simplicity of the remedial method, which raises the question how much additional simplicity is offered by aggregate methods. One way to evaluate the gain in simplicity is to look at the quantity of data that must be maintained by the partnership. As discussed earlier, separate asset accounting requires a partnership to maintain two two-dimensional matrices: one showing the percentage interest of each partner in changes in net asset value for each allocation period, and the other showing changes in the value of each asset during each allocation period.

The aggregate methods collapse a dimension, by enabling a partnership to compute its tax allocations for any particular allocation period by reference only to a series of one-dimensional arrays. These arrays include the book and tax capital account balances for each partner, and the tax basis of each asset. Some of the savings in recordkeeping is illusory, since the partnership must calculate these arrays for each allocation period, and assembling these arrays over time essentially reconstructs a series of two-dimensional matrices like those required under asset-by-asset methods. Still, the aggregate methods eliminate the need to maintain data on the changes in value of each asset during each allocation period: these changes are only relevant for book allocations, and these will presumably depend only on aggregate changes in net asset value.

Although aggregate methods do provide some reduction in the quantity of computations, the low cost of automated computing calls into question whether the benefits of aggregate methods are particularly significant.⁹⁹ Ultimately, a partnership's choice of an aggregate method rather than separate asset accounting may be more a question of philosophy than cost.¹⁰⁰ Separate asset accounting methods, particularly the remedial method, emphasize the aggregate nature of partnerships by tracking each partner's interest in each partnership asset. Aggregate methods emphasize the entity nature of partnerships, by using the partnership's overall gains and losses to track changes in the values of partners' interests in the partnership. So long as partnerships represent a true blend of aggregate and entity qualities, neither method can claim superiority. In this circumstance, the flexibility offered by the regulations is understandable.

E. *Contributed Assets*

Aggregate methods can be easily extended to contributed assets. These assets give rise to a disparity between book and tax capital accounts that can be incorporated in the revaluation account specified in the drafting formulations given above for the full netting and partial netting methods. As a general rule, however, the regulations require that pre-contribution changes in value from contributed assets be accounted for separately from changes in value reflected in revaluations.¹⁰¹

One can see possibilities for abuse if pre-contribution changes in value were included in the aggregate calculations. For example, suppose a high-bracket taxpayer contributes an appreciated asset to a pre-

⁹⁹ See Letter of Terence Floyd Cuff to Michael Mundaca, Ass't Sec'y (Tax Policy) *et al.* (Mar. 3, 2011), at 21.

¹⁰⁰ A further consideration, which favors separate asset accounting using the remedial method, is trading fungibility. See *infra* Part VII.A (p. 442).

¹⁰¹ Treas. Reg. § 1.704-3(e)(3)(i).

existing partnership consisting of low-bracket or exempt taxpayers. If pre-contribution increases in value were included in allocations under the partial netting method, then a prompt sale of the asset by the partnership would generate a gain that might be allocated largely to the pre-existing partners if they had substantial positive revaluation account balances attributable to increases in value from other assets. The use of an aggregate method in this context would enable the contributing partner to completely dispose of an appreciated asset while recognizing only a portion of the gain.

Similarly, a partnership that was planning to sell an appreciated asset might seek to shift some of the gain to a newly admitted low-bracket or exempt partner, who would contribute another appreciated asset. The new partner would have a positive revaluation account that would attract some of the gain on the sale of the partnership asset.

While these opportunities for tax avoidance are a genuine concern, they can be addressed by the existing anti-abuse rule, which applies to aggregate methods as well as asset-by-asset methods.¹⁰² The anti-abuse rule states that a chosen allocation method is not reasonable if contribution of an asset and the choice of method are made with a view to shifting the consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' tax liability. Either of the avoidance opportunities described above would be vulnerable to attack under this anti-abuse rule.

The regulations authorize the Service to expand the circumstances in which aggregation will be permitted, either by published guidance or private letter ruling.¹⁰³ The Service has used this authority to grant automatic permission for partnerships involving registered investment companies that meet certain guidelines, allowing these partnerships to include contributed property within the scope of their aggregate methods; the Service has also issued a series of private letter rulings

¹⁰² *Id.*

¹⁰³ Treas. Reg. § 1.704-3(e)(4).

granting this permission to particular investment partnerships in circumstances that do not appear to have a tax avoidance motive.¹⁰⁴ There would be no need, however, for partnerships and the Service to devote the resources to obtain and issue these rulings, if the aggregate methods were extended generally to contributed property, subject to the constraints of the anti-abuse rule.

¹⁰⁴ Rev. Proc. 2001-36, 2001-1 C.B. 1326; I.R.S. Priv. Ltr. Ruls. 2014-21-001 (May 23, 2014), 2012-16-019 (Jan. 4, 2012), 2004-48-024 (July 27, 2004), 2004-38-029 (Mar. 18, 2004), 2002-10-047 (Mar. 8, 2002), 98-51-012 (Sept. 14, 1998), 98-51-013 (Sept. 14, 1998), 98-51-022 (Sept. 14, 1998), 98-51-032 (Sept. 14, 1998), 98-51-033 (Sept. 14, 1998).

VII. DISPOSITIONS OF PARTNERSHIP INTERESTS

The discussion so far has focused principally on revaluations that occur in the context of the admission of a new partner. The complete or partial withdrawal of a partner, whether by transfer to another existing or new partner, or in redemption of the partner's interest, raises issues regarding the consequences of any revaluations. These consequences can affect the acquiring partner as well as the remaining partners, who may see themselves as innocent bystanders. Ideally, it should be possible to manage the partnership's affairs so that the tax consequences to an acquiring partner are identical regardless of whether the interest is acquired directly from the partnership or from another partner; and if from another partner, regardless of which partner. Partners who are not a party to the transfer or redemption should be unaffected. The relevant regulations have recently been revised to more closely achieve these ideals, but they do not yet do so perfectly.

A. *Transfers*

An investment partnership that operates like an open-end investment company may have few or no transfers from one partner to another. Instead, purchases and sales will ordinarily be to or from the partnership. It is nevertheless useful to explore the effects of secondary trading on accounting for revaluations because closed-end investment partnerships do exist, and the rules treating publicly traded partnerships as corporations do not apply to some investment partnerships.¹⁰⁵

¹⁰⁵ I.R.C. § 7704(c). The principal limitation is in paragraph (3), which treats a publicly traded partnership as a corporation if it would qualify as a regulated investment company.

Assume that the partnership elects under Section 754 to adjust the basis of its assets by the difference between the price of the interest sold and the share of the partnership's total asset basis attributable to that interest. This difference represents the net gain or loss realized by the seller, as well as previous owners of the interest, if any. Failing to make the adjustment would give the buyer an added tax burden or benefit from this same gain or loss.¹⁰⁶

Mechanically, partnership gains and losses are first allocated without regard to Section 754; then each partner's gain or loss is subject to a separate adjustment.¹⁰⁷ The separate adjustment for any period is the amount of the partner's Section 754 adjustment allocated to assets sold during the period.¹⁰⁸ When the partnership interest is bought, the purchasing partner's Section 754 adjustment is allocated among the assets held by the partnership at that time, pursuant to regulations issued under Section 755 of the Code.

The Section 704(c) regulations provide, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner."¹⁰⁹ Since the same principles are intended to apply to revalued property,¹¹⁰ transferees of partners who would be subject to reverse Section 704(c) allocations will step into the shoes of those partners, even if a Section 754 election is made.¹¹¹

Partnership interests of a given class will be fungible for trading purposes only if the tax consequences of purchasing a unit of partner-

¹⁰⁶ The effects of this double counting are not permanent, because upon the ultimate liquidation of the partners' interest any difference between the partner's overall economic gain or loss and the cumulative amount of gain or loss reported for tax purposes will be properly taken into account. The Section 754 election only affects the timing of gain or loss.

¹⁰⁷ Treas. Reg. § 1.743-1(j)(2).

¹⁰⁸ Treas. Reg. § 1.743-1(j)(3).

¹⁰⁹ Treas. Reg. § 1.704-3(a)(7).

¹¹⁰ Treas. Reg. § 1.704-3(a)(6)(i).

¹¹¹ Treas. Reg. § 1.704-3(a)(7).

ship interest from one partner are the same as those of purchasing any other unit of that class from another partner or from the partnership. This ideal will be realized only if the partnership uses the remedial method (or can make sufficient curative allocations to eliminate completely the selling partner's history under the ceiling rule), and the Section 754 adjustment is allocated among partnership assets in a manner that precisely reflects the selling partner's share of increases and decreases in the value of each asset.

Until 1999, the basis allocation regulations under Section 755 adopted an approach that was more mindful of the entity approach to partnership taxation. Under the standard method prescribed by those regulations, a positive adjustment was allocated only among assets that had increased in value, in proportion to the increase; a negative adjustment was similarly allocated only among assets that had decreased in value.¹¹² Whether an asset has increased or decreased in value for the partnership as an entity, however, may have little to do with the amounts of net increases or decreases from the asset that were allocated to the seller. The only necessary relationship is that the sum of the unrealized net increases and decreases for all assets of the partnership at the time of the sale that are allocated to the seller, or to the seller's predecessors in interest, must be equal to the total Section 754 adjustment.

The prior regulations authorized the Service to permit alternate methods of allocating the Section 754 adjustment that would create positive adjustments to some assets and negative adjustments to others, resulting in the same net adjustment as under the standard method.¹¹³ Yet each of these alternate methods required that positive adjustments be made only to assets that had increased in value at the entity level, and that negative adjustments be made only to assets that had decreased in value. This requirement ignores the possibility that a

¹¹² Treas. Reg. §§ 1.755-1(a)(1)(ii), -1(a)(1)(iii) (prior to amendment by T.D. 8847, 64 Fed. Reg. 69,903 (Dec. 15, 1999)).

¹¹³ Treas. Reg. § 1.755-1(a)(2) (prior to amendment by T.D. 8847, *id.*).

seller may have net increases attributable to an asset even though the asset has a net decrease in value for the partnership as a whole, and *vice versa*. This possibility arises whenever the ceiling rule would have applied under the traditional method if the partnership had sold the asset just before the transfer giving rise to the Section 754 adjustment.

The regulations now provide that a Section 754 adjustment shall be allocated to each asset in accordance with the amount of gain or loss that would have been allocated to the buyer upon a hypothetical sale of the asset for its fair market value immediately after the transfer of the partnership interest.¹¹⁴ This approach can result in positive adjustments for some assets and negative adjustments for others,¹¹⁵ in each case regardless of whether the particular assets have built-in gain or loss for the partnership as a whole. The appeal of this approach for a partnership that uses the remedial method is that the Section 754 adjustment will be precisely equal to the selling partner's share of increases and decreases attributable to each partnership asset. Consequently, when the asset is sold, the Section 754 adjustment will precisely offset the amount of gain or loss allocated to the buyer before the adjustment and attributable to periods before the buyer bought the partnership interest. Partnerships that use the remedial method can achieve fungibility in this respect because partners that acquire an interest will not be subject to tax on net increases or decreases in the value of an asset that occurred before the purchase,

¹¹⁴ Treas. Reg. § 1.755-1(b)(1)(ii).

¹¹⁵ Treas. Reg. § 1.755-1(b)(1)(i). The discussion here assumes that the regulations are valid, although some have questioned whether the IRS has the authority to allocate basis adjustments in this manner. See Barksdale Hortenstine, William P. Wasserman, Gregory J. Marich, Kevin M. Richards & Brian Ladin, *Proposed Regulations Relating to Optional Basis Adjustments (Section 734(b), 743(b) and 755)*, PRACTISING LAW INSTITUTE, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1999, at 398.

regardless of whether they buy from the partnership or from another partner.¹¹⁶

Fungibility is possible, however, only if the partnership uses the remedial method. Otherwise, the Section 754 adjustment, which is based on the allocation of gain or loss on a hypothetical sale, might itself be limited by the ceiling rule, but the gain or loss on an ultimate sale might not be so limited, or *vice versa*. In either case, gain or loss allocated to the acquiring partner upon the sale of a partnership asset may reflect pre-purchase increases or decreases in value. Avoiding this possibility is another reason for investment partnerships to adopt the remedial method.

Partnerships that use an aggregate method cannot achieve fungibility under the new regulations. The allocation of gain or loss on a hypothetical sale of each asset might not be sufficient to completely eliminate disparities between book and tax capital accounts. Moreover, the amount of gain or loss allocated to each asset on the hypothetical sale would depend on the polarity and magnitude of the selling partner's revaluation account, which may differ from one partner to the next. Only by coincidence would the allocated amount be equal to the selling partner's share of increases and decreases in value for that asset. When an asset is sold, the allocation of gain or loss will depend on the polarity and magnitude of the partners' revaluation accounts at that time. These revaluation accounts will reflect the seller's history, since the partnership-level allocation is performed before taking into account the Section 754 adjustment with respect to the acquiring partner. The amounts allocated to the acquiring partner on the sale of an asset will reflect not only the seller's history but also changes in the revaluation accounts of all of the partners before and after the transfer. No methodology for allocating a Section 754 ad-

¹¹⁶ The preamble to the Section 755 regulations, when first issued in proposed form, indicates that this fungibility is an intended outcome of the new rules, when applied in the context of the remedial method. Notice of Proposed Rule-making, 63 Fed. Reg. 4408 (Jan. 29, 1998).

justment at the time of the transfer can possibly anticipate these post-transfer changes in revaluation accounts, and therefore fungibility cannot be achieved by a partnership using an aggregate method. Given that the benefits of simpler computations under the aggregate methods are fairly modest when compared with the remedial method, a partnership that values fungibility in trading will have strong reasons to prefer the remedial method.

B. *Redemptions*

Revaluations that occur upon the admission of a new partner, or upon a realignment of existing partners' interests, are only part of the story. The redemption of a partner's interest can also cause a revaluation, and the accounting after such a revaluation must deal with the absence of the redeemed partner as a person to whom gains and losses may be allocated. As with transfers, the only hope of a coherent outcome is through an appropriate Section 754 adjustment, but this hope is not realized by the current rules for allocating the Section 754 adjustment among the assets held by the partnership when the partner's interest is redeemed.

To simplify the discussion, assume that all redemptions are paid in cash, so that no unrealized gain or loss is "carried out" to the departing partner. In the case of cash redemptions, the allocation equation holds if net increases and decreases of former as well as continuing partners are taken into account and the Section 754 adjustment is disregarded. This result occurs because the partnership's realized gains and losses are based on the sum of the increases and decreases in the value of each asset during the periods in which it was held, and these increases and decreases will have been allocated to either continuing or former partners.

Ideally, the Section 754 adjustment would be allocated among assets upon a redemption in a manner similar to that used for transfers. The adjustment allocated to each asset would be the redeemed part-

ner's share of net increases and decreases for that asset up to the redemption date. This approach in effect gives the redeemed partner a seat at the allocation table whenever gains or losses are subsequently allocated on assets that the partnership bought before the redemption.

Unfortunately, even after the 1999 amendments, the Section 755 regulations continue to require upward adjustments to be made first to the bases of assets that have increased in value (to the extent of the increase), and downward adjustments to be made first to the bases of assets that have decreased in value (to the extent of the decrease).¹¹⁷ When proposing the regulations in their current form, the Service stated that because the adjustments following a redemption affect all partners, whereas an adjustment following a transfer affects only the transferee partner, differing approaches for the allocation of the Section 754 adjustment were necessary in the two contexts.¹¹⁸ In the transfer context, the regulations look to the allocation of gain or loss to the transferee partner on a hypothetical sale; but in the redemption context, the regulations look only to overall built-in gain or loss at the entity level. Yet this respect for the entity wrecks havoc on entity-level allocations.

In the case of a transfer, irregularities in the operation of the Section 754 adjustment have no effect on the partnership's allocation arithmetic, because the Section 754 adjustment is applied to the partner's gain or loss *after* the partnership's gain or loss has been allocated.¹¹⁹ In the case of a redemption, however, the Section 754 adjustment is applied at the partnership rather than at the partner level, and therefore it directly affects the partnership's allocations. If the portion of the adjustment allocated to each asset is not equal to the redeemed partner's share of increases and decreases for that asset, the allocation equation will be out of balance when applied to the con-

¹¹⁷ Treas. Reg. § 1.755-1(c)(2). Any remaining adjustments are to be made to the basis of all assets, in proportion to their fair market values.

¹¹⁸ Notice of Proposed Rulemaking, 63 Fed. Reg. 4408 (Jan. 29, 1998).

¹¹⁹ See *supra* note 107.

tinuing partners after the Section 754 adjustment. Each asset will have a discrepancy between the Section 754 adjustment allocated to it and the redeemed partner's share of increases and decreases for the asset. For partnerships that use the traditional method, these discrepancies add a further distortion to those introduced by the ceiling rule.

These discrepancies also throw off the calculations described above for curative allocations. For any allocation period, the allocation equation will be out of balance by the sum of the discrepancies for the assets sold in that period. Because of the aggregate discrepancy, the partnership might have sufficient spare gains for a curative allocation but not spare losses, or *vice versa*. This asymmetry could never arise if the allocation equation were balanced. The partnership may still attempt to perform curative allocations to the maximum extent possible, allocating gross gains among partners with overall net increases, allocating gross losses to partners with overall net decreases, and using any excesses on both the gain and the loss side to offset ceiling rule account balances of the right polarity.

A disturbing possibility now arises. The partnership may have gains that exceed the amounts absorbed by partners with net increases or ceiling rule accounts with positive balances, and the partnership may have losses that exceed the amounts absorbed by partners with net decreases or ceiling rule accounts with negative balances. When the allocation equation balances, these excess gains and losses always equal each other, so they can be effectively offset by allocating each in the same manner, however arbitrary. When the allocation equation does not balance, there will be either leftover gain or leftover loss after the offset. This leftover gain or loss is a fallout from the vagaries of the Section 754 adjustment allocation. All the partnership can do is allocate the leftover gain or loss in some arbitrary manner, make an appropriate adjustment to the partner's ceiling rule accounts, and cure the problem when the allocation equation swings out of balance the other way, as it must, in a later year.

The Section 754 adjustment after a redemption also complicates matters for a partnership that uses the remedial method. The gain or loss allocated to each partner on a subsequent sale of an asset is no longer the sum of the partner's share of increases and decreases in value of that asset for the allocation periods during which the asset was held. The mismatch between the redeemed partner's share of these increases and decreases in value, and the amount of the Section 754 adjustment allocated to the asset, produces some leftover gain or loss that has to be allocated to somebody. There is simply no principled way to do this. The general partnership allocation regulations contain rules for adjusting book capital accounts to reflect a Section 754 adjustment upon a redemption,¹²⁰ but these adjustments are irrelevant for an investment partnership that marks to market book accounts upon each issuance or redemption of a partnership interest.

The Section 754 adjustment allocated to each asset will not affect tax capital accounts until the asset is sold, but a partnership using the remedial method would be well advised to determine the amount of the adjustment to the basis of each asset that will produce leftover gain or loss (which will be the amount by which the Section 754 adjustment exceeds, or falls short of, the redeemed partner's share of increases and decreases in value), and perform a notional allocation of this amount among the continuing partners at the time of the redemption. This allocation will govern the allocation of the leftover gain or loss that is realized when the asset is sold.

This approach cannot spare the continuing partners the random effects of the vagaries of the Section 754 adjustment, and it adds complexity to the recordkeeping; but it has an important benefit of preserving trading fungibility. A subsequent Section 754 adjustment upon a sale of a partnership interest will adjust the basis of each partnership asset in an amount based on the gain or loss that would be allocated to the seller upon a hypothetical sale of each partnership as-

¹²⁰ Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4).

set. If the partnership agreement makes clear how much leftover gain or loss would be allocated to the seller on such a hypothetical sale, then the subsequent Section 754 basis adjustment will offset the effect of the actual allocation of leftover gain or loss to the transferee partner when the asset is actually sold.

All of these problems could be avoided if the Section 755 regulations were amended to provide that the basis adjustment to each asset following a redemption is the amount that would be allocated to the redeeming partner if the asset had been sold just before the redemption. For a partnership that uses the remedial method, this approach would cause the basis of each asset to be adjusted by the redeeming partner's share of increases and decreases in value, eliminating the need for special allocations of leftover gain or loss.

Even such an amendment to the Section 755 regulations would be insufficient to avoid distortions in the case of a Section 734 adjustment that arises in the context of a distribution that falls short of a complete redemption. Typically, no Section 734 adjustment needs to be made, since the distribute partner will not recognize gain or loss unless the distribution includes cash and marketable securities that exceed the distribute partner's basis, in which case the partner will recognize gain equal to that excess.¹²¹ But if gain is recognized, the partnership can increase the basis of its assets by the amount of that gain.¹²²

Any gain recognized by the distributee partner represents a portion of that partner's share of increases in asset value for prior periods. Those increases in value, when realized, must be allocated to the distributee partner, who, after all, will be continuing as a partner, using the particular method chosen by the partnership for accounting for revaluations. Yet the basis increase under Section 734 is made to the common basis of the partnership's property, and therefore bene-

¹²¹ I.R.C. § 731.

¹²² I.R.C. § 734(b)(1)(A).

fits all partners, not just the distributee partner. As a result, the Section 734 adjustment does not fully protect the distributee partner from being taxed again when those increases in value are realized, even though some of that gain was already recognized on the distribution. And to that degree, the other partners will get a windfall, in that they will enjoy, but do not deserve, their shares of the basis increase.¹²³

These distortions can be corrected only by revamping the methodology for Section 734 adjustments in the case of nonliquidating distributions, so that those adjustments would benefit only the distributee partner, just as Section 743 adjustments incident to a transfer benefit only the transferee partner. If that partner is later redeemed in full, that partner's unused share of any such adjustments could then properly be reapplied to the common basis of partnership property, since the continuing partners will then need to protection of those adjustments to offset the reallocation to them of gains and losses resulting from subsequent realizations of the redeemed partner's share of increase in decreases in value from prior periods.

¹²³ For a fuller description of this problem, with examples, see Robert Frastai, *Section 734/743 Basis Adjustments: Common Issues That Are Commonly Missed* 14–23 (unpublished manuscript, presented to Tax Forum on Jan. 3, 2011). See also Howard E. Abrams, *Partnership Inequalities: The Consequences of Book/Tax Disparities* 6–8, available at <http://www.law.uchicago.edu/files/file/abrams.pdf>.

VIII. DEPRECIATION

Depreciation adds a further element of complexity. As with gains and losses, the regulations require that the difference between tax basis and book value be taken into account, using Section 704(c) principles, in computing depreciation after the revaluation.¹²⁴ This section briefly describes some of the additional issues that depreciation presents in this context.

Depreciation deductions for an asset do not generally track its actual decline in value. Instead, the deductions reflect the recovery of the taxpayer's cost over a prescribed period of time.¹²⁵ The objective in allocating a partnership's depreciation deductions is not an accurate reflection of the partners' economic income, but rather a proper sharing of the tax benefits of this cost recovery.

Unlike future gains and losses, depreciation deductions are known in advance. The tax planning opportunities provided by the predictability of depreciation are enhanced by the freedom partners generally have to allocate depreciation. The regulations require that the allocation of depreciation deductions track the sharing of the economic loss that would occur if the asset actually declined in value by an amount equal to the depreciation deductions, but as a practical matter this risk of loss may be small because tax depreciation is often more rapid than economic depreciation. Moreover, this risk can be eliminated over time by charging back to the partners receiving the benefits of the depreciation deductions a corresponding amount of gain realized on the disposition of the asset, or of other items of partnership income. As part of the requirement that the economic effect of an allocation be substantial, the regulations provide that an allocation of loss or deduction will be disregarded if it is reasonably expected to be offset by a

¹²⁴ Treas. Reg. §§ 1.704-1(b)(4)(i), -3(a)(6)(i).

¹²⁵ S. REP. NO. 144, 97th Cong., 1st Sess. 39, 48 (1981).

subsequent allocation of income, and the varying marginal tax rates of the partners create a tax savings from the allocation.¹²⁶ This substantiation requirement does not significantly restrict the allocation of depreciation deductions, however, because for this purpose the asset is presumed to decline in value by the amount of the depreciation.

A new partner joining a partnership that owns a partly depreciated asset is entitled to share in the remaining depreciation deductions that accrue over the balance of the asset's tax depreciation period. If, as is often the case, the asset has an economic useful life that substantially exceeds its tax depreciation period, then the new partner's investment in the asset may be recovered over a period that is extremely short in relation to the asset's useful life. The method chosen by the partnership for performing reverse Section 704(c) allocations can magnify this effect, which, judging by the examples in the regulations, is the principal reason why the regulations include an anti-abuse rule that constrains a partnership's choice of method.

While a complete discussion of the application of Section 704(c) principles to depreciable property is beyond the scope of this article,¹²⁷ there are issues that arise in the context of revaluations that are not squarely addressed by the regulations, which focus primarily on contributed property in their treatment of depreciation. These issues are highlighted below, in the context of each of the permitted methods for allocating depreciation after a revaluation.

A. *Traditional Method*

Although the regulations do not expressly state how Section 704(c) principles are to be applied in computing depreciation deduc-

¹²⁶ Treas. Reg. § 1.704-1(b)(2)(iii)(c).

¹²⁷ In particular, the discussion that follows assumes that the partnership applies one method consistently to all of its revaluations. For a discussion of the complexities that result when depreciation is calculated by a partnership that uses a mixture of methods, see Rubin & Whiteway, *supra* note 82, at 100–04.

tions after a revaluation, they do provide a lengthy example applying these principles using the traditional method in a case involving a two-person partnership that subsequently admits a third partner.¹²⁸ In essence, all of the tax depreciation is allocated to the new partner, up to the new partner's share of the book depreciation, and the balance is allocated among the continuing partners. The ceiling rule applies if the new partner's share of the book depreciation exceeds the total amount of tax depreciation that is available to allocate.

The regulations offer no example dealing with depreciation under the traditional method (or any other method) after multiple revaluations.¹²⁹ A more general formulation is needed that replicates the results in the regulations when it is applied to a single revaluation.

The partnership's book depreciation for an asset can be seen as the sum of the partnership's tax depreciation and a "depreciation" of each of the revaluation adjustments that have been made for that asset. The regulations require that book depreciation be equal to tax depreciation times the ratio of book value to tax basis.¹³⁰ One can similarly depreciate each revaluation adjustment in an amount equal to tax depreciation times the ratio of the revaluation adjustment to tax basis. Because book value is the sum of tax basis and all the revaluation adjustments, book depreciation will be the sum of tax depreciation and the depreciation of the revaluation adjustments computed in this manner. The difference between book depreciation and tax depreciation has the effect of eliminating the difference between book value and tax basis over the depreciable life of the asset, because both are reduced to zero. The depreciation of each revaluation adjustment represents the amount by which the book-tax difference generated by the adjustment is reduced in each subsequent period. If the revaluation adjustment is upwards, the depreciation will be positive; if downwards, the depreciation will be negative.

¹²⁸ Treas. Reg. § 1.704-1(b)(5), Ex. (18).

¹²⁹ See Jackel, *supra* note 58, at 1142.

¹³⁰ Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

The revaluation adjustment for an asset is allocated among the partners at the time of the revaluation. Each partner's share of the revaluation adjustment is the amount by which the partner's book capital account is increased or decreased as a result of the revaluation of that asset. When the revaluation adjustment is depreciated, the depreciation can be allocated among the partners in the same manner as the revaluation adjustment itself.

A partner's share of tax depreciation can be expressed as the partner's share of book depreciation minus the partner's share of the depreciation of any revaluation adjustments. Under the traditional method, this formulation works if each partner's share is a positive number. If the formula results in negative tax depreciation for some partners, then those partners must be allocated zero tax depreciation and the ceiling rule will limit the amount of tax depreciation allocated to the remaining partners.

This general formulation may be summarized in the following procedure: (1) Calculate book depreciation, which equals tax depreciation times the ratio of book value to tax basis; (2) allocate book depreciation; (3) allocate each revaluation adjustment that has affected the book value of the asset; (4) calculate the depreciation of each revaluation adjustment, which equals tax depreciation times the ratio of the revaluation adjustment to tax basis; (5) allocate the depreciation of each revaluation adjustment in the same manner as the revaluation adjustment itself; (6) sum each partner's shares of the depreciation of the revaluation adjustments, treating depreciation of downwards adjustments as negative; (7) subtract from each partner's share of book depreciation the sum of the partner's shares of the depreciation of the revaluation adjustments; and (8) allocate tax depreciation among partners with net positive amounts in step seven in proportion to these amounts. The last step implements the ceiling rule.

This procedure replicates the results described in the regulations for a single revaluation. In the simplest case, for example, book depreciation is allocated among the partners equally and the revaluation is

caused by the admission of a new partner. If the new partner's share of book depreciation exceeds the partnership's total tax depreciation, then the depreciation of the revaluation adjustment allocated among the continuing partners, which is the difference between the partnership's book and tax depreciation, will exceed the continuing partners' shares of book depreciation. As a result, only the new partner will have a positive balance in step seven, and all of the tax depreciation will be allocated to the new partner. If the new partner's share of book depreciation does not exceed the partnership's total tax depreciation, all partners will have positive balances in step seven, the new partner will be allocated tax depreciation equal to the new partner's share of book depreciation, and the continuing partners will share the remaining tax depreciation.

The traditional method for allocating depreciation can be reflected in a partnership agreement with the following language:

- (a) The partnership's tax depreciation on each asset during any allocation period shall be allocated among the partners with net positive amounts of tentative depreciation under subsection (b) for the asset, in proportion to these amounts.
- (b) A partner's tentative depreciation for an asset in an allocation period shall be the partner's share of the partnership's book depreciation, decreased or increased by the partner's share of the partnership's depreciation of each upward or downward revaluation adjustment for the asset.
- (c) The partnership's tax depreciation for an asset in an allocation period shall be the partnership's depreciation computed for federal income tax purposes for the fiscal year containing the allocation period, prorated by the number of days in the partnership's fiscal year included in the allocation period.

- (d) The partnership's book depreciation for an asset in an allocation period shall be the partnership's tax depreciation times the ratio of the book value of the asset to its tax basis at the beginning of the allocation period; if the asset's tax basis is zero, the partnership's book depreciation shall be determined under any reasonable method selected by the general partner.
- (e) The partnership's book depreciation for each asset in an allocation period shall be allocated [in accordance with the sharing of book income, or any other method agreed to by the partners].
- (f) The revaluation adjustment for each asset shall be determined upon each revaluation to be the amount by which the book value of the asset is increased or decreased as a result of the revaluation.
- (g) A partner's share of a revaluation adjustment for an asset shall be the amount by which the partner's capital account is increased or decreased as a result of the change in the book value of the asset.
- (h) The partnership's depreciation of the revaluation adjustment for an asset in an allocation period shall be the partnership's tax depreciation times the ratio of the revaluation adjustment to the tax basis of the asset at the beginning of the allocation period.
- (i) The depreciation of a revaluation adjustment for an asset shall be allocated in proportion to the partners' shares of the revaluation adjustment.

B. *Curative Allocations*

The need for curative allocations to correct ceiling rule problems with depreciation should arise less often than with gains and losses on investments. With gains and losses on investments, the ceiling rule

applies whenever an appreciated asset decreases in value after a revaluation, or *vice versa*. With depreciation, the ceiling rule generally applies upon the admission of a new partner only if the ratio of the asset's tax basis to its book value is less than the new partner's share of the book depreciation. Thus, the ceiling rule is primarily a problem for assets that are almost fully depreciated for tax purposes.

When the ceiling rule does apply, however, it is harder to correct with curative allocations of depreciation on other assets. The effectiveness of the curative allocations described above for gains and losses depends as a practical matter on the low correlation between changes in the value of each asset. The net gain or loss allocated to each partner is likely to be the net result of the offsetting of larger gross gains and losses, which provide the raw material for the curative allocation. Depreciation, however, is not the result of any similar netting. If a partner is allocated too little depreciation on an asset because of the ceiling rule, it is likely that the effect of the ceiling rule on other assets is similar. A limited curative allocation might be performed by allocating the partnership's tax depreciation for all assets, in step eight above, in proportion to the positive balances in step seven above based on all assets combined. A partner that has a negative balance in step seven for one asset might not have a negative balance overall, and for such a partner this type of curative allocation will correct for the ceiling rule.

The regulations substantially widen the scope for curative allocations by allowing partnerships to make curative allocations of other income, provided that the tax effect of an allocation of the other income is the same as the tax effect of a reduced depreciation deduction.¹³¹ Many partnerships will have sufficient other income of the requisite character to offset fully the effects of the ceiling rule. This ought to be a salutary result, but it has a disturbing side effect

¹³¹ Treas. Reg. § 1.704-3(c)(3)(iii)(A). A partnership may, if it chooses, limit its curative allocations to other depreciation deductions. *See* Treas. Reg. § 1.704-3(c)(4), Ex. (2).

when combined with the tendency of tax depreciation to be much more rapid than economic depreciation.

As noted above, the ceiling rule is most likely to come into play when an asset is almost fully depreciated for tax purposes. If an asset has only one year remaining in its tax depreciation period when a new partner is admitted, any tax depreciation allocated to the new partner will accrue in that year. When curative allocations are available to eliminate the effects of the ceiling rule, the new partner will effectively enjoy tax depreciation equal to the book depreciation allocated to that partner, which could be a much larger number if the asset is worth much more than its tax basis. In such a case, the asset is likely to have a remaining economic useful life that is much longer than the one year remaining in its tax depreciation period, but the new partner's investment in the asset will essentially be written off in the first year. If the new partner is in a higher tax bracket than the existing partners, the curative allocation will cause an overall savings in the aggregate tax liability of the partners, and the regulations treat this as an unreasonable use of curative allocations.¹³²

Depreciation of revalued property raises the same issues as depreciation of contributed property regarding the ways in which the ceiling rule and curative allocations can create a potential for abuse. This topic has been addressed by others in the context of contributed property,¹³³ and will be touched on only lightly here. One point that becomes more readily apparent in the revaluation context, however, is that the perceived evil arising from the "abusive" use of curative allocations can arise quite easily in a case that does not implicate either the ceiling rule or curative allocations. Suppose a partnership of low-bracket or exempt partners has an asset with one remaining year of tax depreciation but a substantial remaining economic useful life, and a fair market value that is ten times its tax basis. After the admission of

¹³² Cf. Treas. Reg. § 1.704-3(c)(4), Ex. (3).

¹³³ See Cunningham, *supra* note 75; Hortenstine & Marich, *supra* note 87; Cuff, *supra* note 97.

a new ten-percent high-bracket partner, the partnership will have just enough tax depreciation to allocate to the new partner so that the new partner's tax depreciation and book depreciation are equal. This allocation provides a one-year tax write-off of the new partner's investment in the asset, which is precisely the result that the regulations find abusive when the partnership needs to make curative allocations to achieve it.¹³⁴ So the rules that limit a partnership's choice of method do not (and indeed cannot) completely eliminate the abuses they are intended to address, but they avoid increasing the opportunities for abuse.

Many partnerships do not face the question of abuse because their partners are expected to be in similar tax brackets, so the choice of allocation method has more to do with who pays the tax rather than how much total tax is paid. For these partnerships, the choice of allocation method is a question of balancing fairness among partners with the added complexity of making the curative allocations. If a partnership chooses to make curative allocations, it faces three decisions: *how much* income or deductions should be made subject to the curative allocations, *to whom* the allocations should be made, and *from whom* the allocations should be made.

One approach would be to make curative allocations first of depreciation deductions and then, if necessary, of other income. The allocation of depreciation deductions would be made in the manner suggested above, by aggregating each partner's tentative depreciation for each asset (which would be computed without regard to the ceiling rule, and might be negative), and allocating total tax depreciation to partners with positive net aggregate tentative depreciation. In any situation where some partners have negative net aggregate tentative depreciation, the partnership's total tax depreciation will be less than the amount allocable to partners with positive net aggregate tentative depreciation. Those partners will suffer a depreciation shortfall equal

¹³⁴ See *supra* note 132.

to the negative tentative depreciation of the first group of partners. If the partnership has enough income to cover the shortfall, it can perform a complete curative allocation; otherwise, the available income should be allocated away *from* those partners with shortfalls, in proportion to the shortfalls, and *to* those partners with negative tentative depreciation, in proportion to those negative amounts. Any shortfalls that are not offset in this manner can be recorded in a ceiling rule account, in order to potentially benefit from a curative allocation of available income in a subsequent allocation period.

A significant complication arises when not every partner with a positive ceiling rule account balance has a sufficient share of reallocable income to eliminate that partner's ceiling rule account balance. In such a case, the curative allocation cannot be made away from partners strictly in proportion to positive ceiling rule account balances, since some partners will "run out" of reallocable income before others. In such a case, any further curative allocations must be limited to the remaining partners. More precisely, the partners with positive ceiling rule account balances must be ranked by the ratio of the partner's share of reallocable income divided by the partner's ceiling rule account balance. A series of curative allocations must then be performed, each involving a successively smaller group of partners, reallocating income from just those partners who still have income to reallocate at each point in the series.

This approach, while complex, can be implemented as follows in a partnership agreement, again without a reference to Section 704(c) principles:

- (a) The partnership's tax depreciation during any fiscal year shall be allocated among the partners with net positive amounts of tentative depreciation under subsection (b) for all assets in all allocation periods in the fiscal year, in proportion to these amounts.

[paragraphs (b)–(i) parallel the corresponding paragraphs under the traditional method]

- (j) The partnership shall perform a series of curative allocations of reallocable income, in each of which the reallocable income of each partner with both a positive ceiling rule account balance and a positive amount of reallocable income remaining after any prior curative allocations in the series shall be reallocated from those partners, in proportion to, and to the extent of, their positive ceiling rule account balances, but only until at least one such partner no longer has reallocable income, to partners with negative ceiling rule account balances, in proportion thereto.
- (k) The reallocable income of the partnership shall be its income from depreciable property [or other category as appropriate].
- (l) The partnership shall maintain a ceiling rule account for each partner with respect to depreciation, which shall be initially zero and shall be:
 - (i) increased by
 - (A) the partner's combined tentative depreciation for all allocation periods during the fiscal year, and
 - (B) income allocated to the partner under paragraph (j); and
 - (ii) decreased by
 - (A) the depreciation allocated to the partner under paragraph (a), and
 - (B) income allocated from the partner under paragraph (j).

In this formulation, all addition and subtraction follow the usual rules of arithmetic in their treatment of negative numbers. If a partner's tentative depreciation is negative, the increase mandated by clause (l)(i)(A) will cause the partner's ceiling rule account to go down, and

may cause the partner's ceiling rule account balance to drop below zero.

C. Remedial Method

Curative allocations may be able to offset fully the effects of the ceiling rule for many partnerships, but at a serious price in terms of complexity. Moreover, curative allocations, when they work, can be perceived as too effective. Because they close gaps between book and tax capital accounts attributable to a revaluation of an asset over the remaining tax depreciation period of the asset, this gap closing will happen very quickly for an asset that is almost fully depreciated. While the Service is concerned about the tax-motivated income-shifting opportunities that may arise, partnerships with partners in roughly the same bracket, and therefore no motive to shift income, can legitimately complain that curative allocations create their own distortions.

For example, suppose a new partner is admitted to a partnership that owns an asset with one year remaining in its tax depreciation period but a book value that greatly exceeds its tax basis. If curative allocations eliminate the effect of the ceiling rule, the new partner's investment will be effectively written off within a year. This is a boon to the new partner, but if all partners are in a similar tax bracket, tax allocations are a zero-sum game: the continuing partners face an accelerated tax on their shares of the appreciation in the portion of the asset that has been implicitly transferred to the new partner. While Section 704(c) principles generally contemplate that the continuing partners must recognize more income in order to allow the new partner to benefit from tax depreciation that more closely tracks book depreciation, it seems harsh to force this income on the contributing partners over a period that is much shorter than the remaining useful life of the asset.

The culprit is the rule in the partnership allocation regulations providing that after a revaluation the revalued book value must be de-

preciated over the asset's remaining tax depreciation period.¹³⁵ The Section 704(c) regulations appear constrained to follow this rule under the traditional method and with curative allocations, since these methods do no more than reallocate existing tax items. The regulations prescribe a quite different approach, however, for partnerships that use the remedial method.

Under the remedial method, the partnership creates notional depreciation allocable to any partner whose depreciation is limited by the ceiling rule, and creates a corresponding amount of income to any partner whose depreciation, absent the ceiling rule, would have been negative.¹³⁶ The remedial method ensures that any new partner that contributes cash will be entitled to tax depreciation that is equal to book depreciation. The regulations ensure that the book depreciation is not too rapid, however, by prescribing that the book value attributable to the revaluation adjustment of an asset must be depreciated over a recovery period available for property of that type newly placed in service at the time of the revaluation.¹³⁷

A consequence of this approach to book depreciation is that the book value of an asset that has been revalued more than once must be divided into successive revaluation "layers," each with its own depreciation period. As with the traditional method, there is the possibility of negative revaluation adjustments resulting in negative depreciation. In the context of the remedial method, this negative depreciation can lead to the creation of notional depreciation for the continuing partners, and offsetting notional income for the new partner.

The remedial method can be most succinctly stated in a partnership agreement if there is no distinction made between "real" depreciation and "notional" depreciation created by the remedial method. Each partner whose depreciation, computed without regard

¹³⁵ See *supra* note 130.

¹³⁶ Treas. Reg. § 1.704-3(d)(1). As usual, the regulations express the rule in terms of contributed property, but the same approach applies to revalued property.

¹³⁷ Treas. Reg. § 1.704-3(d)(2).

to the ceiling rule, is positive is entitled to that amount of depreciation; and each partner whose depreciation is negative is allocated notional income in that amount. Here is a sample clause:

- (a) Each partner whose net amount of tentative depreciation under subsection (b) for an asset is positive shall be allocated tax depreciation equal to that amount; and each partner whose net amount is negative shall be allocated that amount of notional taxable income.

[paragraphs (b)–(c) parallel the corresponding paragraphs under the traditional method]

- (d) The partnership's book depreciation for an asset in an allocation period shall be the sum of the partnership's tax depreciation and the depreciation of each revaluation adjustment.

[paragraphs (e)–(g) parallel the corresponding paragraphs under the traditional method]

- (h) The partnership's depreciation of the revaluation adjustment for an asset in an allocation period shall be determined using any recovery period and depreciation method that is available to the partnership for newly purchased property (of the same type as the revalued asset) that is placed in service at the time of the revaluation, as selected by the tax matters partner; and this depreciation shall be negative if the revaluation adjustment is a decrease.

[paragraph (i) parallels the corresponding paragraph under the traditional method]

A curious and somewhat problematic outcome of this implementation of the remedial method is the possibility that an asset may have negative book value. This can occur whenever a depreciable asset is revalued downwards. If, as suggested above, the revaluation adjustment generates negative depreciation that is combined with the tax

depreciation to produce a lower book depreciation, then after the tax basis has been reduced to zero there may still be some undepreciated portion of the revaluation adjustment, and the book value of the asset will be negative at that point to that extent. Subsequent book depreciation will be negative, and will bring the book value of the asset back up to zero by the end of the depreciation period of the revaluation adjustment. During this period of negative book depreciation, partners whose shares of the (downwards) revaluation adjustment exceed their shares of the (negative) book depreciation will be allocated notional depreciation, and other partners will be allocated notional income.

In the absence of any guidance on this point from the regulations, one can imagine a different approach to determining book depreciation after a downward revaluation, in which one simply scales down the book depreciation that would have accrued absent the revaluation. This approach parallels the rule that applies to both upwards and downwards revaluation adjustments in the context of the traditional method and curative allocations. This approach has the virtue of avoiding the creation of negative book value and negative depreciation, but as we saw with curative allocations, it has the drawback of sometimes working too fast, accelerating deductions to partners who suffered the effect of the downward adjustment, and accelerating income to other partners.

D. Sales of Depreciable Assets

When a depreciable asset subject to a revaluation is sold, the allocation of the gain or loss on the sale must take into account both the revaluation adjustments and the depreciation that has already been claimed. The taxable gain or loss is the book gain or loss minus the undepreciated portion of each revaluation adjustment. The book gain and loss can be allocated by agreement among the partners, with appropriate adjustments to book capital accounts, and the revaluation

adjustments are allocated among partners as part of the revaluation. It is therefore possible to allocate to each partner the difference between the partner's share of the book gain or loss and the partner's shares of the undepreciated portions of the revaluation adjustments. These differences add up to the partnership's taxable gain or loss.

A partnership that uses the traditional method may find that the ceiling rule prevents an allocation of this difference to each partner. Instead, a taxable gain must be allocated among partners with positive differences and a taxable loss among partners with negative differences, in each case in proportion to the differences. Yet even if the ceiling rule does not apply to the allocation of gain or loss, the use of the traditional method will perpetuate any prior ceiling rule disparities that arose from the asset's depreciation.

A limited use of curative allocations may correct these disparities. This can be accomplished by keeping track of each partner's net ceiling rule disparity for each asset; that is, the net sum of the differences between each year's depreciation of the asset allocation to the partner and the amount that would have been allocated to the partner in the absence of the ceiling rule. The net ceiling rule disparity can then be added to the partner's shares of the book gain or loss and the revaluation adjustments in computing the net balance that is used to allocate the taxable gain or loss. This method eliminates some but not all ceiling rule disparities. In particular, if the partnership's taxable gain or loss is smaller than the ceiling rule disparities that have arisen, no allocation of the gain or loss alone can fully offset the disparities.

It is possible that gain or loss on the sale may have a different character, such as Section 1231 gain, from the asset's depreciation deductions, which offset ordinary income. Although the regulations generally require curative allocations to have the same character as items limited by the ceiling rule, there is a special exception allowing curative allocations of gain from the disposition of an asset to correct for ceiling rule disparities that arose on the depreciation of that as-

set.¹³⁸ This exception is available, however, only if the curative allocation is specifically provided for in the partnership agreement. Moreover, it appears to be limited to gain from that particular asset: there is no authorization to make curative allocations of this gain to offset ceiling rule disparities that arose from the depreciation of another asset.

Not surprisingly, only the remedial method offers complete relief from ceiling rule distortions. Under the remedial method, a partner's allocated gain or loss from the disposition of a depreciable asset is simply the partner's share of book gain or loss minus the partner's share of the undepreciated balance of any revaluation adjustments. The partner may be allocated a net gain even though the partnership as a whole has a loss, or vice versa; but the beauty of the remedial method is that it can accommodate these situations.

A portion of the taxable gain realized on the sale of depreciable personal property will typically constitute depreciation recapture. It seems reasonable to treat a portion of each partner's share of the taxable gain from an asset as depreciation recapture to the extent of the partner's share of the depreciation deductions from the asset. This may not always be possible, however, since there may be no gain allocated to a particular partner, even though that partner previously claimed depreciation deductions and the partnership has a taxable gain at the entity level. This situation can arise either because the partner's interest was acquired at a relatively high price or because the partnership's allocation of book gain or loss is different from its prior allocation of book depreciation. In neither case is the ceiling rule a necessary factor, and the remedial method is unable to eliminate this effect.

If all of the gain is depreciation recapture, then under the traditional method or with curative allocations that gain is all there is to allocate, and no further questions of character arise. If the partnership

¹³⁸ Treas. Reg. § 1.704-3(c)(3)(iii).

uses curative allocations, it can use this recapture income to offset ceiling rule disparities that arose from depreciation on other property, since this recapture income has the same character as income sheltered by the depreciation itself. It is unclear, however, whether notional items created under the remedial method should be depreciation deductions and recapture income, or Section 1231 gain and loss.

Section 1231 gain or loss has a sort of potential ceiling rule problem of its own. Each taxpayer is required to net Section 1231 gains and losses, and any overall net gain is taxable as a capital gain, while any overall net loss is deductible as an ordinary loss.¹³⁹ The partnership regulations require the separate reporting of each partner's share of the "combined net amount" of the Section 1231 gains and losses of a partnership.¹⁴⁰ If a partnership has equal amounts of Section 1231 gains and losses, but under the partnership agreement the gains are allocated differently from the losses, then an allocation of the partnership's overall net Section 1231 gain or loss (which is zero) cannot properly reflect the allocations provided in the partnership agreement. Notwithstanding the literal terms of the regulations, the only sensible approach is to disaggregate the Section 1231 gains and losses at the partnership level, and allocate them separately. This need to disaggregate can arise regardless of whether the partnership revalues its assets.

Gain on the sale of a depreciable asset is commonly a combination of depreciation recapture and Section 1231 gain. Under any method of allocating post-revaluation gains, or even in the absence of a revaluation, the question arises as to how much of the gain allocated to each partner should be depreciation recapture. This determination has no economic effect, since the partners' capital accounts are increased in the same manner by allocations of depreciation recapture and Section 1231 gain. As noted above, it is not generally possible to ensure that the depreciation recapture income will be allocated back to

¹³⁹ I.R.C. § 1231(a)(1) and (2). Gain or loss on the sale of property used in a trade or business is generally Section 1231 gain or loss. I.R.C. § 1231(a)(3).

¹⁴⁰ Treas. Reg. § 1.702-1(a)(3).

those partners who claimed the depreciation deductions that are now being recaptured. The simplest approach would be to allocate the two types of income proportionately: if two-thirds of the partnership's gain is depreciation recapture, then two-thirds of the gain allocated to each partner would be depreciation recapture. Once again, however, it is unclear whether notional items created under the remedial method should be depreciation recapture or Section 1231 gain. The only examples in the regulations applying the remedial method to the sale of property deal with the sale of land for a pure capital gain or loss, so this character issue does not arise.¹⁴¹

E. Transfers of Partnership Interests

If a partnership interest is sold, the buyer is entitled to claim a portion of the depreciation deductions allocable to the interests transferred, subject to any adjustments resulting from a Section 754 election by the partnership. For the taxable year of the partnership in which the interest is sold, depreciation is allocated between the buyer and the seller based on the number of days in the taxable year before and after the sale. This allocation is apparently required to be based on daily proration regardless of whether the partnership performs an interim closing of its books on the date of sale¹⁴² because depreciation is assumed to accrue ratably during the entire taxable year of the partnership, even for assets acquired after the sale.¹⁴³

If the basis of an asset is adjusted downward as a result of a Section 754 election, the adjustment is treated as a item of negative depreciation that offsets depreciation otherwise allocated to the buyer (with any excess being treated as ordinary income), which is taken into

¹⁴¹ Treas. Reg. § 1.704-3(d)(7), Exs. (2) and (3).

¹⁴² A partnership may allocate tax items between the transferor and the transferee based either on an interim closing of the partnership's books or on a reasonable proration method. Treas. Reg. § 1.706-1(c)(2)(ii).

¹⁴³ Prop. Treas. Reg. § 1.168-2(k), 49 Fed. Reg. 5940, 5956 (Feb. 16, 1984).

account over the remaining recovery period for the asset.¹⁴⁴ If the basis is adjusted upwards, the increase is treated as the acquisition of a new asset at the time of the sale, and the buyer is entitled to depreciate the increase as if the asset had been placed in service at that time.¹⁴⁵ It is unclear whether a downwards adjustment that follows a prior upwards adjustment is first applied to offset the upwards adjustment, or reduces both the original basis and the upwards adjustment on a *pro rata* basis.

A consequence of treating an upwards Section 754 adjustment as newly acquired property is that the buyer will generally be entitled to less favorable depreciation for the adjustment compared with the buyer's share of the partnership's depreciation of the original cost of the property. The buyer's share of the partnership's depreciation will extend over the remaining portion of the original depreciable life of the asset, based generally on the law in effect when the asset was placed in service. The depreciation of the adjustment will extend over the full depreciable life of the property starting with the year of sale, based generally on the law in effect when the sale occurs.

The buyer potentially inherits the seller's history of ceiling rule distortions that arose from earlier allocations of depreciation, as well as gain or loss, although these may be eliminated by curative allocations or notional items that are taken into account in allocating the basis adjustment under Section 755. Yet even if the ceiling rule does not apply or is corrected by a curative allocation or notional items, the tax consequences to the buyer will depend upon the identity of the seller. Consider a partnership with two groups of partners: One group that acquired its interests upon the formation of the partnership, and a second group that acquired its interests later, at a higher price, with the partnership being revalued at that time. The second group will in effect be entitled to claim depreciation deductions on assets owned by

¹⁴⁴ Treas. Reg. §1.743-1(j)(4)(ii).

¹⁴⁵ Treas. Reg. §1.743-1(j)(4)(i).

the partnership at the time of their admission using a basis that is higher than the basis used by the first group. A person buying a partnership interest will be entitled to a Section 754 adjustment based on the excess of the price paid over the seller's share of the basis of partnership assets. The seller's share of this basis will be higher for a seller in the second group than the first group, and the Section 754 adjustment will be correspondingly lower. Thus, even though the total basis on which the buyer's share of the partnership's depreciation deductions is based will be the same regardless of who the seller is, a larger portion of this basis will be attributable to the Section 754 adjustment if the seller is in the first group. As we have seen, however, the depreciation of the Section 754 adjustment is generally less favorable than the depreciation of the partnership's original basis because the Section 754 adjustment is treated as the cost of newly acquired property. As a result, the buyer's depreciation deductions can be adversely affected by the identity of the seller even in the absence of any ceiling rule distortions.

F. *Redemptions*

In our discussion of gains and losses, the Section 754 adjustment upon a redemption at least potentially filled the "empty chair" of the departed partner, so that the amount of subsequent gains and losses allocated to the continuing partners, to the extent attributable to increases or decreases in value before the redemption, was unaffected by the redemption. In practice, vagaries of the ceiling rule and the Section 755 allocation prevent this ideal from being realized.

In the case of depreciation, however, the redemption is expected to affect what is allocated to continuing partners. If the redeeming partner receives cash, the investment of the remaining partners becomes more concentrated in the partnership's depreciable property, and it makes sense that their depreciation deductions should increase. Even in the absence of a Section 754 adjustment, the depreciation de-

ductions of the continuing partners will increase because the deductions are being spread among fewer partners. An upwards Section 754 adjustment will increase them even more.

The redeemed partner's ceiling rule disparities affect the partner's basis, and are therefore taken into account in determining both the redeemed partner's gain or loss and the amount of the Section 754 adjustment. The overstatement or understatement of depreciation allocated to the other partners because of these ceiling rule disparities will be corrected over time as the adjustment to asset basis is reflected in subsequent depreciation or gains and losses. Because of the vagaries of the Section 755 allocation, a prior understatement of depreciation may be corrected by a decrease in allocated capital gain, and an overstatement of depreciation may be corrected by an increase in allocated capital gain. Thus, while ceiling rule disparities are eliminated over time, permanent distortions in the character of income can result.

G. Simplified Methods

Allocating depreciation after a series of revaluations under the method described above is more complex than allocating gains and losses on securities, because the partnership must separately track the depreciation of each revaluation adjustment for each asset. Given this complexity, and that depreciation is not intended to track economic changes in value, a strong case can be made for allowing partnerships to use a simplified method of tracking revaluation adjustments, provided that the method does not create ways of transferring tax liabilities among partners in a tax-motivated manner. The present regulations provide a special aggregation rule for securities partnerships, but this rule applies only to qualified financial assets, and therefore does not apply to depreciable property even if owned by a securities partnership.¹⁴⁶ A partnership is permitted to aggregate personal prop-

¹⁴⁶ Treas. Reg. § 1.704-3(e)(3).

erty that is included in a single asset account of a contributing partner and the partnership under Section 168, and presumably this rule would also apply to revalued property.¹⁴⁷ But such a limited aggregation rule does not simplify matters much.

The regulations authorize the Service, by published guidance or by letter ruling, to permit the aggregation of assets that are not qualified financial assets, and by partnerships that are not securities partnerships. So it is worth speculating what such an aggregate method might look like. Under one approach, the method would allocate a portion of the tax depreciation in a manner that closes gaps between partners' book and tax capital accounts, and allocate the remaining tax depreciation in proportion to book depreciation.

For example, the partnership's overall gap between the tax basis and the book value of each depreciable asset at the beginning of an allocation period could be measured, and that gap could have a depreciation adjustment in an amount equal to the tax depreciation for the asset during that allocation period, times the ratio of the gap to the tax basis. If, as will usually be the case, the gap is positive (that is, book value exceeds tax basis), the total gap depreciation for all assets can be allocated among the partners with book accounts that exceed their tax accounts. If the gap were negative, this depreciation would be allocated among the other partners, with tax accounts that exceed their book accounts. Each partner's share of total gap depreciation is subtracted from the partner's share of total book depreciation, and the tax depreciation is then allocated among partners with a positive balance.

Such a method is simpler because the partnership no longer needs to keep track of each revaluation adjustment for each asset, and allocate each such adjustment among the partners. Instead, the partnership allocates the depreciation based on the overall gap between book value and tax basis for each asset. This approach can be combined with a simplified method for gains and losses by applying

¹⁴⁷ Treas. Reg. § 1.704-3(e)(2)(i).

one first, then the other. For example, depreciation can be allocated in the manner described above, and any gains or losses, whether on depreciable or other property can then be allocated based on any gaps that remain. In this context, the simplified methods scramble ordinary and capital items of income and deduction, and are therefore suitable only for partnerships that are willing to accept the scrambling with the simplicity.

In most cases, a simplified method along the lines described above would not ordinarily create opportunities for tax abuse, because it diminishes gaps between book and tax accounts over time and may be less likely to generate ceiling rule distortions than the traditional asset-by-asset method. The Service should allow such methods that achieve at least some measure of simplicity without improper shifts in tax liability.

IX. CONCLUSION

At the beginning of the 1990s, partnerships that revalued regularly were plagued by the requirement that each asset be treated separately, were subject to the tyranny of the ceiling rule, and were forced to allocate Section 754 adjustments in a manner that frustrated fungible trading. Regulations issued since that time have solved most of these problems, although some difficulties remain. The regulations continue to focus almost exclusively on contributed property, leaving the treatment of revalued property to be sorted out by analogy. Fortunately, by using the proportion-to-book approach and the remedial method with separate asset tracking, an investment partnership can simplify its allocations and achieve trading fungibility. Today's rules provide valuable flexibility in the majority of circumstances that lack abuse potential, and permit each partnership to determine for itself the approach that best serves its needs for fairness and ease of administration.

