

**To:** Eileen Alexanderson [REDACTED]  
**From:** Jeffrey Epstein  
**Sent:** Sat 3/30/2013 6:36:48 PM  
**Subject:** Re: amh

On Sat, Mar 30, 2013 at 4:45 PM, Eileen Alexanderson <[REDACTED]> wrote:

What's the question on AMH?

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**From:** Jeffrey Epstein [mailto:[jeevacation@gmail.com](mailto:jeevacation@gmail.com)]  
**Sent:** Saturday, March 30, 2013 09:02 AM Eastern Standard Time  
**To:** Melanie Spinella; Eileen Alexanderson  
**Subject:** amh

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## **Partnership - Audit Technique Guide - Chapter 3 - Contribution of Property with Built-in Gain or Loss - IRC section 704(c) (Revised 12-2007)**

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Revised 12/2007

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Each chapter in this Audit Techniques Guide (ATG) can be printed individually. Please follow the links at the beginning or end of this chapter to return to either the previous chapter or the Table of Contents or to proceed to the next chapter.

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## Introduction

When a partner contributes property to a partnership which has increased or decreased in value, the property has an inherent built-in gain or built-in loss that arose during the period in which the partner owned the property outside of the partnership. Thus, at the time of contribution, the property has a tax basis to the partnership that differs from its fair market value (FMV). As was discussed in Chapter 1, the property's FMV at the time of contribution is what is called the "book value." Where the "book value" (FMV at contribution) and the "tax basis" (basis carried over from the contributing partner) differ, the property is referred

to as “section 704(c) property.”

The goal of IRC section 704(c) is to prevent the shifting of tax consequences (gain, loss, and deductions) with respect to appreciated or depreciated property contributed by a partner to a partnership. It upholds the assignment of income principle by requiring the contributing partner to be taxed on the portion of the gain or loss that arose prior to the property’s contribution to the partnership. This chapter will cover:

- IRC section 704(c) in the context of non-depreciable property
- IRC section 704(c) in the context of depreciable property
- IRC section 704(c) in the context of amortizable property
- Impact of IRC section 704(c) on the sharing of non-recourse liabilities
- “Reverse” IRC section 704(c) which addresses re-valuations
- IRC section 704(c)(1)(C) and duplication of built-in losses
- The Anti-Abuse Rule

## **Overview**

Prior to 1984, there was no special rule that a contributing partner had to take into account the gain or loss inherent in property at the time of contribution. In 1984, Congress took action to prevent partners from shifting pre-contribution gain or loss among themselves and made IRC section 704(c) mandatory. As a result, gain or loss inherent in contributed property must be allocated back to the contributing partner. In the case of non-depreciable property, this can happen all at once when the property is sold. On the other hand, gain or loss inherent in depreciable property will be recognized over time as depreciation deductions are allocated to other partners and away from the contributing partner, thereby increasing the contributing partner’s share of partnership income.

Final regulations for 704(c) were issued on December 21, 1993. These regulations include an anti-abuse rule in Treas. Reg. section 1.704-3(a)(10). A firm grounding in the basic operation of IRC section 704(c) is critical to understanding the proper allocation of gain, loss, and cost recovery pertaining to IRC section 704(c) property. Additionally, IRC section 704(c) principles have an impact on a contributing partner’s share of partnership non-recourse debt.

## **ISSUE: IRC SECTION 704(c) AND NON-DEPRECIABLE PROPERTY**

### **Example 3-1**

Adam and Melvin form an equal partnership in which Adam contributes raw land with a tax basis of \$10,000 and a FMV of \$50,000. Melvin contributes \$50,000 of cash. The land is IRC section 704(c) property because there is a \$40,000 appreciation that occurred prior to its contribution to the partnership. Its book value is \$50,000 and its tax basis is \$10,000.

If the partnership were to sell the land for \$50,000, the entire gain would be allocated to Adam.

If the land appreciated in the hands of the partnership and it were sold for \$100,000, \$50,000 of the gain would be split equally between Adam and Melvin and the built-in gain of \$40,000 would be allocated to Adam.

Consistent with the assignment of income principles, Melvin is only allocated a portion of the gain that accrued during the time that he owned the land via the partnership. All of the built-in gain of (\$40,000) that accrued prior to contribution is allocated back to the contributing partner.

### **Allocation Methods – Non-depreciable Property**

Although straightforward in its aim of upholding the assignment of income principle and allocating to the contributing partner any built-in gain or loss, IRC section 704(c) becomes more complicated when there has been a tax gain but a book loss.

#### **Example 3-2**

Taking the facts from Example 3-1, if the land decreased in value to \$30,000 and was sold, there would be a tax gain of \$20,000 (\$30,000 less tax basis of \$10,000). Following IRC section 704(c) principles, this gain would be allocated to Adam. Melvin, on the other hand, has suffered an economic loss but has no accompanying tax loss. Remember that Melvin bought an undivided interest in a partnership that owned land worth \$50,000. The land had a book value of \$50,000 and was sold for \$30,000, resulting in a \$20,000 book loss. The problem here is that there is no tax loss to match Melvin's book (or economic) loss. Melvin has run into the so called "ceiling rule" which prevents a partnership from allocating items of income, gain, loss, and deduction that exceed 100% of the total amounts of such items that the partnership actually recognizes for tax purposes.

The partnership can remedy problems caused by the ceiling rule, depending upon which method the partnership chooses for allocating the IRC section 704(c) gain or loss.

The regulations discuss three allocation methods:

- Traditional Method
- Traditional Method with Curative Allocations
- Remedial Method

The traditional method with curative allocations and the remedial method are designed to remedy the noncontributing partner's lack of a tax loss allocation in the presence of an economic loss. Under the traditional method, the

noncontributing partner's lack of a tax loss to match his economic loss is not corrected until the partnership liquidates or that partner sells its partnership interest.

### Traditional Method

This method focuses solely on eliminating the contributing partner's built-in gain or loss. Under the facts of Example 3-2, the noncontributing partner would be forced to wait until the partnership liquidates in order to get a tax loss to match his economic loss. The partners' tax capital and book capital accounts under the traditional amount are as follows:

|                        | Contributing Partner Adams |         | Noncontributing Partner Miller |         |
|------------------------|----------------------------|---------|--------------------------------|---------|
|                        | Tax                        | Book    | Tax                            | Book    |
| <b>Initial Balance</b> | 10,000                     | 50,000  | 50,000                         | 50,000  |
| <b>Land Sale</b>       | 20,000                     | -10,000 | 0                              | -10,000 |
|                        | 30,000                     | 40,000  | 50,000                         | 40,000  |

If the partnership distributes its cash of \$80,000 in complete liquidation, (Melvin's initial cash contribution of \$50,000 plus \$30,000 from the sale of the land), the results would be as follows:

|                         | Contributing Partner Adams | Noncontributing Partner Miller |
|-------------------------|----------------------------|--------------------------------|
| <b>Outside Basis</b>    | 30,000                     | 50,000                         |
| <b>Cash Distributed</b> | (40,000)                   | (40,000)                       |

|                             |        |        |
|-----------------------------|--------|--------|
| <b>IRC section 731 Gain</b> | 10,000 |        |
| <b>IRC section 731 Loss</b> |        | 10,000 |

Under the traditional method, the ceiling rule causes Melvin to incur an economic loss which will not be matched by a current tax loss. Instead, the loss will be recognized for tax purposes upon disposition of his partnership interest. Melvin is not allocated a tax loss in conjunction with his book loss because the partnership doesn't have a tax loss to allocate to him.

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### **Traditional Method with Curative Allocations**

A partner may not be willing to defer until tomorrow a tax loss associated with today's economic loss. Because the ceiling rule will not allow the partner to take a loss greater than the partnership's actual associated tax loss, the regulations permit a partnership to elect "curative allocations." A "curative allocation is an allocation of gain, loss, or deduction made in order to remedy the disparities caused by the ceiling rule. In making a curative allocation, a partnership looks at the tax items it has generated for the year and searches for one that is of the same character as the item that was limited by the ceiling rule. It then allocates that tax item among the contributing and noncontributing partners to the extent necessary to overcome the ceiling rule distortion. This is done for tax purposes only and does not affect the book capital accounts. The result is that the noncontributing and the contributing partners are allocated offsetting tax items – the noncontributing partner receives a loss or a gain reduced from what he would normally have received, and the contributing partner receives the mirror opposite.

### **Remedial Allocation Method**

Unlike the curative allocation method, the remedial method does not force the partnership to look for a tax item that truly exists. Instead, the partnership simply invents what it needs – it manufactures whatever tax allocations the noncontributing partner needs to accompany his book allocations. At the same time, it invents an offsetting item in the same amount as the fictional tax items and

allocates it to the contributing partner. Thus, any remedial allocations of loss to one partner will result in an offsetting allocation of gain to the other partner. It is important to realize that in spite of their purely fictitious origins, remedial allocations are real for tax purposes. They affect both the partners' tax liabilities and their outside bases. Since these allocations are created solely for tax purposes, they do not affect the partners' book capital accounts.

### Example 3-3

In the Example 3-2, Melvin has a \$10,000 book loss with no accompanying tax loss. Under the remedial allocation method, the partnership creates a tax loss of \$10,000 for Melvin and a tax gain of \$10,000 for Adam:

|                            | Contributing Partner<br>Adams |          | Noncontributing Partner<br>Miller |          |
|----------------------------|-------------------------------|----------|-----------------------------------|----------|
|                            | Tax                           | Book     | Tax                               | Book     |
| <b>Initial Balance</b>     | 10,000                        | 50,000   | 50,000                            | 50,000   |
| <b>Land Sale</b>           | 20,000                        | (10,000) | 0                                 | (10,000) |
| <b>Remedial Allocation</b> | 10,000                        |          | (10,000)                          |          |
|                            | 40,000                        | 40,000   | 40,000                            | 40,000   |

Note that the book capital accounts are not affected by the remedial allocation. Also, as a result of the remedial allocation, the tax capital and the book capital accounts are equal.

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## ISSUE: IRC SECTION 704(c) AND DEPRECIABLE PROPERTY

### Example 3-4

Al contributes equipment with a FMV of \$100 and an adjusted basis of \$40. The equipment is 10-year depreciable property with a 5-year remaining life. The partnership will depreciate it under the straight-line method. Betty contributes \$100 cash. Under the partnership agreement, Al and Betty are equal partners. The partnership's book value in the equipment equals the FMV of the property at contribution, \$100. The partnership's tax basis in the equipment equals the contributing partner's tax basis at the time of contribution, \$40. In Year 1, the equipment generates book depreciation of \$20 and tax depreciation of \$8.

Note: Without IRC section 704(c), Al and Betty, as 50/50 partners, would share the tax depreciation equally.

The partners' capital accounts would be adjusted as follows in the first year:

|                                  | Al  |      | Betty |      |
|----------------------------------|-----|------|-------|------|
|                                  | Tax | Book | Tax   | Book |
| <b>Capital Account</b>           | 40  | 100  | 100   | 100  |
| <b>Depreciation Deduction</b>    | (4) | (10) | (4)   | (10) |
| <b>Adjusted Capital Accounts</b> | 36  | 90   | 96    | 90   |

Although Betty is the owner of half of the property's FMV (that is, half of \$100), the depreciation deductions Betty receives over the remaining 5-year life, under a pro rata allocation of depreciation, deductions (\$4 per year for 5 years, or \$20) do not equal half of the property's FMV. In terms of cost recovery, Betty would have been better off purchasing a one half interest in the property directly from Al. The IRC section 704(c) allocation methods address this inequity between book and tax allocations.

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### Traditional Method

Under the traditional method, the noncontributing partner is allocated tax depreciation, to the extent of real tax depreciation available, up to his or her amount of book depreciation. To the extent permitted by the ceiling rule, the noncontributing partner is treated as if he or she purchased an undivided interest in the contributed property.

### Example 3-5

Assume the same facts as in Example 3-4 except that the partnership uses the traditional allocation method. The partnership's capital accounts are as follows:

|                                  | Al  |      | Betty |      |
|----------------------------------|-----|------|-------|------|
|                                  | Tax | Book | Tax   | Book |
| <b>Capital Account</b>           | 40  | 100  | 100   | 100  |
| <b>Traditional Allocation</b>    | 0   | (10) | (8)   | (10) |
| <b>Adjusted Capital Accounts</b> | 40  | 90   | 92    | 90   |

The ceiling rule limits the allocation to \$8 because that is the total partnership tax depreciation for the year.

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### Traditional Method with Curative Allocations

As was described earlier, if the traditional method with curative allocations is used then the partnership looks for another tax item of the same amount and character as the item limited by the ceiling rule. This item must exist in the partnership's tax house for that year; otherwise no curative allocation can be made. If the partnership has such an item, it will further reduce Betty's book/tax disparity.

### Example 3-6

Assume the same facts as in Example 3-5, except that the partnership has \$4 of ordinary income to be allocated.

The partnership's capital accounts are as follows:

|                                  | Al  |      | Betty |      |
|----------------------------------|-----|------|-------|------|
|                                  | Tax | Book | Tax   | Book |
| <b>Capital Account</b>           | 40  | 100  | 100   | 100  |
| <b>Traditional Allocation</b>    | 0   | (10) | (8)   | (10) |
| <b>Balance</b>                   | 40  | 90   | 92    | 90   |
| <b>Curative Allocation</b>       | 4   | 2    | 0     | 2    |
| <b>Adjusted Capital Accounts</b> | 44  | 92   | 92    | 92   |

The partnership uses the curative allocation method and allocates the entire \$4 of income to Al. Alternatively, if the partnership had \$4 of deductions available, a disproportionate allocation of \$4 of deductions could be made to Betty.

### **Remedial Allocation Method**

When used in conjunction with depreciable property, the remedial method uses a special rule for calculating the amount of book depreciation. It introduces a split depreciation scheme. Recall that when property is transferred to a partnership, the partnership normally steps into the shoes of the contributing partner and continues to depreciate the property using the same method and the property's remaining life. Under the remedial allocation method, the portion of the book value equal to the adjusted tax basis is recovered in this manner. The remainder of the book value (book value less tax basis) is recovered as if it were a newly purchased asset placed in service at the time of contribution.

### Example 3-7

Al contributes equipment with a FMV of \$100 and an adjusted basis of \$20. The equipment is 10-year IRC section 1245 property with a 5-year remaining life. Betty contributes \$100 cash. Under the partnership agreement, Al and Betty are equal partners. The partnership's book value in the equipment equals the FMV of the property at the time of contribution, \$100. The partnership's tax basis in the equipment equals Al's tax basis at the time of contribution, \$20. The partnership uses the remedial allocation method. Assume that the partnership has no income.

The tax basis portion of the equipment (\$20) is depreciated over its remaining 5-year life. The excess (\$80) is depreciated as if it were a newly purchased asset. In this example, it is depreciated over a 10-year life.

The annual depreciation deduction for the first 5 years is calculated as follows:

| Equipment                             |     |      |
|---------------------------------------|-----|------|
|                                       | Tax | Book |
| <b>Book = Tax (\$20), 5 years</b>     | 4   | 4    |
| <b>Book &gt; Tax (\$80), 10 years</b> | 0   | 8    |
| <b>Total Depreciation</b>             | 4   | 12   |

The remedial allocation method yields the following result in the first year:

|                               | Al  |      | Betty |      |
|-------------------------------|-----|------|-------|------|
|                               | Tax | Book | Tax   | Book |
| <b>Capital Account</b>        | 20  | 100  | 100   | 100  |
| <b>Traditional Allocation</b> | (0) | (6)  | (4)   | (6)  |

|                                  |    |    |     |    |
|----------------------------------|----|----|-----|----|
| <b>Balance</b>                   | 20 | 94 | 96  | 94 |
| <b>Remedial Allocation</b>       | 2  | 0  | (2) | 0  |
| <b>Adjusted Capital Accounts</b> | 22 | 94 | 94  | 94 |

The remedial allocation method totally eliminates Betty's book/tax disparity each year because the partnership is able to manufacture exactly what is needed. The curative allocation method in the prior example only eliminates Betty's book/tax disparity if the partnership actually has other income or deductions in the appropriate amount and character.

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### **Method Summary**

The most obvious difference between the traditional allocation method and the other two (curative allocations and remedial allocation methods) is that under the traditional method, the contributing partner can shift taxable income to other partners if the ceiling rule applies. A high bracket taxpayer will thus favor the traditional method because there are no curative or remedial allocations to prevent income shifting.

For depreciation or amortization purposes, the noncontributing partner may favor the traditional method with curative allocations. This is because the excess book value may be depreciated over a short remaining life. In contrast, the remedial method will bifurcate the asset and start a whole new depreciation period for the "excess book value asset" which may be a longer time period. However, the noncontributing partner may favor the remedial allocation method if the partnership does not have actual items of income (or deduction) of the appropriate type to make sufficient curative allocations.

It should be remembered that the partnership can use any reasonable method of making allocations. The partnership is not limited to the three methods described in the regulations. Whether or not a method will be considered to be "reasonable"

will depend on whether or not the allocations cause the contributing partner to bear the tax benefits and burdens of the built-in gain or loss. Allocations that are not consistent with the assignment of income doctrine would obviously not be reasonable.

The choice of method may be made on a property-by-property basis Treas. Reg. section 1.704-3(a)(2).

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## **ISSUE: IRC SECTION 704(c) AND IRC SECTION 197 INTANGIBLES**

Allocations of amortization deductions are made in accordance with IRC section 704(c) on contributed intangible assets with built-in gain or loss. IRC section 197 was enacted in 1993 to simplify the law regarding the amortization of certain acquired intangibles. It established a mandatory 15-year recovery period for assets such as goodwill, trademarks, franchises, licenses granted by governmental agencies, and customer-based intangibles. Other assets, such as patents and copyrights, are amortizable under IRC section 197 if they are purchased as part of a trade or business.

To properly apply the IRC section 704(c) allocation methods, it must first be determined whether the intangible asset contributed by the contributing partner is amortizable under IRC section 197. The general definition of section 197 intangibles is found in IRC section 197(d) and includes, in part, goodwill, going concern, patents, copyrights, and licenses. The definition of an amortizable section 197 intangible is found in IRC section 197(c)(1). There are two requirements for a section 197 intangible to be considered to be an amortizable section 197 intangible: Generally, the asset must be:

1. Acquired by the taxpayer after August 10, 1993, and
2. Held in connection with the conduct of a trade or business or an activity described in IRC section 212

Note that intangibles acquired by the contributor prior to the enactment of IRC section 197 are not amortizable IRC section 197 intangibles, (with the exception of a taxpayer making an election to apply the provisions of IRC section 197 to property acquired after July 25, 1991).

There is an important exclusion from the definition of amortizable IRC section 197 assets that addresses certain self-created assets. This is found in IRC section 197(c)(2). If self-created, any of the following assets will be not be amortizable under IRC section 197: goodwill, going concern value, workforce in place, business books and records, patents, copyrights, formulas, processes, designs, patterns, know-how, format, customer-based intangibles, supplier-based intangibles, and other similar items. (Note that governmental licenses, covenants not to compete, and franchises, trademarks, and trade names do not fall within the

exclusion.)

### Allocation Methods for Amortizable IRC Section 197 Intangibles

In situations where the contributed asset was an amortizable IRC section 197 intangible in the hands of the contributor, the partnership may make either curative or remedial allocations of amortization. It is important to note that this also applies to a zero-basis intangible that otherwise would have been amortizable to the contributing partner (that is, if the asset had basis). See Treas. Reg. section 1.197-2(g)(4) for the general rules.

#### Example 3-8

XYZ Corporation owns and operates a broadcasting station which has been in business since 1985. In January 1995, the corporation purchases additional licenses from the Federal Communications Commission for \$150 and began using them in the active conduct of the business. These 1995 licenses are described in IRC section 197 and are amortizable over the mandatory 15-year recovery period (amortization of \$10 per year). In January 2000, when the licenses have increased in value to \$550, XYZ forms an equal partnership with ABC Corporation to expand XYZ's existing business operations. XYZ contributes the licenses and ABC contributes \$550 cash. At the time of contribution, the licenses have an adjusted tax basis of \$100.

Since the licenses are amortizable IRC section 197 intangibles in the hands of XYZ Corporation, the partnership may make either curative or remedial allocations to the noncontributing partner, ABC to amortize its share of the partnership's licenses.

Recall that the remedial method treats the excess of the book value over the tax basis of the contributed property as if it were a newly created asset with a new holding period. Under the remedial method, the partnership would treat the contributed property as if it were two assets, one with an adjusted basis of \$100 (the original tax basis of \$150 less accumulated amortization of \$50), and the other with a basis of \$450 (the difference between the adjusted tax basis of \$100 and the book value of \$550). The tax portion of \$100 is amortizable over the remaining 10 years of its recovery period. The built-in gain portion of \$450 is treated as a newly purchased asset by the partnership and is amortizable for book purposes over a new 15-year period.

Annual partnership book vs. tax amortization for the year is calculated as follows:

| IRC Section 197 Intangible                    |     |      |
|-----------------------------------------------|-----|------|
|                                               | Tax | Book |
| <b>Book = Tax (\$100), 10 years remaining</b> | 10  | 10   |

|                                        |    |    |
|----------------------------------------|----|----|
| <b>Book &gt; Tax (\$450), 15 years</b> | 0  | 30 |
| <b>Total Depreciation</b>              | 10 | 40 |

|                                  | <b>XYZ</b> |             | <b>ABC</b> |             |
|----------------------------------|------------|-------------|------------|-------------|
|                                  | <b>Tax</b> | <b>Book</b> | <b>Tax</b> | <b>Book</b> |
| <b>Capital Account</b>           | 100        | 550         | 550        | 550         |
| <b>Traditional Allocation</b>    | (5)        | (20)        | (5)        | (20)        |
| <b>Balance</b>                   | 95         | 530         | 545        | 530         |
| <b>Remedial Allocation</b>       | 15         | 0           | (15)       | 0           |
| <b>Adjusted Capital Accounts</b> | 110        | 530         | 530        | 530         |

Thus in 2000, ABC receives a remedial allocation of amortization in the amount of \$15 ( $\$450/15 = \$30/2 = \$15$ ).

### **Allocation Method for Nonamortizable IRC section 197 Intangibles**

#### **Example 3-9**

#### **Post 1993 Goodwill**

Ken starts a business in 1998. In 2000 he forms a 50/50 partnership with Jose who contributes \$1,000,000 cash. The assets of Ken's business consisted of equipment with a basis and a FMV of \$300,000 and self-created goodwill with a zero basis and a FMV of \$700,000. The goodwill is not an amortizable IRC section 197 intangible in Ken's hands because it is a self-created asset. IRC section 197(c)(2). However, if the goodwill had basis, it is the type of asset that otherwise would be amortizable to the contributing partner (goodwill acquired after the enactment of IRC section 197). The partnership can make either curative or remedial allocations to Jose to amortize his share of the partnership's goodwill. Ken will

receive no amortization deductions because he had a zero basis in the goodwill.

For assets that were nonamortizable in the hands of the contributor, the partnership may make amortization allocations to the noncontributing partner only using the remedial method. The contributing partner will be allocated remedial income and the noncontributing partners will be allocated matching remedial amortization deductions.

### **Allocation Method for Nonamortizable IRC section 197 Intangibles**

For assets that were nonamortizable in the hands of the contributor, the partnership may make amortization allocations to the noncontributing partner only using the remedial method. The contributing partner will be allocated remedial income and the noncontributing partners will be allocated matching remedial amortization deductions.

#### **Example 3-10**

##### **Pre 1993 Goodwill**

Ken starts a business in 1989. In 1994, he forms a 50/50 partnership with Jose, an unrelated person, who contributes \$1,000,000 cash. The assets of Ken's business consisted of equipment with a basis and a FMV of \$300,000 and self-created goodwill with a zero basis and a FMV of \$700,000. The goodwill, in the hands of Ken, is not an amortizable IRC section 197 intangible because it was created prior to the enactment of IRC section 197. The partnership can only use the remedial method to amortize Jose's share of the partnership's goodwill. Ken will receive no amortization because the goodwill was not an amortizable IRC section 197 intangible in Ken's hands.

##### **Anti-Churning Rules**

Remedial allocations may not, however, be made if the partner contributing the nonamortizable intangible and the noncontributing partners are related and the asset is subject to the anti-churning rules of IRC section 197. The purpose of the anti-churning rules is to prevent taxpayers from transforming assets which were not of a character to be amortized prior to the enactment of IRC section 197 into amortizable assets by selling them to a related party. Thus, the anti-churning rules may limit the amortizability of intangibles acquired by a partnership or from a partnership in a transaction involving related parties. See the following example:

#### **Example 3-11**

Ken starts a business in 1985. Fortunately, the business is successful and earns profits every year. As of 1995, his business consists of two assets, equipment with a basis and a FMV of \$300,000 and self-created goodwill with a basis of zero and a FMV of \$700,000. The goodwill is an IRC section 197 intangible, but it is not an amortizable IRC section 197 intangible in Ken's hands because it was created

prior to the enactment of IRC section 197. In 1995, Ken forms a partnership with a corporation in which he is the sole shareholder. Ken contributes his business to the partnership and the partnership adopts the remedial method for making allocations. Because the noncontributing partner (the wholly owned corporation) is related to Ken and because the intangible was owned by the contributing partner prior to the enactment of IRC section 197, the partnership is unable to amortize the asset. Thus, the corporation is prohibited from receiving remedial allocations of amortization.

Prior to the enactment of IRC section 197, intangibles that had a determinable useful life and a tax basis were amortizable over their useful lives. If these types of assets are sold between related parties, the anti-churning rules will not apply. See the following example:

### **Example 3-12**

A publisher owns a subscription list (customer-based intangible) that has a determinable useful life, an ascertainable value, and a zero tax basis. The list was created prior to the enactment of IRC section 197. A partnership is formed with the publisher and the publisher's subsidiary as partners. In 2000, the publisher sells the customer list to the partnership which amortizes the list. Even though this is a related party transaction, the partnership will be able to amortize the list because it was an asset of a character subject to amortization prior to the enactment of IRC section 197.

Contrast the above example with the following:

### **Example 3-13**

A real estate management partnership has management contracts which were acquired prior to the enactment of IRC section 197. The contracts have an indefinite life. The partnership would like to be able to amortize the contracts under IRC section 197. The partnership sells the contracts to a corporation which is wholly owned by the partnership. In this case, the corporation will not be able to amortize the contracts because they were held by a related party prior to the enactment of IRC section 197 and because they were not of a character subject to amortization.

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## **ISSUE: ANTI-ABUSE RULE**

The 704(c) regulations contain an anti-abuse rule in Treas. Reg. section 1.704-3(a)(10) which states that an allocation method is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Additionally, Treas. Reg. section 1.704-3(a)(2) states that it may be unreasonable to use one method for appreciated property and another method for depreciated property. While IRC section 704(c) applies on a property-by property basis, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate.

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## **ISSUE: EFFECT OF IRC SECTION 704(c) ON PARTNERS' SHARE OF NON-RECOURSE LIABILITIES**

As was discussed in Chapter 1, a partner's share of non-recourse liabilities is the sum of three amounts defined in Treas. Reg. section 1.752-3. IRC section 704(c) impacts the calculation of the second amount, and it can have an impact on the third amount, the excess non-recourse liabilities for partnerships using the optional method. Treas. Reg. section 1.752-3(a)(3). The IRC section 704(c) method is relevant only to the extent of "extra excess" IRC 704(c) amounts. For a review of the basics of calculating a partner's share of non-recourse liabilities, see Chapter 1.

As seen in Revenue Ruling 95-41, the IRC section 704(c) allocation method employed by the partnership can affect the amount calculated under Treas. Reg. section 1.752-3(a)(2), which is the amount of any taxable gain that would be allocated to the partner under IRC section 704(c) if the partnership disposed of the property in full satisfaction of the liability. In analyzing a hypothetical sale to determine this amount, it is necessary to make two calculations, one using the property's tax basis and one using the property's book value. The impact of the hypothetical sale on the partnership's noncontributing partner must be taken into consideration.

Revenue Ruling 95-41 gives an example of an equal partnership formed between A and B. A contributes IRC section 704(c) property having a basis of \$4,000 and a FMV of \$10,000. The property is encumbered with \$6,000 of non-recourse debt. B contributes \$4,000 cash. If the partnership disposed of the property for satisfaction of the debt and no other consideration, the tax and book amounts would be as follows:

| <b>Tax</b>             |       | <b>Book</b>            |        |
|------------------------|-------|------------------------|--------|
| <b>Amount Realized</b> | 6,000 | <b>Amount Realized</b> | 6,000  |
| <b>Tax Basis</b>       | 4,000 | <b>Book Basis</b>      | 10,000 |
| <b>Tax Gain</b>        | 2,000 | <b>Book Loss</b>       | 4,000  |

**Traditional Method:** Partner A would be allocated \$2,000 of gain from the hypothetical sale of the contributed property. Therefore, A would be allocated \$2,000 of non-recourse liabilities under Treas. Reg. section 1.752-3(a)(2) immediately after contributing the property. Recall that under the traditional method, there are no offsetting allocations, so A's gain (and therefore his liability share under Treas. Reg. section 1.752-3(a)(2)) is only \$2,000.

**Remedial Method:** Partner B, the noncontributing partner has a \$2,000 book loss in the hypothetical sale. Under the traditional method, B would not have a tax loss to accompany his book loss because the partnership has no tax loss to give him. The remedial method, however, can manufacture a tax loss to allocate to B and the ceiling rule applies. If this happens, a tax gain in an equal amount must be manufactured to allocate to A. Thus, under the remedial method, A has not only a \$2,000 hypothetical tax gain on the sale of the property but also A has a \$2,000 hypothetical offsetting allocation of gain created by using the remedial method. Thus, under the remedial method, since A would be allocated \$4,000 of gain in the hypothetical sale, A will have a \$4,000 share of the non-recourse liabilities under Treas. Reg. section 1.752-3(a)(2).

Although a contributing partner may not look favorably on the prospect of being allocated notional items of income or gain under the remedial method during the partnership's operating years, the remedial method does have the advantage of potentially increasing the contributing partner's non-recourse liability share under Treas. Reg. section 1.752-3(a)(2).

**Traditional Method with Curative Allocations:** If the partnership were to use the traditional method with curative allocations, it would be able to make reasonable allocations to B to allow B to have a tax loss that more closely reflects his economic loss. The hypothetical sale scenario, however, cannot shed light on what items the partnership might use for curative allocations. Therefore, curative allocations are not taken into account in determining debt share under Treas. Reg. section 1.752-3(a)(2). If the partnership used the traditional method with curative allocations, A would be allocated \$2,000 of non-recourse liabilities for the Treas. Reg. section 1.752-3(a)(2) sharing layer.

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## **ISSUE: "REVERSE" 704(c) – REVALUATIONS**

A new partner who pays a FMV for a partnership interest will ordinarily not want

to be taxed on the built-in gain that accrued in the partnership's assets prior to the time of his arrival. Similarly, the existing partners will not want to allocate losses to the new partner that arose prior to his arrival. While IRC section 704(c) deals with newly contributed property, "reverse" IRC section 704(c) requires that the existing partners be taxed on the appreciation or depreciation that occurred prior to the admission of a new partner. See Treas. Reg. section 1.704-3(a)(6).

Assuming that the partnership follows the capital account maintenance rules, the entry of a new partner by contribution will ordinarily result in the restatement of the partnership's book capital accounts to reflect the FMV of partnership assets. In partnership jargon, these restatements to FMV are usually referred to as "book-ups" or "book-downs." Since assets (other than cash) typically gain or lose value over time, there will likely be a disparity between the book and tax capital accounts of the existing partners, analogous to the book/tax disparity of a partner who contributes property with a built-in gain or loss.

All of the principles of IRC section 704(c) previously discussed are applied in this situation. The difference from the prior examples is that the "existing partners" are in the same position as the "contributing partner" and the "new partner" is analogous to the "noncontributing partner" (thus the term "reverse IRC section 704(c) allocations"). For example, the new partner will want to be allocated the amount of depreciation or amortization that he/she "paid" for; however, under the traditional method, the ceiling rule may prevent this.

### **Section 704(c)(1)(C) and Built-in Loss Property**

In order to prevent a partner contributing built-in loss property to a partnership from transferring the loss to another person through the subsequent transfer of his partnership interest, the American Jobs Creation Act of 2004 amended IRC section 704(c) of the Code by adding IRC section 704(c)(1)(C), effective for contributions of property to a partnership after October 22, 2004. Under new IRC section 704(c)(1)(C), if "built-in loss" property is contributed to a partnership, the built-in loss shall be taken into account only in determining the items allocated to the contributing partner, and, except as provided in regulations, in determining the amount of items allocated to the other partners, the basis of the contributed property shall be treated as being equal to its FMV at the time of contribution. For this purpose, a "built-in loss" is defined to mean the excess of the adjusted basis of the property in the hands of the contributing partner over its FMV at the time of its contribution to the partnership.

### **Example 3-14**

Larry contributes a note receivable with a value of \$100,000 and a basis to Larry of \$200,000 to Partnership P. Donna contributes \$100,000 cash. If Larry subsequently sells his interest to Bob for \$100,000, he will recognize a \$100,000 loss, the difference between his outside basis (\$200,000) and the amount he realized on the sale (\$100,000). Assuming the partnership does not have an IRC

section 754 election in place, the partnership could sell the note receivable and recognize the same \$100,000 loss again. IRC section 704(c)(1)(C) (ii) prevents this by treating the partnership's basis in the built-in loss property as equal to its FMV at the time it was contributed to the partnership (\$100,000), thereby eliminating the built-in loss with respect to noncontributing partners.

### **Examination Techniques**

- Make a 3-year comparison of the balance sheet to identify newly contributed property.
- If the taxpayer keeps both book and tax capital accounts, compare the book and tax capital accounts going back 7 years and note any differences.
- Review the partnership agreement not only for instances of contributed property, but also to ascertain what IRC section 704(c) allocation method is being used.
- Review appraisals of contributed property and decide in the beginning of the audit if an engineering referral should be made.
- Review the returns of all of the partners. If the partnership is making remedial or curative allocations to the noncontributing partner, make sure that the contributing partner is picking up the offsetting allocations.
- Make sure that offsetting allocations are passed through to the contributing partner's return.

### **Issue Identification**

- If intangibles have been contributed to the partnership, the examiner will want to review IRC section 197.
- If depreciable IRC section 704(c) property has been sold, the examiner should carefully review Treas. Reg. section 1.1245-1(e)(2)(iv) to calculate recapture. Remedial and curative allocations can complicate the calculation of recapture.
- Check to see if the allocation method applied to a specific property is consistent from year to year

### **Documents to Request**

- Partnership Agreement
- Appraisals of contributed property (if any of the partners are related or commonly controlled);
- Documentation and/or an explanation of how the value of partnership capital was determined upon the entry of a new partner;
- Letter, memos, or minutes, or agreements pertaining to contributed property
- Schedule reflecting non-recourse liability sharing

### **Interview Questions**

- What property was contributed upon formation of the partnership?
- What property was contributed subsequent to formation?

- Have new partners entered this partnership? If so, how was the purchase price determined?
- What IRC section 704(c) allocation method is in place?
- Does the partnership maintain both book and tax capital accounts? If not, how does the partnership track IRC section 704(c) built-in gains and losses

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