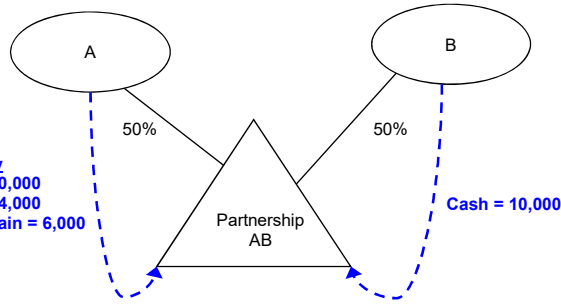


Reg. 1.704-3(b)(2), Example 1

Traditional Method of Making 704(c) Allocations



704(c) gain is book value less tax basis on contribution. Book value of contributed property at the time of contribution is fair market value. 704(c) gain is reduced by decreases in the difference between the property's book value and adjusted tax basis.

	Assets			Liabilities & Partner's Capital		
	Book	Tax	Diff.	Book	Tax	Diff.
Balance Sheet After the Contribution						
Cash	10,000	10,000		A capital account	10,000	4,000
Property net book value	10,000	4,000	6,000	B capital account	10,000	10,000
Total Assets	<u>20,000</u>	<u>14,000</u>		Total capital accounts	<u>20,000</u>	<u>14,000</u>
Year 1 Income Statement						
Equipment income	1,500	1,500				
Operating expenses	(1,500)	(1,500)				
Depreciation	(1,000)	(400)				
Net income (loss)	<u>(1,000)</u>	<u>(400)</u>				
Dep'n to A	(500)	0				
Dep'n to B (noncontrib'g ptr)	(500)	(400)				
Balance Sheet at End of Year 1						
Cash	10,000	10,000		A capital account	9,500	4,000
Property net book value	9,000	3,600	5,400	B capital account	9,500	9,600
Total	<u>19,000</u>	<u>13,600</u>		Total capital accounts	<u>19,000</u>	<u>13,600</u>
Sale at Beginning of Year 2						
Property sales proceeds	9,000	9,000				
Property net book value	9,000	3,600				
Gain (loss)	<u>0</u>	<u>5,400</u>				
Gain alloc. to A (704(c) gain)	0	5,400				
Gain alloc. to B	0	0				
Balance Sheet Immediately After the Sale						
Cash	19,000	19,000		A capital account	9,500	9,400
Property net book value	0	0	0	B capital account	9,500	9,600
Total	<u>19,000</u>	<u>19,000</u>		Total capital accounts	<u>19,000</u>	<u>19,000</u>
Gain (loss) on Liquidation						
Gain (loss) to A if liquidated	0	100				
Gain (loss) to B if liquidated	0	(100)				

Tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners. The "ceiling rule" under the traditional method limits the tax depreciation that can be allocated to B (the noncontributing partner) equal to the total tax depreciation of the partnership for that asset.

704(c) gain was reduced from \$6,000 to \$5,400, because there was a decrease in the difference between the property's book value and its adjusted tax basis.

The ceiling rule created this distortion. If the remedial allocation method had been used, neither A nor B would recognize gain or loss on the liquidation.

Example 1 Operation of the traditional method --

(i) Calculation of built-in gain on contribution.

A and B form partnership AB and agree that each will be allocated a 50 percent share of all partnership items and that AB will make allocations under section 704(c) using the traditional method under paragraph (b) of this section. A contributes depreciable property with an adjusted tax basis of \$4,000 and a book value of \$10,000, and B contributes \$10,000 cash. Under paragraph (a)(3) of this section, A has built-in gain of \$6,000, the excess of the partnership's book value for the property (\$10,000) over A's adjusted tax basis in the property at the time of contribution (\$4,000).

(ii) Allocation of tax depreciation.

The property is depreciated using the straight-line method over a 10-year recovery period. Because the property depreciates at an annual rate of 10 percent, B would have been entitled to a depreciation deduction of \$500 per year for both book and tax purposes if the adjusted tax basis of the property equalled its fair market value at the time of contribution. Although each partner is allocated \$500 of book depreciation per year, the partnership is allowed a tax depreciation deduction of only \$400 per year (10 percent of \$4,000). The partnership can allocate only \$400 of tax depreciation under the ceiling rule of paragraph (b)(1) of this section, and it must be allocated entirely to B. In AB's first year, the proceeds generated by the equipment exactly equal AB's operating expenses. At the end of that year, the book value of the property is \$9,000 (\$10,000 less the \$1,000 book depreciation deduction), and the adjusted tax basis is \$3,600 (\$4,000 less the \$400 tax depreciation deduction). A's built-in gain with respect to the property decreases to \$5,400 (\$9,000 book value less \$3,600 adjusted tax basis). Also, at the end of AB's first year, A has a \$9,500 book capital account and a \$4,000 tax basis in A's partnership interest. B has a \$9,500 book capital account and a \$9,600 adjusted tax basis in B's partnership interest.

(iii) Sale of the property.

If AB sells the property at the beginning of AB's second year for \$9,000, AB realizes tax gain of \$5,400 (\$9,000, the amount realized, less the adjusted tax basis of \$3,600). Under paragraph (b)(1) of this section, the entire \$5,400 gain must be allocated to A because the property A contributed has that much built-in gain remaining. If AB sells the property at the beginning of AB's second year for \$10,000, AB realizes tax gain of \$6,400 (\$10,000, the amount realized, less the adjusted tax basis of \$3,600). Under paragraph (b)(1) of this section, only \$5,400 of gain must be allocated to A to account for A's built-in gain. The remaining \$1,000 of gain is allocated equally between A and B in accordance with the partnership agreement. If AB sells the property for less than the \$9,000 book value, AB realizes tax gain of less than \$5,400, and the entire gain must be allocated to A.

(iv) Termination and liquidation of partnership.

If AB sells the property at the beginning of AB's second year for \$9,000, and AB engages in no other transactions that year, A will recognize a gain of \$5,400, and B will recognize no income or loss. A's adjusted tax basis for A's interest in AB will then be \$9,400 (\$4,000, A's original tax basis, increased by the gain of \$5,400). B's adjusted tax basis for B's interest in AB will be \$9,600 (\$10,000, B's original tax basis, less the \$400 depreciation deduction in the first partnership year). If the partnership then terminates and distributes its assets (\$19,000 in cash) to A and B in proportion to their capital account balances, A will recognize a capital gain of \$100 (\$9,500, the amount distributed to A, less \$9,400, the adjusted tax basis of A's interest). B will recognize a capital loss of \$100 (the excess of B's adjusted tax basis, \$9,600, over the amount received, \$9,500).

Capital Accounts Rollforward

	A (contrib'g ptr)		B (noncontrib'g ptr)	
	Book	Tax	Book	Tax
Initial contribution	10,000	4,000	10,000	10,000
Year 1 income (loss)	(500)	0	(500)	(400)
Balance at end of the year 1	<u>9,500</u>	<u>4,000</u>	<u>9,500</u>	<u>9,600</u>
Gain on sale (beginning of year 2)	0	5,400	0	0
Balance before liquidation	<u>9,500</u>	<u>9,400</u>	<u>9,500</u>	<u>9,600</u>
Liquidating distributions	(9,500)	(9,500)	(9,500)	(9,500)
(Gain) loss on liquidation	<u>0</u>	<u>(100)</u>	<u>0</u>	<u>100</u>