

**PARTNERSHIP AND LIMITED LIABILITY COMPANY UPDATE**

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**I. Proposed Regulations: Sections 704(c) and 737 Regarding The Tax Treatment of Installment Obligations and Property Acquired Pursuant to a Contract**

The proposed regulations amend §1.704-3(a)(8) to clarify that, if a partnership disposes of section 704(c) property in exchange for an installment obligation, the installment obligation is treated as the section 704(c) property. The proposed regulations also clarify that, if a partner contributes a contract that is section 704(c) property to a partnership, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, the acquired property is treated as the section 704(c) property for purposes of sections 704(c) and 737. For this purpose the term contract includes, but is not limited to, options, forward contracts, and futures contracts.

The proposed regulations amend §1.704-4(d)(1) to provide that an installment obligation received by a partnership and property acquired pursuant to a contributed contract are treated as section 704(c) property for purposes of section 704(c)(1)(B) to the extent that the installment obligation or the acquired property is section 704(c) property under §1.704-3(a)(8). As a result, if the installment obligation or property acquired pursuant to a contributed contract is distributed by a partnership to a partner other than the contributing partner within 7 years of the contribution, the contributing partner may recognize gain or loss under section 704(c)(1)(B). The proposed regulations include a similar rule under §1.737-2(d)(3).

***By way of technical background:***

Section 704(c)(1)(A) provides that income, gain, loss or deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of the contribution.

Under section 704(c)(1)(B) and the regulations thereunder, any partner that contributes section 704(c) property to a partnership must recognize gain or loss on the

distribution of such property to another partner within 7 years of its contribution. The amount of gain or loss recognized is the amount of gain or loss that would have been allocated to such partner under section 704(c)(1)(A) if the property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution.

Under section 737(a) and the regulations thereunder, any partner that contributes section 704(c) property to a partnership may recognize gain on a distribution of property (other than money) by the partnership to that partner. The amount of gain recognized is the lesser of: (1) the amount by which the fair market value of the distributed property exceeds the distributee partner's adjusted tax basis in the partner's partnership interest, or (2) the net precontribution gain of the partner. Section 737(b) defines the net precontribution gain of the partner as the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) if all property that (1) had been contributed to the partnership by the distributee partner within 7 years of the distribution and (2) is held by such partnership immediately before the distribution, had been distributed by such partnership to another partner.

For purposes of section 704(c)(1)(A) and (B) and section 737, if a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. See §§1.704-3(a)(8), 1.704-4(d)(1), and 1.737-2(d)(3).

If a partnership disposes of property in an installment sale, income is taken into account under the installment method unless the partnership elects otherwise. See section 453. Upon the satisfaction of an installment obligation at other than its face value or the distribution, transmission, sale, or other disposition of an installment obligation, a taxpayer is generally required, under section 453B, to recognize gain or loss. Section 453B does not apply, however, on the disposition of an installment

obligation in certain situations where the Internal Revenue Code (Code) otherwise provides for nonrecognition of gain or loss. For example, §1.453-9(c)(2) provides that no gain or loss results under section 453(d) (now section 453B) in the case of a contribution to or distribution from a partnership under sections 721 or 731.

In addition, if a partnership acquires property pursuant to a contract such as an option, a forward contract, or a futures contract, the partnership may recognize no gain or loss on the acquisition of the property.

These regulations are proposed to apply to installment obligations received by a partnership on or after November 24, 2003 in exchange for section 704(c) property and to property acquired on or after November 24, 2003, by a partnership pursuant to a contract that is section 704(c) property.

## **II. Revenue Ruling 2004-43**

In 1995 regulations were issued under sections 704(c) and 737 which provide that sections 704(c)(1)(B) and 737 do not apply to a transfer by a partnership of all of its assets and liabilities to a second partnership in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership. Under those regulations a subsequent distribution of the contributed property is subject to sections 704(c)(1)(B) or 737 only to the same extent that a distribution by the contributor/ partnership would have been subject to sections 704(c)(1)(B) or 737.

When partners in multiple partnerships desire to go their separate ways it is difficult to divide up their interests without the recognition of taxable income. A common technique that has been used in the “divorce” of partners has been the merger of the various partnerships (through the use of multiple disregarded entities) with the subsequent distribution in redemption of the various separate properties in liquidation of the newly created “merged” partnership. There were two specific technical hurdles

that had to be overcome. The first was the disguised sale rules under section 707(a)(2)(B) and the anti-mixing bowl rules (sections 704(c)(1)(B) and 737). To avoid the presumption of a sale under the disguised sale regulations, the parties usually aged the transaction for at least two year before distributing out the contributed assets in a redemption transaction. With regard to avoiding the anti-mixing bowl rules, it was thought that so long as the contributed partnerships did not already have section 704(c) property subject to the 5 or 7 year restrictions under the anti-mixing bowl rules then the successor in merger would not have a new layer of gain subject to those rules.

On April 12, 2004, the Internal Revenue Service (IRS) published Revenue Ruling 2004-43, 2004-18 I.R.B. 842 which specifically addresses the application of sections 704(c)(1)(B) and 737 to the distribution of property by a partnership following an assets-over partnership merger. The holding in the revenue ruling results in the creation of a new layer of section 704(c) gain for purposes of gain recognition under sections 704(c)(1)(B) and 737 (for those partners of the non-successor partnership under the merger).

This result has been challenged by most of the professional community since a clear reading of the current regulations would indicate that a new layer of gain for purposes of 704(c)(1)(B) and 737 should only be created “to the same extent” that the contributed property was already subject to such gain recognition. Revenue Ruling 2004-43 results in a new layer of section 704(c) gain being created in an assets-over partnership merger where none existed before. This layer of gain is in addition to any section 704(c) gain inherent in the asset at the time of the merger. If the transferor partnership had distributed section 704(c) property prior to the merger, only the original section 704(c) gain layer would have been subject to recognition under sections 704(c)(1)(B) or 737. By creating the new layer of section 704(c) gain, Revenue Ruling 2004-43 requires the recognition of gain on the distribution by the transferee partnership of section 704(c) property acquired in an assets-over merger to

a greater extent than would have been required upon the distribution of such asset by the transferor partnership prior to the merger.

Although issued on April 12, 2004, the revenue ruling applies retroactively to the effective date of the 704(c)(1)(B) and 737 regulations – January 9, 1995.

### **III. Revenue Ruling 2004-49**

On May 4, 2004 Revenue Ruling 2004-49, I.R.B. 2004-21, was issued dealing with the amortization of section 197 intangibles in a revaluation of an existing partnership pursuant to a reverse section 704(c) adjustment.

A partnership that revalues a section 197 intangible following a new member's contribution of cash to the partnership in exchange for a partnership interest may allocate amortization on the intangible in a manner that takes into account the built-in-gain or loss from the revaluation under Regulation section 1.704-1(b)(2)(iv)(f). The permissible manner of allocation will depend upon whether or not the section 197 intangible is amortizable in the hands of the partnership. Assuming that the section 197 intangible is amortizable in the hands of the partnership (i.e., is an "amortizable section 197 intangible," the IRS concluded that the anti-churning rules of Code section 197(f)(9) do not prevent the partnership from claiming amortization deductions. The partnership is allowed to make reverse section 704(c) allocations of amortization (including curative and remedial allocations) to take into account the built-in gain or loss from the revaluation of the intangible. If the revalued section 197 was not amortizable in the hands of the partnership, the partnership may only make remedial allocations of amortization to take into account the built-in-gain or loss from the revaluation. Traditional or curative allocations of amortization are not permitted.

#### **IV. Revenue Procedure 2004-51 Reverse Like-Kind Exchanges**

Under Revenue Procedure 2004-51, I.R.B.2004-33, July 20, 2004, Treasury has narrowed the scope of the safe harbor that allowed the use of an accommodation party in a "parking" transaction to facilitate a reverse like-kind exchange. In a parking transaction, replacement property is parked with an accommodation party under a qualified exchange accommodation arrangement (QEAA) until the taxpayer can arrange for the transfer of the relinquished property to the ultimate transferee. As modified, the safe harbor will not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date that qualified indicia of ownership of the property are transferred to an exchange accommodation titleholder. This rule is effective for transfers on or after July 20, 2004.

#### **V. Reg. Section 1.704-1 Regarding the Revaluation of Partner's Capital Account**

On June 9, 1993 Treasury issued Revenue Procedure 93-27 to resolve the tax treatment of a partner who receives a partnership interest in exchange for services. The Revenue Procedure held that the receipt of a capital interest in a partnership was compensation income to the service partner, while the receipt of a profits interest was not currently taxable.

A capital interest is one which would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. A profits interest is a partnership interest other than a capital interest. In addition, the receipt of a profits interest was held to be taxable if (1) the profits interest related to a substantially certain and predictable stream of income from partnership assets, or (2) if within two years of receipt, the partner disposes of the profits interest. In addition, a profits

interest in a "publicly traded partnership" did not qualify under the Revenue Procedure.

On August 2, 2001 Treasury issued Revenue Procedure 2001-43, I.R.B. 2001-34,191, which provided guidance on the treatment of the grant of a partnership profits interest that is substantially nonvested for the provision of services to, or for the benefit of, the partnership. This revenue procedure clarifies Rev. Proc. 93-27 by providing that the determination under Rev. Proc. 93-27 of whether an interest granted to a service provider is a profits interest is, under the circumstances described below, tested at the time the interest is granted, even if, at that time, the interest is substantially nonvested (within the meaning of §1.83-3(b) of the Income Tax Regulations). Accordingly, where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of this revenue procedure and Rev. Proc. 93-27, the Internal Revenue Service will not treat the grant of the interest or the event that causes the interest to become substantially vested (within the meaning of §1.83-3(b) of the Income Tax Regulations) as a taxable event for the partner or the partnership. Taxpayers to whom this revenue procedure applies need not file an election under section 83(b) of the Code. This revenue procedure applies only when: a) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest, b) upon the grant of the interest, or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deduct any amount (as wages, compensation, or otherwise) for the fair market value of the interest, and c) all other conditions of Rev. Proc. 93-27 are satisfied.

The concern under these two Revenue Procedures was that the admission of a service partner into an existing partnership (which had appreciated assets) would always cause the receipt of a capital interest unless either the partnership allocations froze the values such that the existing partners were not diluted or the partnership revalued the

existing partners capital to account for the appreciation in the assets (so in liquidation the new service partner did not receive an interest in the appreciation in the assets at the time the partnership interest was granted).

Regarding the revaluation of partnership property under the section 704(b) capital account maintenance regulations, there was no ability to revalue the existing partners' capital accounts upon the grant of the interest to the service partner.

To resolve this problem, Treasury has modified the capital account maintenance regulations effective for partnership interests granted for services on or after May 6, 2004. The modified regulations expand the circumstances under which a partnership is permitted to increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property. Specifically, the regulations proposed to allow revaluations in connection with the grant of an interest in the partnership (other than a de minimis interest) as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

## **VI. Revenue Ruling 2004-86**

### **Delaware Statutory Trusts and Like-Kind Exchanges**

In effecting a like-kind exchange it is sometime desirable and/or necessary to acquire as the replacement property a fractional interest in like-kind property. For example, when the relinquished property is real estate, if certain criteria are met, replacement property under the exchange can be a fractional tenant-in-common (“TIC”) interest in real estate. The question is whether or not the TIC interest is a separate interest in real property or an interest in a common business enterprise with others – a partnership. Treasury issued its co-ownership ruling standard, Revenue Procedure 2002-22, which established the criteria the government will use when determining whether or not to issue an advanced ruling that the TIC interest is as a separate interest in real estate.

This standard establishes fifteen criteria which must be met to receive the advance ruling. There are some common problems faced by those acquiring a TIC interest. For example, lenders sometimes have trouble with multiple owners of the same property (bankruptcy remote issues, etc.)

Revenue Ruling 2004-86 offers one possible solution under very narrow circumstances - the use of a Delaware Statutory Trust (“DST”).

Delaware law provides that a DST is an unincorporated association recognized as an entity separate from its owners. A DST is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the beneficial owners of a DST may not assert claims directly against the property in the trust. A DST may sue or be sued, and property held in a DST is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a DST are entitled to the same limitation on personal liability because of actions of the DST that is extended to stockholders of Delaware corporations. A DST trust may merge or consolidate with or into one or more statutory entities or other business entities.

In Revenue Ruling 2004-86 Treasury provides a narrow window for the use of a DST in real property like-kind exchanges where the trust holds the real property. If the facts of the situation warrant, the DST provides the lender with a single borrower to look to for payment, each separate beneficiary an interest in the property which is treated as an interest in the fee ownership of the real estate (qualifying the beneficial interest in the trust as replacement property for a like-kind exchange of real property) while still affording general liability protection.

If the DST is classified as a trust for federal tax purposes (the provisions stated below – i.e. the trustee has no power to alter the investments) then the trust will be classified as a grantor trust and a beneficial interest in the trust will be viewed as a separate interest in the real property (qualifying for like-kind exchange treatment). However, if the DST is treated as a business entity (the trustee can alter the investments, etc.)

then the entity will be classified as either a partnership or an association taxable as a corporation. The Ruling specifically states that if the DST is a business entity it will not be able to elect out of Subchapter K since the property is titled in the name of the trust (not the beneficiary).

### **Background**

Section 301.7701-2(a) defines the term "business entity" as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded.

Section 301.7701-3(a) provides that an eligible entity can elect its classification for federal tax purposes. Under §301.7701-3(b)(1), unless the entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-4(a) provides that the term "trust" refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting and conserving it for the beneficiaries. Usually the beneficiaries of a trust do no more than accept the benefits thereof and are not voluntary planners or creators of the trust arrangement. However, the beneficiaries of a trust may be the persons who create it, and it will be recognized as a trust if it was created for the purpose of protecting and conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.

Section 301.7701-4(b) provides that there are other arrangements known as trusts

because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for federal tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through business organizations that are classified as corporations or partnerships.

Section 301.7701-4(c)(1) provides that an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. *See Comm'r v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.

A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors. *See Comm'r v. North American Bond Trust*, 122 F.2d at 546.

The facts under the ruling were very narrow and will not apply to most situations:

- a) The trust did not have the responsibility for the payment of taxes, assessments, fees, insurance, maintenance, ordinary repairs, and utilities, or other charges related to the property;
- b) The lease term was set and the rent was fixed for the term of the trust;
- c) Upon contribution to the DST, the grantor's obligations related to the property were fully assumed by the DST;
- d) The trust agreement provided that the interests in the DST were freely transferable;

- e) The DST terminated the earlier of 10 years from the date of its creation or the disposition of the property, but did not terminate on the bankruptcy, death, or incapacity of the beneficiaries;
- f) The trust agreement further provides that interests in *DST* will be of a single class, representing undivided beneficial interests in the assets of *DST*.
- g) The trustee was required to distribute all available cash less reserves on a quarterly basis to each beneficiary in proportion to their respective interests;
- h) The trustee was required to invest cash received between such quarterly distributions in short-term obligations and was only permitted to invest in obligations maturing prior to the next quarterly distribution.;
- i) The trust agreement provided that the trustee's activities were limited to the collection and distribution of income and that the trustee could not exchange assets, purchase additional assets, negotiate/renege the lease, nor accept additional contributions of assets to *DST*.

## **VII. Regulation Sections 1.465-8 and 1.465-20**

On April 30, 2004, Treasury finalized Regulations 1.465-8 and 1.465-20 relating to the treatment of the at-risk rules related to amounts borrowed from a person who has an interest in an activity other than that of a creditor.

Section 465 limits the deductibility of losses to a taxpayer's economic investment (the amount at risk) in the activity at the close of a taxable year. A taxpayer is generally considered at risk in an activity to the extent of cash and the adjusted basis of property contributed by the taxpayer to the activity. In general, a taxpayer's amount at risk also includes any amounts borrowed for use in the activity if the taxpayer is personally liable for repayment or if property other than property used in the activity is pledged as security.

Under section 465(b)(3) amounts borrowed for use in an activity will not increase the borrower's amount at risk in the activity if the lender has an interest other than that of a creditor in the activity (a disqualifying interest) or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. This rule applies even if the borrower is personally liable for the repayment of the loan or the

loan is secured by property not used in the activity. Section 465(c)(3)(D) provides that this rule applies to new activities (activities that were not subject to section 465 before 1978) only to the extent provided in regulations. For example, until these new regulations were issued, this rule did not apply to the activity of holding real estate where one partner loaned money to the partnership and another partner was the party ultimately responsible for the payment of the debt ( the responsible partner was “at-risk” on the debt amount).

Fortunately, there are exceptions to the application of these regulations. Certain amounts borrowed are excepted from the rules.

For purposes of determining a corporation's amount at risk, an interest in the corporation as a shareholder is not an interest in any activity of the corporation. Thus, amounts borrowed by a corporation from a shareholder may increase the corporation's amount at risk.

For purposes of determining a taxpayer's amount at risk in an activity of holding real property, the limitation does not apply so long as the debt is secured by real property used in the activity and is either:

- 1) Qualified Non-recourse Indebtedness as defined in section 465(b)(6)(B); or
- 2) Financing that, if it were non-recourse, would be financing described in section 465(b)(6)(B)

If a borrower is personally liable for the repayment of a loan for use in an activity, a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

*Capital interest.* A capital interest in an activity means an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity. The partners of a partnership and the shareholders of an S corporation are considered to have capital

interests in the activities conducted by the partnership or S corporation.

*Interest in net profits.* It is not necessary for a person to have any incidents of ownership in the activity in order to have an interest in the net profits of the activity. For example, an employee or independent contractor any part of whose compensation is determined with reference to the net profits of the activity will be considered to have an interest in the net profits of the activity.

***Non-recourse loans secured by assets with a readily ascertainable fair market value***

In the case of a non-recourse loan for use in an activity where the loan is secured by property which has a readily ascertainable fair market value a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

***Non-recourse loans secured by assets without a readily ascertainable fair market value***

In the case of a non-recourse loan for use in an activity where the loan is secured by property which does not have a readily ascertainable fair market value a person shall be considered a person with an interest in the activity other than that of a creditor if the person stands to receive financial gain (other than interest) from the activity or from the sale of interests in the activity. For the purposes of this section persons who stand to receive financial gain from the activity include persons who receive compensation for services rendered in connection with the organization or operation of the activity or for the sale of interests in the activity. Such a person will generally include the promoter of the activity who organizes the activity or solicits potential investors in the activity.

***Treatment of amounts borrowed from certain persons and amounts protected against loss***

The following amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged:

- (1) Amounts that do not increase the taxpayer's amount at risk because they are borrowed from a person who has an interest in the activity other than that of a creditor or from a person who is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor; and
- (2) Amounts (whether or not borrowed) that are protected against loss.

*Effective date.* These provisions are effective for amounts borrowed after May 3, 2004.

## **VIII. Regulations Related to Depreciation of Property Acquired in a section 1031 Exchange or Acquired in a section 1033 Involuntary Conversion**

On March 1, 2004, Treasury issued regulations relating to the depreciation of property subject to section 168 of the Internal Revenue Code (MACRS property). Specifically, these regulations provide guidance on how to depreciate MACRS property acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033 when both the acquired and relinquished property are subject to MACRS in the hands of the acquiring taxpayer.

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business or held for the production of income. The depreciation allowable for depreciable tangible property placed in service after 1986 generally is determined under section 168 (MACRS property). Under section 1031(a)(1) no gain or loss is recognized on an exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment. Under section 1031(d) the basis of property acquired in an exchange is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by the amount of gain (or decreased by the amount of loss) that was recognized on such exchange.

Section 1033(a)(1) provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain is recognized. Under section 1033(b)(1) the basis of property acquired by the taxpayer in such a transaction is the basis of the converted property. Under section 1033(a)(2)(A) if property is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, and, within the appropriate time frame the taxpayer purchases property that is related in service or use to the converted property or

purchases stock in the acquisition of control of a corporation owning such property, then the taxpayer may elect to recognize gain only to the extent that the amount realized upon such conversion exceeds the cost of such other property. Under section 1033(b)(2) if such an election is made, the basis of the replacement property acquired by the taxpayer generally is the cost of that property decreased by any gain not recognized by reason of section 1033(a)(2).

The IRS became aware of inconsistent depreciation treatment by taxpayers of property that has a basis determined under section 1031(d) or 1033(b) (replacement property). Certain taxpayers were depreciating the replacement property using the same depreciation method, recovery period, and convention as the exchanged or involuntarily converted property (relinquished property) while other taxpayers were depreciating the replacement property as if it were newly placed in service.

In response, the IRS and Treasury issued Notice 2000-4, published January 18, 2000. Notice 2000-4 instructed taxpayers how to depreciate replacement MACRS property, provided that the exchanged or involuntarily converted property was also MACRS property (relinquished MACRS property). The notice stated that replacement MACRS property placed in service after January 3, 2000, is depreciated over the remaining recovery period of, and using the same depreciation method and convention as, the relinquished MACRS property and that any excess of the basis in the replacement MACRS property over the adjusted basis in the relinquished MACRS property is treated as newly purchased MACRS property. The Notice also stated that the IRS and Treasury intended to issue regulations to address these transactions.

Property acquired in a like-kind exchange or involuntary conversion to replace property whose depreciation allowance is computed under a depreciation system other than MACRS is not within the scope of the temporary regulations. Additionally, the regulation does not provide guidance for a taxpayer acquiring property in an exchange for property that the taxpayer depreciated under the Accelerated Cost

Recovery System (ACRS) or for a taxpayer acquiring an automobile for another automobile for which the taxpayer used the Standard Mileage Rate method of deducting expenses.

***General Rule***

***Exchanged Basis***

The temporary regulations provide a general rule that the exchanged basis is depreciated over the remaining recovery period of, and using the depreciation method and convention of, the relinquished MACRS property.

However, this general rule only applies if the replacement MACRS property has the same or a shorter recovery period or the same or a more accelerated depreciation method than the relinquished MACRS property.

The general rule can adversely affect taxpayers engaging in like-kind exchanges or involuntary conversions. For example, a taxpayer must depreciate replacement MACRS property with a shorter recovery period over the longer recovery period of the relinquished MACRS property even if the taxpayer could depreciate the replacement MACRS property over a shorter recovery period by treating such property as newly acquired MACRS property. Accordingly, the temporary regulations provide an election not to apply the temporary regulations and to treat the replacement MACRS property as MACRS property placed in service by the acquiring taxpayer at the time of replacement. Taxpayers may use this election to ameliorate the possible adverse effects of applying the general rule to this type of transaction.

The general rule does not apply if the replacement MACRS property has a longer recovery period or less accelerated depreciation method than the relinquished property. If the recovery period of the replacement MACRS property is longer than that of the relinquished MACRS property, the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement

over the remainder of the recovery period as if it had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer. Similarly, if the depreciation method of the replacement MACRS property is less accelerated than that of the relinquished MACRS property, then the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement using the less accelerated depreciation method of the replacement MACRS property that would have applied to the replacement MACRS property if the replacement MACRS property had originally been placed in service when the relinquished MACRS property was placed in service by the acquiring taxpayer.

### ***Excess Basis***

Any excess of the taxpayer's basis in the replacement MACRS property over the taxpayer's exchanged basis in the relinquished MACRS property is referred to as the excess basis. Generally, the excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer in the taxable year in which the replacement MACRS property is placed in service by the acquiring taxpayer or, if later, the taxable year of the disposition of the relinquished MACRS property (time of replacement). The depreciation allowances for the excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the replacement MACRS property at the time of replacement. In addition, the excess basis may be taken into account for purposes of computing the deduction allowed under section 179.

### ***Special Rules***

#### ***Deferred Exchanges***

Because of the complex nature of certain like-kind exchange and involuntary conversion transactions, the temporary regulations provide special rules for certain circumstances. If a taxpayer disposes of the relinquished MACRS property prior to the acquisition of the replacement MACRS property, the temporary regulations do not

allow the taxpayer to take depreciation on the relinquished MACRS property during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. This results because, in a deferred exchange or if a taxpayer does not replace converted property until after the taxpayer no longer owns the converted property, the taxpayer has no property to depreciate during that intervening period. Accordingly, the recovery period for the replacement MACRS property is suspended during this period. The temporary regulations do not address the issue of whether an intermediary (such as an exchange accommodation titleholder) is entitled to depreciation.

### ***Acquisition Prior To Disposition***

When replacement MACRS property is acquired and placed in service by a taxpayer before the relinquished MACRS property is disposed of by the taxpayer (for example, under threat of condemnation), the regulations allow the taxpayer to depreciate the unadjusted depreciable basis of the replacement MACRS property until the time of disposition of the relinquished MACRS property by the taxpayer. The taxpayer must include in taxable income in the year of disposition of the relinquished MACRS property the excess of the depreciation allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation that would be allowable on the excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer to the time of disposition of the relinquished MACRS property. The depreciation of the depreciable excess basis of the replacement MACRS property continues to be depreciated by the taxpayer. The IRS and Treasury may consider providing additional future guidance with respect to this issue and request comments relating thereto. The IRS and Treasury also invite taxpayers to comment on whether the allowance of depreciation for the replacement MACRS property should be followed by basis reduction at the time of disposition of the relinquished MACRS property, or whether some other approach should be taken.

### ***Transactions Involving Non-depreciable Property***

Because land or other non-depreciable property acquired in a like-kind exchange or involuntary conversion for MACRS property is not depreciable, such property is not within the scope of the temporary regulations. Further, if MACRS property or both MACRS property and land or other non-depreciable property are acquired in a like-kind exchange or involuntary conversion for land or other non-depreciable property, the basis of the replacement MACRS property is treated as property placed in service by the acquiring taxpayer in the year of replacement.

### ***Election Not To Apply Temporary Regulations***

The temporary regulations include a provision by which taxpayers may elect not to apply these temporary regulations. If a taxpayer elects not to apply the temporary regulations, the taxpayer must treat the entire basis (i.e., both the exchanged and excess basis) of the replacement MACRS property as being placed in service by the acquiring taxpayer at the time of replacement. Consistent with this treatment, the taxpayer treats the relinquished MACRS property as disposed of at the time of the disposition of the relinquished MACRS property. The election must be made by typing or legibly printing at the top of Form 4562, *Depreciation and Amortization*, "ELECTION MADE UNDER SECTION 1.168(i)-6T(i)," or in the manner provided for on Form 4562 and its instructions.

### ***Additional First Year Depreciation***

Temporary regulations issued under §§1.168(k)-1T and 1.1400L(b)-1T (September 8, 2003)) provide that the exchanged basis (referred to as the "carryover basis" in such regulations) and the excess basis, if any, of the replacement MACRS property (referred to as the "acquired MACRS property" in such regulations) is eligible for the additional first year depreciation deduction provided under section 168(k) or 1400L(b) if the replacement MACRS property is qualified property. However, if

qualified property is placed in service by the taxpayer and then disposed of by that taxpayer in a like-kind exchange or involuntary conversion in the same taxable year, the relinquished MACRS property (referred to as the "exchanged or involuntarily converted MACRS property" in such regulations) is not eligible for the additional first year depreciation deduction.

**IX. Letter Ruling 200403056**  
**Self-employment Taxes on Retirement Payments**

On September 29, 2003, the IRS issued PLR 200403056 which discussed the applicability of self-employment taxes to retirement payments to a partner. The ruling concluded that varying retirement payments over the partner's lifetime qualified as non-taxable for self-employment tax purposes. Significant retirement payments over the first five years of retirement are then reduced to \$100 per month for the remaining life of the retired partner. The PLR concludes that the varying payments satisfy the requirements of Internal Revenue Code section 1402(a)(10), and are, therefore, excludible from gross income when determining net earnings from self-employment.

***Analysis***

Section 1401 imposes a tax on the self-employment income of every individual. Section 1402(b) defines "self-employment income" as the "net earnings from self-employment" derived by the individual, subject to certain conditions and limitations.

Section 1402(a), in defining the term "net earnings from self-employment," specifically excludes retirement payments to a partner if the requirements in section 1402(a)(10) and the regulations thereunder are met.

Section 1402(a)(10) and section 1.1402(a)-17 of the Income Tax Regulations provide that such retirement payments are excluded from "net earnings from self-employment" if:

(1) the payments are made on a periodic basis by a partnership pursuant to a written plan that provides for payments on account of retirement to partners generally or to a class or classes of partners to continue at least until the partner's death (to qualify as payments on account of retirement, the payments must constitute bona fide retirement income; generally, retirement benefits are measured by, and based on, such factors as years of service and compensation received);

(2) the retired partner to whom the payments are made rendered no service with respect to any trade or business carried on by the partnership (or its successors) during the taxable year of the partnership (or its successors), which ends within or with the taxable year of the partner and in which the payment was received;

(3) no obligation exists (as of the close of the partnership year referred to in (2) above) from the other partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and

(4) the retired partner's share of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in (2) above.

Regulation section 1.1402(a)-17 provides that by operations of the conditions set forth in the above subparagraphs either all payments on account of retirement received by a retired partner during the taxable year of the partnership ending within or with the taxable year of the partnership are excluded or none of the payments are excluded. The regulation further provides that the effects of the conditions set forth in (3) and (4) above is that the exclusion may apply with respect to such payments received by the retired partner during the taxable year only if at the close of the partnership taxable year the retired partner has no financial interest in the partnership except for the right to retirement payments.

Therefore, retirement payments made by under the Retirement Program to a retired partner will be excluded from "net earnings from self-employment" by section 1402(a)(10) if (1) the retired partner renders no service during the taxable year which

ends within or with the taxable year of the partner and in which the payment is received, (2) at the close of that taxable year, no obligation exists from the partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and (3) at the close of that taxable year, the retired partner's share of the capital of the Firm has been paid to him in full.

#### **X. Revenue Ruling 2004-49**

##### **Amortization of Section 197 Intangibles Upon a Revaluation of Property**

Revenue Ruling 2004-49, I.R.B. 2004-21, issued on May 4, 2004, addresses the revaluation of partnership property when a partnership revalues a section 197 intangible following a new member's contribution to the partnership in exchange for a partnership interest. The methods available under the section 704(c) rules (traditional, curative, or remedial) depend upon whether or not the section 197 intangible being stepped up was amortizable in the hands of the partnership. Assuming that the section 197 intangible was amortizable in the hands of the partnership it is allowed to make reverse section 704(c) allocations using any of the three available methods. However, if the revalued intangible asset was not amortizable in the hands of the partnership, the partnership may only make remedial allocations of amortization to take into account the built-in-gain or loss from the revaluation. Traditional or curative allocations of amortization are not permitted.

##### ***Analysis***

Section 197(a) provides that a taxpayer is entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over the 15-year period beginning with the month in which the intangible was acquired.

A section 197 intangible is amortizable if (a) it is acquired by the taxpayer after August 11, 1993 and (b) it is held in connection with the conduct of a trade or business or an activity described in section 212. The term section 197 intangible means (a) goodwill; (b) going concern value; (c) any of the following intangible items: (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment, (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers), (iii) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar items, (iv) any customer-based intangible, (v) any supplier-based intangible, and (vi) any other similar item; (d) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; (e) any covenant not to compete (or other arrangement to the extent the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof; and (f) any franchise, trademark, or trade name.

Section 197 intangible do not include goodwill or going concern value (or for which depreciation or amortization would not have been allowable but for section 197) and that is acquired by the taxpayer after August 11, 1993 if (i) the intangible was held or used at any time on or after July 25, 1991, and on or before August 11, 1993 by the taxpayer or a related person, (ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before August 11, 1993, and, as part of the transaction, the user of such intangible does not change, or (iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before August 11, 1993 (the “anti-churning rule”). The purpose of the anti-churning rules is to prevent the amortization of the section 197 intangible unless it was transferred after August 11, 1993 in a transaction giving rise to a significant change in ownership or use.

Under sections 197-2(h)(5) and 197(f)(9) intangibles may be amortized by the acquirer if the intangible was an amortizable intangible in the hands of the seller (or transferor), but only if the acquisition transaction and the transaction in which the seller (or transferor) acquired the intangible or interest therein are not part of a series of related transactions.

Upon the contribution of cash or property to a partnership, in exchange for an interest in the partnership, the contributed property must be revalued and the existing partnership's property may be revalued under the section 704(b) capital account maintenance regulations. Under the existing regulation, section 1.197-2(g)(4)(i), to the extent that an intangible was an amortizable section 197 intangible in the hands of the contributing partner, a partnership may make allocations of amortization deductions with respect to the intangible to all of its partners under any of the permissible methods described in the regulations under section 704(c). To the extent that an intangible was not an amortizable section 197 intangible in the hands of the contributing partner, the intangible is not amortizable by the partnership. However, if a partner contributes a section 197 intangible to a partnership and the partnership adopts the remedial allocation method for making section 704(c) allocations of amortization deductions, the partnership generally may make remedial allocations of amortization deductions with respect to the contributed intangible.

Section 1.197-2(h)(12)(vii)(A) provides that the anti-churning rules do not apply to curative or remedial allocations of amortization with respect to goodwill and going concern value if such intangible was an amortizable intangible in the hands of the contributing partner.

However, section 1.197-2(h)(12)(vii)(B) provides that, if goodwill and/or going concern value was not amortizable in the hands of the contributing partner, a non-contributing partner generally may receive remedial allocations, unless such partner is related to the partner that contributed the intangible (or if, as part of a series of related

transactions that includes the contribution of the intangible to the partnership, the contributing partner or related person (other than the partnership) becomes (or remains) a direct user of the contributed intangible).

Revenue Ruling 2004-49 applies these same principles to reverse allocations. If, pursuant to §1.704-1(b)(2)(iv)(f), a partnership revalues a section 197 intangible that was amortizable in the hands of the partnership, then the section 197 anti-churning rules do not apply and the partnership may make reverse section 704(c) allocations (including curative and remedial allocations) of amortization to take into account the built-in gain or loss from the revaluation of the intangible. If the revalued section 197 intangible was not amortizable in the hands of the partnership, then the partnership may make remedial, but not traditional or curative, allocations of amortization to take into account the built-in gain or loss from the revaluation of the intangible, provided that such allocations are not limited by §1.197-2(h)(12)(vii)(B).

#### **XI. Letter Ruling 200436011** **Sharing of Non-recourse Liabilities**

The determination of the allocation of third tier debt allocations of excess non-recourse liabilities under section 1.752-3(a)(3) has significance both in the determination of a partner's tax basis in their partnership interest and in the evaluation of the presumed sale proceeds from a refinancing distribution under the disguised sale rules. This letter ruling suggests a more narrow interpretation (than most professions thought were available) of the methods available in the allocation of such third tier debt.

The allocation of non-recourse debt is controlled under the section 1.752-3(a)(3) regulations. Those regulations contemplate that the parties will allocate the excess non-recourse liabilities (those remaining after the allocations of non-recourse debt due to minimum gain and section 704(c) minimum gain) in a manner that is consistent with the way they share a significant item of partnership income or gain

which has substantial economic effect. The regulation goes on to provide a second approved method for the allocation of excess non-recourse liabilities. The second sanctioned method provides that the partnership agreement may specify the partner's interest in the partnership profits for purposes of allocating the excess non-recourse liabilities provided the interests so specified are reasonably consistent with allocations of some other significant item of partnership income or gain that has substantial economic effect under section 704(b).

The letter ruling holds that "a significant item of partnership income or gain" refers to a significant class of partnership income or gain. The tier three allocation should match the excess non-recourse deductions up with the manner in which the partners share a significant economic class of partnership income or gain. For example, an allocation of gross income associated with a preferred return on capital is an allocation of a portion of a class of income and allocating tier three liabilities 100% to the preferred interest holder based upon this allocation does not truly reflect overall the economic relationship between the parties with respect to that item of partnership income. Accordingly, the ruling requires that "significant item of partnership income or gain" refers to partnership income of a certain character or type (not a portion such as a preferred return), such as gain from the sale of property or tax-exempt income.

This ruling is significant for both the determination of tax basis (for gain or loss purposes) and the determination if debt financed distributions are treated as disguised sale proceeds under the section 707(a)(2)(B) regulations (when property is contributed to a partnership followed by a refinancing distribution).

## **XII. Proposed Regulation**

### **Allocation of Liabilities to a Disregarded Entity**

On August 12, 2004, Proposed Regulations were issued related to the allocation of debts to a disregarded entity. The proposed regulations provide rules under section 752 for taking into account certain obligations of a business entity that is disregarded as separate from its owner (for purposes of characterizing and allocating partnership

liabilities). The proposed regulations clarify the existing regulations concerning when a partner may be treated as bearing the economic risk of loss for a partnership liability based upon an obligation of a disregarded entity. Because of statutory limitations on liability, the owner of a disregarded entity may have no obligation to satisfy payment obligations. The current regulations consider such limitations on the payment obligations of a partner or related person to be relevant in determining the extent to which the partner or related person is treated as bearing the economic risk of loss for a partnership liability. The proposed regulation takes the position that only the assets of a disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity and a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity's assets.

Under the proposed regulations, the net value of a disregarded entity equals the fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law, including the disregarded entity's enforceable rights to contributions from its owner but excluding the disregarded entity's interest in the partnership (if any) and the fair market value of property pledged to secure a partnership liability (which is already taken into account under §1.752-2(h)(1)), less obligations of the disregarded entity that do not constitute, and are senior to, or of equal priority to, payment obligations of the disregarded entity.

After the net value of a disregarded entity is initially determined under the rules of the proposed regulations, the net value of the disregarded entity is NOT redetermined unless the obligations of the disregarded entity that do not constitute, and are senior to, or of equal priority to, payment obligations of the disregarded entity change by more than a de minimis amount or there is more than a de minimis contribution to or distribution from the disregarded entity.

The regulations are proposed to apply to liabilities incurred or assumed by a partnership on or after the date the regulations are published as final regulations in the Federal Register.