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Sub K Tax Issues – Technical Terminations, “Regulatory” Allocations, §704(c) Property, and §754 Elections

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Agenda

Technical Termination Risks and Opportunities

704(c) Methods

“Stop-Loss” Reallocations

754 Elections

Allocating 734 and 743(b) Adjustments

Technical Terminations

- Section 708(b)(1)(B)
  - Sale or exchange 50 percent or more of the total interest in partnership capital and profits
    - Section 761(e) treats distributions of partnership interests as exchanges for this purpose
  - Sale of the same interest in a 12-month period is treated as only one sale
  - Period is a consecutive 12 months, not a taxable year

Consequences of a “Tech Term”

- Many consequences, including importantly
  - Taxable year ends, resulting in a short year(s)
  - All tax elections no longer apply, and new partnership can make different elections, such as
    - 754 election
    - 704(c) methods
  - Re-start of depreciation for assets such as 5-year MACRS energy property, which generally delays basis recovery

704(c) Methods

Section 704(c)

- When does section 704(c) apply?
  – Contribution of property when FMV and tax basis differ
  – Revaluation events (e.g., admittance of new partner, non-pro rata distribution)
- Mechanics of Section 704(c)
  – Allocate difference between FMV and tax basis to contributing partner
  – Section 704(c) is generally tracked on an asset by asset basis

Section 704(c) Methods

- Traditional
  - 704(b) book and tax difference attributable to built-in gain or loss specially allocated to contributing partner
  - Ceiling rule

Section 704(c) Methods *(cont.)*

- Traditional with Curative Allocations
  - Curative allocation attempts to correct the ceiling rule limitation
  - Curative allocations
    - May not exceed the amount necessary to offset the effect of the ceiling rule
    - Must be expected to consist of tax items that have substantially the same effect on the partners as the tax items affected by the ceiling rule

Section 704(c) Methods *(cont.)*

- Remedial Method
  - Corrects the ceiling rule limitation
  - Partnership creates
    - correcting “notional” item allocated to noncontributing partner
    - offsetting “notional” item allocated to contributing partner

Example – Traditional Method

- Depreciation
  - Tax: $200 contributed basis with 2 years remaining life ($133 recovered in year 1, $67 in year 2 under tail end of 5YR MACRS schedule)
  - Book: $1,200 FMV ($800 recovered in year 1, $400 in year 2)

	TEI - 99%		Developer - 1%	
	Book	**Tax**	**Book**	**Tax**
Year 1 Depreciation	(792)	(133)	(8)	0
Book/Tax Shortfall		**(679)**		
Year 2 Depreciation	(396)	(67)	(4)	0
Book/Tax Shortfall		**(329)**		

Example – Remedial Method

- Depreciation
  - Tax: $200 contributed basis with 2 years remaining life ($133 recovered in year 1, $67 in year 2 under tail end of 5YR MACRS schedule)
  - Book: $1,200 FMV ($233 recovered in year 1, $387 in year 2) *Note the change in book!*

	TEI - 99%		Developer - 1%	
	Book	**Tax**	**Book**	**Tax**
Year 1 Depreciation	(231)	(133)	(2)	0
Remedial Allocations		**(98)**		**98**
Year 2 Depreciation	(383)	(67)	(4)	0
Remedial Allocations		**(316)**		**316**

“Stop-Loss” Reallocations

Typical “Stop-Loss” Reallocation

- Special allocation providing that
  - No losses or deductions may be allocated to a member to the extent the allocation would lead to a deficit in such member's “Adjusted Capital Account”

- Adjusted Capital Account
  - Generally defined as the capital account, plus the amount of partner’s minimum gain, plus the partner’s DRO obligation

ITC Recapture – Basic Rule

- Reg. §1.47-6(a)(2)(i)(b) provides for recapture of ITC claimed through a partnership if
  - a partner's proportionate interest in the "general profits" of the partnership (or in the particular item of ITC property) is reduced below
    - 66 2/3% of its original amount when the ITC was claimed
  - Reductions in proportionate interest can occur, for example, by a sale of a partnership interest, by a change in the partnership agreement, or by the admission of a new partner

ITC Recapture – Basic Rule *(cont.)*

- In Reg. § 1.46-3(f)(2)(i), general profits are described as
  - the taxable income of the partnership as described in section 702(a)(8) (i.e., bottom-line profit or loss) regardless of whether the partnership has a profit or a loss for its taxable year during which the ITC property is placed in service

ITC Example – Problem Here?

- TEI contributes $5 million cash; Developer contributes $10 million pre-COD ITC property
- TEI allocated 99% for 5 years, and 5% thereafter
- TEI has priority $250,000 distribution right, with priority allocations to cover distributed cash
- Stop-loss provision
- No TEI DRO
- Developer has right to call TEI interest at FMV after 5 years have passed

ITC Example – Problem Here? *(cont.)*

Based on projections, parties expect the capital accounts of TEI as follows:

BOP	ITC Reduction	Distributions	99% Share Profit/(Loss)	Reallocation	EOP
5,000	(2,250)	(250)	(2,000)	-	500
500	-	(250)	(2,250)	2,000	0
0	-	(250)	(1,500)	1,750	0
0	-	(250)	(750)	1,000	0
0	-	(250)	250	-	0

UNICAP principles respected?

Recapture risk?

ITC Example – Problem Here? *(cont.)*

Taking into account the reallocation, Developer estimates TEI's share of 704(b) and net taxable income as follows:

Year	Partnership Net Income/(Loss)	TEI Distributive Share	TEI % Share
1	(2,020)	(2,000)	99%
2	(2,273)	(250)	11%
3	(1,515)	250	(17%)
4	(758)	250	(33%)
5	253	250	99%
1-5	(6,313)	(1,500)	24%

The Issues

- Is there any 704(b) income to reallocate if UNICAP principles are respected?

- TEI's actual and anticipated share of net partnership loss during the 5-year compliance period is not 99%
  – Does this cause recapture (because the TEI's actual interest in partnership net losses goes down to 0% in years 2 - 4)?
  – Alternatively, do these anticipated allocations undermine the original 99% allocation of the ITC?

Inventories – IRS Guidance

- TAM 9527003
  - IRS took position that taxpayer that produced and sold electricity had inventories

ITC Recapture – IRS Guidance

- PLR 8651050
  - Rules that re-allocation of loss to prevent an adjusted capital account deficit (and subsequent re-allocation of gain to reverse the re-allocation of loss) <u>not</u> considered as a shift in "general profits"

ITC Recapture – IRS Guidance

- TAM 8931001
  - Does not reach recapture; however, concludes that when the bottom-line allocations do not reflect the “real economics,” ITCs cannot be allocated in accordance with the bottom-line allocations
    - Also suggests allocations may lack substantiality
  - Suggests that <u>anticipated</u> reallocations under “stop-loss” arrangements may, in some cases, undermine original allocation of ITC

754 Elections

Section 754

- Election to adjust basis of partnership property
- If made, partnership must adjust basis pursuant to sections 734(b) and 743(b)
- Election is made on a timely-filed partnership return. See Reg. § 301.9100-2 for 12 month extension of time to file election
- Once made, election is effective for all future years unless revoked with approval of district director
  - Tech term requires new election

Section 734(a) – General Rule

- The basis of partnership property not adjusted as the result of a <u>distribution</u> of property <u>unless</u>,
  - 754 election is in effect, or
  - "Substantial basis reduction"
- Helps maintain parity between outside and inside basis

Section 743(a) – General Rule

- The basis of partnership property not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless,
  - 754 election is in effect, or
  - "Substantial built-in loss" immediately after transfer

Section 743(a) – Principles

- Affects transferee partner only
- Aggregate theory based
- Eliminates double counting of income or loss
- Maintains parity of inside basis and outside basis
- Subsequent transfers
  - Transferee's basis adjustment determined without regard to any prior transferee's basis adjustment

Mandatory Basis Adjustments

- A “substantial basis reduction” for purposes of section 734(b) is a downward adjustment of more than $250,000
- A “substantial built-in loss” for purposes of section 743(b) exists when the partnership’s basis in the assets exceeds the assets’ fair market value by more than $250,000
  - Rules under sections 734(b) and 743(b) do not apply to securitization partnerships
  - Section 743(b) basis adjustments do not apply to certain electing investment partnerships

Tiered Partnerships

- Rev. Rul. 87-115
  - Upper-tier and lower-tier partnership must have election in effect in order to push section 743(b) adjustment down to lower-tier's assets
- Rev. Rul. 92-15
  - Upper-tier and lower-tier partnership must have election in effect in order to push section 734(b) adjustment down to lower-tier's assets
- Allocation of step-up among upper-tier partnership's assets under section 755

Allocating 734 and 743(b) Adjustments

Amount of 734(b) Adjustment

- Increase inside basis by
  - The amount of any gain recognized by distributee partner under section 731(a)(1) (which applies to cash distributions in excess of outside basis)
  - Basis potentially "lost" in the transaction under sections 732(a)(2) or 732(b)
- Decrease inside basis by
  - Any loss recognized to the distributee partner under section 731(a)(2)
  - Basis potentially "gained" or duplicated in the transaction under section 732(b)

Allocation of 734(b) Adjustment

- General Rule
  - Where a distribution of property results in an adjustment to the basis of undistributed property, the adjustment allocated to remaining partnership property of a character (capital gain or ordinary) similar to that of distributed property
- Gain on Cash Distributions
  - Allocated per Reg. § 1.755-1(c)(1)(ii) “only to capital gain property”
  - Industry practice to allocate solely to section 197 goodwill or going concern value

Amount & Allocation of 743(b) Adjustment

- 743(b) adjustments generally equal gain or loss that would be allocated to the transferee from a hypothetical transaction where, immediately after the transfer of the partnership interest, all of partnership property is sold in a fully taxable transaction for fair market value
  - Notwithstanding the total amount of the 743(b) adjustment, basis adjustments to individual assets can be positive and negative
    - Special rules for substituted basis transactions under Treas. Reg. §1.755-1(b)(5)

Residual Valuation Principles

- If the assets of the partnership constitute a trade or business, partnership required to use the residual method (i.e., 338(h)/1060 principles) to determine the value of partnership assets
  - Consequence of the residual method are, in many cases, that 743(b) adjustments are allocated to section 197 intangibles notwithstanding that partnership’s assets may consist chiefly of 5-year MACRS “energy property”

Example –Valuation Rule

- Operating partnership obtains following valuation of its assets:

Asset	FMV
Cash	100
5YR MACRS	10,000
Real Property	2,000
Total	12,100

- Developer sells its interest prior to flip for $11,000

Example –Valuation Rule *(cont.)*

- In a hypothetical liquidation, Developer interest would be entitled to $11,000 only if partnership assets were worth $13,000
- Therefore, 743(b) adjustment allocated based upon the following values:

Asset	FMV
Cash	100
5YR MACRS	10,000
Real Property	2,000
Class VI Intangibles	900
Total	13,000

Questions?

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