

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Allocations of Depreciation Recapture Among Partners in a Partnership

REG-209762-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the allocation of depreciation recapture among partners in a partnership. The proposed regulations amend existing regulations to require that any gain characterized as depreciation recapture must be allocated to each partner in an amount equal to the lesser of the partner's share of total gain from the sale of the property or the partner's share of depreciation from the property. The proposed regulations affect partnerships and their partners. This document also contains a notice of public hearing on the proposed regulations.

DATES: Written comments must be received by March 6, 1997. Outlines of oral comments and requests to speak at the public hearing scheduled for March 27, 1997, at 10 a.m., must be received by March 6, 1997.

ADDRESSES: Send submissions to CC:DOM:CORP:R [REG-209762-95], room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R [REG-209762-95], Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Daniel J. Coburn or Deborah Harrington, (202) 622-3050 (not a toll-free number); concerning submissions

and the hearing, Evangelista Lee, (202) 622-7190 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document proposes to change the current Income Tax Regulations (26 CFR part 1) relating to the characterization and allocation of depreciation recapture among partners in a partnership.

Section 1245 of the Internal Revenue Code requires taxpayers to recharacterize as ordinary income some or all of the gain on the disposition of certain types of business properties. The amount recharacterized as ordinary income (recapture gain) is the lesser of: (a) the gain realized on disposition, or (b) the total deductions allowed or allowable for depreciation or amortization from the property. Section 1.1245-1(e)(2) of the Income Tax Regulations currently provides that each partner's share of recapture gain will generally be determined in accordance with the provisions of section 704. The regulations also provide that, if the partnership agreement provides for the allocation of total gain from the property but does not provide for the allocation of recapture gain, recapture gain is allocated in the same manner as total gain.

The current regulations create some uncertainty because it is unclear how recapture gain is allocated under section 704. The allocation of recapture gain cannot have substantial economic effect because classifying a portion of the gain as recapture gain merely changes the tax character of the gain. In addition, by allowing the partnership to allocate recapture gain in the same manner as total gain, the current regulations increase the possibility that a partner may receive an allocation of recapture gain in excess of the partner's share of depreciation from the property. For example, if a partner acquires an interest in a partnership that has fully depreciated the property and the property is subsequently sold at a gain, the partner may be allocated a portion of the total gain and a portion of the recapture gain, even though the partner did not receive any depreciation deductions from the property. This mismatch between depreciation allocations and recapture allocations should be minimized because recapture gain is intended to offset the earlier depreciation deductions taken from the property

and should therefore be allocated to the extent possible to the partner that received those depreciation deductions. Finally, the current regulations do not provide guidance on the allocation of recapture gain from contributed property subject to section 704(c). In the legislative history of the 1984 amendment to section 704(c), Congress suggested that Treasury and the Service issue regulations governing the allocation of recapture gain inherent in property contributed to a partnership. See H.R. Rep. No. 861, 98th Cong., 2d Sess. 857 (1984); see also Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 214 (Comm. Print 1984). In the 1994 preamble to the section 704(c) final regulations, Treasury and the Service indicated that this issue would be considered in a separate regulations project. 59 Fed. Reg. 66,726 (1994).

Explanation of Provisions

The proposed regulations provide guidance on allocating recapture gain among partners, including recapture gain attributable to contributed property. The proposed regulations provide that a partner's share of recapture gain is equal to the lesser of (1) the partner's share of total gain arising from the disposition of the property, or (2) the partner's share of depreciation or amortization from the property. This rule seeks to insure, to the extent possible, that a partner recognizes recapture on the disposition of property in an amount equal to the depreciation or amortization deductions previously taken by the partner on the property. If recapture gain remains unallocated under the general rule, the remaining unallocated gain is allocated among those partners whose shares of total gain on the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Recapture gain may be unallocated under the general rule if, for example, the total gain allocated to a partner on the sale of the property is less than the amount of depreciation previously allocated to that partner.

The proposed regulations provide special rules for determining a partner's share of depreciation or amortization from contributed property subject to section 704(c). The proposed regulations provide that a contributing partner's share of depreciation or amortization

includes depreciation or amortization allowed or allowable prior to contribution. In addition, the proposed regulations provide that curative and remedial allocations generally reduce the contributing partner's share of depreciation or amortization and increase the noncontributing partners' shares of depreciation or amortization.

Treasury and the Service request comments on whether these special rules can be incorporated into accounting systems that track section 704(c) allocations for partnerships with multiple section 704(c) properties.

Proposed Effective Date

These amendments are proposed to apply to properties acquired by a partnership on or after the date the regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 27, 1997, at 10:00 a.m. in room 3313 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by March 6, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 6, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Daniel J. Coburn and Deborah Harrington, Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.704-3 is amended as follows:

1. Paragraphs (a)(9) and (a)(10) are redesignated as paragraphs (a)(10) and (a)(11), respectively.

2. New paragraph (a)(9) is added. The addition reads as follows:

§ 1.704-3 Contributed property.

(a) * * *

(9) *Contributing and noncontributing partners' recapture shares.* For special rules applicable to the allocation of recapture gain with respect to property contributed by a partner to a partnership, see § 1.1245-1(e)(2) and 1.1250-1(f).

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Par. 3. Section 1.1245-1 is amended by revising paragraph (e)(2) to read as follows:

§ 1.1245-1 General rule for treatment of gain from dispositions of certain depreciable property.

* * * * *

(e) * * *

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section 1245(a)(1) by the partnership is equal to the lesser of the partner's share of the

total gain from the disposition of the property or the partner's share of the depreciation or amortization with respect to the property. Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph is allocated among the partners whose shares of total gain exceed their shares of depreciation or amortization with respect to the property and is allocated to those partners in proportion to (but not in excess of) their shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property.

(ii) A partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property. If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(iii)(A) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period prior to the property's contribution.

(B) The partners' shares of depreciation or amortization with respect to property contributed by a partner must be adjusted to account for any curative allocations. (See § 1.704-3(c) for a description of the curative allocation method). The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to the contributed property and by the amount of any curative allocation of deduction or loss (other than capital loss) allocated to the noncontributing partners with respect to the contributed property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner's share of any curative allocation of ordinary income to the contributing partner with respect to the contributed property and by the amount

of any curative allocation of deduction or loss (other than capital loss) allocated to the noncontributing partner with respect to the contributed property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations.

(C) The partners' shares of depreciation or amortization with respect to property contributed by a partner must be adjusted to account for any remedial allocations. (See § 1.704-3(d) for a description of the remedial allocation method). The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of ordinary income to the contributing partner with respect to the contributed property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to the contributed property.

(D) The principles of this paragraph (e)(2)(iii) apply in determining the effect of remedial or curative allocations on a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f).

(iv) Examples. The application of this paragraph (e)(2) may be illustrated by the following examples:

Example 1. Recapture allocations. (i) *Facts.* A and B each contribute \$5,000 cash to form AB, a general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for \$5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation).

(ii) *Year 1.* In its first year of operations, AB has \$1,000 of depreciation from the partnership equipment. (To simplify this example, the partnership's depreciation deductions are determined without regard to any first-year depreciation conventions.) In accordance with the partnership agreement, AB allocates 90 percent (\$900) of the depreciation to A and 10 percent (\$100) of the depreciation to B. At the end of the year, AB sells the equipment for \$5,200, recognizing \$1,200 of gain (\$5,200 amount realized less \$4,000 adjusted

tax basis). In accordance with the partnership agreement, the first \$800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining \$400 of gain is allocated \$200 to A and \$200 to B.

(iii) *Recapture allocations.* \$1,000 of the gain from the sale of the equipment is treated as gain recognized under section 1245(a)(1). Under paragraph (e)(2)(i) of this section, each partner's share of this section 1245 gain is the lesser of the partner's share of total gain recognized on the sale of the equipment or the partner's share of total depreciation with respect to the equipment. Thus, A's share of the section 1245 gain is \$900 (the lesser of A's share of total gain (\$1,000) and A's share of depreciation (\$900)) and B's share of the section 1245 gain is \$100 (the lesser of B's share of total gain (\$200) and B's share of depreciation (\$100)). Accordingly, \$900 of the \$1,000 of total gain allocated to A will be treated as ordinary income and \$100 of the \$200 of total gain allocated to B will be treated as ordinary income.

Example 2. Recapture allocation limited by gain share. Assume the same facts as in *Example 1*, except that the partnership agreement provides that gains and losses from the sale of depreciable property will be allocated equally between the partners. On the sale of the equipment, the partnership's total gain of \$1,200 is allocated \$600 to A and \$600 to B. Under paragraph (e)(2)(i) of this section, A's share of the section 1245 gain is limited to \$600 (the amount of total gain allocated to A) even though A's share of the total depreciation from the equipment was \$900. The remaining \$400 of section 1245 gain must be allocated to B. Accordingly, all \$600 of total gain allocated to A is treated as ordinary income and \$400 of the \$600 of total gain allocated to B is treated as ordinary income.

Example 3. Determination of partners' shares of depreciation with respect to contributed property.

(i) *Facts.* C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of \$800 and a fair market value of \$2,800. D contributes \$2,800 cash. Prior to contributing C1, C claimed \$200 of depreciation from C1. At the time of contribution, C1 has four years remaining on its 5-year recovery period and is depreciable under the straight-line method. At the time CD is formed, it purchases depreciable personal property D1 for \$2,800, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions).

(ii) *Traditional method.* C and D will each be allocated \$350 of the total of \$700 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, C will not be allocated any tax depreciation from C1 and D will be allocated the entire \$200 of tax depreciation from C1. C and D will each be allocated \$200 of book and tax depreciation from D1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is \$200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is \$200 (the amount of tax depreciation allocated to D). C and D each have a \$200 share of depreciation with respect to D1.

(iii) *Effect of curative allocations.* If the partnership elects to make curative allocations under § 1.704-3(c) using depreciation from D1, the results in year 1 will be the same as under the traditional method, except that \$150 of the \$200 of tax depreciation from D1 that would have been allocated to C under the traditional method will be allocated to D as additional depreciation with

respect to C1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 will be reduced to \$50 (the total depreciation taken by C prior to contribution (\$200) decreased by the amount of the curative allocation to D (\$150)). C's share of depreciation with respect to D1 will still be \$200 and D's share of depreciation with respect to C1 will be \$350 (the depreciation allocated to D under the traditional method (\$200) increased by the amount of the curative allocation to D (\$150)). D's share of depreciation with respect to D1 will still be \$200.

(iv) *Effect of remedial allocations.* If the partnership elects the remedial allocation method for making section 704(c) allocations under § 1.704-3(d), there will be \$600 of total book depreciation from C1 in year 1. (Under the remedial allocation method, the amount by which C1's book basis (\$2,800) exceeds its tax basis (\$800) is depreciated over a 5-year life, rather than a 4-year life). C and D will each be allocated one-half (\$300) of the total book depreciation. As under the traditional method, C will be allocated \$0 of tax depreciation from C1 and D will be allocated \$200 of tax depreciation from C1. Because the ceiling rule would cause a disparity of \$100 between D's book and tax allocations of depreciation, D will also receive a \$100 remedial allocation of depreciation with respect to C1, and C will receive a \$100 remedial allocation of income with respect to C1. As a result, after the first year of partnership operations, D's share of depreciation with respect to C1 is \$300 (the depreciation allocated to D under the traditional method (\$200) increased by the amount of the remedial allocation (\$100)). C's share of depreciation with respect to C1 is \$100 (the total depreciation taken by C prior to contribution (\$200) decreased by the amount of the remedial allocation of income (\$100)). As under the traditional method, C and D each have a \$200 share of depreciation with respect to D1.

(v) *Effective date.* This paragraph (e)(2) is effective for properties acquired by the partnership on or after the date the regulations are published as final regulations in the **Federal Register**.

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Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 12, 1996, 61 F.R. 65371)