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Saving Subchapter K: Substance, Shattered Ceilings, and hte Problem of Contributed Property

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Saving Subchapter K

SUBSTANCE, SHATTERED CEILINGS, AND THE PROBLEM OF CONTRIBUTED PROPERTY

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Partnerships are unique in the world of federal income taxation. Unlike individuals and other taxable entities, a partnership is not a taxpayer.[1] Rather, its partners are the taxpayers. Accordingly, a partnership must allocate the income and other items generated by its operations among its partners for inclusion on their federal income tax returns.[2] The rules governing these allocations, set forth in Section 704 of the Internal Revenue Code, are the operational lifeblood of partnership taxation, dictating who receives such allocations, as well as their amount and timing.

Partnership allocations are equally critical as a theoretical matter, encapsulating the ideals underlying Subchapter K, which governs the taxation of partners and partnerships. Particularly foundational is the equitable requirement that transactions have "substance," such that the tax consequences resulting from a transaction parallel the economic consequences resulting from the same transaction.[3] I call this fundamental principle the "Substance Principle."

Flexibility is also vital to Subchapter K. The rules governing partnerships cover an incredibly broad spectrum of business arrangements, from the most rudimentary to the most sophisticated, and Subchapter K must provide malleable rules to accommodate these diverse commercial relationships. To that end, Section 704

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1 I.R.C. § 701 (2006).

2 *Id.* § 702(a).

3 The Substance Principle relates to horizontal equity, rather than vertical equity. Similarly situated taxpayers can only be treated alike when the tax and economic consequences of a transaction match one another. Put another way, the Substance Principle aims to ensure that the right taxpayer pays tax on the right amount at the right time. Accordingly, the Substance Principle focuses on the partner's ultimate tax liability, reflecting the interaction between the partnership's internal allocations and such partner's extra-partnership tax attributes.

presumptively allows partners to organize their enterprises and share its economic profits and losses in any manner that is sensible and efficient.[4]

Section 704 is in crisis. The number of business entities electing to be governed by Subchapter K is skyrocketing.[5] Yet the enforcement resources dedicated to Subchapter K remain woefully insufficient.[6] And a recent statutory enactment has rendered portions of Section 704 unsustainably complex. More troubling, this crisis threatens the integrity of Subchapter K. Undue complexity in partnership allocations impairs the operation of many partnership provisions, thereby reducing Subchapter K's administrability and coherence. In addition, this complexity creates numerous opportunities for tax sheltering among partners, the costs of which are borne by the public at large.

The source of the partnership allocation crisis is Congress's desire to harmonize flexibility and the Substance Principle. Indeed, the most foundational issue in Subchapter K is how to reconcile these ideals and, more importantly, how to respond when no such reconciliation is possible.[7] Congress has sought to maximize partnership flexibility while

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4 I.R.C. § 704(a), (b). A partner's distributive share of income, gain, loss, deduction and credit is determined by the partnership agreement to the extent the partnership's allocations have substantial economic effect. For a discussion of the substantial economic effect safe harbor, see *infra* Part I.A.

5 Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2005*, 27 STAT. INCOME BULL. 69, 70 fig.B (2007). The number of partnerships grew by 8.5% in 2005, the most recent year for which partnership return information is available. Indeed, the number of partnerships has increased at an average annual rate of 5.8% since 1995. *Id.* at 69 fig.A. This increase is due in large measure to the explosive growth of limited liability companies ("LLCs"). For the fourth consecutive year, LLCs grew more than all other entity types, increasing by 15.4% in 2005. *Id.* at 75. Indeed, since 1995, the number of limited liability companies has grown by more than 1,100% (approximately 119,000 returns filed by LLCs in 1995 versus 1,465,000 returns filed by LLCs in 2005). *Id.*; STAFF OF JT. COMM. ON TAX'N, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY at 11 (JCX-48-08) (June 4, 2008), *available at* http://www.jct.gov/x-48-08.pdf.

6 INTERNAL REVENUE SERVICE, FISCAL YEAR 2007 ENFORCEMENT AND SERVICE STATISTICS, *available at* http://www.irs.gov/pub/irs-news/2008_enforcement.pdf. In 2008, the Internal Revenue Service ("Service") examined .42% of all partnership returns (13,203 partnership returns examined and 3,146,994 partnership returns filed in 2007 calendar year). *Id.* Since 1998, the Service has examined an average of .36% of all partnership returns annually. *Id.* In addition, with few exceptions, the percentage of partnership returns examined since 1998 has been lower than the percentage of any other type of income tax return examined for such year. *Id.* The only exception is S corporation returns for the 2003 through 2005 fiscal years, but the difference is never larger than .06%. *Id.* (For 2003 through 2005, the Service examined .35%, .26%, and .33% of all S corporation returns and it examined .30%, .19%, and .30% of all partnership returns.); *see also* Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 252 (1999) [hereinafter Lokken, *Future Without Subchapter K*] ("[M]any tax practitioners believe that very few IRS auditors of partnership returns understand enough of subchapter K to challenge partnership accounting for items subject to the more complicated aspects of subchapter K . . . . This perception diminishes taxpayers' incentives to try their best to comply in any but the largest of transactions.").

7 The conflict between flexibility and the Substance Principle parallels the foundational theoretical conflict between aggregate and entity principles underlying Subchapter K more broadly. The entity theory treats the partnership as an entity separate and distinct from its partners. By contrast, the aggregate theory treats the partnership as nothing more than the aggregate of its partners. Many commentators believe that the tension between aggregate and entity principles is the primary source of conflict in Subchapter K. *See, e.g.*, Mark P. Gergen, *The End of the Revolution of*

simultaneously complying with the Substance Principle, and, to some extent, it has succeeded. But Congress has shown a decided preference for flexibility, even at the price of sacrificing the Substance Principle, in those instances where flexibility and the Substance Principle are impossible to reconcile.

Partnership contributions and the allocations attributable to contributed property present precisely this formidable challenge, and this Article proposes a solution to the conflict. The rules governing allocations attributable to contributed property, set forth in Section 704(c), have a long, dynamic history marked by the failure to reconcile flexibility and the Substance Principle. With some variation, the Section 704(c) allocation regime has followed a flexible, choice-based model that often tolerates, and sometimes mandates, breaches of the Substance Principle. This approach has significantly complicated partnership allocations and facilitated various tax shelter transactions.[8] Yet Congress has remained steadfast in its commitment to flexibility.

The time has come, however, for Congress to decide which policy—flexibility or the Substance Principle—lies at the heart of Subchapter K. Congress recently enacted Section 704(c)(1)(C), which withdraws certain allocations from the historic Section 704(c) regime and requires that such allocations be made in a manner entirely consistent with the Substance Principle.[9] Despite Congress's laudable intentions, Section 704(c)(1)(C) is a disaster. This flawed provision has rendered the rules governing allocations attributable to contributed property wholly unworkable, thereby increasing the complexity of partnership allocations and Subchapter K generally. Indeed, Subchapter K can no longer support Congress's overdrawn loyalty to flexibility.[10] Thus, it is time for Congress to enact a mandatory rule governing all allocations attributable to contributed property, and that rule should reflect Congress's renewed commitment to the Substance Principle. That rule is the deferred sales method.

Part I of this Article traces the history of the rules governing allocations attributable to contributed property and their evolving relationship to the Substance Principle. This part also illustrates how the current Section 704(c) allocation regime permits income and loss shifting among partners, allowing tax sheltering that ultimately imposes costs on

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Partnership Tax?, 56 SMU L. REV. 343, 344 (2003); Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 369 (2003) [hereinafter Lokken, *As the World Turns*].

8 *See, e.g.*, TIFD III-E, Inc. v. United States (*Castle Harbour)*, 459 F.3d 220 (2d Cir. 2006), *rev'g* 342 F. Supp. 2d 94 (D. Conn. 2004); Santa Monica Pictures, LLC v. Comm'r, T.C.M. (RIA) 2005-104.

9 American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(a), 188 Stat. 1418 (2004) (codified at I.R.C. § 704(c)(1)(C)).

10 For a thoughtful discussion of the cost of Congress's commitment to flexibility, see Lokken, *Future Without Subchapter K*, *supra* note 6, at 271-72.

the public.[11] Part II discusses my proposed solution to the crisis created by Section 704(c)(1)(C)'s enactment, the deferred sales method, and suggests that adopting this allocation methodology would reduce abuse, increase coherence and, most importantly, simplify Subchapter K. Part III examines several objections to the deferred sales method, and concludes that such objections are especially unpersuasive in light of modern circumstances. Indeed, this part concludes that the deferred sales method is entirely consistent with the broader shift in Subchapter K towards the Substance Principle when necessary to promote equity and prevent abuse.

I. THE IMPOSSIBLE BALANCING ACT: SECTION 704(C) ALLOCATIONS

A. The Problem of Contributed Property

The Section 704 allocation rules are absolutely fundamental to the theory and practice of Subchapter K. Absent these rules, Subchapter K would lack any mechanism for delivering the income, gain, loss, deduction, and credit generated by a partnership to the real taxpayers, its partners. Partnership allocations also serve as the guardian of the Substance Principle in Subchapter K. Whether or not the right taxpayer pays tax on the right amount at the right time, as required by the Substance Principle, depends entirely on the Section 704 allocation rules.

Yet Congress created a formidable challenge by insisting that these allocation rules promote both flexibility and the Substance Principle. Congress's goal was to create allocation rules sufficiently flexible so as to permit partners to share the fruits of their enterprise in any manner consistent with commercial expectations while simultaneously ensuring compliance with the Substance Principle. In addition, such allocation rules were to be simple and have a low potential for abuse.

To a great extent, Congress achieved its goal with the elegant general allocation rule set forth in Section 704(b) as interpreted by Department of the Treasury ("Treasury"). Section 704(b) provides that a partnership may allocate items among its partners based on the terms of its partnership agreement so long as such allocations have substantial economic effect.[12] Thus, a partnership's allocations must have substantial

[11] Section 704(c) is, alas, highly technical, and thus my discussion necessarily requires examination of the way these rules operate in practice. To make this analysis more accessible, I use a series of simple examples intended to expose breaches of the Substance Principle and the income and loss shifting potential of these rules. Impatient readers may wish to skip to Part II.

[12] I.R.C. § 704(b)(2) (2006). Congress enacted the substantial economic effect rules in 1976. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(d), 90 Stat. 1520 (1976). The substantial economic effect rules operate as a safe harbor. If an allocation has substantial economic effect, thereby falling within the safe harbor, such allocation will be respected as drafted. By contrast, if an allocation lacks substantial economic effect or the partnership agreement fails to provide allocations,

economic effect in order to be respected. Congress, however, left the challenging task of defining the term "substantial economic effect" to Treasury.

In 1983, Treasury proposed regulations interpreting Section 704(b) and its substantial economic effect requirement.[13] Heavily influenced by the Substance Principle, substantial economic effect requires, among other things, that a partnership's allocations be consistent with the underlying economic arrangement of the partners.[14] Indeed, the tax consequences of a transaction must parallel the economic consequences of such transaction. If a partnership allocates a tax item to a partner, the allocation will only be respected for federal income tax purposes if the partner also receives the economic benefit or burden that corresponds to such allocation.

For purposes of Subchapter K, a partner's tax investment and economic investment in a partnership are measured separately. A partner's economic investment is measured by a set of financial records called the "capital account."[15] The balance in a partner's capital account represents the amount that she is entitled to receive on the liquidation of the partnership or her interest therein.[16] Any economic benefit or burden borne by a partner must be reflected in an adjustment to her capital account, referred to as a book allocation.[17] A partner's capital account

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then a partner's distributive share of the relevant item will be determined based on the partner's interest in the partnership. I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(3) (as amended in 2008). Little guidance exists on the partner's interest in the partnership and, therefore, prudent practitioners typically draft allocations to comply with the substantial economic effect safe harbor. *See* WILLIAM S. MCKEE ET AL., FEDERAL INCOME TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02[3] (4th ed. 2007). Accordingly, this Article assumes that a partnership drafts all allocations to comply with the substantial economic effect safe harbor.

13 Prop. Treas. Reg. § 1.704-1, 48 Fed. Reg. 9871 (Mar. 9, 1983). Allocations possess substantial economic effect if the following threshold requirements are satisfied: (1) the allocations have economic effect and (2) the economic effect of the allocations is substantial. Treas. Reg. § 1.704-1(b)(2)(i) (as amended in 2008).

14 Treas. Reg. § 1.704-1(b)(2)(ii)(a) (defining economic effect). A partnership's allocation will have economic effect if the partnership agreement provides that (1) the partners' capital accounts are determined and maintained in accordance with the rules set forth in Treasury Regulation section 1.704-1(b)(2)(iv), (2) liquidating distributions are made in accordance with the partners' positive capital account balances, and (3) the partnership agreement includes a deficit restoration obligation. *Id.* § 1.704-1(b)(2)(ii)(b).

The economic effect of an allocation is substantial if there is a reasonable possibility that such allocation will affect substantially the dollar amounts that the partners will receive from the partnership, independent of tax consequences. *Id.* § 1.704-1(b)(2)(iii). More specifically, the economic effect of an allocation is not substantial if (1) the after-tax economic consequences, determined on a present value basis, of at least one partner may be enhanced when compared to the consequences if the allocation were not included in the partnership agreement, and (2) there is a strong likelihood that the after-tax consequences, determined on a present value basis, of no partner will be diminished when compared to the consequences if the allocation were not included in the partnership agreement. *Id.* A detailed discussion of the substantiality requirement is beyond the scope of this Article. For a thoughtful discussion of such requirement, see MCKEE ET AL., *supra* note 12, ¶ 11.02[2][b].

15 Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1).

16 *Id.* § 1.704-1(b)(2)(ii)(b)(2).

17 *Id.* § 1.704-1(b)(2)(iv)(b).

balance and the book allocations made thereto serve as Subchapter K's proxy for the economic arrangement between the partners.[18]

The capital account thus functions as the benchmark against which the partnership's tax allocations are measured. A partner's basis in her partnership interest, referred to as her "outside basis," reflects her tax investment in the enterprise and must parallel the partner's capital account. To illustrate, if a partnership allocates one dollar of taxable income to a partner, then she should be entitled to receive one additional economic dollar on liquidation, and her capital account should be increased accordingly.[19] Simply put, tax allocations possess substantial economic effect to the extent that they are made to the same partner, in the same amount, and at the same time as the corresponding book allocations are reflected in such partner's capital account.

Through this application of Section 704(b) and its corresponding regulations, Treasury achieves a sensible balance between flexibility and the Substance Principle. Partners are free to organize their business in whatever manner best suits their commercial expectations and to share the economic benefits and burdens of the venture accordingly. So long as the partnership allocates its tax items in parallel with its economic items, any sharing arrangements provided in the partnership agreement will be respected. Partnerships are thus permitted maximum flexibility in structuring their allocations within the collar of the Substance Principle. The Internal Revenue Service assumes the role of referee in what is essentially an intra-partnership matter, determining only whether partnership allocations exceed the boundaries of the substantial economic effect safe harbor.

Consider the consequences if several individuals form a partnership. The partners contribute equal amounts of cash to the partnership, and agree to share all profits, losses and the corresponding tax items ratably. The cash contributions are immediately reflected in each partner's capital account and outside basis.[20] If the partnership uses the contributed cash to purchase property, then the partners would share any gains or losses subsequently recognized on such property equally for both tax purposes and book purposes. Accordingly, each partner's capital account and outside basis, operating in tandem, would be increased or decreased by her ratable share of the recognized gain or loss attributable

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[18] For a thoughtful discussion of the importance of capital accounts to Subchapter K, see Daniel L. Simmons, *Built-In Gain and Built-In Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, FLA. TAX REV. (forthcoming Winter, 2009) (on file with author).

[19] Similarly, if a partnership allocates one dollar of taxable loss to a partner, then she should be entitled to receive one less economic dollar on liquidation, and her capital account should be reduced accordingly.

[20] I.R.C. § 722 (2006); Treas. Reg. § 1.704-1(b)(2)(iv)(d).

to the property.[21] And these tax allocations would possess substantial economic effect.

Were this partnership to liquidate following the disposition of its property, each partner would be entitled to a distribution equal to the positive balance in her capital account.[22] The capital accounts would reflect each partner's initial economic investment in the partnership adjusted by her share of the partnership's gains or losses subsequently recognized with respect to the property. Likewise, each partner's outside basis in her partnership interest would equal her adjusted capital account balance. The tax burden of each dollar earned by the partnership would fall on the partner who received the economic benefit of such earnings as reflected in her liquidating distribution. Throughout the life of the partnership, the tax allocations would have paralleled the book allocations, thus operating in harmony with the Substance Principle. The right partner would have paid tax on the right amount at the right time.

The balance between flexibility and the Substance Principle reflected in Section 704(b) dissolves when a partner contributes property to a partnership.[23] Under current law, such contribution transaction is treated differently for book purposes and tax purposes. The result is a "book/tax disparity" between the contributing partner's capital account and her outside basis in her partnership interest. From an economic perspective, the partner contributes property with a specific fair market value to the partnership, and, subject to the entrepreneurial risks of the venture, is entitled to receive such fair market value on the liquidation of the partnership. Accordingly, the contributing partner's initial capital account equals the fair market value of the property at contribution, and the contributed property's book value to the partnership similarly equals its fair market value.[24]

By contrast, from a tax perspective, a contribution of property to a partnership is a nonrecognition event. Thus, a contributing partner recognizes no gain or loss when she contributes property to a partnership.[25] Rather, any precontribution gain or loss is preserved for future recognition. Consistent with nonrecognition treatment, certain transferred basis provisions treat the decision to exchange property for a partnership interest as follows: the contributing partner's outside basis in her partnership interest equals her basis in the contributed property at

21 I.R.C. § 705(a); Treas. Reg. § 1.704-1(b)(2)(iv)(b).

22 Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

23 As will be discussed, the problem of contributed property emerges when the contributing property's basis and fair market value differ at contribution. If the contributed property's fair market value equals its basis, no such problem will arise.

24 Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1). If the contributed property is encumbered, the contributing partner's initial capital account would equal the fair market value of the property reduced by any liabilities that the partnership assumes or takes the property subject to. For purposes of this Article and the examples contained herein, it is assumed that any property contributed to a partnership is free of liabilities.

25 I.R.C. § 721(a).

contribution,[26] and the partnership's basis in the contributed property, referred to as "inside basis," is the partner's basis in the property at contribution.[27]

The foregoing regime yields different treatment of precontribution gains and losses for book and tax purposes. In calculating the partner's capital account, the contributed property is valued as though it had been sold at contribution.[28] Indeed, the contributing partner receives credit in her capital account for any increase or decrease in the property's value generated prior to contribution. For tax purposes, however, such precontribution gains or losses are not recognized; they are simply transferred and preserved through Subchapter K's basis rules.[29]

To illustrate, consider the following example, "Example 1," which will be referred to throughout this Article. A and B form an equal partnership, with A contributing $200 cash and B contributing Blackacre. The partnership agreement provides that A and B will share all items of income, gain, loss, and deduction equally. At formation, Blackacre's fair market value is $200, and its basis is $300, the amount B paid to acquire the property.

Blackacre's book value when contributed is $200, its fair market value. Each partner's capital account is credited with $200 to reflect the fair market value of such partner's contribution. In this sense, B immediately bears the economic loss attributable to her precontribution ownership of Blackacre.[30] B purchased Blackacre for $300, yet her capital account reflects only Blackacre's diminished value of $200.

For tax purposes, Blackacre's $100 built in loss is not recognized on contribution. A takes an outside basis of $200 in her partnership interest, B takes an outside basis of $300 in her partnership interest, and the partnership takes an inside basis of $300 in Blackacre. By transferring B's basis in Blackacre, the property's $100 precontribution loss is preserved for future recognition.[31]

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[26] I.R.C. § 722.

[27] I.R.C. § 723.

[28] Because it characterizes the contribution transaction as an exchange between the contributing partner and the partnership itself, this capital account treatment of partnership contributions reflects the entity theory of partnerships.

[29] The tax treatment of partnership contributions reflects the aggregate theory of partnerships. The contribution transaction is characterized as an exchange among the partners. In exchange for an undivided interest in the contributed property, the contributing partner receives an undivided interest in the property contributed by the other partners.

[30] If the partnership were to liquidate immediately after formation, B would receive a $200 liquidating distribution. Accordingly, B would receive only $200 in liquidation of her initial $300 investment in Blackacre, thereby realizing a $100 economic loss.

[31] Indeed, Blackacre's $100 built in loss is preserved at two levels. First, the $100 built in loss is preserved in B's outside basis in her partnership interest. The partnership interest is worth $200, but B's outside basis is $300. Second, the loss is preserved in the partnership's inside basis in Blackacre. Blackacre's fair market value is $200, yet the partnership's inside basis is $300.

What results is an immediate book/tax disparity. B's outside basis in her partnership interest is $300, but her capital account is $200. Put another way, B bears the $100 economic loss attributable to Blackacre's precontribution decline in the value, as reflected in her capital account, yet the corresponding tax loss is deferred for future recognition.

The contribution transaction effectively unhinges the tax treatment of contributed property from the corresponding book treatment, thereby breaching the Substance Principle and creating the potential for abuse. When future taxable events occur, such as a sale of the contributed property, the book consequences and the tax consequences of such event will differ.[32] Because the contributed property's book value reflects the recognition of precontribution gains and losses, but its inside basis does not, future book gains and losses will necessarily differ from future tax gains and losses.[33] For instance, if the partnership subsequently sells the contributed property, it would recognize different amounts of gain or loss for book and tax purposes. Accordingly, the partnership's tax allocations would not equal its book allocations, and such tax allocations would not have substantial economic effect.

To illustrate, consider the consequences in Example 1 if the partnership sells Blackacre for $200. Since there has been no postcontribution change in Blackacre's value, the sale would generate no book gain or loss ($200 amount realized minus $200 book value). Consequently, each partner's capital account would remain unchanged, continuing to reflect her initial $200 economic investment in the partnership. For tax purposes, however, the partnership would recognize a $100 loss on Blackacre's sale ($200 amount realized minus $300 basis).

Now the partnership is faced with the problem of contributed property—how should it allocate the $100 tax loss between A and B? The allocation of the $100 tax loss cannot have substantial economic effect and, therefore, would not be respected as a proper allocation under Section 704(b). Substantial economic effect requires timely, parallel allocations of book and tax items, but identical allocations would be impossible after Blackacre's sale. For book purposes, the sale of Blackacre would generate no gain or loss. Indeed, the $100 book loss corresponding to the $100 recognized tax loss was previously reflected in B's capital account at contribution. Accordingly, the substantial

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[32] This assumes that the contributed property's fair market value and basis are not equal at contribution. If the contributed property's fair market value equaled its basis at contribution, the book consequences of future events would match the corresponding tax consequences.

[33] Treas. Reg. § 1.704-1(b)(4)(i) (as amended in 2008). Any book items realized will be reflected in each partner's capital account. *Id.* § 1.704-1(b)(2)(iv)(g). By contrast, any tax items recognized will be reflected in each partner's outside basis, but such tax items will not be contemporaneously reflected in each partner's capital account. I.R.C. § 705(a) (2006).

economic effect rules provide no guidance as to how the partnership should allocate the $100 tax loss recognized on Blackacre's sale.

Congress enacted Section 704(c) in answer to this question, thereby providing partnerships with a regime governing allocations attributable to contributed property. Like the general allocation rules of Section 704(b), the goal was to create a regime that maximized flexibility while complying with the Substance Principle. Yet unlike these general allocation rules, this goal was impossible to achieve in the contributed property context.

As the example indicates, the divergent treatment of the contribution transaction for book and tax purposes compromises the Substance Principle. From the time of contribution, the contributing partner has a book/tax disparity. That is, the contributing partner's tax investment in the partnership, as reflected in her outside basis in her partnership interest, does not equal her economic investment in the partnership, as reflected in her capital account. If the book/tax disparity results from a contribution of built in loss property, as in Example 1, then the contributing partner has borne the tax liability for dollars in excess of the amount that she would be entitled to receive on liquidation.[34] By contrast, if the book/tax disparity results from the contribution of built in gain property, the contributing partner is entitled to receive dollars at liquidation for which she has yet to bear the corresponding tax liability.[35] As will be discussed *infra*, these breaches of the Substance Principle create the potential for abusive transactions, particularly transactions involving income and loss shifting.[36]

These distortions can be remedied, and compliance with the Substance Principle can be restored, but only by sacrificing flexibility. The Substance Principle would command allocating all items attributable to contributed property in a manner sensitive to their precontribution or postcontribution nature. Precontribution tax items would be allocated to the contributing partner in order to match prior book allocations reflected in the contributing partner's capital account at contribution. By contrast, postcontribution tax items would be allocated among the partners consistent with each partner's postcontribution economic interest in such property, as set forth in the partnership agreement. These allocations would eliminate the book/tax disparities created at contribution, thereby preventing abuse and ensuring that the tax consequences attributable to

[34] To illustrate, B made a $300 after-tax investment in Blackacre, but that investment only entitles her to receive $200 on liquidation of the partnership. Accordingly, her tax investment exceeds her economic investment in the partnership.

[35] To illustrate, consider a partner that contributes property with a fair market value of $500 and a basis of $100 to a partnership. The contributing partner will not recognize the property's $400 built in gain at contribution. Her outside basis in her partnership interest will be $100, but her initial capital account will be $500. Put another way, she has made a $100 after-tax investment in the partnership, but she is entitled to receive $500 on liquidation. Thus, her economic investment exceeds her tax investment.

[36] *See infra* Part I.C.1.

ownership of the contributed property ultimately parallel the corresponding economic consequences.

But a rule entirely consistent with the Substance Principle would deny partnerships any flexibility in allocating items attributable to contributed property. A partnership would have to account for events occurring outside the partnership, particularly the precontribution ownership of property, when making allocations attributable to contributed property. Consequently, the partnership's freedom in making intra-partnership allocations attributable to contributed property would be lost. Compliance with the Substance Principle would require a uniform and mandatory approach to these allocations. The partnerships would no longer have a choice between alternative methods of allocating precontribution gains and losses.

Again, consider Example 1 and the allocation of the $100 precontribution loss recognized on Blackacre's sale. Consistent with the Substance Principle, the partnership would allocate the $100 precontribution loss entirely to B, the contributing partner. This allocation, made after Blackacre's disposition, would eliminate B's book/tax disparity. B's capital account would remain $200, and her outside basis in her partnership interest would decrease from $300 to $200.[37] B would bear both the economic and the tax consequences attributable to her precontribution ownership of Blackacre and, as will be discussed *infra*, no improper loss shifting would occur.[38]

Although it is impossible to reconcile flexibility and the Substance Principle within Section 704(c), it is possible to solve the problem of contributed property. The solution, however, would require Congress to make a very difficult choice between flexibility and the Substance Principle. Specifically, Congress would have to commit itself to the Substance Principle at the cost of flexibility. Congress has yet to make this choice, remaining steadfast in its commitment to flexibility. Nonetheless, Congress's relationship with the Substance Principle has grown stronger throughout the years because of concerns regarding Section 704(c)'s inequity and potential for abuse. The remainder of this Part I discusses the evolution of the rules governing allocations attributable to contributed property, especially the developing role of the Substance Principle in Section 704(c).

B. The 1954 Internal Revenue Code

The Internal Revenue Code of 1954 included the first comprehensive rules governing the taxation of partnerships and partners.[39] As noted, Congress's goal throughout Subchapter K was to

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37 I.R.C. § 705(a)(2).

38 *See infra* Part I.B.2. (discussion of allocations not subject to the ceiling rule).

39 Internal Revenue Code of 1954, Pub. L. No. 83-591, 68 Stat. 730, 68A Stat. 3 (1954).

provide flexible and fair rules consistent with the contemporary commercial expectations of persons doing business in partnership form. Grossly underestimating the cost of deviating from the Substance Principle, Congress's initial formulation of the rules governing allocations attributable to contributed property reflected a strong preference for flexibility.

1. The Default Rule: Entity-based Allocations

The initial Section 704(c) allocation regime, set forth in Section 704(c)(1) of the 1954 Code, made no distinction between allocations attributable to contributed property and allocations attributable to property generally.[40] Disregarding the unique nature of precontribution gains and losses, Congress directed partnerships to allocate such precontribution items under the general allocations rules. Built in gains and losses were treated just like any other gain or loss, as if they had been generated during the period of time that the partnership, rather than the contributing partner, owned the property.[41]

To illustrate, suppose that the partnership in Example 1 sells Blackacre for $200, its fair market value at contribution. As before, the sale would generate no book gain or loss ($200 amount realized minus $200 book value), and each partner's capital account would remain unchanged.[42] For tax purposes, however, the partnership would recognize a $100 loss on Blackacre's sale ($200 amount realized minus $300 basis). The partnership would allocate this tax loss just like any other taxable item, equally between A and B. Thus, the partnership would allocate $50 of the tax loss to A, thereby reducing her outside basis in her partnership interest from $200 to $150.[43] Similarly, it would allocate the remaining $50 of the tax loss to B, which would reduce her outside basis from $300 to $250.

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[40] I.R.C. § 704(c)(1) (1954). Section 704(c)(1) provided that "depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall . . . be allocated among the partners in the same manner as if such property had been purchased by the partnership." This initial formulation of the rules governing allocations attributable to contributed property reflected the entity theory of partnerships.

[41] H.R. REP. NO. 83-1337, at 66 (1954); S. REP. NO. 83-1622, at 380 (1954) ("For example, if a partner contributes to a partnership [built in gain] property . . . , the gain upon the sale of such property by the partnership will, . . . be taxable to each of the partners in accordance with his distributive share of gains in the identical manner as if the property had been purchased by the partnership.").

[42] Treas. Reg. § 1.704-1(b)(2)(iv)(d)(3), (g) (as amended in 2008). Partnerships were not required to maintain capital accounts until Treasury proposed the substantial economic effect regulations in 1983. Accordingly, the 1954 Code's partnership allocation provisions did not command the capital account analysis set forth in this example or Example 2, discussed *infra* Part I.B.3. Nonetheless, I include the capital account analysis in these examples to better highlight the flaws of Section 704(c), particularly its breaches of the Substance Principle and its potential for abuse.

[43] I.R.C. § 705(a)(2)(2006).

Table 1: Allocations Using Section 704(c)(1) of the 1954 Code

	A		B	
	Book	Tax	Book	Tax
Initial Balance	200	200	200	300
Sale of Blackacre	0	(50)	0	(50)
Ending Balance	200	150	200	250

The Section 704(c)(1) allocation rule violated the Substance Principle. In so doing, it perpetuated the distortions caused by the contribution transaction and created additional, equally problematic distortions. B bore the $100 precontribution economic loss at the time she contributed Blackacre, as reflected in her $200 capital account balance. But Congress's allocation rule only would have allocated a $50 tax loss to B, leaving her with a lingering $50 book/tax disparity ($200 capital account versus $250 outside basis). The disposition of Blackacre was the only event that could have eliminated B's book/tax disparity while she remained a partner. Yet after Blackacre's sale, B still would have a book/tax disparity. And, as will be discussed, B would continue to have such book/tax disparity until the partnership liquidated or she disposed of her partnership interest. Simply put, the tax consequences of B's precontribution ownership of Blackacre failed to parallel the corresponding economic consequences.

A also would have a $50 book/tax disparity following Blackacre's sale ($200 capital account versus $150 outside basis). A bore no portion of Blackacre's precontribution economic loss, but the partnership would allocate her a portion of the corresponding tax loss. Like B, A's book/tax disparity cannot be remedied while she remains a partner.

In addition, A's book/tax disparity would indicate that improper loss shifting, which will be discussed *infra*, has occurred.[44] When the partnership allocated $50 of the tax loss recognized on Blackacre's sale to A, it effectively would shift such precontribution loss from B to A. A would become the beneficiary of a $50 tax loss for which B had borne the corresponding economic loss at contribution. This allocation would allow A to improperly shelter $50 of otherwise taxable income.[45]

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[44] For a more detailed discussion of income and loss shifting, particularly the motivations for and public cost of such transactions, see *infra* Part I.C.1.

[45] That is, the $50 tax loss attributable to Blackacre's sale would offset $50 of income or gain that A otherwise would have included in taxable income for the year.

Accordingly, the right partner would not pay tax on the right amount at the right time.

To some extent, these distortions were temporary. When the affected partner disposed of her partnership interest or the partnership liquidated, such transaction would eliminate the partner's book/tax disparity and reverse any prior income or loss shifts. In Example 1, for instance, if the partnership liquidated after selling Blackacre, B would receive a liquidating distribution of $200 in accordance with the positive balance in her capital account. For tax purposes, B would recognize a $50 loss on such distribution ($200 distribution minus $250 outside basis), and this $50 loss would represent the portion of Blackacre's $100 precontribution loss that the partnership failed to allocate to her after the property's sale.[46] Thus, after liquidation, B would have borne Blackacre's entire $100 precontribution tax loss, thereby matching the treatment of the property's $100 precontribution economic loss, which was reflected in B's capital account at contribution.[47]

Notwithstanding their temporary nature, these breaches of the Substance Principle were incredibly problematic. As will be discussed *infra*, even temporary shifts of income and loss impose a significant cost on the public.[48] In addition, the transactions necessary to eliminate the affected partner's book/tax disparity and reverse the income or loss shifting—the liquidation of the partnership or the disposition of such partner's partnership interest—may not occur for many years, if ever. Indeed, the more time that passed without such events occurring, the more these temporary problems resembled permanent distortions.

Although this allocation approach violated the Substance Principle, Congress concluded that such approach was justified by its simplicity and conformity with commercial expectations.[49] Congress believed that most partners expected to share precontribution gains and losses just like postcontribution gains and losses.[50] If this prediction were

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[46] I.R.C. § 731(a)(2).

[47] Similarly, A would recognize a $50 gain as a result of the liquidating distribution. *Id.* § 731(a)(1). This $50 gain would offset the $50 shifted tax loss that the partnership allocated to A on Blackacre's disposition, thereby realigning her economic and tax investment in the partnership. Indeed, Congress was well aware of the temporary nature of the distortions caused by Section 704(c)(1). H.R. REP. NO. 83-1337, at 66 (1954); S. REP. NO. 83-1622, at 380 (1954) ("While the rule may result in possible detriment (or gain) to noncontributing partners, it should be noted that there will, in general, be a corresponding loss (or gain) to such partners upon sale or disposition of their interest in the partnership.").

[48] *See infra* Part I.C.1.

[49] H.R. REP. NO. 83-1337, at 66 (1954) ("This general treatment was adopted because of its extreme simplicity as contrasted with any other alternative and because it conforms to the usual expectations of partners."); S. REP. NO. 83-1622, at 380 (1954).

[50] Commentators shared Congress's opinion of contemporary commercial expectations. *See, e.g.*, J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 128 (1954) [hereinafter Jackson et al., *1954 A.L.I. Project*]:

> It is felt that the average partner in a small partnership would reasonably expect any potential gains or losses with respect to contributed property to accrue to the partnership

wrong, or the sharing of precontribution items raised a commercial issue among the partners, the partners could address such concerns through the partnership agreement, thereby correcting distortions or compensating disadvantaged partners. Consistent with the emerging hallmark of Subchapter K, the general rules governing partnership allocations were sufficiently flexible to permit such adjustments.[51]

2. The Elective Rule: Ceiling Limited Allocations

The initial Section 704(c) allocation regime was also flexible enough to provide relief for partnerships seeking greater conformity with the Substance Principle, even at the cost of additional complexity. Congress adopted an alternative, elective allocation rule, set forth in Section 704(c)(2) of the 1954 Code, that recognized the unique nature of precontribution gains and losses. If a partnership elected to make contributed property allocations under Section 704(c)(2), it would make such allocations in a manner that took into account the difference between the contributed property's fair market value and basis at contribution.[52] To the extent permissible, the partnership would allocate precontribution gains and losses to the contributing partner, thereby

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> as a whole and to the partners at the time that the contributed property is sold or depreciated, to be so reflected in each partner's distributive share at the end of the partnership's taxable year.

Id.

[51] The American Law Institute also published its recommendations with respect to partnership allocations in 1954. Jackson et al., *1954 A.L.I. Project*, *supra* note 50. Like Congress, the A.L.I. believed that the rules governing allocations attributable to contributed property should minimize complexity, maximize certainty in planning, and operate in a manner consistent with commercial expectations. Accordingly, it proposed the transference of basis approach for allocations attributable to contributed property. Under this approach, a partner recognized no gain or loss at contribution, and the partnership's basis in the contributed property equaled such property's basis immediately prior to contribution. Each partner's outside basis in her partnership interest equaled a proportionate share of the partnership's aggregate inside basis in all of its property. Indeed, the transference of basis approach made no independent effort to equate each partner's outside basis with the basis of the property she contributed to the partnership. As a consequence, each partner had an initial book/tax disparity, reflecting the disconnect between such partner's economic investment in the partnership and her deemed tax investment, as reflected in her outside basis. Following contribution, the transference of basis approach required the partnership to make all allocations attributable to contributed property according to the general allocation rules set forth in the partnership agreement. Accordingly, and in stark contrast to the other allocation methodologies discussed in this Article, the transference of basis approach resulted in a permanent shift of precontribution gains and losses among the partners. The A.L.I. considered a permanent shift preferable to a temporary shift because the certainty of a permanent shift would better allow partners to quantify the tax consequences of a contribution and correct any resulting distortions in their economic arrangements. However, cognizant that permanent shifting may not be desirable to all partnerships, the A.L.I. supported the elective use of alternative allocation methodologies. *Id.* at 127-30. Accordingly, the A.L.I. recommended that Congress allow partnerships to elect to allocate items attributable to contributed property under either (1) the entity approach ultimately adopted by Congress in 1954 and set forth in Section 704(c)(1) or (2) the partial deferred sales method, described *infra* note 82. *Id.*

[52] I.R.C. § 704(c)(2) (1954). A partnership could elect to apply Section 704(c)(2) on a property-by-property basis. Treas. Reg. § 1.704-1(c)(2)(i) (1956).

reducing the potential for book/tax disparities and income and loss shifting.

For instance, if the partnership in Example 1 sells Blackacre for \$200, the partnership would allocate the entire \$100 recognized tax loss to B, the contributing partner, under Section 704(c)(2). B previously recognized Blackacre's \$100 precontribution economic loss, as reflected in her capital account and, therefore, she would be the proper recipient of the corresponding tax loss. Consistent with the Substance Principle, this allocation would eliminate B's book/tax disparity, avoid the creation of additional book/tax disparities, and prevent the shifting of any precontribution loss from B to A.[53]

Based on this example, the elective Section 704(c)(2) allocation rule appears to codify the Substance Principle, thereby solving the problem of contributed property. Such a conclusion, however, would be premature. The foregoing example assumed that the fair market value of the contributed property remained unchanged while held by the partnership. But how would Section 704(c)(2) operate if that assumption were relaxed? Specifically, how would a partnership allocate precontribution gains and losses when such gains and losses were offset by postcontribution changes in value?[54]

To illustrate, return to Example 1. Suppose that Blackacre appreciated after contribution, and the partnership ultimately sells the property for \$250. For book purposes, the partnership would recognize a \$50 gain (\$250 amount realized minus \$200 book value), which it would allocate equally between A and B. Each partner's capital account would be increased accordingly from \$200 to \$225. For tax purposes, Blackacre's disposition would generate a \$50 loss (\$250 amount realized minus \$300 inside basis), which the partnership must allocate between A and B. But how should this \$50 tax loss be allocated between A and B?

The answer depends on Congress's characterization of the \$50 loss recognized on Blackacre's sale. Congress could have characterized this loss in one of two ways—as a net loss, comprised of both precontribution and postcontribution changes in the property's value, or as a gross loss recognized by the partnership at the time of sale. Each characterization would have resulted in a different allocation rule: one would have been consistent with the Substance Principle and one would have violated the Substance Principle.

If the \$50 loss were considered a net loss, it would be composed of two items—a \$100 precontribution loss and a \$50 postcontribution

53 For a more thorough discussion of the consequences of Blackacre's sale under an allocation rule consistent with the Substance Principle, see *supra* Part I.A.

54 Put another way, how would the rules governing allocations attributable to contributed property operate in either of the following circumstances: (1) a partner contributes built in loss property to a partnership, the property appreciates following contribution, and the partnership later sells such property or (2) a partner contributes built in gain property to a partnership, the property depreciates following contribution, and the partnership later sells such property?

gain. These components would be separately allocated to A and B in a manner sensitive to each partner's ownership interest in Blackacre over time. Accordingly, the partnership would allocate the $100 precontribution tax loss entirely to B, thereby matching the treatment of the corresponding $100 precontribution economic loss. By contrast, the $50 postcontribution tax gain would be allocated equally between A and B just like the corresponding $50 book gain. Following the sale, neither partner would have a book/tax disparity, and no portion of Blackacre's precontribution loss would have shifted from B to A.[55] Indeed, this bifurcated allocation approach would comply with the Substance Principle and provide a perfect solution to the problem of contributed property.[56]

Congress, however, characterized the $50 tax loss as a gross loss, not a net loss. The partnership would recognize a $50 loss on Blackacre's sale ($250 amount realized minus $300 inside basis) and, therefore, the partnership would have a $50 loss—and nothing more—to allocate to A and B. Indeed, under Section 704(c)(2), the partnership itself would act as an internal constraint—essentially, a ceiling—on the amount that could be allocated to A and B. Put another way, in allocating the $50 loss, the partnership was only permitted to account for events occurring inside the partnership, particularly Blackacre's sale. The partnership was not permitted to consider circumstances outside the partnership that might otherwise affect the allocation of the $50 loss, such as Blackacre's ownership over time. Accordingly, Section 704(c)(2) provided that the total gain or loss allocated to the partners was "limited to a 'ceiling' which [could not] exceed the amount of gain or loss realized by the partnership."[57] This rule is referred to as the ceiling rule.[58]

In Example 1, the partnership would recognize a $50 loss on Blackacre's sale and, therefore, the ceiling rule would limit the partnership's permissible allocation to such $50 tax loss. Recall that the partnership would allocate a $25 book gain to both A and B after selling

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55 As discussed, the partnership would recognize a $50 book gain on Blackacre's sale, and the partnership would allocate each partner $25 of such book gain. Hence, A's and B's capital accounts each would increase from $200 to $225. For tax purposes, the partnership would allocate a $25 tax gain to A, thereby increasing her outside basis in her partnership interest from $200 to $225. By contrast, the partnership would allocate a $75 net tax loss to B ($100 precontribution loss plus $25 postcontribution gain), which would reduce her outside basis from $300 to $225. Accordingly, following Blackacre's sale, each partner's outside basis would equal her capital account balance.

56 Also, this bifurcated allocation approach would be consistent with the aggregate theory of partnerships. Under this theory, A would be treated as if she purchased an undivided interest in Blackacre in exchange for $100, one-half of her investment in the partnership. If A sold such undivided interest for $125, A would recognize a $25 gain.

57 Treas. Reg. § 1.704-1(c)(2)(i) (1956). Section 704(c)(2) of the 1954 Code did not explicitly provide for the ceiling rule, but the legislative history of Section 704(c) assumed its application. *See* S. REP. NO. 83-1622 at 93 (1954) (providing an example in which the ceiling rule limits the amount of depreciation allocated to a noncontributing partner).

58 The ceiling rule infused entity principles into an allocation regime that otherwise was consistent with the aggregate theory of partnerships. As a result, Section 704(c)(2) of the 1954 Code was a hybrid rule, reflecting both aggregate and entity theories of partnerships.

Blackacre for $250. Under the Substance Principle, the partnership would allocate a $25 tax gain to A to match her book allocation. However, the ceiling rule would prevent this result and require the partnership to allocate only the $50 loss actually recognized. As a result of the ceiling rule's application, A necessarily would have a book/tax disparity following Blackacre's sale, and a portion of Blackacre's built in loss would shift from B to A.[59] In an effort to minimize these adverse consequences, the partnership would allocate the entire $50 tax loss to B and none to A.[60]

Table 2: Allocations Under the Ceiling Rule

	A		B	
	Book	Tax	Book	Tax
Initial Balance	200	200	200	300
Sale of Blackacre	25	0	25	(50)
Ending Balance	225	200	225	250

When compared to Section 704(c)(1), which disregarded the unique nature of contributed property allocations, Section 704(c)(2) provided partners with a more equitable result. Yet distortions persisted under Section 704(c)(2) because of the ceiling rule. Although the magnitude of such distortions was smaller, the violation of the Substance Principle was no less problematic.[61]

In Example 1, for instance, both A and B would have $25 book/tax disparities following Blackacre's sale, and such book/tax disparities would not be eliminated until the partners terminate their relationships with the partnership. Further, the ceiling rule's application would shift $25 of B's precontribution tax loss from B to A. A would

[59] Before the partnership sold Blackacre, A's capital account and outside basis were $200. As a result of the sale, the partnership would allocate a $25 book gain to A, thereby increasing her capital account from $200 to $225. For tax purposes, the partnership would recognize a $50 loss, which it then would allocate between A and B. If none of the loss were allocated to A, she would have a $25 book/tax disparity ($225 capital account versus $200 outside basis), and $25 of Blackacre's precontribution loss would shift to her. By contrast, to the extent the partnership would allocate any of the $50 loss to A, her outside basis would decrease below its initial $200 balance. As A's outside basis would fall, her book/tax disparity would increase and more of Blackacre's precontribution loss would shift.

[60] Treas. Reg. § 1.704-1(c)(2)(i) ex.2 (1956).

[61] *See* J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1207 (1954) [hereinafter Jackson et al., *1954 Internal Revenue Code*] ("[A]lthough the ceiling rule modification . . . provides for allocation of gains, losses and depreciation allowances with respect to contributed property more in accordance with economic reality than . . . the entity approach [of Section 704(c)(1)], in some instances it still results in an offsetting gain or loss on the disposition of the partnership interest.").

receive the benefit of a $25 economic gain, as reflected in her capital account, but she would not bear the tax burden of the corresponding $25 tax gain. Indeed, A's $25 tax gain would be sheltered by $25 of Blackacre's precontribution loss, which the ceiling rule would shift to her. Like Section 704(c)(1), the right partner would not pay tax on the right amount at the right time under the ceiling limited rule of Section 704(c)(2).[62]

3. The Problem Intensifies: Contributions of Depreciable Property

The ceiling rule also caused significant distortions in the depreciation of contributed property. To illustrate these problems, consider Example 2. X contributed $200 cash to the partnership and Y contributed a depreciable building ("Building") to the partnership. Y purchased the Building six years earlier for $150. At contribution, the Building had a fair market value of $200 and a basis, adjusted to reflect prior depreciation deductions, of $60.

Following contribution, the Building had a book value of $200 and an inside basis of $60 to the partnership. X's and Y's initial capital accounts were $200. Consistent with her capital account, X's outside basis in her partnership interest was $200. By contrast, Y's outside basis was $60. Thus, Y had an immediate book/tax disparity resulting from the Building's $140 precontribution gain.[63] Indeed, Y received the economic benefit of the Building's precontribution increase in value, as reflected in her capital account, but the corresponding tax gain was deferred.

As noted, the Building is depreciable property. Prior to contribution, Y depreciated the Building on straight-line basis using a ten-year recovery period.[64] Thus, Y took annual depreciation deductions of $15 with respect to the Building ($150 initial basis divided by ten-year recovery period) in each of the previous six years. After Y's contribution, the partnership will continue to depreciate the Building. But

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62 In addition to the ceiling rule, Congress provided a third alternative allocation rule for partners contributing certain undivided interests in property to a partnership. I.R.C. § 704(c)(3) (1954). Under this rule, the partnership would allocate items attributable to these undivided interests as if the undivided interests had never been contributed to the partnership. *Id.* The scope of this rule, however, was quite limited. It only applied if all of the partners held undivided interests in the contributed property, and each partner's interests in such property corresponded to her interest in the partnership. For a more detailed discussion of former Section 704(c)(3), see Jackson et al., *1954 Internal Revenue Code*, *supra* note 61, at 1208-10.

63 At contribution, the Building has a $140 precontribution gain, which reflects two different factors. The first is an increase in the Building's fair market value. Y purchased the property for $150, and its fair market value is $200 at contribution. The second is excess depreciation. More specifically, Y has taken $90 of depreciation deductions with respect to the Building, thereby reducing its basis from $150 to $60.

64 To simplify Example 2, the depreciation conventions set forth in Section 168(d) have been disregarded and the recovery periods set forth in Section 168(c) have been modified. *See* I.R.C. § 168(c)-(d).

how it does so, and how it allocates the resulting depreciation deductions between X and Y, presents familiar challenges.

Consistent with the nonrecognition treatment of partnership contributions, the partnership would step into the shoes of the contributing partner.[65] That is, the partnership would depreciate the property as if it were the contributing partner, using the same methodology and recovery period. In Example 2, the partnership would depreciate the Building on a straight-line basis over the four years remaining in the property's ten-year recovery period, thereby taking an annual depreciation deduction of $15.

For capital account purposes, the partnership would recover the contributed property's book value using the same methodology and remaining recovery period applicable for tax purposes.[66] In Example 2, the partnership would recover the Building's $200 book value on a straight-line basis over the four years remaining in the property's recovery period. Thus, the Building would generate $50 of book depreciation annually, and the partnership would allocate such book depreciation equally between X and Y.

Again, the ceiling rule would interfere with the partnership's depreciation allocations. The partnership would allocate $25 of book depreciation to each partner, but the partnership only has $15 of tax depreciation. The ceiling rule would apply to the partnership's allocation, thereby preventing the partnership from making a parallel $25 tax allocation to X and Y. Indeed, the partnership would not be permitted to allocate anything more than the $15 of tax depreciation. Thus, the partnership would allocate the entire $15 of tax depreciation to X in order to minimize the adverse effects of the ceiling rule.[67] By contrast, the partnership would allocate no tax depreciation to Y.

Table 3: Depreciation Allocations Under the Ceiling Rule

	X		Y	
	Book	Tax	Book	Tax
Initial Balance	200	200	200	60
Depreciation	(25)	(15)	(25)	0
Ending Balance	175	185	175	60

[65] I.R.C. § 168(i)(7)(2006).

[66] Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) (as amended in 2008). Specifically, the partnership's book depreciation must equal "an amount that bears the same relationship to the [contributed property's] book value" as the corresponding tax depreciation "bears to the adjusted basis of the property." *Id.*

[67] Treas. Reg. § 1.704-1(c)(2)(i) ex. 1 (1956).

The partnership's ceiling limited allocation of the $15 tax depreciation would violate the Substance Principle. After accounting for the Building's depreciation deduction, X would have a $10 book/tax disparity ($175 capital account versus $185 outside basis), reflecting the partnership's failure to allocate her sufficient tax depreciation. Further, application of the ceiling rule would shift $10 of the Building's precontribution gain from Y to X. By allocating $10 less tax depreciation than book depreciation to X, the partnership would deny her a tax deduction for a $10 economic loss she suffered during the year.[68] In doing so, X, rather than Y, would bear the burden of $10 of the Building's precontribution tax gain. Put another way, Y would receive the economic benefit of such $10 precontribution gain at contribution, as reflected in her initial $200 capital account. Yet Y would avoid the corresponding $10 tax burden because of the ceiling rule's application.[69]

This pattern would continue for the remainder of the Building's recovery period. Each year, the ceiling rule would limit the partnership's allocations. Accordingly, X's book/tax disparity would increase annually, and portions of the Building's precontribution tax gain would shift from Y to X. By the end of the Building's recovery period, X and Y would have book/tax disparities of $40, and $40 of precontribution gain would have shifted from Y to X.[70] Indeed, Y would have avoided the tax liability for $40 of the Building's precontribution gain, even though she received the corresponding economic benefit for such amount at contribution. Yet again, the right partner would not have paid tax on the right amount at the right time.

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[68] Consider the depreciation of the Building under the aggregate theory of partnerships. In exchange for $100 of her contribution, A would receive an undivided interest in the Building, worth $100. The Building had fours years remaining in its recovery period and, therefore, A would be entitled to a $25 depreciation deduction ($100 basis divided by 4 years).

[69] Like the ceiling rule distortions previously discussed *supra* Part I.B.2, these distortions were temporary. They would reverse themselves following a liquidation of the partnership, the disposition of the affected partner's partnership interest and, in many instances, a disposition of the contributed property. However, also like the distortions previously discussed, these distortions were highly problematic despite their temporary nature.

[70] At the end of the Building's remaining four-year recovery period, the partnership would have allocated book depreciation of $100—$25 annually for four years—to X, and her capital account would have decreased from $200 to $100. By contrast, the partnership would have allocated $60 of tax depreciation—$15 annually for four years—to X and her outside basis would have decreased from $200 to $140. Thus, X would have a book/tax disparity of $40 when the Building was fully depreciated. Y too would have a $40 book/tax disparity. During the Building's remaining recovery period, the partnership would have allocated $100 of book depreciation to Y, thereby reducing her capital account from $200 to $100. For tax purposes, Y would have been allocated no depreciation and her outside basis would have remained unchanged at $60. As a result of the ceiling rule's application, $40 of the Building's precontribution gain would have shifted from Y to X. Simply put, X would have borne the tax burden of $40 of Y's precontribution gain in the Building, for which Y previously received credit in her capital account.

4. The Cost of Violating the Substance Principle—Part 1

The initial Section 704(c) allocation regime reflected Congress's tempered view of deviations from the Substance Principle. Congress understood that both the general rule of Section 704(c)(1) and the ceiling limited approach of Section 704(c)(2) might shift precontribution gains and losses among partners. Yet Congress expected that such shifts would be relatively minor and of small public cost. One witness at a congressional hearing addressing the enactment of Subchapter K testified that "[t]he problems in the partnership field usually involve the question of which partner is to be taxed and when. The Government is frequently nothing but an arbitrator and stakeholder in an intrapartnership controversy."[71] It was this estimation, more than anything else, that supported Congress's decision to make flexibility, rather than the Substance Principle, the hallmark of the rules governing allocations attributable to contributed property.[72]

C. *The 1984 American Law Institute*

1. The Cost of Violating the Substance Principle—Part 2

Thirty years' experience with allocations attributable to contributed property proved that Congress had miscalculated the cost of disregarding the Substance Principle. Contrary to the views expressed in 1954, income and loss shifting, like any deferral technique, did compromise the government's interests. The government was much more than an impartial referee with respect to allocations attributable to contributed property; it had a vested stake in such allocations.

As discussed *supra*, distortions created by breaches of the Substance Principle are temporary, ultimately correcting themselves.[73] If the partnership liquidates or the affected partner disposes of her partnership interest, such event will eliminate existing book/tax

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[71] *Forty Topics Pertaining to the General Revision of the Internal Revenue Code—Topic 29—Partnerships: Hearing Before the H. Comm. on Ways and Means*, 83d Cong. 1368, 1370 (1953) (Statement of Mark H. Johnson, American Bar Association); *see also* Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 125.

[72] *See, e.g.*, Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 112:

> Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the group. Since the Treasury from the standpoint of tax policy is not greatly concerned about this allocation, the issues are essentially not between Treasury and taxpayer-partner but between partner and partner. Consequently, tax technicians should be able to agree on the formulation of rules to govern the complex partnership relationship, and this formulation should not raise issues that pass beyond technical tax policy.

Id.; *see also* Jackson et al., *1954 Internal Revenue Code*, *supra* note 61, at 1210 ("In view of the three different rules governing contributed property, the 1954 Code allows the partners considerable leeway in determining the allocation gain, loss and allowances with respect to such property.").

[73] *See supra* notes 48-51 and accompanying text.

disparities and reverse income and loss shifts. Accordingly, from an intra-partnership perspective, no one is harmed by temporary income or loss shifts.

But income and loss shifting is not without cost. On the contrary, income and loss shifting imposes a tremendous cost on the government. When partners are subject to different tax rates, the Section 704(c) allocation rules allow the shifting of income to partners with lower tax rates, and the shifting of losses and deductions to partners with higher tax rates.[74] As a result, the government suffers a current revenue loss. Although such income and loss shifts may reverse themselves one day and the government ultimately may collect the avoided tax revenue, the government nonetheless suffers a permanent revenue loss because of the time value of money.[75] Indeed, the longer the deferral, the larger the public cost.

2. The Proposal: The Deferred Sales Method

The American Law Institute ("A.L.I.") initiated a comprehensive review of the rules governing allocations attributable to contributed property in 1984.[76] Recognizing Section 704(c)'s potential for abuse, the A.L.I. considered alternative allocation rules that better effectuated the Substance Principle. The most promising approach was the deferred sales method.[77]

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[74] In Example 1, for instance, imagine that A had a tax rate of thirty-five percent, whereas B was not subject to tax. If B could shift $50 of Blackacre's precontribution loss, then A could shelter $50 of income otherwise subject to tax at a thirty-five percent rate. This loss shift would save A $17.50 ($50 sheltered income * 35% tax rate) without affecting B's tax liability. Accordingly, neither A nor B would be injured by the loss shift. The government, however, would suffer a current revenue loss of $17.50 if the partnership used Section 704(c) to shift Blackacre's precontribution loss.

[75] If, as in *supra* note 74, the partnership liquidates following Blackacre's sale, A would recognize a $50 gain, and such gain would offset the previously allocated $50 loss attributable to the property's sale. Assuming constant tax rates, A would incur a tax liability of $17.50 at liquidation. Because of the time value of money, however, A's future tax liability would not fully offset the revenue loss incurred in the year of Blackacre's sale. Accordingly, the deferral would represent a permanent loss to the government and permanent benefit to A. *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1124 (1974).

[76] AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER K, PROPOSALS ON THE TAXATION OF PARTNERS 127-40 (1984) [hereinafter 1984 A.L.I. PROJECT].

[77] The deferred sales method initially appeared in General Counsel Memorandum 10,092, issued by Treasury in 1932. I.R.S. Gen. Couns. Mem. 10,092, XI-1 C.B. 114 (1932), *revoked by* I.R.S. Gen. Couns. Mem. 26,379, 1950-1 C.B. 58 (1950). Thereafter, Congress, Treasury and commentators have considered various formulations of the deferred sales method. The form of the deferred sales method set forth in the 1932 Treasury memorandum is referred to as the partial deferred sales method and is described in greater detail *infra* note 82. The A.L.I. in 1954 also considered the application of the partial deferred sales method. *See* Jackson et Al., *1954 A.L.I. Project*, *supra* note 50, at 120-23; *see also* COMM. ON P'SHIPS, N.Y. STATE BAR ASS'N TAX SECTION, COMMENTS RELATING TO PROPOSED REGULATIONS TO BE ISSUED PURSUANT TO SECTIONS 704(c), 707(a)(2) AND 752 (1985), *reprinted in* 85 TAX NOTES TODAY 102-57 (May 22, 1985) [hereinafter 1985 NYSBA COMMENTS] (recommending that Treasury include the partial deferred sales method in regulations to be issued under Section 704(c)). Future formulations of the deferred sales method, including the A.L.I.'s 1984 proposal, generally followed an alternative

As discussed *supra*, the core problem with contributed property is the treatment of the contribution transaction, which differs for book and tax purposes.[78] To some extent, all allocation methods aimed to ameliorate this problem, but only the deferred sales method addressed the source of the problem—the contribution itself. The deferred sales method treated the contribution transaction as a taxable exchange between the contributing partner and the partnership. Although the contributing partner recognized no gain or loss at contribution, such precontribution gain or loss was deferred for future recognition on the occurrence of certain triggering events. This deferred precontribution gain or loss is referred to as the "deferred sales amount."

As in any taxable transaction, the partnership's inside basis in the contributed property was its fair market value at the time of contribution. Similarly, the contributed property's book value and the contributing partner's initial capital account each equaled the property's fair market value at contribution. Under the deferred sales method, however, the contributing partner took an outside basis in her partnership interest equal to the contributed property's basis at contribution. The contributing partner also had the deferred sales amount, which reflected the contributed property's precontribution gain or loss.[79]

Certain future events triggered the contributing partner's recognition of the deferred sales amount. If the partnership disposed of the contributed property or the contributing partner disposed of her partnership interest, the contributing partner would recognize the deferred sales amount. Similarly, distributions would trigger recognition of the deferred sales amount.

The practical effect of the deferred sales method was to quarantine any precontribution gains or losses with the contributing partner. And this result was extraordinary. Under the deferred sales method, the contributing partner, and only the contributing partner, recognized the built in gains or losses attributable to contributed property. Accordingly, allocations attributable to contributed property no longer resulted in book/tax disparities or the shifting of income and losses. Simply put, the deferred sales method aligned Section 704(c) and the Substance Principle and solved the problem of contributed property.[80]

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approach referred to as the full deferred sales method. *See* 1984 A.L.I. PROJECT, *supra* note 76, at 129-31; *see also* Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992) (proposing the full deferred sales method as one of three contributed property allocation rules). Unless otherwise specified, any references to the deferred sales method are references to the full deferred sales method.

[78] *See supra* Part I.A.

[79] After contribution, the contributing partner's outside basis plus her deferred sales amount equaled the contributed property's fair market value at contribution. That is, the contributing partner's outside basis and her deferred sales amount, taken together, equaled the basis that the contributing partner would have had in her partnership interest if such partnership interest had been acquired in a fully taxable transaction.

[80] Like the ceiling limited approach of Section 704(c)(2), the deferred sales method represented a hybrid of the entity and aggregate theories of partnerships. The contribution

To illustrate, consider the deferred sales method's application to Example 1. Under the deferred sales method, B's contribution of Blackacre would be treated as a taxable exchange in which B received a partnership interest valued at $200 and the partnership received Blackacre, also valued at $200. The partnership would take an inside basis of $200 in Blackacre, reflecting the property's fair market value at contribution. B would recognize a $100 loss on the contribution exchange ($200 amount realized minus $300 precontribution basis), but such loss would be deferred for future recognition. Thus, B would have a deferred sales amount of $100. B's outside basis in her partnership interest would be $300 and her initial capital account would be $200.[81]

If the partnership later sells Blackacre for $250, the partnership would recognize a book gain and a tax gain of $50 ($250 amount realized minus $200 book value/inside basis). The partnership would allocate these gains equally between A and B, $25 to each partner. Additionally, Blackacre's sale would trigger B's deferred sales amount, and she would recognize the $100 precontribution tax loss deferred at contribution. The recognition of the deferred sales amount would not require an adjustment to B's capital account because the corresponding $100 precontribution economic loss was previously reflected in B's capital account.

Table 4: Allocations Using the Deferred Sales Method

	A		B	
	Book	Tax	Book	Tax
Initial Balance	200	200	200	300
Sale of Blackacre	25	25	25	25
Def. Sales Amt.				(100)
Ending Balance	225	225	225	225

After Blackacre's sale, the advantages of the deferred sales method would become apparent. The partnership would make parallel

transaction was treated as a sale between the contributing partner and the partnership, thereby following the entity theory. By contrast, subsequent allocations attributable to the contributed property followed the aggregate theory. The contributing partner recognized any precontribution gain or loss, although not at the time contribution. The partners shared any precontribution gains or losses pursuant to the partnership agreement. Accordingly, allocations attributable to contributed property were made in a manner sensitive to the ownership of such contributed property over time.

81 A's consequences would remain unchanged under the deferred sales method. Following contribution, she would have a $200 capital account and a $200 outside basis.

allocations to A for book and tax purposes and, therefore, Blackacre's sale would not create a book/tax disparity in A's accounts ($225 capital account versus $225 outside basis). In addition, the deferred sales method would eliminate B's book/tax disparity. For book purposes, the partnership would allocate a $25 economic gain to B, thereby increasing her capital account from $200 to $225. For tax purposes, however, B would recognize a net tax loss of $75, comprised of the $25 allocated postcontribution gain and the $100 deferred sales amount. B's outside basis in her partnership interest would decrease from $300 to $225, thereby aligning her outside basis and her capital account.

The deferred sales method also would prevent the shifting of Blackacre's $100 precontribution loss from B to A. By quarantining Blackacre's $100 precontribution loss in her deferred sales amount, the deferred sales method would ensure that only B would recognize such amount. The right partner would pay tax on the right amount at the right time.[82]

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[82] The A.L.I. in 1954 considered an alternative formulation of the deferred sales method referred to as the partial deferred sales method. *See* Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 120-23; *see also* Jackson et al., *1954 Internal Revenue Code*, *supra* note 61, at 1206-07. Although the partial deferred sales method and the full deferred sales method have many similarities, the partial deferred sales method treats the contribution transaction in a fundamentally different manner. Specifically, the partial deferred sales method treats the contribution transaction as a taxable exchange of partial undivided interests in property between the partners. Accordingly, the contribution is split into two transactions: a taxable exchange of property and a nonrecognition transaction. To illustrate, consider the partial deferred sales method's application to Example 1. Recall that A contributed $200 cash and B contributed Blackacre, with a fair market value of $200 and a basis of $300, to the equal partnership. Under the partial deferred sales method, B would exchange a fifty percent interest in Blackacre—worth $100 with a basis of $150—for $100 of A's cash contribution. B would recognize a $50 loss, but such loss would be deferred in her deferred sales amount. B's outside basis in this portion of her contribution would be $150 and the partnership's inside basis in such portion would be $100, reflecting exchange characterization. Second, B would contribute the remaining portion of Blackacre to the partnership in a nonrecognition transaction. Consistent with nonrecognition treatment, B's outside basis and the partnership's inside basis in this portion of the contribution would be $150. Taken together, B's outside basis in her partnership interest would be $300, her deferred sales amount would be $50, and the partnership's inside basis in Blackacre would be $250. After contribution, the partial deferred sales method would operate just like the full deferred sales method. That is, the same future events would trigger recognition of the deferred sales amount. For a more detailed discussion of the partial deferred sales method, see generally Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 TAX L. REV. 627, 682-84 (1986); 1985 NYSBA COMMENTS, *supra* note 77.

The partial deferred sales method's treatment of the contribution transaction is more consistent with the aggregate view of partnerships than the full deferred sales method and, therefore, many commentators view the partial deferred sales method as the theoretically correct method of allocating items attributable to contributed property. However, the partial deferred sales method's conceptual purity also leads to heightened complexity when compared to the full deferred sales method. More importantly, as will be discussed *infra* note 192, the full deferred sales method, which reflects both the aggregate and entity theories of partnerships, is more consistent with Subchapter K as it exists in practice. *See, e.g.*, Laura E. Cunningham & Noel B. Cunningham, *Simplifying Subchapter K: The Deferred Sale Method*, 51 SMU L. REV. 1, 6-7 (1997) (concluding that both formulations of the deferred sales method tax the same amount of gain, but the full deferred sales method is simpler); John P. Steines Jr., *Partnership Allocations of Built in Gain or Loss*, 45 TAX L. REV. 615, 641 (1990); 1985 NYSBA COMMENTS, *supra* note 77.

3. The Proposal Continued: Contributions of Depreciable Property

The deferred sales method also solved problems concerning the depreciation of contributed property. Consistent with its treatment of the contribution as a taxable exchange, the deferred sales method required the partnership to treat contributed property as newly purchased property. Thus, the partnership recovered its inside basis in such property using the appropriate methodology and a new recovery period.

Additionally, the deferred sales method required the contributing partner to recognize a portion of her deferred sales amount in each year of the contributed property's new recovery period. Thus, the contributing partner recognized the deferred sales amount incrementally throughout the contributed property's depreciable life. The portion of the deferred sales amount recognized annually was proportionate to the partnership's depreciation deduction for the taxable year. Specifically, the percentage of the deferred sales amount recognized equaled the percentage of the partnership's initial inside basis in the contributed property recovered during such year.

To illustrate, consider the deferred sales method's application to Example 2. Recall that the Building's fair market value was \$200 and its adjusted basis was \$60 at contribution. Under the deferred sales method, Y would recognize a \$140 gain on the contribution exchange, but this gain would be deferred through her deferred sales amount. Y's outside basis in her partnership interest would be \$60, and her capital account would be \$200. The partnership's inside basis in the Building would be \$200, reflecting its fair market value at contribution.[83]

For tax purposes, the partnership would treat the Building as newly placed in service property, and depreciate it using the straight-line method over a fresh ten-year recovery period. Accordingly, the partnership would take annual depreciation deductions of \$20 (\$200 inside basis divided by ten-year recovery period). For book purposes, the partnership would use the same methodology and recovery period, resulting in annual book depreciation deductions of \$20 (\$200 book value divided by ten-year recovery period). The partnership would allocate these book and tax deductions equally between X and Y, \$10 to each partner. Additionally, Y would amortize her deferred sales amount over the Building's ten-year recovery period, thereby recognizing \$14 (\$140 deferred sales amount divided by ten-year recovery period) of the Building's precontribution gain annually.

In the first year following contribution, the partnership would allocate \$10 of book depreciation to X and Y, thereby reducing each partner's capital account from \$200 to \$190. The partnership similarly

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[83] Again, the consequences of the contribution to X would remain unchanged under the deferred sales method. A would have a capital account of \$200 and an outside basis of \$200.

would allocate $10 of tax depreciation to each partner. X's outside basis in her partnership interest would decrease from $200 to $190, just like her capital account. Y, however, also would recognize $14 of her deferred sales amount and, therefore, she would recognize a net $4 gain ($14 deferred sales amount minus $10 depreciation deduction). Accordingly, Y's outside basis would increase from $60 to $64.

Table 5: Depreciation Allocations Using the Deferred Sales Method

	X		Y	
	Book	Tax	Book	Tax
Initial Balance	200	200	200	60
Depreciation	(10)	(10)	(10)	(10)
Def. Sales Amt.				14
Ending Balance	190	190	190	64

Again, the benefits of the deferred sales method would be evident. Because X would receive parallel allocations for book and tax purposes, she would not develop a book/tax disparity. Although Y would continue to have a book/tax disparity, such disparity would decrease. And most importantly, none of the Building's precontribution gain would shift to X.

This pattern would repeat itself annually throughout the Building's depreciable life. At the conclusion of the ten-year recovery period, neither X nor Y would have a book/tax disparity, and none of the Building's $140 precontribution gain would have shifted from Y to X.[84] Y would have received economic credit for the Building's $140 built in gain at contribution, as reflected in her capital account. Similarly, at the end of the Building's recovery period, Y would have borne the corresponding tax burden of the Building's $140 precontribution gain.

[84] At the end of the ten-year recovery period, the partnership would have allocated book depreciation of $100 and tax depreciation of $100 to both X and Y ($10 annual book/tax depreciation multiplied by ten years). For capital account purposes, X's and Y's capital accounts would have decreased from $200 to $100. Similarly, X's outside basis would have decreased from $200 to $100. In addition, Y would have recognized her entire $140 deferred sales amount, thereby resulting in a net $40 gain over the Building's ten-year recovery period ($140 deferred sales amount minus $100 tax depreciation). Accordingly, her outside basis would have increased from $60 to $100.

4. The A.L.I.'s Recommendation: No to the Deferred Sales Method

Ultimately, the A.L.I. did not recommend the deferred sales method's adoption. The A.L.I.'s primary reservations related to valuation and the methodology's complexity.[85]

For the A.L.I., the deferred sales method's most troublesome feature was its dependence on asset valuation.[86] Specifically, the deferred sales method required a partnership to determine the contributed property's fair market value at contribution in order to compute the deferred sales amount and the partnership's inside basis. The A.L.I. feared that such valuation requirement would result in unanticipated tax consequences to the partners and would afford partnerships new opportunities for strategic behavior.[87]

Additionally, the A.L.I. was concerned about the deferred sales method's complexity.[88] Unlike the allocation rules set forth in Section 704(c) of the 1954 Code, the deferred sales method required the partnership to make computations in the year of contribution and in each year thereafter. As noted, the partnership would have to value all property at contribution. The partnership then would have to determine annually whether any adjustments to the deferred sales amount are necessary, for example to reflect the depreciation of contributed property.

Further questions arose regarding the deferred sales method's proper scope. The A.L.I. believed that the same methodology should govern Section 704(c) and allocations following the admission of a partner to an existing partnership.[89] This conclusion, however, would have expanded the deferred sales method's scope and complexity. Partnerships admit new partners regularly, and each admission would necessitate the deferred sales method's application. The A.L.I. believed that the administrative burden created by such expansive use of the deferred sales method was too great to impose on partnerships.[90]

Although acknowledging the ceiling rule's incompatibility with the Substance Principle, the A.L.I.'s rejection of the deferred sales method tacitly endorsed the ceiling limited approach of Section 704(c)(2).[91] Indeed, the A.L.I. believed that the ceiling rule possessed an important advantage compared to the deferred sales method. The ceiling

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85 1984 A.L.I. PROJECT, *supra* note 76, at 131-38.

86 *Id.* at 131-36.

87 For a more detailed discussion of the valuation objection to the deferred sales method, see *infra* Part III.A.

88 1984 A.L.I. PROJECT, *supra* note 76, at 136-38.

89 *Id.* at 136. Problems virtually identical to the problem of contributed property arise in other contexts, including the admission of a new partner to an existing partnership. *See* discussion *infra* note 98.

90 1984 A.L.I. PROJECT, *supra* note 76, at 137.

91 *Id.* at 139.

rule used readily ascertainable numbers computed by reference to the contributed property's basis and ultimate sales price. The A.L.I. felt that "this 'reality' testing may provide a significant check on manipulating allocation arrangements between partners."[92]

Like Congress in 1954, the A.L.I. assumed that partners rarely used Section 704(c) or the ceiling rule in an abusive manner.[93] But the A.L.I.'s discussion of allocations attributable to contributed property concluded with a prescient remark:

> If, because of the ease with which gain or loss on contributed property can be shifted between partners, such shifting is being broadly used to gain tax advantage, a rule to prevent such shifting may be appropriate. If, on the other hand, such shifting generally occurs only because of valuation uncertainty or a desire by taxpayers to avoid the additional complexity that a § 704(c)(2) allocation agreement entails, then the adoption of a rule similar to the deferred-sale approach described above seems unwise.[94]

Thus, the A.L.I. suggested that if partnerships strategically used contributed property allocations to shift income or losses, congressional reconsideration of the deferred sales method would be proper.

D. The 1984 Internal Revenue Code

Congress, too, was ultimately compelled to acknowledge the many abusive transactions capitalizing on the tax law's general failure to account for the time value of money.[95] The Deficit Reduction Act of 1984 attempted to curb many of these abuses, including tax-advantaged allocations attributable to contributed property.[96] In amending Section 704(c), Congress required that partnerships allocate items attributable to contributed property by accounting for the difference between the property's basis and its fair market value at contribution.[97] Congress thus converted the elective allocation rule previously set forth in Section

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92 *Id.*

93 *Id.* at 139-40.

94 *Id.* at 140.

95 *See* JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 7 (Comm. Print 1984), *reprinted in* 5 TAX REFORM 1984: A LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1984: THE LAW, REPORTS, HEARINGS, DEBATES AND RELATED DOCUMENTS (Bernard D. Reams, Jr. ed., 1985) [hereinafter 1984 JOINT COMMITTEE EXPLANATION]; H.R. REP. NO. 98-432, at 1095 (1984).

96 Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71, 98 Stat. 494 (1984) (codified in Prior I.R.C. § 704(c)(1984)).

97 I.R.C. § 704(c) (1984). Specifically, Section 704(c) provided that

> [u]nder regulations prescribed by the Secretary, income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Id.

704(c)(2) into a mandatory rule governing all allocations attributable to contributed property.[98]

Section 704(c)'s amendment reflected a newfound congressional commitment to the Substance Principle. How closely aligned the Section 704(c) allocation rules and the Substance Principle would become, however, was entirely dependent on the fate of the ceiling rule. And, on this point, Congress faltered.

The 1984 Act's legislative history appeared to contemplate the ceiling rule's continuing application.[99] Nonetheless, Congress granted Treasury broad authority to issue regulations governing allocations attributable to contributed property.[100] Indeed, this legislative grant explicitly authorized Treasury to adopt alternative allocation methodologies that accelerated the elimination of book/tax disparities, including those perpetuated by the ceiling rule.[101]

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[98] Congress omitted certain allocations, such as allocations following the admission of a partner to an existing partnership, from this new Section 704(c) allocation regime believing such allocations were sufficiently addressed by the Section 704(b) substantial economic effect regulations. *See* 1984 JOINT COMMITTEE EXPLANATION, *supra* note 95, at 212. These allocations, referred to as reverse Section 704(c) allocations, raise issues indistinguishable from those raised by allocations attributable to contributed property. The Section 704(b) substantial economic effect regulations permit a partnership to rebook its assets to reflect their fair market value following the occurrence of certain enumerated events, including the admission of a partner to an existing partnership. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2008). If the partnership revalues its assets, then the historic partners' capital accounts are increased or decreased to reflect any book gains or losses. *Id.* § 1.704-1(b)(2)(iv)(f)(2), (3). The rebooking is not a taxable event, however, and no corresponding adjustments are made to the partnership's inside basis in its assets or to the historic partners' outside basis in their partnership interests. Like a partnership contribution, the rebooking results in an immediate book/tax disparity for the historic partners. Thus, the partnership can no longer make parallel book and tax allocations with respect to its historic property. Put another way, the rebooking of partnership property creates a problem identical to the problem of contributed property. Allocations attributable to rebooked property cannot have substantial economic effect and necessarily require an alternative allocation regime. Accordingly, the Section 704(b) substantial economic effect regulations command that a partnership apply Section 704(c) principles when allocating items attributable to rebooked property. *Id.* § 1.704-1(b)(2)(iv)(f)(4). For a detailed discussion of reverse Section 704(c) allocations, see generally MCKEE ET AL., *supra* note 12, ¶ 11.02[2][c][ii].

[99] The 1984 Act's legislative history is virtually silent on the ceiling rule, only mentioning it in one footnote. 1984 JOINT COMMITTEE EXPLANATION, *supra* note 95, at 213, n.4; H.R. REP. NO. 98-432, at 1209, n.3. (1984). Congress granted Treasury the authority to permit partnerships to use more accelerated means of eliminating book/tax disparities than those permitted under prior law. 1984 JOINT COMMITTEE EXPLANATION, *supra* note 95, at 213. In a footnote to this statement, the legislative history suggests amending an example in the former Section 704(c) regulations applying the ceiling rule to depreciable property. Specifically, the legislative history suggested that the example could be amended to permit an electing partnership to use any gains recognized on the contributed property's subsequent disposition to offset prior ceiling rule distortions. *Id.* at 213 n.4. The implication, however, was that the new Section 704(c) regime would preserve the ceiling rule. *See* Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992).

[100] *See* 1984 JOINT COMMITTEE EXPLANATION, *supra* note 95, at 213-14; H.R. REP. NO. 98-861, at 857 (1984) (Conf. Rep.); H.R. REP. NO. 98-432, at 1209 (1984).

[101] *See* 1984 JOINT COMMITTEE EXPLANATION, *supra* note 95, at 213. Specifically, the Joint Committee on Taxation's explanation of the 1984 Act provides that "[i]t was anticipated that Treasury Regulations may permit partners to agree to a more rapid elimination of disparities between the value and adjusted basis of contributed property (determined at the time of contribution) among partners than is required by the new rules." *Id.*

Congress directed partnerships to rely on the prior Section 704(c) regulations until Treasury issued regulations interpreting the 1984 amendment to Section 704(c).[102] In doing so, Congress subjected all Section 704(c) allocations to the ceiling rule. It would be almost a decade before Treasury issued the regulations that would shape the future relationship between allocations attributable to contributed property and the Substance Principle.

E. The 1992 Treasury Regulations

In December 1992, Treasury proposed new regulations under Section 704(c) ("Section 704(c) Regulations").[103] Consistent with all prior efforts to regulate allocations attributable to contributed property, Treasury strove to implement the challenging congressional mandate to maximize both flexibility and the Substance Principle, while simultaneously minimizing complexity and the potential for abuse.[104]

The Section 704(c) Regulations give partnerships myriad options. They permit partnerships to use any reasonable method of allocating items attributable to contributed property so long as such method accounts for the difference between the property's fair market value and its basis at contribution.[105] The partnership selects a reasonable allocation methodology on a property-by-property basis and, therefore, it is not limited to one allocation method.[106] Rather, a partnership can apply multiple allocation methodologies to its various contributed properties.

The Section 704(c) Regulations list three methods that Treasury considers reasonable means of allocating items attributable to contributed property.[107] The first is the traditional method subject to the ceiling

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[102] *Id.* at 214.

[103] *See* Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992).

[104] *Id.* The preamble to the proposed Section 704(c) Regulations states that Congress granted Treasury broad regulatory authority in drafting such regulations because of

> Congressional concern that the existing regulations under the formerly elective method did not provide sufficient flexibility and were overly burdensome for taxpayers in situations where there was little potential for abuse. The proposed regulations attempt to provide guidance that is consistent with the intent of Congress in enacting the amendments to [S]ection 704(c) and that is relatively simple for taxpayers to comply with and for the Internal Revenue Service to administer.

Id. (citations omitted).

[105] Treas. Reg. § 1.704-3(a)(1) (as amended in 2005). With the exception of the remedial allocation method, discussed *infra* notes 115-120 and accompanying text, an allocation method is not reasonable if it involves notional allocations or requires the partnership to adjust its basis in contributed property to reflect precontribution gains or losses. Treas. Reg. § 1.704-3(a)(1) (as amended in 2005). Accordingly, the Section 704(c) Regulations expressly forbid the use of the deferred sales method.

[106] Treas. Reg. § 1.704-3(a)(2) (as amended in 2005).

[107] *Id.* § 1.704-3(b)-(d). The use of these three allocation methods is subject to a general anti-abuse rule. Treas. Reg. § 1.704-3(a)(10) (as amended in 2005, and additional amendments to the anti-abuse rule proposed by Prop. Treas. Reg. § 1.704-3(a)(10), 73 Fed. Reg. 28,765 (May 19, 2008)). Under this anti-abuse rule, a partnership's allocation method will not be considered

rule.[108] Indeed, this is the previously elective approach of Section 704(c)(2) of the 1954 Code.[109] Despite the acknowledged inability of the traditional method to eliminate all book/tax disparities, Treasury simply was not prepared to repeal the ceiling rule.[110]

But Treasury was prepared to provide partnerships with relief from the ceiling rule. The Section 704(c) Regulations permit partnerships to elect two alternative allocation methods, each reflecting the reemergence of the Substance Principle in the contributed property context.

One of these methods is the traditional method with curative allocations.[111] As its name suggests, the traditional method with curative allocations begins with the application of the traditional method subject to the ceiling rule. If the ceiling rule causes a book/tax disparity for a noncontributing partner, the partnership can make curative allocations of other existing tax items to alleviate the distortion.[112] Curative allocations will only be respected to the extent they are reasonable, which requires that the tax item used to make the curative allocation have the same effect on the partners as the item limited by the ceiling rule.[113]

The traditional method with curative allocations, however, is not a perfect solution to the problem of contributed property. Curative allocations can only be made with items actually recognized by the partnership. Thus, the success of this method is entirely dependent on the items the partnership recognizes.[114] Absent the recognition of an item that

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reasonable if the contribution and subsequent contributed property allocations are made "with a view to shifting the tax consequences" of precontribution gains and losses "among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability." *Id.*

108 Treas. Reg. § 1.704-3(b) (as amended in 2005).

109 For a more detailed discussion of the mechanics of the traditional method subject to the ceiling rule, see *supra* Part I.B.2.

110 *See* Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992) ("[T]he ceiling rule may prevent elimination of the entire effect of the disparity between the fair market value and adjusted basis in the partnership for the contributing partner and may create a disparity for the noncontributing partners. The proposed regulations retain the traditional method despite this potential for distortions."). Many commentators have suggested that Treasury retained the ceiling rule due to concerns regarding its authority to administratively repeal such rule. *See, e.g.*, Laura Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93, 95 (1996) [hereinafter Cunningham, *Use and Abuse*]; Marich & McKee, *supra* note 82, at 692, n.111; Steines, *supra* note 82, at 665, n.173; *see also Tax Simplification Act of 1991: Hearing on H.R. 2777 Before the H. Subcomm. on Select Revenue Measures*, 102d Cong. (statement of David E. Peterson, Chairman of the Legislative Comm., Coalition of Publicly Traded Partnerships, noting that in the Coalition's discussions with Treasury and IRS staff, it was revealed that Treasury doubted that they had the authority to eliminate the ceiling rule), *reprinted in* 91 TAX NOTES TODAY 159-28 (July 30, 1991).

111 Treas. Reg. § 1.704-3(c) (as amended in 2005). For a helpful example of the application of the traditional method with curative allocations, see Simmons, *supra* note 18, manuscript at 13-15 (sale of contributed property) and 19-20 (depreciation of contributed property).

112 Treas. Reg. § 1.704-3(c)(1) (as amended in 2005).

113 *Id.* § 1.704-3(c)(3)(iii). Additionally, a curative allocation will only be reasonable to the extent it does not exceed the amount necessary to eliminate the book/tax disparity caused by the ceiling rule. *Id.* § 1.704-3(c)(3)(i).

114 If a partnership fails to recognize any items with which to make a reasonable curative allocation in the year a ceiling rule distortion arises, the partnership may make such curative allocation in a succeeding taxable year when it recognizes a proper item. *Id.* § 1. 704-3(c)(3)(ii).

happens to qualify as a reasonable curative allocation, the partnership is precluded from making a curative allocation and curing the ceiling rule distortion.

Treasury's last allocation method is the remedial allocation method.[115] Like the traditional method with curative allocations, the

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[115] T.D. 8501, 1994-1 C.B. 191 (finalized by T.D. 8585, 1995-1 C.B. 120). Treasury did not include the remedial allocation method in the initial Section 704(c) Regulations proposed in 1992. Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992). Rather, such regulations included the deferred sales method. *Id.* However, when Treasury issued the final Section 704(c) Regulations in 1994, it reserved on the third allocation method and simultaneously issued proposed and temporary regulations introducing the remedial allocation method. T.D. 8500, 1994-1 C.B. 183. Treasury downplayed the shift from the deferred sales method to the remedial allocation method, stating in the preamble to temporary Treasury Regulation that

> [a]fter considering the many comments received concerning the deferred sale method and upon further review by the IRS and Treasury, it was determined that the results of the deferred sale method in the original proposed regulations could be achieved using a less complex method. Therefore, the IRS and Treasury have included a revised deferred sale method referred to as the remedial allocation method in these temporary regulations.

Id. The deferred sales method and the remedial allocation method do share common traits—both eliminate ceiling rule distortions through the use of notional tax allocations. Yet the deferred sales method and the remedial allocation method differ in critical respects. Most importantly, the deferred sales method and the remedial allocation method treat contributions as fundamentally different transactions, and this difference reverberates through many aspects of the respective allocation rules. Indeed, many commentators believed that the deferred sales method's integration into Subchapter K would present numerous challenges not evident with the remedial allocation method. *See, e.g.*, COMM. ON P'SHIPS., N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON TREASURY REGULATION SECTION 1.704-3T AND CERTAIN OTHER SECTION 704(C) MATTERS, *reprinted in* 94 TAX NOTES TODAY 86-15 (May 4, 1994) [hereinafter 1994 NYSBA COMMENTS]; TAXATION SECTION, D.C. BAR ASS'N, COMMENTS ON PROPOSED REGULATION SECTION 1.704-3 PERTAINING TO ALLOCATIONS IN CONNECTION WITH BUILT-IN GAIN OR LOSS PROPERTY CONTRIBUTED TO PARTNERSHIPS, *reprinted in* 93 TAX NOTES TODAY 84-32 (Apr. 16, 1993) [hereinafter DCBA COMMENTS].

The mechanics of the deferred sales method as set forth in the proposed Section 704(c) Regulations generally tracked the A.L.I.'s 1984 proposal, discussed *supra* Part I.C.2. However, Treasury's formulation of the deferred sales method and the A.L.I.'s proposal differed in several notable respects. First, the proposed Section 704(c) Regulations clarified the triggering effect of subsequent distributions. Specifically, distributions to the contributing partner only would have triggered recognition of the deferred sales amount to the extent that the distributed property's fair market value plus any cash distributed exceeded the contributing partner's outside basis. Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B), 57 Fed. Reg. 61,345 (Dec. 24, 1992). Second, the proposed Section 704(c) Regulations would have adopted a bifurcated approach to depreciation. *Id.* § 1.704-3(d)(7), 57 Fed. Reg. 61,345. Under the proposed Section 704(c) Regulations, the partnership would have divided its inside basis in the contributed property into two components—one equal to the contributing partner's basis in such property at contribution and the other equal to the remainder. The partnership would have depreciated the portion equal to the contributing partner's basis on a step in the shoes basis using the contributed property's remaining recovery period. By contrast, the partnership would have depreciated the remaining portion, which would equal the deferred sales amount, as newly placed in service property using a fresh recovery period. *Id.* Although Treasury did not include the deferred sales method in the final Section 704(c) Regulations, the bifurcated depreciation approach survived and governs the depreciation of contributed property under the remedial allocation method. Treas. Reg. § 1.704-3(d)(2), (7) ex. 1 (as amended in 2005).

Treasury's deferred sales method proposal was virtually identical to prior, unsuccessful congressional proposals. Specifically, on several occasions, Congress tried to enact legislation that would have required large partnerships—those having at least 250 members—to use the deferred sales method. *See* Revenue Act of 1992, H.R. 11, 102d Cong. § 4301(a), *reprinted in* 92 TAX NOTES TODAY 203-96 (Oct. 7, 1992) (pocket vetoed by President Bush on November 5, 1992); Tax Fairness and Economic Growth Acceleration Act of 1992, H.R. 4210, 102d Cong. § 4301(a), *reprinted in* 92 TAX NOTES TODAY 66-20 (Mar. 26, 1992) (vetoed by President Bush at 138 Cong. Rec. H. 1604 (March 24, 1992)); Tax Simplification Act of 1991, H.R. 2777, 102d Cong. § 201, remedial allocation method uses the traditional method as its baseline, only deviating from it when the ceiling rule causes a book/tax disparity for a noncontributing partner.[116] If the ceiling rule applies, the partnership makes a notional allocation to the affected noncontributing partner in order to eliminate her book/tax disparity.[117] Simultaneously, the partnership makes an offsetting notional allocation to the contributing partner.[118] The sole purpose of these allocations is to remedy ceiling rule distortions, and they are otherwise invisible to the partnership.[119] Because the remedial allocations offset one another, the partnership's aggregate taxable income or loss remains unchanged. Further, remedial allocations are made for tax purposes only; they have no effect on the partners' capital accounts.[120] Simply put, remedial allocations are offsetting fictional allocations intended to eliminate the problems—shifting and book/tax disparities—perpetuated by the ceiling rule.

For the most part, the Section 704(c) Regulations remain the primary rules governing allocations attributable to contributed property. A partnership may elect between these three alternative allocation regimes, each with its own idiosyncrasies, and it may make such election on a property-by-property basis.[121] Consistent with much of Subchapter K, flexibility reigns supreme within the Section 704(c) Regulations. Yet partnerships also have the opportunity to achieve results more consistent with the Substance Principle through either curative allocations or remedial allocations.

Perhaps, however, the Section 704(c) Regulations are best described as a Pyrrhic victory for Congress and Treasury. The current Section 704(c) allocation regime does reflect both of Congress's primary goals for Subchapter K—flexibility and the Substance Principle. But, as

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reprinted in 91 TAX NOTES TODAY 138-24 (June 28, 1991) (failed to reach floor vote in House of Representatives); STAFF OF JT. COMM. ON TAX'N, 101ST CONG., WIDELY HELD PARTNERSHIPS: COMPLIANCE AND ADMINISTRATIVE ISSUES (Comm. Print 1990); 138 Cong. Rec. H1604 (1992); Library of Congress: Thomas, S.1394, http://thomas.loc.gov/cgi-bin/query/D?c102:10:./temp/~c1025TjONg:: (follow "Bill Summary & Status file" hyperlink; then follow "All Congressional Actions" hyperlink) (last visited Apr. 3, 2009) (on file with author); Library of Congress: Thomas, H.R. 11, http://thomas.loc.gov/cgi-bin/bdquery/z?d102:HR00011:@@@R (last visited June 15, 2009).

[116] Treas. Reg. § 1.704-3(d) (as amended in 2005). For a helpful example of the application of the traditional method with remedial allocations, see Simmons, *supra* note 18, manuscript at 15-16 (sale of contributed property) and 20-22 (depreciation of contributed property).

[117] Treas. Reg. § 1.704-3(d)(1), (7) exs. 1 & 2 (as amended in 2005).

[118] *Id.*

[119] *Id.* § 1.704-3(d)(3), (4)(ii).

[120] *Id.* § 1.704-3(d)(4)(i), (ii).

[121] For instance, as discussed *supra* note 115, the remedial allocation method has a unique approach to depreciation. Neither the traditional method nor the traditional method with curative allocations applies this approach. Rather, they follow a step-in-the-shoes approach to depreciation. In addition, as discussed *supra* note 114, the traditional method with curative allocations permits a partnership to make curative allocations in the years following the year in which the noncontributing partner's ceiling rule distortion arises. By contrast, the other allocation methods require a partnership to make all necessary allocations in the taxable year the noncontributing partner's ceiling rule distortion occurs.

Part II of this Article explains, the cost of Congress's failure to choose between flexibility and the Substance Principle has been quite high. And the enactment of Section 704(c)(1)(C) in 2004 only exacerbated this predicament.

F. The Enactment of Section 704(c)(1)(C)

In the American Jobs Creation Act of 2004, Congress amended Section 704(c) in order to thwart certain loss shifting partnership transactions.[122] The stated goal of Section 704(c)(1)(C) was to prevent the transfer of precontribution losses, but the amendment's impact is far broader.[123] When applicable, Section 704(c)(1)(C) provides a mandatory allocation rule entirely consistent with the Substance Principle. Simply put, Section 704(c)(1)(C) partially repeals the ceiling rule.

Under Section 704(c)(1)(C), a partnership may not allocate any portion of a precontribution loss to a partner other than the contributing partner.[124] Indeed, built in losses are disregarded for purposes of making allocations to noncontributing partners.[125] To this end, the partnership treats built in loss property as if it had been acquired in a taxable exchange and takes an inside basis in such property equal to its fair market value at contribution.[126] Accordingly, when future taxable events occur, such as a sale of the contributed property, the noncontributing

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[122] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(a), 188 Stat. 1418, 1589 (2004) (codified in I.R.C. § 704(c)(1)(C)).

[123] *See* STAFF OF JT. COMM. ON TAX'N, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 384-86 (Comm. Print 2005); H.R. REP. NO. 108-755, at 621 (2004) (Conf. Rep.); H.R. REP. NO. 108-548, at 281-83 (2004). Indeed, the legislative history of Section 704(c)(1)(C) focuses primarily on transactions in which precontribution losses are duplicated following the transfer of the contributing partner's partnership interest. Under certain circumstances, a subsequent sale of the contributed property will improperly duplicate and shift such precontribution losses to the remaining partners, including the transferee partner. Notwithstanding this narrow focus, the relevant legislative history specifies a much broader underlying concern—the improper transfer of built in losses among partners. *See* STAFF OF JT. COMM. ON TAX'N, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 384-86 (Comm. Print 2005); H.R. REP. NO. 108-548, at 283 (2004). Thus, Section 704(c)(1)(C)'s legislative history is ambiguous. It is unclear whether Congress intended the provision to prevent all shifts of precontribution losses or only those occurring following the contributing partner's sale of her partnership interest. As will be discussed, the literal language of Section 704(c)(1)(C), by contrast to the legislative history, is quite clear. For a more detailed discussion of these transactions and the intended effect of Section 704(c)(1)(C), see generally Darryll Jones, *It's the Ceiling Rule Stupid!*, 107 TAX NOTES 1579 (June 20, 2005); Lukasz Rachuba, *New Issues with Partnership Built-In Loss Property*, 107 TAX NOTES 1569 (June 20, 2005).

[124] I.R.C. § 704(c)(1)(C)(i) (2006). The following analysis is based on a literal reading of Section 704(c)(1)(C). As discussed *supra* note 123, the language of Section 704(c)(1)(C) is not ambiguous. Section 704(c)(1)(C) applies "if any property so contributed [to a partnership] has a built-in loss." *Id.* For a less literalist reading of Section 704(c)(1)(C), see Simmons, *supra* note 18, manuscript at 52-82.

[125] I.R.C. § 704(c)(1)(C)(ii). Section 704(c)(1)(C)(ii) controls built in loss property allocations made to "other partners." That is, it governs allocations made to partners other than the contributing partner, including noncontributing partners and any transferee partners.

[126] *Id.* § 704(c)(1)(C) (flush language). A "built in loss" is the excess of the contributed property's adjusted basis over its fair market value at contribution. *Id.*

partner will receive parallel book and tax allocations. No new book/tax disparities will arise and no losses will shift from the contributing partner to the noncontributing partner.

However, Section 704(c)(1)(C)'s applicability is quite limited. The provision only applies to built in loss property contributed to a partnership. And even in these circumstances, Section 704(c)(1)(C) does not apply to all of the partnership's allocations. Section 704(c)(1)(C) only applies when the partnership makes allocations attributable to such built in loss property to the noncontributing partner. Section 704(c)(1)(C) does not govern allocations made to the contributing partner; these allocations remain subject to the historic rules of Section 704(c), now set forth in Section 704(c)(1)(A).[127] Allocations attributable to built in gain property also fall outside Section 704(c)(1)(C)'s parameters and, therefore, partnerships continue to make these allocations under Section 704(c)(1)(A).[128] In essence, Section 704(c)(1)(C) bifurcated the rules governing allocations attributable to contributed property: Section 704(c)(1)(C) governs allocations attributable to built in loss property made to noncontributing partners, and Section 704(c)(1)(A) governs all other allocations attributable to contributed property.

To illustrate, consider Section 704(c)(1)(C)'s effect on Example 1. Prior to Section 704(c)(1)(C), the partnership would have recognized a \$50 book gain on Blackacre's sale for \$250 (\$250 amount realized minus \$200 book value). The partnership would have allocated each partner a \$25 book gain, increasing her capital account from \$200 to \$225. By contrast, the partnership would have recognized a \$50 tax loss on the sale (\$250 amount realized minus \$300 inside basis), and the ceiling rule would have governed the allocation of such loss.[129] Accordingly, the partnership would have allocated the entire \$50 tax loss to B. As discussed, the application of the ceiling rule would have resulted in distortions, each reflecting Section 704(c)(1)(A)'s failure to comply with the Substance Principle. Specifically, A and B would have had \$25 book/tax disparities, and \$25 of Blackacre's precontribution loss would have shifted from B to A.

Section 704(c)(1)(C) alters the tax consequences of Blackacre's sale.[130] The partnership must now bifurcate the transaction and determine

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[127] In the Omnibus Budget Reconciliation Act of 1989, Congress amended Section 704(c). Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7642, 103 Stat. 2106, 2380 (1989). Former Section 704(c) was redesignated Section 704(c)(1)(A), and the Section 704(c)(1)(B) mixing bowl rule, discussed *supra* Part II.B.4.a., was added to the Code.

[128] In addition, Section 704(c)(1)(C) does not apply to reverse Section 704(c) allocations, discussed *supra* note 97.

[129] *See* Treas. Reg. § 1.704-3(b)(1) (as amended in 2005). For purposes of this illustration, it is assumed that the partnership did not elect to apply the traditional method with curative allocations or the remedial allocation method, either of which may have cured the ceiling rule distortion.

[130] For capital account purposes, the consequences of Blackacre's sale would remain unchanged. Like before Section 704(c)(1)(C)'s enactment, the partnership would recognize a \$50 book gain and allocate it equally between A and B.

A's and B's tax consequences separately. The partnership's allocations to B, the contributing partner, would remain subject to Section 704(c)(1)(A). The partnership would recognize a $50 tax loss, which it would allocate entirely to B because of the ceiling rule. Thus, B would have a $25 book/tax disparity following Blackacre's sale ($225 capital account versus $250 outside basis).

By contrast, the partnership would determine A's tax consequences under Section 704(c)(1)(C). As discussed, a partnership disregards precontribution losses when making allocations to a noncontributing partner under Section 704(c)(1)(C). Accordingly, the partnership would not account for Blackacre's $100 precontribution loss when determining the A's tax consequences. To this end, the partnership's inside basis in Blackacre would be $200, the property's fair market value at contribution. The partnership would recognize a $50 tax gain on the sale ($250 amount realized minus $200 Section 704(c)(1)(C) inside basis) and allocate $25 of such tax gain to A. Accordingly, A would receive matching book and tax allocations following Blackacre's sale.

Table 6: Allocations under Section 704(c)(1)(C)

	A		B	
	Book	Tax	Book	Tax
Initial Balance	200	200	200	300
Sale-704(c)(1)(A)			25	(50)
Sale-704(c)(1)(C)	25	25		
Ending Balance	225	225	225	250

To the extent applicable, Section 704(c)(1)(C) repeals the ceiling rule and aligns the rules governing allocations attributable to contributed property and the Substance Principle. In the foregoing example, A would not have a book/tax disparity following Blackacre's sale. In addition, none of Blackacre's $100 precontribution loss would shift from B to A. By eliminating the precontribution loss from the partnership's inside basis, Section 704(c)(1)(C) ensures that no portion of such loss inures to the benefit of the noncontributing partner. Indeed, the ceiling rule no longer causes book/tax disparities or loss shifting for noncontributing partners. Under Section 704(c)(1)(C), the right noncontributing partner pays tax on the right amount at the right time.[131]

More importantly, Section 704(c)(1)(C) highlights a fundamental shift in congressional thinking about Subchapter K. Throughout the years, Congress has remained steadfast in its commitment to promoting both flexibility and the Substance Principle in Section 704(c) and, more broadly, in Subchapter K. Section 704(c)(1)(C) reflects Congress's recognition of the high cost of such approach. Congress has demonstrated a newfound willingness to choose between flexibility and the Substance Principle, and Section 704(c)(1)(C)'s enactment is an example of such trend. Indeed, Congress's choice has been the Substance Principle.

II. THE SOLUTION: THE DEFERRED SALES METHOD

A. *The Unraveling of the Impossible Balancing Act*

Despite the commendable policy shift reflected in Section 704(c)(1)(C), its practical effect is disastrous. As discussed, the enactment of Section 704(c)(1)(C) split the rules governing allocations attributable to contributed property into two fundamentally distinct allocation regimes. Section 704(c)(1)(A) and Section 704(c)(1)(C) have different theoretical bases and unique compliance requirements. Hence, these allocation regimes require separate administrative infrastructures. Simply put, Section 704(c)(1)(C) necessitates a foundational

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[131] Section 704(c)(1)(C)'s application, however, does result in a new distortion—the partners' aggregate outside basis in their partnership interests exceeds the partnership's aggregate inside basis in its property. After Blackacre's sale, A and B would have an aggregate outside basis of $475, but the partnership would have an aggregate inside basis of $450. The inside/outside basis mismatch results from the application of different allocation rules to different partners. The traditional rule of Section 704(c)(1)(A), including the ceiling rule, applies to the contributing partner, and Section 704(c)(1)(C) applies to the noncontributing partner. A remedial allocation to the contributing partner would solve this problem. Specifically, if the partnership made a remedial loss allocation to the contributing partner equal to the gain recognized by the noncontributing partner, such remedial allocation would eliminate the inside/outside basis disparity. As will be discussed *infra* note 143, the Section 704(c) Regulations do not permit a remedial allocation to the contributing partner under these circumstances. Thus, Treasury would have to authorize such remedial allocations through a revision of the Section 704(c) Regulations or the issuance of regulations under Section 704(c)(1)(C).

Interestingly, one of the primary objections to a literalist application of Section 704(c)(1)(C) is that such application results in this inside/outside basis disparity. Simmons, *supra* note 18, manuscript at 55 ("The inside/outside basis disparity created by this [literalist] analysis suggests that the result is not correct."). Specifically, the inside/outside basis disparity reflects the impermissible recognition of notional tax items by the noncontributing partner without a corresponding recognition of gain at the partnership level. *Id.* at 55-56. As will be discussed *infra* Part III.C.2, Congress has increasingly used notional allocations to prevent abuse and better align Subchapter K and the Substance Principle. Accordingly, a literalist application of Section 704(c)(1)(C) should not be rejected because it would result in the noncontributing partner recognizing notional tax gains. On the contrary, such notional tax allocations would eliminate the shifting of built in losses and, therefore, better align the rules governing allocations attributable to contributed property and the Substance Principle—at least with respect to the noncontributing partner.

transformation in the way that partnerships make allocations attributable to contributed property.

Prior to Section 704(c)(1)(C), contributed property allocations were governed exclusively by Section 704(c)(1)(A) and the Section 704(c) Regulations. Likewise, this Section 704(c)(1)(A) regime continues to govern the majority of such allocations, including allocations attributable to built in gain property and allocations related to built in loss property if made to the contributing partner.[132] Like much of Subchapter K, the Section 704(c)(1)(A) allocation regime strives to maximize partnership flexibility. To this end, Section 704(c)(1)(A) offers a partnership a choice of three different allocation methodologies—some simple, some more equitable—that it may select on a property-by-property basis.[133] Although all three methods share common roots in the traditional method subject to the ceiling rule, each allocation methodology is distinctive, possessing its own unique complexities and idiosyncrasies.[134] To state the obvious, the simultaneous application of three independent allocation methodologies, each the subject of highly technical regulations, is anything but simple.

Nonetheless, Congress enacted Section 704(c)(1)(C), thereby introducing an entirely foreign allocation regime into the already complicated world of Section 704(c). Despite its limited applicability, Section 704(c)(1)(C) requires the creation of a new regulatory framework. Unlike Section 704(c)(1)(A), Section 704(c)(1)(C) is anchored in the Substance Principle and treats a partnership contribution as a deferred taxable exchange. Accordingly, Section 704(c)(1)(C) necessarily requires a different administrative infrastructure to reflect its equity-based foundations and unique compliance requirements. Perhaps more challenging, Section 704(c)(1)(C) forces partnerships to adapt to a fundamentally different way of thinking about allocations attributable to contributed property—at least for the modest number of allocations to which Section 704(c)(1)(C) applies.

Viewed independently, Section 704(c)(1)(A) and Section 704(c)(1)(C) are both challenging provisions, each raising distinct administrative and complexity concerns. Taken together, Section

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132 In addition, reverse Section 704(c) allocations, discussed *supra* note 97, remain subject to Section 704(c)(1)(A).

133 Treas. Reg. § 1.704-3(a)(1), (2) (as amended in 2005).

134 All three of the allocation methodologies set forth in the Section 704(c) Regulations begin with the application of the traditional method subject to the ceiling rule. Indeed, the partnership's ability to make curative allocations or remedial allocations is only triggered by a noncontributing partner suffering a ceiling rule distortion. Treas. Reg. § 1.704-3(c)(1), (d)(1) (as amended in 2005). *See, e.g.*, Barksdale Hortenstine & Gregory J. Marich, *An Analysis of the Rules Governing Partnership Allocations with respect to Contributed Properties: The Final Regulations under Section 704(c)*, 581 PRAC. L. INST. TAX LAW AND ESTATE PLANNING COURSE HAND BOOK SERIES 1295, 1316 (2003) (describing the Section 704(c) Regulations as having "one horse in the barn", and identifying such "horse" as the traditional method subject to the ceiling rule). Notwithstanding these common roots, each allocation methodology has its own unique attributes. *See supra* note 121 for examples of such attributes.

704(c)(1)(A) and Section 704(c)(1)(C) elevate the complexity of Section 704(c) to critical levels. Simply put, the current bifurcated Section 704(c) allocation regime compromises the integrity of the rules governing allocations attributable to contributed property. And in doing so, it endangers the heart of Subchapter K—its allocation provisions.

Let me consider two arguments that might defend this bifurcated allocation regime. First, one might assert that the complexity of current law is overstated, particularly when technological advances are considered. Second, one might argue that Section 704(c)(1)(C)'s positive effect on equity and abuse prevention justifies the increased complexity resulting from its passage. As will be discussed, neither of these arguments is persuasive.

The first argument would maintain that modern partnerships are better equipped than their predecessors to handle Subchapter K's complexity, including the bifurcated Section 704(c) regime. As Subchapter K has grown increasingly complex, partnerships and technology have adapted. Programmers have developed sophisticated computer models that accomplish many of the computations and allocations, including Section 704(c) allocations, previously performed manually.[135] Thus, it is reasonable to conclude that the commercial environment will adapt to Section 704(c)(1)(C) and any regulations related thereto, and capable analysts will develop models that account for allocations governed by such rules.

Even so, the complexity of Subchapter K and the sophistication of partnerships are not the only variables that determine whether Section 704(c) remains viable. One must also consider the number of business entities subject to Subchapter K and the Internal Revenue Service's enforcement activities. And these later variables clearly demonstrate Section 704(c)'s fatal flaws.

In 1997, Treasury adopted the "check the box" regulations, which permit unincorporated business associations, such as limited liability companies, to elect whether to be taxed as corporations or as partnerships under Subchapter K.[136] Since that time, the number of entities electing to be taxed under Subchapter K has grown dramatically due primarily to the rise of the limited liability company.[137] Indeed, there has been explosive growth in the number of business entities electing to be treated as partnerships for federal income tax purposes, and this trend is expected to continue.[138]

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[135] *See* 1984 A.L.I. PROJECT, *supra* note 76, at 138; *see also* R. Donald Turlington, *Section 704(c) and Partnership Book-Tax Disparities, The Ceiling Rule and the Art of Tax Avoidance*, 46 INST. ON FED. TAX'N. 26, § 26.08 (1988).

[136] Treas. Reg. § 301.7701-2 (as amended in 2008); Treas. Reg. § 301.7701-3 (as amended in 2006).

[137] *See* sources cited *supra* note 5 and accompanying text.

[138] *See* sources cited *supra* note 5 and accompanying text.

In turn, as the number of entities subject to Subchapter K has increased, so too have the Service's enforcement needs. Historically, enforcement rates in Subchapter K have been extraordinarily low when compared to enforcement in other income tax contexts.[139] And this disparity has yet to be corrected, despite more than a decade of "check the box" and the resulting increase in the number of entities governed by Subchapter K.[140] There is, therefore, especially little reason to expect that the enforcement resources dedicated to Subchapter K will be sufficient to keep pace with the explosive growth in the number of entities electing to be treated as partnerships for federal income tax purposes.

Accordingly, Subchapter K is poised for a perfect storm. The dramatic increase in the number of entities electing to be taxed under Subchapter K and the lack of necessary enforcement resources has placed great stress on an already fragile system. Under these challenging circumstances, Section 704(c)(1)(C) is simply too much. The rules governing allocations attributable to contributed property cannot withstand the pressure of a bifurcated Section 704(c) allocation regime.

The second argument defending Section 704(c)(1)(C) would assert that the provision's additional complexity is justified by increased equity and decreased abuse. Yet because Section 704(c)(1)(C) applies to such a narrow universe of allocations, its benefits are necessarily limited. Section 704(c)(1)(C) only prevents abuse with respect to those allocations that fall within its modest parameters. Although Section 704(c)(1)(C) prevents loss shifting transactions, Section 704(c)(1)(C) fails to address the related problem of income shifting. Thus, an opportunistic partnership may continue to allocate precontribution gains so as to shift income among its partners.[141]

Additionally, Section 704(c)(1)(C) fails to provide comprehensive results consistent with the Substance Principle. Again, Section 704(c)(1)(C) does not govern allocations involving built in gain property and, therefore, such allocations are deprived of the benefit of the perfect alignment between Section 704(c)(1)(C) and the Substance Principle.[142]

Also, Section 704(c)(1)(C) denies partners contributing built in loss property an equitable result. Indeed, the tax consequences to a contributing partner are far less equitable today than prior to Section 704(c)(1)(C)'s enactment. A contributing partner no longer has the option to eliminate book/tax disparities attributable to built in loss property following the application of the ceiling rule. That is, a partner

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139 *See* sources cited *supra* note 6.

140 *See* sources cited *supra* note 6.

141 As discussed *supra* note 107, the Section 704(c) Regulations contain an anti-abuse rule. Accordingly, a partnership can only shift precontribution gains and losses to the extent that the underlying allocations do not violate this anti-abuse rule.

142 Additionally, Section 704(c)(1)(C) does not apply to reverse Section 704(c) allocations.

contributing built in loss property is currently denied the benefit of the alternative Section 704(c)(1)(A) allocation rules—the traditional method with curative allocations and the remedial allocation method—intended to cure ceiling rule distortions.[143] Accordingly, Section 704(c)(1)(C) affords a contributing partner less equity and less flexibility than such partner had under prior law.

Section 704(c)(1)(C)'s modest applicability invariably mitigates its beneficial impact on equity and abuse. Yet despite its limited applicability, Section 704(c)(1)(C) is a disaster from a complexity perspective. Thus, absent more definitive support for the proposition that Section 704(c)(1)(C)'s profoundly adverse effect on the complexity of Section 704(c) is outweighed by increases in equity and decreases in abuse, such proposition must fail. And Congress must reconsider the current bifurcated Section 704(c) allocation regime. If Subchapter K is to weather this perfect storm, Congress must fundamentally reform the rules governing allocations attributable to contributed property.

B. Shelter from the Storm: The Deferred Sales Method

In failure, however, Section 704(c)(1)(C) may have found its greatest success. Section 704(c)(1)(C) has devastated the rules governing allocations attributable to contributed property, and congressional action is urgently needed to salvage these rules. Indeed, repairing the damage caused by Section 704(c)(1)(C) may force Congress to make the choice between flexibility and the Substance Principle that it has skillfully avoided for more than fifty years. And this would be an extraordinary achievement, particularly for a provision as flawed as Section 704(c)(1)(C).

It is time for Congress to solve the problem of contributed property. To this end, Congress must choose the Substance Principle and

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[143] Under Section 704(c)(1)(C), a contributing partner's book/tax disparity cannot be remedied through the application of an alternative allocation methodology. Put another way, the traditional method with curative allocations and the remedial allocation method are no longer available to partners contributing built in loss property. Because Section 704(c)(1)(A) governs the partnership's allocations to the contributing partner, the Section 704(c) Regulations also apply. Under these regulations, the availability of the traditional method with curative allocations or the remedial allocation method hinges on the occurrence of one triggering event—a noncontributing partner developing a book/tax disparity. Treas. Reg. § 1.704-3(c)(1), (d)(1) (as amended in 2005). If the ceiling rule's application does not create a book/tax disparity for a noncontributing partner, the partnership may not make curative or remedial allocations to any partner, including the contributing partner. And herein lies the problem. Under Section 704(c)(1)(C), the noncontributing partner will always receive equal book and tax allocations and will never develop a book/tax disparity. Accordingly, the partnership will not have the ability to correct the contributing partner's lingering book/tax disparity through curative allocations or remedial allocations. Unless and until the contributing partner disposes of her partnership interest or the partnership liquidates, the contributing partner's book/tax disparity will remain. This problem could be solved through a revision of the Section 704(c) Regulations or the issuance of regulations under Section 704(c)(1)(C). Specifically, such regulations could permit the partnership to make a remedial allocation to the contributing partner to the extent necessary to eliminate any book/tax disparity remaining following the partnership's sale of the contributed property.

abandon flexibility. Congress must adopt the deferred sales method as the exclusive means of allocating all items attributable to contributed property.

1. The Adoption of the Deferred Sales Method

The deferred sales method would require partnerships to make all allocations attributable to contributed property in a manner entirely consistent with the Substance Principle.[144] Unlike current law, the deferred sales method would treat property contributions as taxable exchanges between the contributing partner and the partnership.[145] Notwithstanding this characterization, the contributing partner would recognize no gain or loss at contribution. Rather, such gain or loss would be deferred for future recognition and retained as the contributing partner's deferred sales amount. Consistent with exchange treatment, the partnership would take an inside basis in the contributed property equal to such property's fair market value at contribution.[146] Thus, any precontribution gain or loss would remain with the contributing partner, captured in her deferred sales amount. The contributing partner's initial outside basis in her partnership interest would be her basis in the contributed property prior to contribution.

The contributing partner would recognize the deferred sales amount when certain triggering events occur.[147] The partnership's disposition of the contributed property or the contributing partner's disposition of her partnership interest both would trigger the recognition of the deferred sales amount.[148] Similarly, the contributing partner would recognize the deferred sales amount on receipt of a distribution or on the partnership's distribution of the contributing property.[149]

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[144] *See supra* Part I.C.2.

[145] In addition, the deferred sales method would govern all reverse Section 704(c) allocations, which are discussed *supra* note 97.

[146] Hence, Section 723 would require amendment. As previously discussed, *supra* note 27 and accompanying text, Section 723 currently provides that the partnership's initial inside basis in contributed property equals such property's precontribution basis in the hands of the contributing partner.

[147] After the contributing partner's recognition of all or any portion of her deferred sales amount, such partner would have to adjust her outside basis to reflect the recognition of this amount. Accordingly, Congress would have to amend Section 705 to permit such adjustment.

[148] If the partnership disposed of the contributed property in a nonrecognition transaction, for example, in a like kind exchange under Section 1031, the contributing partner's recognition of the deferred sales amount would be deferred. The partnership would treat the property received in the nonrecognition transaction just like the contributed property. Accordingly, a subsequent disposition or distribution of such property would trigger the contributing partner's recognition of the deferred sales amount. *See* Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992). For a comprehensive discussion of the deferred sales method's application in various contexts, including like kind exchanges, see Cunningham & Cunningham, *supra* note 82, at 28-35.

[149] To some extent, distributions to the contributing partner would trigger only partial recognition of the deferred sales amount. If the cash or the distributed property's fair market value is less than the contributed property's fair market value at contribution, the distribution would not trigger recognition of the entire deferred sales amount. Rather, the contributing partner would

Also, the deferred sales method would affect the depreciation of contributed property. Because the contribution would be characterized as a taxable exchange between the partner and the partnership, the partnership would treat the contributed property as newly placed in service property.[150] Accordingly, the partnership would depreciate the contributed property using the appropriate methodology and a new recovery period.[151]

Throughout the property's recovery period, the contributing partner would incrementally recognize her deferred sales amount. The portion of the deferred sales amount recognized annually would be computed by reference to the partnership's inside basis in the contributed property. Specifically, the contributing partner would recognize a portion of the deferred sales amount proportionate to the amount of the partnership's initial inside basis recovered through its annual depreciation deduction.

The deferred sales method would successfully align the rules governing allocations attributable to contributed property and the Substance Principle. In so doing, the deferred sales method would solve the problem of contributed property. Because the deferred sales method would quarantine precontribution gains and losses with the contributing partner, such gains and losses would not be reflected in the partnership's inside basis in the contributed property. Accordingly, no precontribution gains or losses would shift from the contributing partner to the noncontributing partner, and no noncontributing partner would develop a

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recognize a portion of the deferred sales amount computed by reference to a hypothetical partial sale of the contributed property. Specifically, the amount of the deferred sales amount recognized would equal the amount of the contributed property's built in gain or loss that would have been recognized at contribution if the contributing partner had exchanged a portion of the contributed property for the cash or property ultimately distributed. Because of the variation in partnership distributions, a de minimis exception to this partial recognition rule may be appropriate. In addition, if the partnership distributed the contributed property to the contributing partner, the contributing partner would not recognize the deferred sales amount. On the contrary, her basis in the contributed property would be adjusted to reflect the deferred sales amount.

[150] Since the partnership would no longer follow a "step in the shoes" depreciation approach, Congress would have to amend Section 168(i)(7) to exclude partnership contributions from such approach.

[151] Although the deferred sales method would stretch depreciation deductions when compared to current law, a restarted recovery period is most consistent with the deferred sales method's characterization of the contribution as a taxable exchange. Further, to some extent, decelerating the depreciation of contributed property would eliminate a troublesome opportunity for tax-motivated behavior. *See* TIFD III-E, Inc. v. United States (*Castle Harbour)*, 459 F.3d 220, 225 (2d Cir. 2006). By contrast, as discussed *supra* note 115, Treasury proposed a bifurcated depreciation approach under the deferred sales method. *See* Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (Dec. 24, 1992). Indeed, the remedial allocation method currently follows this depreciation approach. Treas. Reg. § 1.704-3(d)(2) (as amended in 2005). Although the bifurcated depreciation approach is a reasonable compromise position, reflecting the hybrid nature of partnership contributions, a restarted recovery period would provide a better balance between equity, abuse prevention, and simplicity. For a detailed discussion, including helpful examples, of the tax consequences associated with the choice of recovery period, see Hortenstine & Marich, *supra* note 134, at 1360-66; Gregory J. Marich et al., *The Remedial Allocation Method: A Viable Cure for the Ceiling Rule*, 65 TAX NOTES 1267, 1272-75 (1994).

book/tax disparity. Further, the contributing partner's book/tax disparity would be eliminated when she recognized her deferred sales amount.

The deferred sales method would harmonize the rules governing allocations attributable to contributed property and the Substance Principle. Absent any additional benefits, this harmonization would adequately justify the deferred sales method's adoption. Even so, the deferred sales method would offer additional benefits no alternative allocation methodology can replicate. It would unify the rules governing allocations attributable to contributed property and streamline the rules governing allocations generally. Simply put, the deferred sales method would simplify Subchapter K.

2. The Simplification of Section 704(c)

The deferred sales method would dramatically simplify the rules governing allocations attributable to contributed property. The adoption of a unitary approach to Section 704(c) allocations would invariably alleviate the complexity of current law, where a partnership may simultaneously make contributed property allocations under four different rules. This simplification gain, however, is not unique to the deferred sales method. The transition to any uniform allocation methodology would ease the administrative and compliance burden of Section 704(c).

But the deferred sales method's impact beyond the boundaries of Section 704(c) is unique among the Section 704(c) allocation methodologies. By contrast to alternative methodologies, the simplification gains achieved by the deferred sales method produce a ripple effect throughout Subchapter K. Indeed, the deferred sales method would ameliorate the current complexity of Section 704 and, more broadly, Subchapter K.

3. The Simplification of Section 704

A distinctive benefit of the deferred sales method is its broader, synchronizing effect on Section 704, particularly the Section 704(b) general allocation rules. The deferred sales method would merge the rules governing allocations attributable to contributed property into the Section 704(b) substantial economic effect regime, thereby streamlining partnership allocations generally.

As discussed *supra*, partnership allocations will only be respected to the extent such allocations have substantial economic effect.[152] In turn, substantial economic effect requires that a partnership's tax allocations parallel its economic allocations. If a partnership cannot

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[152] *See supra* Part I.A.

make identical allocations for book and tax purposes following a taxable event, such tax allocations will not have substantial economic effect.

Herein lies the problem with contributed property. Because the treatment of a partnership contribution differs for capital account purposes and tax purposes, future taxable events do not result in equal book and tax allocations and, therefore, such tax allocations lack substantial economic effect. Indeed, in enacting Section 704(c), Congress's goal was to provide partnerships with guidance regarding these common allocations necessarily falling outside the substantial economic effect safe harbor.

The deferred sales method would solve the problem of contributed property and, thus, a partnership's contributed property allocations could have substantial economic effect. Unlike current law, the deferred sales method would treat a partnership contribution as a taxable exchange. In so doing, the contribution transaction would be treated consistently for capital account purposes and tax purposes.[153] When future taxable events occur, for example, a sale of the contributed property, the resulting book and tax consequences would be identical. Thus, such contributed property allocations would have substantial economic effect to the extent they otherwise comply with the requirements of the substantial economic effect safe harbor.

Simply put, the deferred sales method would permit a partnership to allocate items attributable to contributed property just like it allocates partnership items generally—under the Section 704(b) substantial economic effect rules. Synchronizing Section 704(c) and Section 704(b) would increase the uniformity of partnership allocations, thereby reducing the complexity of the Section 704 allocation rules. Of equal importance, Section 704's simplification would fortify the allocation provisions lying at the heart of Subchapter K.

4. The Simplification of Subchapter K

The deferred sales method's simplifying effect extends well beyond Section 704 and partnership allocations. Indeed, the deferred sales method would achieve a goal considered impossible by many. The deferred sales method would render obsolete a series of complex anti-abuse rules, referred to as the mixing bowl rules and the disguised sale rule. In so doing, these provisions would become the proper subject of congressional repeal, thereby streamlining Subchapter K.[154]

Each of these anti-abuse rules aims to prevent transactions capitalizing on the combination of partnership contributions and

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[153] Indeed, several commentators have noted that the deferred sales method would eliminate the need for partnerships to maintain separate books for tax and capital account purposes. *See* Cunningham & Cunningham, *supra* note 82, at 16.

[154] *See id.* at 22.

distributions. Like contributions, when a partnership makes a distribution, neither the partner nor the partnership typically recognizes a gain or loss.[155] Accordingly, throughout the years, opportunistic partnerships developed transactions combining contributions and distributions in order to avoid the recognition of income or loss attributable to contributed property. Congress responded by enacting three complex anti-abuse regimes intended to eliminate these transactions.

a. Avoidance Transaction #1: Income and Loss Shifting

Prior to the enactment of these anti-abuse regimes, a contributing partner could shift precontribution gains and losses, thereby avoiding recognition of such amounts, if she contributed property to the partnership and the partnership later distributed the property to another partner. To illustrate, consider the following Example 3. J and K formed an equal partnership with J contributing $500 cash and K contributing Orangeacre. At contribution, Orangeacre had a fair market value of $500 and a basis of $100. K recognized no gain at contribution, and her outside basis in her partnership interest was $100.[156] The partnership took an inside basis of $100 in Orangeacre, thereby preserving the property's $400 precontribution gain for future recognition.[157]

If the partnership distributed Orangeacre to J when the property's fair market value was $500, neither J nor the partnership would have recognized any gain.[158] J would have taken a $100 basis in Orangeacre, the partnership's inside basis in the property prior to distribution.[159] Orangeacre's $400 precontribution gain would have been preserved for future recognition, even though the property would have left the partnership. Indeed, the distribution would have shifted such $400 precontribution gain from K to J. K would have received the economic benefit of Orangeacre's appreciation at contribution, as reflected in her $500 capital account, but the distribution would have allowed K to avoid the tax burden of the corresponding $400 precontribution gain. J, rather than K, ultimately would have borne such tax burden, for example, following the property's sale.[160]

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155 I.R.C. § 731(a)-(b) (2006).

156 *Id.* §§ 721(a), 722.

157 *Id.* § 723.

158 *Id.* § 731(a)(1), (b).

159 *Id.* §§ 732(a)(1), 733. If a partnership distributes property to a partner, the partner takes a basis in the distributed property equal to the partnership's inside basis in such property immediately prior to distribution. The partner's outside basis is then reduced by the basis she takes in the distributed property.

160 Like many of the income and loss shifts discussed in this Article, this income shift would have been temporary and would have reversed itself following the liquidation of the partnership or J's disposition of her partnership interest. However, as discussed *supra* Part I.B.1, these shifts are incredibly problematic despite their temporary nature.

Congress enacted the Section 704(c)(1)(B) mixing bowl rule to curtail this transaction.[161] Under current law, if a partner contributes property to a partnership and the partnership later distributes the property to another partner, the contributing partner must recognize all or a portion of such property's precontribution gain or loss at distribution.[162] In so doing, the Section 704(c)(1)(B) mixing bowl rule prevents the shifting of many precontribution gains and losses. Section 704(c)(1)(B)'s application, however, has limitations. Most importantly, this mixing bowl rule only applies to property distributions occurring within seven years of such property's contribution to the partnership.[163]

b. Avoidance Transaction #2: Nonrecognition on Property Exchanges

Distributions also allowed partners to avoid the recognition of gain or loss on transactions that, in substance, constituted property exchanges. If a partner contributed property to a partnership and subsequently received a distribution of different property, the partner could achieve a result likely impossible outside the partnership—a tax-free property exchange.[164] To illustrate, reconsider Example 3. After formation, assume that the partnership purchased a baseball card for $500. If the partnership distributed the baseball card to K, no gain or loss would have been recognized, and K's basis in the baseball card would have been $100.[165] By using the partnership as a conduit, K effectively would have exchanged Orangeacre for the baseball card without recognizing Orangeacre's $400 built in gain. By contrast, if K would have exchanged Orangeacre and the baseball card directly, she would

[161] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7642, 103 Stat. 2106 (1989) (codified at I.R.C. § 704(c)(1)(B)). For a detailed discussion of the Section 704(c)(1)(B) mixing bowl rule, see MCKEE ET AL., *supra* note 12, ¶ 11.04[4].

[162] I.R.C. § 704(c)(1)(B)(i). If contributed property is distributed to a partner other than the contributing partner within seven years of its contribution, Section 704(c)(1)(B) requires the contributing partner to recognize a gain or loss. The gain or loss recognized is computed based on a hypothetical sale of the contributed property for its fair market value at the time of distribution. Specifically, the amount of gain or loss recognized equals the precontribution gain or loss that the contributed partner would have been allocated under Section 704(c)(1)(A) on such hypothetical sale. *Id.* To illustrate, consider the application of Section 704(c)(1)(B) to Example 3. Assuming the partnership distributes Orangeacre to J within seven years of contribution, K would recognize a $400 gain on the property's distribution. That is, the partnership would recognize $400 on the hypothetical sale of Orangeacre ($500 amount realized minus $100 inside basis), and allocate the entire gain to K under Section 704(c)(1)(A).

[163] I.R.C. § 704(c)(1)(B). Additionally, Section 704(c)(1)(B) does not necessarily require the contributing partner to recognize her entire precontribution gain or loss. As discussed *supra* note 162, the amount recognized by the contributing partner is determined based on a hypothetical sale of the contributed property at the time of distribution. If the contributed property's fair market value has changed since contribution, the partnership may not recognize the entire precontribution gain or loss.

[164] Property exchanges are generally subject to tax, but a taxpayer will not recognize gain or loss on certain nonrecognition transactions, for instance transactions qualifying as a like kind exchange under Section 1031.

[165] I.R.C. §§ 731(a)(1), (b), 732(a)(1), 733.

have recognized a $400 gain on Orangeacre's disposition ($500 amount realized minus $100 basis).[166] Accordingly, K would have avoided the recognition of Orangeacre's $400 built in gain by structuring her exchange as a contribution followed by a distribution.

Congress responded to this transaction by enacting the Section 707(a)(2)(B) disguised sale rule and the Section 737 mixing bowl rule.[167] Under current law, if a partnership distributes property to a partner that previously contributed property to the partnership, then, to some extent, such partner must recognize the amount of gain or loss that she would have recognized on a direct exchange of the contributed and distributed properties.[168] Like the Section 704(c)(1)(B) mixing bowl rule, these rules

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166 I.R.C. § 1001(a).

167 Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 73, 98 Stat. 494 (1984) (codified at I.R.C. § 707(a)(2)(B)); Energy Policy Act of 1992, Pub. L. No. 102-486, § 1937(a), 106 Stat. 2776 (1992) (codified at I.R.C. § 737).

168 I.R.C. §§ 707(a)(2)(B), 737(a). Section 707(a)(2)(B) provides that if (1) a partner contributes property to a partnership, (2) the partnership distributes cash or property to such partner in a related transaction, and, (3) taken together, such transfers are properly characterized as a sale, then such contribution and distribution will be treated as a sale between unrelated parties. *Id.* § 707(a)(2)(B). Section 707(a)(2)(B) treats the sale as occurring on the date that the partnership is considered to be the owner of the contributed property. Treas. Reg. § 1.707-3(a)(2) (1992). A contribution followed by a distribution will be treated as a sale if the partnership would not have made the distribution but for the partner's contribution of property, and to the extent the contribution and distribution do not occur simultaneously, the distribution is not dependent on the entrepreneurial risk of the partnership. *Id.* § 1.707-3(b)(1). This disguised sale determination is made based on all the facts and circumstances surrounding the transaction, and the Section 707(a)(2)(B) regulations contain a list of ten factors to be accounted for when making such determination. *Id.* § 1.707-3(b)(2). In addition, the Section 707(a)(2)(B) regulations contain two rebuttable presumptions regarding sale characterization. First, if the contribution and distribution occur within a two-year period, such transactions will be presumed to be a sale. *Id.* § 1.707-3(c)(1). Second, by contrast, if the contribution and distribution occur more than two years apart, such transactions will be presumed not to be a sale. *Id.* § 1.707-3(d). To illustrate consider Section 707(a)(2)(B)'s application to Example 3. If K contributed Orangeacre and, within a two-year period, the partnership distributed the baseball card to her, such transactions would be treated as a sale unless the facts and circumstances clearly established otherwise. Since the transactions are not simultaneous, K would be deemed to exchange Orangeacre for the partnership's obligation to transfer to her the baseball card in the future, and such sale would be deemed to occur on the date K contributed Orangeacre to the partnership. *Id.* § 1.707-3(b)(2), (f) ex. 3. For a detailed discussion of the Section 707(a)(2)(B) disguised sale rule, see generally MCKEE ET AL., *supra* note 12, ¶ 14.02[3][b].

The Section 737 mixing bowl rule requires a contributing partner to recognize a gain if she receives a distribution within seven years of her contribution. I.R.C. § 737(a), (b). Specifically, the contributing partner recognizes a gain equal to the lesser of: (1) the excess of the distributed property's fair market value plus any cash distributed over the contributed partner's outside basis and (2) the contributing partner's net precontribution gain. *Id.* § 737(a). The contributing partner's net precontribution gain equals the net gain that the contributing partner would recognize under the Section 704(c)(1)(B) mixing bowl rule if the partnership distributed all the property that such contributing partner had contributed to the partnership in the seven years preceding distribution. *Id.* § 737(b). For a discussion of the Section 704(c)(1)(B) mixing bowl rule, particularly the computation of any gains and losses recognized, see *supra* note 162. The Section 737 mixing bowl rule only applies to a transaction to the extent that the Section 707(a)(2)(B) disguised sale rule does not apply. To illustrate, assume that the partnership in Example 3 distributes the baseball card to K in the fifth year following Orangeacre's contribution. Under Section 737, K would recognize a $400 gain on such distribution. The excess of the baseball card's fair market value over K's outside basis equals $400 ($500 fair market value minus $100 outside basis), and K's net precontribution gain equals $400. For a detailed discussion of the Section 737 mixing bowl rule, see generally MCKEE ET AL., *supra* note 12, ¶ 19.08.

are imperfect solutions. Both the Section 707(a)(2)(B) disguised sale rule and the Section 737 mixing bowl rule expire after a period of years.[169] Further, the Section 737 mixing bowl rule fails to ensure that the contributing partner will recognize the contributed property's entire built in gain or loss following disposition.[170]

c. *Abuses Eliminated: The Deferred Sales Method*

The deferred sales method would eliminate these avoidance transactions, thereby rendering the foregoing anti-abuse rules extraneous. Accordingly, Congress could repeal the Section 704(c)(1)(B) and Section 737 mixing bowl rules and the Section 707(a)(2)(B) disguised sale rule.

As discussed, the deferred sales method would quarantine a contributing partner's precontribution gains or losses in her deferred sales amount.[171] Accordingly, the contributing partner, and only the contributing partner, would recognize such precontribution gains or losses. Put another way, a partnership could not shift built in gains or losses from the contributing partner to another partner through distributions and, therefore, the Section 704(c)(1)(B) mixing bowl rule would no longer be necessary.

The deferred sales method also would preclude avoidance transactions intended to disguise a property exchange. Under the deferred sales method, the contributing partner would recognize her deferred sales amount when she received a distribution or the partnership distributed the contributed property. Accordingly, distributions could no longer camouflage taxable property exchanges because they too would trigger recognition of the contributed property's built in gains or losses.[172] Because the contributing partner would recognize her deferred sales

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[169] As discussed *supra* note 168, the Section 707(a)(2)(B) disguised sale rule contains a two-year presumption regarding sale characterization and the Section 737 mixing bowl rule only applies to distributions occurring within seven years of a contribution. I.R.C. § 737(a), (b)(1); Treas. Reg. § 1.707-3(c), (d).

[170] The Section 737 mixing bowl rule only requires a contributing partner to recognize precontribution gains on a partnership distribution; it does not apply to precontribution losses. I.R.C. § 737(a). Even with respect to precontribution gains, this rule does not ensure that the contributing partner recognizes her entire precontribution gain. As discussed *supra* note 168, the contributing partner's recognized gain is the lesser of two amounts. The first amount is computed by reference to the contributing partner's outside basis, which may reflect amounts other than the contributed property. The second amount is computed by reference to the Section 704(c)(1)(B) mixing bowl rule. As discussed *supra* note 162, the Section 704(c)(1)(B) mixing bowl rule does not ensure that the contributing partner recognizes the property's entire precontribution gain.

[171] *See supra* Part II.B.1.

[172] As discussed *supra* note 149, a partner may only recognize a portion of her deferred sales amount following receipt of a distribution. However, this partial recognition does not affect the foregoing conclusion that the deferred sales method would provide a more comprehensive solution to these avoidance transactions. Indeed, if the contributing partner recognizes a portion of her deferred sales amount following a distribution, the amount recognized would be computed by reference to the amount of gain or loss that would have been recognized on a partial sale of the contributed property. Accordingly, even partial recognition of the deferred sales amount would properly address the concern underlying these avoidance transactions.

amount no later than a subsequent triggering distribution, the Section 707(a)(2)(B) disguised sale rule and the Section 737 mixing bowl rule no longer would be required to prevent these avoidance transactions.

The deferred sales method would require no supplemental anti-abuse rules to prevent the use of partnership contributions and distributions to avoid the recognition of precontribution gains and losses. Indeed, the deferred sales method would offer a more comprehensive means of combating these avoidance transactions than the mixing bowl and disguised sale rules. Unlike these provisions, the deferred sales method would not be subject to time restrictions or recognition limitations; any future distribution would trigger the contributing partner's recognition of the deferred sales amount.

Accordingly, Congress could repeal the Section 704(c)(1)(B) and Section 737 mixing bowl rules and the Section 707(a)(2)(B) disguised sales rule, thereby simplifying Subchapter K. The absence of these complex anti-abuse rules would increase administrability, promote compliance, and allow Treasury to redirect scarce enforcement resources to alternative areas of Subchapter K. Simply put, the deferred sales method would transform Subchapter K into a more harmonious and less complex system of taxation.[173] And the deferred sales method is unique in this respect. No other Section 704(c) allocation methodology offers Subchapter K these rewards.

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[173] The deferred sales method would also streamline the Section 754 election regime, discussed in greater detail *infra* notes 184-191, particularly the computation of the Section 743(b) special basis adjustment. When a partner purchases a partnership interest, the partnership generally does not adjust the inside basis of its property to reflect such transaction. I.R.C. § 743(a). However, if a partnership has a Section 754 election in effect, the partnership must adjust the inside basis of its property following a partner's sale of her partnership interest. *Id.* § 743(b). Additionally, Congress amended these rules in 2004 to require a partnership to make a Section 743(b) special basis adjustment if the partnership has a substantial built in loss following the sale of a partnership interest. *Id.* § 743(b), (d) (providing that a partnership has a substantial built in loss if the basis of its property exceeds such property's fair market value by more than $250,000). The Section 743(b) special basis adjustment aims to provide the purchaser of a partnership interest with a cost basis in her share of the partnership's property. The partnership computes the Section 743(b) special basis adjustment based on a series of computations, the most important of which is a hypothetical sale of all of the partnership's assets at fair market value in a fully taxable transaction. Treas. Reg. § 1.743-1(d)(2) (as amended in 2004). The partnership must then allocate such hypothetical gains and losses to the purchasing partner. *Id.* § 1.743-1(d)(1)(ii), (iii). Like any sale, hypothetical or otherwise, Section 704(c) must be accounted for in allocating these gains and losses. *Id.* § 1.743-1(d)(1), (3) ex. 2. Under current law, a partnership may simultaneously have to apply four allocation methodologies with respect to contributed property, and a different methodology for the remaining allocations. By contrast, if Congress adopted the deferred sales method, a partnership would allocate all gains and losses, whether attributable to contributed or non-contributed property, under the general Section 704(b) allocation rule. Given the legendary complexity of the Section 754 regime and its recent expansion, the streamlining of the Section 743(b) special basis adjustment's computation through the application of a unitary allocation rule would represent a welcome and significant step towards the simplification of Subchapter K. For a detailed discussion of the Section 743(b) special basis adjustment, see generally MCKEE ET AL., *supra* note 12, ¶ 24.02; *see also* Marich & McKee, *supra* note 82, at 686-90.

III. THE HISTORICAL CHALLENGES TO THE DEFERRED SALES METHOD

Throughout the years, Congress and commentators alike have carefully considered, but rejected, the deferred sales method.[174] Congress and many commentators objected to the deferred sales method because of its reliance on asset valuation and perceived complexity. Moreover, some commentators feared that the deferred sales method would erode the nonrecognition principles underlying partnership contributions.

Although one could debate whether any of the foregoing objections should have been persuasive when Section 704(c)'s reform was previously considered, these objections are not persuasive today. Concerns regarding valuation, complexity, and nonrecognition do not present insurmountable obstacles to the adoption of the deferred sales method. Indeed, none of these historic objections provides a compelling argument against the adoption of the deferred sales method, particularly when considered in light of the current Section 704(c) crisis.

A. Valuation

As discussed *supra*, the deferred sales method's dependence on asset valuation troubled the A.L.I. in 1984.[175] Unlike other allocation methodologies, the deferred sales method would require the partnership to determine the fair market value of all contributed property. The A.L.I. feared that this requirement would prove burdensome to many partnerships and would allow sophisticated partnerships additional opportunities for strategic behavior.[176]

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[174] *See* T.D. 8501, 1994-1 C.B. 191 (finalized by T.D. 8585, 60 Fed. Reg. 11,906); 1984 A.L.I. PROJECT, *supra* note 76, at 129; Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 120-23. Nonetheless, many commentators have recommended the deferred sales method's adoption. *See* 1985 NYSBA COMMENTS, *supra* note 77 (recommending that any regulations issued under Section 704(c) permit taxpayers to use the deferred sales method); Karen Burke, *Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations*, 63 IND. L. J. 489, 532 (1988) (proposing adoption of deferred sales method, but only in conjunction with reform of the rules governing partnership distributions); Cunningham & Cunningham, *supra* note 82, at 13-14; Marich & McKee, *supra* note 82, at 636; Turlington, *supra* note 135, ¶ 26.08 (supporting the repeal of the ceiling rule).

[175] *Supra* Part I.C.4; *see also* 1985 NYSBA COMMENTS, *supra* note 77 ("The Committee is concerned by the requirement of section 704(c) that each asset be valued where it is contributed to a partnership, even when tax avoidance is unlikely."); Steines, *supra* note 82, at 670.

[176] 1984 A.L.I. PROJECT, *supra* note 76, at 131-36. The A.L.I. raised several valuation objections to the deferred sales method. First, the deferred sales method's valuation requirement could affect the relative tax burden of the partners, and the partners might not anticipate this result if they were otherwise indifferent to valuation. To illustrate, assume two individuals organize a partnership with each contributing property. The partners agree that the properties are of equal value, but they do not establish a value for such properties. Rather, the partners agree that the value of the two properties falls within a certain range. One of the contributed properties is rental property, and the partnership expects such property to generate a fixed amount of annual income without regard to its valuation. Although such income is expected to remain constant, the tax burden of such fixed income under the deferred sales method will vary depending on the valuation of the contributed property. Specifically, as the valuation increases, so too does the partnership's depreciation and the

Although the A.L.I. found this valuation argument compelling, it no longer remains so. Without regard to contributed property, valuation plays a critical role in partnership allocations. Since the issuance of the Section 704(b) substantial economic effect regulations in 1983, valuation has come to permeate the infrastructure of Section 704.[177] For instance, the rules governing capital account maintenance, which a partnership must satisfy in order to establish the substantial economic effect of its allocations, require that a partnership record all property in the relevant partner's capital account at its fair market value at contribution.[178]

More generally, valuation is integral to the proper alignment of Subchapter K and the Substance Principle. If the tax consequences of an investment must parallel the corresponding economic consequences of such investment, as the Substance Principle commands, Subchapter K must adopt a benchmark measure of economic investment. Fair market value, as reflected in the partners' capital accounts, is the natural choice.

B. Complexity

Throughout the years, complexity has been a formidable obstacle to the deferred sales method's adoption. Indeed, many commentators believed that the deferred sales method was too complicated for most partnerships.[179] Yet, as will be discussed, the deferred sales method's similarities to current law and the ongoing crisis in Section 704(c) have rendered these complexity objections wholly unpersuasive.

Early opponents of the deferred sales method believed that the requirement that a partnership maintain separate sets of financial records

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contributing partner's deferred sales amount. Accordingly, the contributing partner would bear a larger share of the rental property's income. Put another way, although the partnership's fixed income remains constant, the distribution of such income between the partners will change based on the contributed property's valuation. Second, the deferred sales method's valuation requirement creates opportunities for abusive behavior. If the partnership's valuation of the contributed property is presumed correct, the partnership may inflate or deflate such value to achieve a tax-advantaged result. For instance, the deferred sales method may create an incentive to inflate the fair market value of contributed property in order to obtain increased depreciation deductions. While the potential certainly exists, such opportunities exist any time a partnership, or any taxpayer, acquires property. Indeed, concerns regarding the opportunistic use of valuation are not unique to partnership allocations or to Subchapter K. Abuses related to improper valuation arise in numerous contexts throughout the federal tax system and the deferred sales method's adoption should not be rejected simply because it presents an opportunity for abuse endemic to the federal income tax system.

177 For a discussion of the substantial economic effect safe harbor, see *supra* notes 13-14 and accompanying text. *See also* Burke, *supra* note 174, at 530; Turlington, *supra* note 135, § 26.08.

178 Treas. Reg. § 1.704-1(b)(2)(iv)(d) (as amended in 2008).

179 *See, e.g.*, Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 122-23; 1984 A.L.I. PROJECT, *supra* note 76, at 136-38; 1994 NYSBA COMMENTS, *supra* note 115 ("The deferred sales method had the potential to be quite complex, and it raised a number of difficult questions relating to the proper treatment of contributed property that is subsequently disposed of by the partnership in a nonrecognition transaction."); DCBA COMMENTS, *supra* note 115 ("[W]e believe that the deferred sale method is far too complex and full of traps for the unwary to be required for use by all partnerships.").

was overly cumbersome.[180] However, like the valuation concerns previously discussed, the issuance of the Section 704(b) substantial economic effect regulations in 1983 effectively mooted this objection.[181]

More recent criticisms have focused on the deferred sales method's administrative and compliance challenges, particularly those related to the deferred sales amount.[182] Commentators believed that the deferred sales amount imposed unique administrative obligations on partnerships and their partners. For instance, the deferred sales method would require partnerships to monitor the deferred sales amount annually to determine whether a triggering event, including depreciation, had occurred. If such an event had occurred, a series of secondary issues would then require consideration: computing the portion of the deferred sales amount recognized, adjusting the contributing partner's outside basis, and reporting any recognized gains or losses. In addition, commentators questioned who would be primarily responsible for complying with these requirements—the partnership or the contributing partner. These commentators believed that Subchapter K's existing complexity presented sufficient challenges to partnerships, but any shift of the compliance burden from the partnership to the contributing partner also would be undesirable.[183]

Contrary to these commentators' views, however, the deferred sales method's most novel feature—the deferred sales amount—has significant roots in Subchapter K. In many respects, the deferred sales amount parallels the Section 743(b) special basis adjustment, and, as will be discussed, this shared sensibility would eliminate many of the complexity objections to the deferred sales method. Indeed, Subchapter K's extensive experience with Section 743(b) refutes the objection that the deferred sales method would present new challenges for partnership taxation.

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180 Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 122. The A.L.I. in 1954 was so intent on avoiding multiple sets of books that it proposed that partnerships make contributed property allocations under the transference of basis approach, discussed *supra* note 51. In support of its recommendation, the A.L.I. cited anecdotal evidence regarding taxpayer compliance with and government enforcement of the modified partial deferred sales method applied in General Counsel Memorandum 10092, discussed *supra* note 77. Specifically, the A.L.I. noted that both taxpayers and revenue agents found partial deferred sales method difficult to comprehend and, therefore, rarely followed the rules as specified in the memorandum.

181 *See supra* note 177 and accompanying text; *see also* Turlington, *supra* note 135, § 26.08.

182 *See, e.g.*, 1984 A.L.I. PROJECT, *supra* note 76, at 136; 1994 NYSBA COMMENTS, *supra* note 115 ("The remedial method represents an innovative solution to those problems. It also should result in a higher compliance level than the deferred sale method, since all relevant tax items presumably will be reflected on the Schedule K-1s prepared by the partnership (as opposed to the deferred sale method under which the individual partners would have had to ascertain the tax consequences to them outside the partnership)."); DCBA COMMENTS, *supra* note 115 (expressing strong reservations regarding the deferred sales method's use by unsophisticated partnerships).

183 *See* 1994 NYSBA COMMENTS, *supra* note 115 (expressing reservations regarding the wisdom of shifting any compliance burden from the partnership to the partners).

In certain circumstances, the Section 743(b) special basis adjustment allows a partner purchasing a partnership interest to adjust her basis in the partnership's property to more properly reflect such property's fair market value at the time of the purchase transaction.[184] Put another way, the Section 743(b) special basis adjustment provides the purchasing partner additional basis in the partnership's property that, when added to or subtracted from her share of the partnership's inside basis, is intended to give her a cost basis in such property.[185] The purchasing partner's special basis adjustment equals the difference between her outside basis and her share of the partnership's inside basis in its property.[186] This aggregate special basis adjustment is then allocated among the partnership's property and, hence, the purchasing partner has a Section 743(b) special basis adjustment in each item of partnership property.[187]

When a taxable event occurs with respect to the partnership's property, the purchasing partner determines her tax consequences by accounting for the portion of the Section 743(b) special basis adjustment allocated to such property. To illustrate, if a partnership sold property and allocated the resulting tax gain between its partners, a purchasing partner with a positive Section 743(b) special basis adjustment attributable to the sold property would reduce her recognized gain by such special basis adjustment.[188]

The Section 743(b) special basis adjustment only affects the purchasing partner's tax consequences. Otherwise, the special basis adjustment is invisible to the partnership.[189] Nonetheless, the partnership has primary responsibility for compliance with Section 743(b).[190] To this

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184 I.R.C. § 743(b) (2006). As discussed *supra* note 173, the Section 743(b) special basis adjustment does not apply to all purchasing partners. Rather, purchasing partners adjust their basis in the partnership's property under Section 743(b) in two situations. The first is when the partnership has previously made a Section 754 election or will make such election for the taxable year of purchase. The second is when the partnership's property has a significant built in loss at the time the partnership interest is purchased.

185 I.R.C. § 743(b)(1)-(2). The Section 743(b) special basis adjustment can be either positive or negative, depending on the changes in value of the partnership's property. If, in the aggregate, the properties' value has increased, the Section 743(b) special basis adjustment is positive. By contrast, if such properties' value has decreased, the Section 743(b) special basis adjustment is negative.

186 For a more detailed discussion of the computation of the Section 743(b) special basis adjustment, see *supra* note 173.

187 *Infra* note 214 and accompanying text.

188 Treas. Reg. § 1.743-1(j)(3)-(4) (as amended in 2004).

189 Treas. Reg. § 1.743-1(j)(1) (as amended in 2004).

190 Treas. Reg. § 1.743-1(k)(1)(i) (as amended in 2004). Following the sale of a partnership interest, the partnership must attach to its tax return for the year of transfer a statement including the following information: the name of the purchasing partner, the computation of the Section 743(b) special basis adjustment, and the partnership properties to which the Section 743(b) special basis adjustment is allocated. Additionally, the purchasing partner is required to notify the partnership of the sale within thirty days of its completion. Treas. Reg. § 1.743-1(k)(2)(i) (as amended in 2004). If the purchasing partner fails to provide such notice, the partnership is not required to make the Section 743(b) special basis adjustment or comply with the foregoing reporting requirements until the purchasing partner provides the required notice or the partner responsible for

end, the partnership identifies triggering events, determines the resulting tax consequences, and reports such information to the purchasing partner.[191]

The deferred sales amount shares much in common with the Section 743(b) special basis adjustment. Similar taxable events, including dispositions and depreciation, trigger the deferred sales amount and the Section 743(b) special basis adjustment. Once triggered, both the deferred sales amount and the Section 743(b) special basis adjustment are personal to the relevant partner. Neither mechanism has any effect on the partnership or the other partners. Further, the deferred sales amount and the special basis adjustment raise parallel bookkeeping and compliance concerns. Thus, it would be easy for Treasury to follow the model adopted by Section 743(b) when drafting the deferred sales method's compliance rules.

Simply put, the feature of the deferred sales method typically at the center of complexity objections—the deferred sales amount—is not unique. On the contrary, the deferred sales amount strongly resembles the Section 743(b) special basis adjustment. Accordingly, Subchapter K's considerable experience with Section 743(b) moots many commentators' complexity objections to the deferred sales method.[192]

More generally, complexity objections to the deferred sales method are more nostalgic than substantive. Each time Congress or commentators have considered the deferred sales method, they invariably have conceded that the federal income tax system, particularly Subchapter K, has grown increasingly complex.[193] This admission is even truer today. Accordingly, concerns about the deferred sales method's

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federal income tax reporting has knowledge of the transfer. Treas. Reg. § 1.743-1(k)(4) (as amended in 2004).

[191] The instructions for Form 1065 provide that "[i]f the basis of partnership property has been adjusted for a transferee partner under section 743(b), the partnership must adjust the transferee's distributive share of the items of partnership income, deduction, gain, or loss in accordance with Regulations section 1.743-1(j)(3) and (4)." Instructions to U.S. Return of Partnership Income, Form 1065, 9 (2008), http://www.irs.gov/pub/irs-pdf/i1065.pdf. "These adjustments . . . must be reported on Schedule K and the transferee partner's Schedule K-1." *Id.*

[192] In addition, the deferred sales method would not disrupt Section 704(c)'s current theoretical balance between the aggregate and entity theories of partnerships. As discussed *supra* note 58, current law reflects a blend of aggregate and entity principles. The foundational rule that a partnership should allocate items attributable to contributed property in a manner sensitive to their precontribution or postcontribution nature is fundamentally an aggregate principle. Yet the ceiling rule infuses entity principles into Section 704(c). Similarly, the deferred sales method is a hybrid of aggregate and entity principles, as discussed *supra* note 80. It applies an entity approach to partnership contributions, but requires partnerships to allocate items according to aggregate principles.

[193] *See, e.g.*, 1984 A.L.I. PROJECT, *supra* note 76, at 138 (admitting that the complexity that was viewed as overwhelming in 1954 may no longer be so extreme); Burke, *supra*, note 174, at 530; Marich & McKee, *supra* note 82, at 686 (noting that even though the deferred sales method was "once considered unduly complex," such method would serve as the "tonic" for the truly complex sections of Subchapter K); Turlington, *supra* note 135 ("Simplicity as an objective of Section 704 is a policy goal long since abandoned. One need only read the Regulations under Section 704(b) and ponder the Treasury's continuing difficulties promulgating Regulations under Section 704(c) to reach that conclusion.").

complexity are no longer persuasive and should not prevent congressional reform of the rules governing allocations attributable to contributed property.

Indeed, complexity is one of the most compelling reasons to adopt the deferred sales method. As discussed *supra*, the current Section 704(c) regime suffers from matchless complexity.[194] And the deferred sales method offers Congress an invaluable opportunity to simplify partnership allocations and, more broadly, Subchapter K.

C. Erosion of the Nonrecognition Regime Governing Contributions

Throughout Subchapter K's history, nonrecognition principles have governed partnership contributions.[195] Precontribution gains and losses are preserved for future recognition, but the contributing partner recognizes no gain or loss at the time of contribution.[196] Two theories support this nonrecognition. The first is a belief that the contributing partner's underlying investment is continuing, albeit in a changed form.[197] Accordingly, recognition of any precontribution gains or losses at contribution would be inappropriate. The second is a concern that the contributing partner's immediate recognition of precontribution gains or losses would deter partnership contributions.[198]

Because the deferred sales method might accelerate the recognition of precontribution gains and losses in certain circumstances, commentators have argued that the method would impermissibly erode the nonrecognition principles governing partnership contributions.[199] In so arguing, these commentators have focused principally on two aspects of the deferred sales method. First, the deferred sales method would expand the universe of events triggering recognition of the contributing partner's built in gain or loss to include partnership distributions and the

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[194] *See supra* Part II.A. Indeed, Section 704(c)(1)(C) raises many issues subject to similar complexity objections. Thus, the deferred sales method's rejection would not necessarily reduce the technical issues facing Treasury. For a discussion of these issues, see Jones, *supra* note 123; Rachuba, *supra* note 123.

[195] *See, e.g.*, Helvering v. Walbridge, 70 F.2d 683, 684 (2d Cir. 1934); I.R.S. Gen. Couns. Mem. 10,092, *supra* note 77.

[196] For a more detailed discussion of the consequences of a partnership contribution, see *supra* Part I.A.

[197] *See* Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 120.

[198] *Id.*; *see also* Cunningham & Cunningham, *supra* note 82, at 4; Lokken, *Future Without Subchapter K*, *supra* note 6, at 276.

[199] *See, e.g.*, DCBA COMMENTS, *supra* note 115 (noting that the deferred sales method would conflict with the deferral regime of Section 721 because it requires a partnership to recognize gain or loss following an expanded list of taxable events); Jackson et al., *1954 A.L.I. Project*, *supra* note 50, at 122-23; Marich & Hortenstine, *supra* note 134, at 1238 ("One must not overlook the fact that the repeal of the Ceiling Rule (or even a relaxation of such rule through an anti-abuse rule) is not simply the elimination of a regulatory rule of convenience—it is a substantial erosion of Sections 703, 721, 722 and 723."); Marich & McKee, *supra* note 82, at 651; Steines, *supra* note 82, at 654-55; Turlington, *supra* note 135.

depreciation of contributed property.[200] Second, the deferred sales method would require partners to recognize notional gains or losses not actually recognized by the partnership.[201] As discussed *supra*, the deferred sales method effectively would divide the partnership's recognized gains or losses into their component parts: the contributing partner's deferred sales amount would reflect the precontribution component of such net gains or losses, and the remainder would reflect the postcontribution component.[202] Thus, the gains or losses ultimately recorded on a partner's income tax return would differ from the amount recognized by the partnership.

Although the deferred sales method might accelerate the recognition of some precontribution gains or losses when compared to current law, this acceleration would not erode the nonrecognition rule governing partnership contributions. Thus, as will be discussed, erosion objections to the deferred sales method fail.[203]

1. Interpretive Questions

The erosion objection has several interpretive flaws that belie its conclusion regarding partnership contributions. First, the deferred sales method would not violate the literal language of Section 721, which contains the nonrecognition rule governing partnership contributions. Under this provision, no gain or loss is recognized on the contribution of property to a partnership in exchange for a partnership interest. Put another way, Section 721 only grants nonrecognition treatment to the contribution transaction itself. The statute is silent on the timing of and triggers for the future recognition of such precontribution gains and losses. Consistent with Section 721, the deferred sales method would not require the recognition of any built in gains or losses at contribution. Accordingly, the deferred sales method would not conflict with the statutory nonrecognition rule governing partnership contributions.[204]

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[200] *See, e.g.*, DCBA COMMENTS, *supra* note 115 (concluding that the deferred sales method "undermines this deferral regime by requiring that deferred gain or loss be triggered by events that do not include the partnership selling or exchanging the contributed property or by the partner selling or exchanging its partnership interest"); Turlington, *supra* note 135. Under current law, the contributing partner typically recognizes her precontribution gains or losses following the partnership's sale of the contributed property or her sale of her partnership interest.

[201] *See, e.g.*, Turlington, *supra* note 135.

[202] *See supra* Part I.C.2.

[203] Taken one step further, one might question whether the erosion of the nonrecognition rule governing partnership contributions is even undesirable. Indeed, several commentators have advocated the elimination of the nonrecognition rules applicable to partnership contributions. *See* David R. Keyser, *A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation*, 5 AM. J. TAX POL'Y 269 (1986); Phillip F. Postlewaite, Thomas E. Dutton & Kurt R. Magette, *A Critique of the A.L.I.'s Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423, 470-73 (1986).

[204] *See* Turlington, *supra* note 135.

Second, the deferred sales method would not impugn any of the rationales supporting the nonrecognition of gains and losses on partnership contributions. As discussed, a contributing partner would not recognize precontribution gains or losses at the time of contribution under the deferred sales method. Thus, the deferred sales method would not compromise either of the rationales underlying nonrecognition—continuity of investment and deterrence.

Lastly, the deferred sales method would not accelerate the recognition of precontribution gains and losses when compared to the general rules governing property exchanges. On the contrary, the deferred sales method would defer the recognition of such amounts. Although the deferred sales method might result in the accelerated recognition of some built in gains and losses when compared to current law, Subchapter K's nonrecognition rules are not the proper baseline for comparison. Nonrecognition itself is an exception to the foundational tax principle that exchanges of property are taxable events.[205] Absent Section 721, partnership contributions would be subject to this general rule just like any other property transaction. Against this baseline, the deferred sales method would act as a deferral mechanism because it would not require the recognition of built in gains and losses at contribution. Indeed, the deferred sales method would perpetuate, rather than frustrate, the historic, tax-advantaged nature of partnership contributions.

The deferred sales method would be consistent with the literal language of Section 721 and the rationales supporting its nonrecognition rule. In addition, the deferred sales method would continue to offer partners a deferral benefit when compared to the general rules governing property exchanges. Thus, the erosion objection invariably fails.

2. The Erosion of the Nonrecognition Rule

However, even if one disregards the foundational flaws of the erosion objection and considers its substantive merits, the conclusion remains unchanged—–the erosion objection is not persuasive. Congress has long since eroded the nonrecognition rules governing partnership contributions. The deferred sales method simply represents the natural culmination of decades of congressional activity that has previously eroded this nonrecognition regime. The features of the deferred sales method perennially challenged by its opponents—the use of notional allocations and the expanded list of events triggering recognition of the deferred sales amount—are not new to Subchapter K. Rather, they are familiar tools that Congress has increasingly wielded in order to prevent abuse and better align Subchapter K and the Substance Principle.

The current Section 704(c) allocation regime, for example, already includes both of these features. The remedial allocation method

[205] I.R.C. § 1001(c) (2006); Treas. Reg § 1.1001-1(a) (as amended in 2007).

eliminates ceiling rule distortions through offsetting notional allocations to the noncontributing and contributing partners.[206] Further, the remedial allocation method requires the incremental recognition of precontribution gains attributable to depreciable property, thereby expanding the universe of events triggering recognition of such precontribution amounts.[207]

More importantly, Section 704(c)(1)(C) itself reflects a congressional willingness to erode Subchapter K's nonrecognition rules. To illustrate, Section 704(c)(1)(C) requires a partnership to take an inside basis in contributed built in loss property equal to such property's fair market value at contribution for purposes of making allocations to the noncontributing partner.[208] Under this inside basis rule, the noncontributing partner recognizes amounts that differ from the amount actually recognized by the partnership.[209] Accordingly, Section 704(c)(1)(C) uses notional allocations to prevent the shifting of precontribution losses.[210]

Beyond Section 704(c)'s parameters, Congress similarly has enacted provisions that include features challenged by the deferred sales method's opponents. As discussed, the Section 704(c)(1)(B) and Section 737 mixing bowl rules and the Section 707(a)(2)(B) disguised sale rule require the contributing partner to recognize her precontribution gains or losses following certain partnership distributions.[211] Thus, these anti-abuse rules already have expanded the universe of transactions triggering recognition of precontribution gains and losses to include partnership distributions.

In addition, the Section 743(b) special basis adjustment relies on notional allocations to more equitably reflect the consequences of a purchase of a partnership interest. As discussed, Section 743(b) permits a purchasing partner to adjust her basis in the partnership's property in order to give her a basis in such property that better reflects such property's fair market value at the time she became a partner.[212] To this end, the partnership computes the purchasing partner's aggregate Section 743(b) special basis adjustment, and such amount is then allocated among the partnership's property under rules set forth in Section 755 and

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[206] *See supra* notes 117-118 and accompanying text.

[207] Treas. Reg. § 1.704-3(d)(1), (7) Example 1 (as amended in 2005).

[208] *See supra* note 126 and accompanying text.

[209] *See supra* Part I.E.

[210] As discussed *supra* note 131, one of the principle objections to a literalist interpretation of Section 704(c)(1)(C) is that such interpretation would require the noncontributing partner to recognize notional tax gains not actually recognized by the partnership. Simmons, *supra* note 18, manuscript at 55.

[211] *See supra* notes 162, 168 and accompanying text.

[212] For a general discussion of the Section 743(b) special basis adjustment, see *supra* notes 184-188 and accompanying text.

its corresponding regulations.[213] Like the deferred sales method, these Section 755 allocation rules follow a netting approach. Indeed, the aggregate Section 743(b) special basis adjustment is broken into its component gains and losses, and such components are allocated among the partnership's property.[214]

Notwithstanding Congress's increased willingness to limit the nonrecognition regime governing partnership contributions, one might argue that the deferred sales method still would represent a significant escalation in such congressional activity. The deferred sales method would be a mandatory allocation rule applicable to all contributed property. By contrast, the foregoing provisions are either elective at the partnership's option or targeted anti-abuse provisions subject to expiration after a period of years.[215] Even Section 704(c)(1)(C), which is mandatory when triggered, only applies to a limited universe of contributed property allocations.[216]

Although the deferred sales method's scope would be broader than prior congressional action, the deferred sales method would not represent an escalation in efforts to curtail nonrecognition. Throughout

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[213] Treas. Reg. § 1.743-1(b), (e) (as amended in 2004); *id.* § 1.755-1(b). For a discussion of the Section 743(b) special basis adjustment's computation, see *supra* note 173.

[214] *Id.* § 1.755-1(b)(1), (2)(ii) ex. 1. Section 755 and its corresponding regulations govern the allocation of the Section 743(b) special basis adjustment among the partnership's property. Since 1998, the Section 755 regulations require a partnership to apply a netting approach when allocating the Section 743(b) special basis adjustment among its property. Prop. Treas. Reg. § 1.755-1, 63 Fed. Reg. 4408 (Jan. 29, 1998). Treasury recognized that some partnership assets may have appreciated while others may have depreciated and, therefore, the Section 743(b) special basis adjustment should be broken into its component parts in order to more properly reflect the built in gains or losses existing at the time the purchasing partner acquires her partnership interest. As a result, the portion of the special basis adjustment allocated to a partnership asset may reflect either a positive or negative adjustment, so long as the sum of the adjustments equals the aggregate Section 743(b) special basis adjustment. Treasury adopted this netting approach under Section 755 for a familiar reason—the Substance Principle. Simply put, separating the Section 743(b) special basis adjustment into its component parts better aligned the tax and economic consequences attributable to a purchasing partner's investment in the partnership. Indeed, Treasury noted in the preamble to the proposed Section 755 regulations that

> [u]nder the current regulations, the partnership may not increase the basis of assets that have a fair market value in excess of basis and, at the same time, decrease the basis of assets that have a basis in excess of fair market value. Thus, if the Section 743(b) adjustment is positive, the partnership may only increase the basis of assets that have a basis that is less than their fair market value. This restriction prevents the partnership from adjusting the basis of its assets in a manner that coordinates a transferee's tax consequences with its economic consequences. The proposed regulations remove this restriction.

Id.; *see also* Gergen, *supra* note 7, at 360; Lokken, *As the World Turns*, *supra* note 7, at 371. For a detailed discussion of the Section 755 allocation rules, see MCKEE ET AL., *supra* note 12, ¶ 24.04.

[215] The remedial allocation method is an elective means of addressing ceiling rule distortions. Treas. Reg. § 1.704-3(d)(1) (as amended in 2005). Further, as discussed *supra* note 173, the Section 743(b) special basis adjustment is generally elective. The Section 704(c)(1)(B) and Section 737 mixing bowl rules and the Section 704(c)(2)(A) disguised sale rule are all mandatory anti-abuse rules. Nonetheless, each of these rules is subject to expiration following a period of years. See *supra* notes 125 & 168 for each provision's expiration date.

[216] *See supra* note 125 and accompanying text.

the years, Congress gradually has eroded the nonrecognition regime governing partnership contributions through reforms intended to prevent abuse and reintroduce the Substance Principle to Subchapter K.[217] The deferred sales method is simply the next step in this evolution. Indeed, without regard to the fate of the deferred sales method, the nonrecognition rules governing partnership contributions have been, and will remain, compromised. Accordingly, erosion objections are especially unpersuasive and should not influence Congress's consideration of the deferred sales method.

IV. CONCLUSION

Section 704(c) no longer works. It is time for Congress to enact fundamental reform of the rules governing allocations attributable to contributed property by adopting the deferred sales method. It is time for the Substance Principle to reign supreme within Section 704(c).

In fairness, Section 704(c) has never worked well. The balance it strikes between flexibility and the Substance Principle has always been problematic, never amounting to more than an uneasy truce between irreconcilable ideals. And the cost of Congress's attempts to reconcile flexibility and the Substance Principle has been incredibly high. Maximizing partnership choice through multiple, elective allocation rules has increased complexity and opportunities for abuse throughout Subchapter K. Equally troubling, this balancing act has placed significant

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[217] As discussed *supra* note 80, the deferred sales method is entirely consistent with the balance between the aggregate and entity theories of partnerships currently reflected in Section 704(c). Indeed, Congress has increasingly used this hybrid theoretical approach to prevent abuse and promote the Substance Principle. For instance, Section 704(c)(1)(C) reflects both aggregate and entity principles. Section 704(c)(1)(C)'s underlying allocation rule adopts the aggregate theory, but its treatment of the contribution transaction for purposes of the noncontributing partner follows the entity theory.

It is interesting to note that recent changes to the rules governing corporate contributions similarly blend aggregate and entity principles. The rules governing corporate contributions, like most of Subchapter C, follow an entity theory of taxation and treat a corporation as an entity separate and distinct from its shareholders. Unlike partnerships, corporations need not strive to allocate precontribution gains and losses to the contribution shareholder. Rather, corporations themselves are subject to tax on such amounts. However, Section 362(e)(2) infused aggregate principles into this entity-based contribution regime in order to prevent certain loss duplicating transactions similar to those spurring Section 704(c)(1)(C)'s enactment in 2004, discussed *supra* note 123. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 836(a), 188 Stat. 1418 (2004) (codified at I.R.C. § 362(e)). When a shareholder contributes property to a corporation in a transaction qualifying for nonrecognition treatment under Section 351, the corporation typically takes a basis in the contributed property equal to the shareholder's basis in such property prior to the contribution. I.R.C. § 362(a) (2006). However, Section 362(e)(2)(A) provides an alternative rule if the corporation's aggregate basis in the contributed property exceeds the aggregate fair market value of such property. Specifically, in these instances, the corporation's aggregate basis in the contributed property shall not exceed the fair market value of such property. Consistent with the aggregate theory, this provision seeks to link a built in loss to the contributing shareholder and ensure that such shareholder, and not the corporation, receives the tax benefit of such precontribution loss.

strain on the allocations provisions that operate as the lifeblood of Subchapter K.

Despite its fragile foundations, however, Section 704(c) has proven itself to be surprisingly durable. Nonetheless, it would be a mistake to assume that the rules governing allocations attributable to contributed property are capable of withstanding all challenges. And Congress made precisely this mistake when it enacted Section 704(c)(1)(C) in 2004.

Section 704(c)(1)(C) introduced unsustainable complexity into Section 704(c) at a time when external pressures were already jeopardizing the allocation regime's continued viability. The explosive growth of business entities electing to be treated as partnerships for federal income tax purposes and the insufficient enforcement resources dedicated to Subchapter K have placed incredible stress on Subchapter K. Section 704(c)(1)(C)'s enactment significantly exacerbated this stress, and Subchapter K is now poised for a perfect storm.

But this may be Section 704(c)(1)(C)'s saving grace. The disastrous effect of Section 704(c)(1)(C) requires congressional reconsideration of the rules governing allocations attributable to contributed property. Indeed, Section 704(c)(1)(C)'s failure compels Congress to answer the question it has skillfully avoided for decades. The time has come for Congress to decide what lies at the heart of Subchapter K flexibility or the Substance Principle.

To some extent, Congress has already answered this question. Throughout the years, Congress has enacted various statutory provisions that better align Subchapter K and the Substance Principle. Section 704(c)(1)(C) itself reflects Congress's increased willingness to sacrifice flexibility in order to further compliance with the Substance Principle.

Now Congress must take the next step. Congress must adopt the deferred sales method as the sole means of allocating items attributable to contributed property. In so doing, Congress would solve the problem of contributed property and solidify Section 704(c)'s commitment to the Substance Principle. The deferred sales method would dramatically reduce the abuses that have plagued Section 704(c) and streamline partnership allocations. Indeed, the deferred sales method would do the impossible. The deferred sales method would simplify Subchapter K. Simply put, the deferred sales method would save Subchapter K from itself.