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SPECIAL REPORT
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Revaluations in Upper-Tier Partnerships — An Alternative Approach

by Robert Burke

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In this report, Burke argues that the two most commonly suggested approaches for dealing with revaluations of the assets and capital accounts of an upper-tier partnership can produce inappropriate results, and he suggests an alternative approach.

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I. Introduction

Section 704(c)(1)(A) is a seemingly modest provision. It requires that:

> income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the 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.

Over the last three decades, the principles underlying this code section have slowly but surely wound their way throughout the entirety of subchapter K. For a provision that for the first 30 years of its existence was entirely elective and applied only to actual contributions of assets in kind to a partnership, its principles now apply in a dizzying array of circumstances and are the subject of multiple additional code provisions, several sets of final regulations, at least three sets of proposed regulations, and one set of temporary regulations. Together, these rules present an intricate mathematical maze that only a few tax advisers who specialize in subchapter K have any hope of navigating.

This report focuses on just one of the more convoluted circumstances in which the rules apply — how the principles of section 704(c)(1)(A) apply in revaluations of assets of an upper-tier partnership (UTP) under reg. section 1.704-1(b)(2)(iv)(*f*) or (*s*).[1] The primary objective is to assist the uninitiated (or partially initiated) in applying the section 704(c) principles in this context by demonstrating the limitations and distortions caused by the two commonly discussed approaches (the aggregate approach and the entity approach[2]) and suggesting an alternative approach that could avoid or minimize those limitations and distortions. Under the alternative approach, a revaluation of the assets of a UTP to the extent attributable to an interest in a lower-tier partnership (LTP) would give rise to notional adjustments at the LTP level that are similar to the basis adjustments that occur under section 743, but would be used to track the tax consequences associated with the built-in gain/loss attributable to the assets of the LTP to the extent that they were reflected in the capital accounts of the UTP in the revaluation. This

[1] These revaluations are commonly referred to as "book-ups" (regardless of whether they are up or down).

[2] *See* Notice 2009-70, 2009-34 IRB 255.

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approach will be referred to as the "look-through approach."

The motive for introducing the look-through approach is not simply to describe a better mousetrap. The motive is to propose a workable alternative because, as described later, the aggregate approach and the entity approach simply do not work appropriately in many circumstances. The entity approach creates unacceptable distortions in the tax consequences to the partners in the UTP except in very limited circumstances, such as when the LTP holds only one nondepreciable asset. The aggregate approach, although arguably better than the entity approach, can cause significant distortions in both the economic and tax arrangements of the partners of the LTP. Thus, mandating its use (as was done in the proposed section 751(b) regulations[3]) is wholly inappropriate in many, if not most, circumstances. On the other hand, making it elective (as has been proposed[4]) makes sense only if there is a reasonable alternative, and the entity approach typically is not.

II. Fundamentals of Revaluations

To understand many of the issues involved in revaluations at UTPs, it is first necessary to understand the tax and economic consequences associated with any revaluation of the assets and capital accounts of a partnership. That in turn requires a basic understanding of the rules under section 704(b) regarding general allocations of profits and losses in a partnership, and the rules under section 704(c)(1)(A) regarding allocations of the tax consequences associated with built-in gain and built-in loss attributable to property contributed in kind to a partnership.

This report assumes that the reader has at least a basic understanding of those rules. Still, an overview may be helpful to ensure a common understanding of the mechanics of the rules and the likely theory underlying them. Moreover, a more detailed understanding of how these rules work in a revaluation is essential to understanding the problems that arise in trying to apply them to revaluations by a UTP.

A. The Rules

1. Section 704(b).

In substance, section 704(b) provides that a partner's distributive share of the income, gain, loss, and deduction of a partnership is determined in accordance with the partnership agreement if the allocation of those items has substantial economic effect.[5] Otherwise, it will be determined in accordance with the partner's interest in the partnership.[6] Reg. section 1.704-1 breaks the requirement that the allocations have substantial economic effect into two separate requirements: (1) the allocation must have economic effect, and (2) the economic effect must be substantial. The requirement that the economic effect of the allocations be substantial is both beyond the scope of this report and of relatively little relevance to the rest of the discussion. Accordingly, it will be ignored.

Under the regulations, for an allocation to have economic effect, the partnership agreement must require that: (1) capital accounts be maintained in accordance with the regulations; (2) liquidating distributions be made in accordance with the positive capital account balances of the partners; and (3) a partner with a deficit balance in his capital account upon liquidation of the partnership be obligated to contribute the amount of that deficit to the partnership (a deficit restoration obligation).[7] Alternatively, the deficit restoration obligation can be eliminated (or limited) if (1) a partner is not allocated losses that would cause or increase a deficit balance in his capital account in excess of any limited deficit restoration obligation he may have and (2) the partnership agreement includes a qualified income offset (generally requiring an allocation of gross income to any partner to the extent that the partner's capital account becomes more negative

[3] Prop. reg. sections 1.704-1(b)(2)(iv)(*f*) and 1.751-1(b)(2)(iv); REG-151416-06, *amended by* 80 F.R. 3926 (Jan. 26, 2015). Temporary regulations under section 721(c) also contain a quasi-mandatory use of the aggregate approach in some circumstances, which taxpayers can disregard, but at the cost of causing any built-in gain attributable to property contributed to the partnership to be recognized if the partnership (1) has a direct or indirect foreign partner related to the contributor and (2) is controlled by the contributor and its affiliates.

[4] Prop. reg. section 1.704-1(b)(2)(iv)(*f*), issued as part of the proposed section 751(b) regulations.

[5] Section 704(b)(2).

[6] Section 704(b).

[7] Reg. section 1.704-1(b)(2)(ii)(*b*).

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than the partner's limited deficit restoration obligation as a result of certain unexpected events).[8] This latter approach is generally referred to as the "alternate economic effect test," and is much more frequently reflected in partnership agreements than is the general test.

Finally, reg. section 1.704-1(b)(2)(ii)(i) provides that allocations will be deemed to have economic effect if they would produce the same economic result as would compliance with the general economic effect test. This provision is referred to as the "economic effect equivalence test." Although there conceivably could be many approaches that meet this test, the general approach that tax advisers believe (or at least hope) meets this test is to set forth in the applicable partnership agreement the economic sharing arrangement between/among the partners and then provide that allocations of income and loss are to be made so that the partners' respective capital account balances align with the amounts they would receive if the partnership sold all its assets at their book values (so no additional income or loss would be realized) and liquidated.[9] The key difference between this test and the other two is that the partners' capital account balances do not control the economic sharing among the partners.[10]

The central component of any set of allocation provisions in a partnership agreement intended to meet (or deemed to meet) the economic effect requirement of the regulations is a partner's capital account. Although there are fairly extensive rules regarding how capital accounts are to be maintained, in general they are increased by contributions and allocations of income and gain, and decreased by distributions and allocations of losses and deductions. As can be seen from the method used to determine capital accounts, a partner's capital account is simply the partner's individual share of the equity account on the partnership's balance sheet. Because under the general economic effect test and the alternate economic effect test the partner will receive an amount equal to his capital account balance upon liquidation of the partnership, the economic effect rules generally ensure that each allocation of profit or loss to the partner will result in a dollar-for-dollar change in what the partner will receive from the partnership no later than upon liquidation of the partnership. In contrast, although the economic effect equivalence test also tries to align the partners' economic sharing with the amounts of income or loss allocated to them, those allocations do not affect the economic sharing arrangement.

Because the purpose of the rules under section 704(b) is to ensure that the allocations of income and loss are valid for federal income tax purposes, it comes as no surprise that the income and loss allocated to the partners in determining their capital accounts are generally determined using federal income tax principles. However, because under the general economic effect test and the alternate economic effect test the capital account balances will ultimately affect the economic sharing arrangement among the partners, the regulations appropriately depart from strict adherence to income tax principles in some circumstances.

For example, the regulations acknowledge that upon a contribution of property in kind by a partner, the partner's capital account should be credited with an amount equal to the fair market value of the contributed property (even though the partnership generally would take the property with a carryover tax basis from the contributing partner) because the partners' economic sharing arrangement will be based on that FMV rather than the somewhat arbitrary amount of the tax basis of the property. In these circumstances, the regulations use the FMV of the property at the time of its contribution as a surrogate for its adjusted tax basis. This surrogate is referred to as the "book value" of the property. It is used in determining the amounts of subsequent gain, loss, and depreciation/amortization attributable to the property that are allocated to the partners'

[8] Reg. section 1.704-1(b)(2)(ii)(*d*).

[9] This approach for trying to comply with the economic effect equivalence test is generally referred to as "target balance allocations."

[10] It is unclear whether revaluations are allowable for partnerships that comply with the economic effect equivalence test because the capital account balances do not affect the economic sharing among the partners. As a result, the general rationale for allowing revaluations discussed later would not apply. Further, reg. section 1.704-1(b)(2)(iv)(*f*) requires that a revaluation be done "principally for a substantial non-tax business purpose." I believe that revaluations should be allowable as long as the tax consequences are not materially different from what they would have been had the partnership complied with either the general economic effect test or the alternate economic effect test, because the capital accounts are still useful in keeping track of cumulative allocations of income and loss among the partners.

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capital accounts, and it is adjusted in the same manner as is a property's adjusted tax basis (for example, it is reduced by depreciation deductions computed by reference to the property's book value).[11]

Because the difference between a property's book value and its tax basis has not been recognized for federal income tax purposes, the items of gain, loss, and deduction based on the property's book value are not the amounts currently includable in the partners' taxable income (or loss). Those amounts continue to be computed based on the property's tax basis, and, as discussed later, it is the job of section 704(c) to essentially translate the amounts of income, loss, and deduction determined with reference to the book value of the partnership's assets into the appropriate amount of those items determined with reference to the tax basis of the assets so that they can be properly reflected on the individual partners' tax returns. To distinguish items determined with reference to the book value of a property from items determined with reference to the tax basis of a property (which are relevant under section 704(c)), allocations of income and loss (and items thereof) computed with reference to the book value of property are commonly referred to as allocations of "book income" or "book loss," and capital accounts maintained with reference to book values are referred to as "book capital accounts."

The other significant section of the regulations that allows the allocations of profits and losses to be affected by the FMV of the partnership's property is reg. section 1.704-1(b)(2)(iv)(*f*).[12] Under that provision, a partnership may elect upon the occurrence of specified events to adjust the book values of its assets to their gross FMVs and to adjust the capital account balances of the partners to reflect the amount of gain or loss that would be allocated to them if all the partnership's assets were sold for their FMVs.[13] It is this mark-to-market adjustment that is commonly referred to as a "revaluation" or "book-up" of capital accounts.

Importantly, although revaluations cause the book values of the partnership's assets and the capital accounts of the partners to be adjusted, they are not realization events for computing taxable gain or loss. Accordingly, the tax basis of the assets and the capital accounts of the partners computed for tax purposes (that is, solely using realized items of income and loss) does not change as a result of a revaluation. However, because the book values of the partnership's assets have been adjusted to their FMVs and the capital accounts of the partners reflect the amount of those adjustments, the regulations under section 704(b) provide that revaluations will be allowed only if (1) subsequent allocations of gain, loss, depreciation, etc. for capital account maintenance purposes (book purposes) are based on the book values of the partnership's assets (rather than their tax bases); and (2) the allocations of those items for tax purposes (that are based on the assets' tax bases rather than book values) are done "in the same manner as under section 704(c)."[14]

As mentioned, under the existing regulations, revaluations are allowed only upon the occurrence of specified events. With the exception of a special rule for some investment partnerships (hedge funds) and a new rule in temporary regulations under section 721(c) (applicable to some transfers of property with built-in gain to partnerships with related foreign partners[15]), the only events that allow a partnership to elect to revalue its assets and capital accounts are:

1. a contribution to the partnership of more than a de minimis amount of money or

[11] The use of the term "book value" in the regulations is somewhat unfortunate because it has connotations of generally accepted accounting principles (or similar financial accounting principles). To avoid confusing the concepts, drafters of partnership agreements often refer to the "book value" as used in the section 704(b) regulations as "carrying value" or "gross asset value." Because GAAP and other financial accounting terminology are irrelevant to the discussion in this report, references to "book value" herein will be to the section 704(b) concept.

[12] Reg. section 1.704-1(b)(2)(iv)(*s*) also allows allocations to be based on the FMVs of the partnership's assets as a result of the exercise of specified noncompensatory options. Because that regulation incorporates, in relevant part, the procedures in reg. section 1.704-1(b)(2)(iv)(*f*), for ease of reference, this report generally just refers to reg. section 1.704-1(b)(2)(iv)(*f*).

[13] Any adjustment to the book values of the partnership's assets will require this type of corresponding adjustment to the partners' capital accounts so that the partnership's balance sheet for book purposes continues to balance.

[14] Reg. sections 1.704-1(b)(2)(iv)(*f*) and 1.704-1(b)(2)(iv)(*s*). *See also* reg. section 1.704-1(b)(4)(i), which likewise contains the "in the same manner as" language.

[15] T.D. 9814 (the temporary section 721(c) regulations).

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property in return for an interest in the partnership;
2. a liquidation of the partnership or a distribution of more than a de minimis amount of money or other property by the partnership as consideration for an interest in the partnership;
3. a grant of an interest (other than a de minimis interest) in the partnership in consideration for the provision of services to or for the benefit of the partnership;
4. in connection with the issuance by the partnership of a noncompensatory option (other than for a de minimis partnership interest); and
5. upon the exercise of a noncompensatory option issued by the partnership.[16]

The five revaluation events share a common characteristic: They all are events that change the economic sharing arrangement among the partners in a manner that would make reliance on capital accounts that reflect only realized gains and losses to determine the economic interests of the partners inconsistent with the new sharing arrangement.

Example 1: Assume Partner A and Partner B are equal partners in a partnership that complies with the requirements of the alternate economic effect test, each having a capital account balance of $100. The partnership has one asset with a tax basis of $200 and an FMV of $400. Partner C is admitted to the partnership as an equal one-third partner in return for a contribution of $200. Giving C a capital account balance of $200 while leaving the capital account balances of A and B at $100 would not properly reflect the desired equal sharing of the partnership's economics. If no revaluation occurred and the partnership sold its asset for its tax basis of $200 and distributed $400 (that is, the $200 sale proceeds plus the $200 contributed by C) to the partners in liquidation based on their capital account balances, C would receive $200 rather than $133 (that is, $400/3) and A and B would each receive only $100. Similarly, if C were never admitted to the partnership but the partnership redeemed half of B's interest in the partnership for $100, having capital accounts of $100 for A and $0 for B would not properly reflect their revised sharing arrangement of two-thirds to one-third.

As Example 1 demonstrates, because the capital accounts will ultimately affect the economic arrangement among the partners, failure to adjust them in the described circumstances to reflect the FMVs of the partnership's assets would (or at least could) distort the economic sharing arrangement among the partners. Therefore, to prevent the tax tail from wagging the economic dog, the regulations allow the partners to revalue their capital accounts to reflect the FMVs of the partnership's assets.[17]

The proposed section 751(b) regulations, issued in November 2014, would add two more elective revaluation events: (1) agreements to change (other than a de minimis change) the manner in which the partners share any item or class of items of income, gain, loss, deduction, or credit of the partnership under the partnership agreement; and (2) a revaluation by either a UTP or an LTP.[18] Although not entirely clear from the language used in the proposed regulations, the first of these events presumably is limited to changes that cause the method for sharing future tax items to differ from the manner in which existing unrealized items are shared (a recapitalization), and, as such, is consistent with

[16] Reg. section 1.704-1(b)(2)(iv)(*f*) and (*s*).

[17] Because the capital accounts do not affect the economic sharing arrangement among the partners under the economic effect equivalence test, the rationale for allowing revaluation is less clear, and they may not be allowed. *See supra* note 10.

[18] The proposed section 751(b) regulations would also make revaluations mandatory for (1) partnerships that distribute money or property (other than a de minimis amount) to a partner as consideration for an interest in a partnership if the partnership owns (directly or through an LTP) section 751 hot assets immediately after the distribution, and for (2) LTPs that own section 751 hot assets if the same persons own (directly or indirectly) more than 50 percent of the capital and profits interests in the LTP and the UTP and the UTP distributes cash or property (other than a de minimis amount) to a partner as consideration for an interest in the UTP. Similarly, the temporary section 721(c) regulations effectively require revaluations of the assets of LTPs in certain circumstances. I believe these mandatory revaluations, presumably motivated by the IRS's desire to permanently lock in the partners' respective shares of gain/loss attributable to specific assets, are inappropriate in many circumstances (being inconsistent with the principals of subchapter K), may distort the economic sharing arrangement among partners, and will inflict an enormous compliance burden on many partnerships in which no distortion of the partners' respective tax burdens occurs. A comprehensive critique of the proposed section 751(b) regulations and the temporary section 721(c) regulations is beyond the scope of this report, but the potential distortion to the tax and economic sharing arrangement of the partners will be demonstrated later.

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the rationale for the five existing revaluation events of preventing the tax rules from affecting the economic deal among the partners.

However, the second of these events — a revaluation by either a UTP or an LTP — is a radical departure from all other existing or proposed revaluation events. Unlike those other events, a revaluation by either a UTP or an LTP does not involve any change in the economic sharing arrangement among the partners of the other partnership. In a revaluation by a UTP, the rationale for allowing the LTP to undertake a revaluation is presumably to allow the UTP to track the consequences of its revaluation to the particular assets of the LTP that accounted for the appreciation or depreciation that was reflected in the UTP's revaluation. Although that tracking may be a laudable goal, as we will see, making the LTP's revaluation elective likely would invite abuse if the only alternative were to use the entity approach, which would typically create significant distortions in the sharing of income and loss among the partners of the UTP.

Although the historic motivation for allowing revaluations presumably has been to prevent the economic effect requirements of the section 704(b) regulations from distorting the economic arrangement among the partners, as is discussed in greater detail later, in many circumstances revaluations can actually cause economic distortions. Moreover, in most circumstances they affect subsequent allocations of taxable income and loss among the partners because some or all of those allocations will be made using section 704(c) principles rather than the rules of section 704(b).

Although the application of section 704(c) principles can be quite complicated, the basic concept behind them is straightforward: Revaluations cause the unrealized appreciation or depreciation in the partnership's assets to be allocated to the partners and reflected in their capital accounts before its actual realization, and some mechanism is necessary to make sure that when the tax items associated with the unrealized appreciation or depreciation are ultimately realized for federal income tax purposes, they are allocated to the partners that previously had their capital accounts adjusted for them. It is this function that the section 704(b) regulations indicate must be done "in the same manner as under section 704(c)."

Before turning to a discussion of section 704(c), one further observation regarding revaluation events should be highlighted, because it will be relevant later. Generally, existing revaluation events involve more than just a change in the economic sharing arrangement among the partners. A transfer of a portion of a partner's interest in a partnership to a third party would certainly change the economic sharing arrangement, but it is not, and conceptually should not be, a revaluation event because failing to revalue the capital accounts would not distort the new economic sharing arrangement. The capital account balances of the partners would be consistent with the new sharing arrangement as long as an appropriate portion of the capital account of the transferor partner is transferred to the transferee partner. Thus, revaluation events have historically been limited to transactions that (1) occur between the partnership and one or more of its partners and (2) are undertaken based on (or taking into account) the values of the partnership's assets (or the partner's interest in the partnership), because it is only those transactions that will cause the non-revalued capital accounts to not properly reflect a revised economic sharing arrangement.

Although the mandatory revaluations under the proposed section 751(b) regulations[19] possibly can be justified as an antiavoidance provision, the elective revaluation proposals applicable to UTPs and LTPs under those regulations seem to lack any compelling rationale and, as discussed later, are likely to cause distortions in either or both the tax and economic sharing arrangements among the partners of the LTP.

2. Section 704(c).

Section 704(c)(1)(A)[20] deals with specific allocations of income and loss attributable to property contributed in kind by a partner. Generally, contributions to a partnership by a partner of property in kind are tax free under section 721 and result in the partnership having a

[19] *See supra* note 18.

[20] Unless otherwise specified, all references to "section 704(c)" will be to section 704(c)(1)(A).

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carryover tax basis for the property based on the contributing partner's tax basis.[21] As a result, contributions of appreciated or depreciated property to a partnership will result in the partnership holding assets with built-in gain or built-in loss. Because allowing (or requiring) the noncontributing partners to be allocated a share of the taxable gain/loss attributable to that built-in gain/loss when realized would clearly be inappropriate, section 704(c) generally requires that the tax consequences attributable to the built-in gain/loss be allocated solely to the contributing partner.[22]

The applicable regulations provide that those allocations can be made using any reasonable method that is consistent with the general purpose of section 704(c).[23] They then describe three methods that generally will be considered reasonable. The approach taken under each of the three methods is to allocate to the extent possible items of taxable income, gain, loss, and deduction to the noncontributing partners equal to the amounts of those items they would have been allocated had the tax basis of the contributed property equaled its book value (its FMV) at the time of contribution. Any additional amounts of those items are then allocated to the contributor. Because the noncontributing partners are generally allocated tax items equal to their allocable shares of the corresponding book items, this approach is often referred to as the "tax follows book" approach.[24] Also, because the only differences between the relevant tax items and book items are those attributable to using the book value of the property rather than its tax basis, the only items affected are those normally computed using the tax basis of the property — that is, gain and loss from dispositions of the property and depreciation deductions[25] — often referred to as "basis derivative items."[26]

The three methods sanctioned by the section 704(c) regulations differ only in how they deal with situations in which the amount of actual tax gain or loss on disposition of the contributed asset or the amount of annual depreciation deductions for the contributed asset is insufficient to put the noncontributing partners in the same positions they would have been in had the contributed property had a tax basis equal to its FMV at the time of its contribution (that is, its book value). Under the first method, referred to as the "traditional method," the noncontributing partners are allocated realized gain, loss, and depreciation deductions for tax purposes up to the amount of the comparable book items allocated to them under the section 704(b) rules.[27] If there is insufficient tax gain, loss, or depreciation to accomplish this objective, the noncontributing partners will be allocated only the amount of the tax items that exist. The requirement under the traditional method that the tax allocations to the noncontributing partners be limited to the actual amount of tax items realized during the year for the contributed property is referred to as the "ceiling rule."[28]

The second and third endorsed methods differ from the traditional method only in how they deal with the ceiling rule.[29] Under the second method — the traditional method with curative allocations — noncontributing partners faced with a ceiling rule limitation for an allocation of gain, loss, or depreciation are allocated similar items from other sources within the partnership up to the amount of the shortfall.[30]

[21] Section 723.

[22] Section 704(c)(1)(C), as added by the American Jobs Creation Act of 2004, contains special rules dealing with contributions of property with built-in losses. Because those provisions seemingly apply only to actual contributions to partnerships and not to revaluations, they will be ignored here.

[23] Reg. section 1.704-3(a)(1).

[24] *See* William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, para. 11.04[1] (4th ed. 2007).

[25] References to "depreciation" should be read to include amortization.

[26] *See, e.g.*, Gary R. Huffman and Barksdale Hortenstine, "Tiers in Your Eyes: Peeling Back the Layers of Tiered Partnerships," 86 *Taxes* 179, 212 (Mar. 2008). Section 704(c), accordingly, is often thought of as a set of rules for allocating tax basis among partners. Although such an analytical approach is helpful in understanding the application of section 704(c) in many circumstances, it can be misleading in others. *See* McKee, Nelson, and Whitmire, *supra* note 24, at para. 11.04[1].

[27] Reg. section 1.704-3(b).

[28] Reg. section 1.704-3(b)(1).

[29] Because the remedial method changes the period over which the book deductions for depreciation can be claimed, it can cause a ceiling rule limitation that would not have existed had the traditional method or the traditional method with curative allocations been used.

[30] Reg. section 1.704-3(c).

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Under the third method — the remedial allocation method — any shortfall in the amount of gain, loss, or depreciation allocated to the noncontributing partners as a result of the ceiling rule causes a notional item of the same type to be created and allocated to the noncontributing partners to effectively eliminate the ceiling rule limitation. A corresponding amount of an offsetting notional item is allocated to the contributing partner.[31] For example, if the allocation of tax depreciation to a noncontributing partner is limited under the ceiling rule, the remedial method would create a notional item in the nature of depreciation that would be allocated to the noncontributing partner, and a corresponding amount of income would be created and allocated to the contributing partner. Note that the created items of income and deduction are notional only in the sense that they are not actually realized by the partnership, but they are real items of income and deduction that must be included in the relevant partners' taxable income.

Because any built-in gain/loss associated with contributed property has already been included in the book value of the property in determining profits and losses under section 704(b), as discussed earlier, the associated tax items when realized and allocated to the partners under section 704(c) are not separately reflected in the partners' book capital accounts to avoid double counting.[32]

Section 704(c) by its terms is applicable only to contributions of property in kind to a partnership. However, as discussed earlier, if a partnership elects to revalue its assets and capital accounts under reg. section 1.704-1(b)(2)(iv)(*f*), it is required to account for the differences between the tax bases and the book values of the booked-up assets "in the same manner as under section 704(c)." Because these allocations are based not on book-tax differences that exist for contributed property but on revalued property already held by the partnership, they are commonly referred to as "reverse section 704(c) allocations." Allocations made under section 704(c) for contributed property are generally referred to as "forward section 704(c) allocations."

B. The Consequences

As previously mentioned, revaluations under reg. section 1.704-1(b)(2)(iv)(*f*) are elective.[33] Although they are sometimes thought of as mere accounting adjustments, they can (and typically do) have significant economic and/or tax consequences that should be carefully considered before one decides to make the election. For purposes of the following discussion, unless otherwise indicated, it is assumed that all partnerships have partnership agreements that comply with the alternate economic effect test.

1. Economic consequences.

As discussed earlier, the likely rationale for allowing partnerships to undergo revaluations is that in situations in which capital accounts affect the economic sharing among the partners, capital accounts that reflect only realized income and loss can distort the economic deal following an event that changes the economic sharing arrangement. Accordingly, it should come as no surprise that a revaluation can, and often does, affect the economic sharing arrangement. What is perhaps the simplest case in which a revaluation can affect the economic sharing among the partners can be demonstrated by the following slightly expanded version of Example 1.

Example 2: Partner A and Partner B form a partnership, with each contributing $100. The partnership buys nondepreciable real estate for $200. When the real estate has appreciated in value to $400, Partner C contributes $200 to the partnership in return for a one-third interest. The partners do not elect to revalue the capital accounts of A and B, but amend the partnership agreement to provide that profits and losses will be allocated among the partners to cause their capital accounts to be in proportion to their percentage interests. Thus, following C's admission to the partnership, the capital accounts of A, B, and C are $100, $100, and $200, respectively.

[31] Reg. section 1.704-3(d).

[32] Reg. section 1.704-1(b)(4)(i).

[33] Revaluations under reg. section 1.704-2(b)(2)(iv)(*s*), however, are mandatory for partnerships that want to comply with the general economic effect test or the alternate economic effect test.

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If the property is later sold for $400, the $200 of gain will be allocated $100 to each of A and B. Because the capital accounts of the partners will then be in proportion to their respective percentage interests, distributions in liquidation of the partnership that are made in accordance with capital account balances will result in the correct economic sharing. However, if the property is sold for less than $400 — say, $300 — the $100 of resulting gain would be allocated equally to A and B in an attempt to get the partners' capital accounts into the ratio of their respective percentage interests. However, because A and B can be allocated only $50 of gain, the ending capital accounts would be $150 for each of A and B and $200 for C, and that is how the $500 (that is, $300 of sale proceeds plus the $200 held by the partnership from C's contribution) of liquidation proceeds would be distributed.

In contrast, if the partnership had elected to do a revaluation when C was admitted as a partner, the property would have had a book value of $400, and the capital account of each partner would have been $200. Upon the sale of the property for $300, the partnership would realize a $100 loss (computed with reference to the $400 book value of the property) that would be allocated $33.33 to each partner. Thus, each partner would have an ending capital account of $166.67 so that the liquidating distribution of $500 would be shared equally among the partners.

Assuming that the partners in the preceding example wanted all partners to share equally in the economic performance of the partnership following the admission of C, electing to undergo a revaluation would ensure the desired outcome. On the other hand, if the negotiated deal among the partners was that C should enjoy a partial priority for all sales of the partnership's property for amounts between $100 and $400, a revaluation would have been unnecessary.[34]

Although Example 2 clearly demonstrates that a revaluation can significantly affect the economic sharing arrangement among partners, the effect in the example is between the newly admitted partner (C) on the one hand and the historic partners (A and B) on the other. Revaluations can also alter the economic sharing arrangement among existing partners. This is an important consideration in Section III of this report, which discusses whether a revaluation at a UTP should allow (or require) a revaluation at the LTP. Consider the following examples.

Example 3: Partner A and Partner B form a partnership. A contributes $100, and B contributes $0. The partnership agreement provides that A will be entitled to a priority distribution to return its contributed capital together with a 10 percent annual return thereon, after which A and B will share 50-50. The allocation provisions in the agreement generally provide for allocations of income and loss between the partners as necessary to cause the capital accounts to reflect (as nearly as possible) the desired distributions. The partnership uses the $100 to buy nondepreciable real estate. When the real estate has appreciated in value to $200 and A's priority return has accrued to $40, Partner C contributes $100 to the partnership in return for a one-third interest.

If the partnership fails to elect to undergo a revaluation, the same type of risk described in Example 2 would result (that is, that a later decrease in value could result in C receiving an inappropriately high share of the liquidation proceeds). On the other hand, if the partnership elects to undergo a revaluation, the capital account balances of the partners at the time of C's admission to the partnership would be $170 for A ($100 + $40 + 50 percent of $60), $30 for B (50 percent of $60), and $100 for C.

Assume that the property is sold in a later period for the same $200 that it was worth at the time of C's admission, and that at the time of the sale, A's 10 percent priority return had accrued an additional $10. Although C will receive the correct amount upon liquidation of the partnership (its $100 capital contribution), the revaluation causes a distortion in the economic sharing between A and B. Absent a revaluation, the partnership would have had $100 of gain to allocate between A and B. Under the partnership agreement, this gain would have been allocated $75 to A ($50 to reflect its accrued priority return plus 50 percent of the remaining $50 of gain) and $25 to B, with

[34] The same economic result, however, could have been achieved by undertaking a revaluation and then specially allocating profits and losses for purposes of section 704(b) to achieve the desired capital account balances.

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the result that the final capital accounts balances would properly reflect the desired economic sharing. However, because the $100 of appreciation in the real estate was included in the capital accounts of A and B at the time of C's admission, there is no remaining gain (based on the property's book value) to be allocated at the time of the sale. Accordingly, A will receive only $170 upon liquidation rather than the $175 that he would have been entitled to receive had the economic sharing arrangement among the partners not been controlled by capital account balances.

Example 4: Partner A and Partner B form a partnership. A contributes $100, and B contributes $0. The partnership generally would like the economic performance of the partnership to be shared equally between them. However, because B made no capital contribution, the partnership agreement provides that income and loss will first be allocated to equate the capital accounts of the two partners, with all additional income and loss allocated 50-50. The partnership buys nondepreciable real estate for $100. Later, when the real estate is worth $200, Partner C is admitted as a one-third partner in return for a capital contribution of $100. The partnership elects to undergo a revaluation. As a result, the capital account for each of the partners is $100.

To highlight the effect of the revaluation on A and B, assume that several years later, when the real estate is still worth $200, C is redeemed for his original contribution of $100. If the value of the real estate thereafter declines and is sold for $160, the partnership realizes a book loss of $40, allocable $20 to each of A and B. Accordingly, when the $160 is distributed to the partners in accordance with their capital accounts, each will receive $80. However, if no revaluation had occurred, the sale would have generated $60 of gain, all of which would have been allocated to B. The ending capital accounts therefore would have been $60 for B and $100 for A, and distributions would have been made accordingly.[35]

There are many other circumstances in which revaluations will change the economic deal between or among the existing partners. One primary circumstance is when a partnership fails to undertake a revaluation upon the occurrence of a revaluation event but undergoes a revaluation upon a later event. Thus, in Example 2, if it were assumed that no revaluation occurred upon the admission of Partner C but that subsequently Partner D was admitted for a new capital contribution, the economic arrangement between Partner A and Partner B on the one hand and C on the other could be affected by a revaluation at the time of D's admission. Before the admission of D, C effectively enjoyed a priority position for any sale of the property for an amount between $100 and $400. If D is admitted when the property still has a value of at least $400, C's priority position relative to A and B would be eliminated as a result of the revaluation at the time of D's admission.[36]

2. Tax consequences.

A revaluation can also affect the timing and nature of the taxable income and loss allocated to partners. In fact, it is probably fair to say that in the majority of partnerships other than those that hold a single nondepreciable asset, a revaluation will or could change the timing (and in some circumstances the nature) of the income or loss allocable to some or all of the partners. Nevertheless, because the mechanics of allocating income and loss following a revaluation are not entirely clear, the exact effect that a revaluation may have in a particular circumstance is also likely to be somewhat unclear.

As mentioned earlier, reg. section 1.704-1(b)(2)(iv)(*f*) requires that following a revaluation,

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[35]The same type of disparate impact on A and B would occur even without the assumption that C was redeemed. The assumed redemption just makes it easier to see that the differences in the amounts distributable to A and B are attributable to the revaluation. Also, eliminating the interest of C makes the revaluation more analogous to what would occur if a revaluation at an LTP was caused by a revaluation at a UTP because the LTP revaluation would occur without any change in the ownership of the LTP.

[36]The economic distortion here and in Example 4 (but not in Example 3) could be eliminated by amending the partnership agreement at the time of the revaluation to provide that subsequent allocations would be made as necessary to cause the capital accounts to reflect the desired economic sharing arrangement. In my experience, these amendments are rarely, if ever, made.

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allocations of gain, loss, depreciation, etc. for capital account maintenance purposes be based on the book values of the partnership's assets and that the allocation of those items for tax purposes be done in the same manner as under section 704(c). Although this concept has been in the regulations for more than 30 years,[37] there is no clear guidance regarding how to apply the requirement that the allocations be done "in the same manner as under section 704(c)."

Undoubtedly, one of the primary reasons for the lack of authority dealing with the mechanics of making reverse section 704(c) allocations is that the directive in reg. section 1.704-1(b)(2)(iv)(*f*) that these allocations be made in the same manner as under section 704(c) is an attempt to fit a square peg into a round hole. Section 704(c) provides rules regarding how to allocate the tax consequences attributable to differences between the value of contributed property and its tax basis (book-tax differences) between the contributing partner and the noncontributing partners. Although reverse section 704(c) allocations serve a similar function in the context of revaluations, they must also serve an entirely different function not generally relevant to forward section 704(c) allocations: They must determine how *existing* partners of a partnership share the tax consequences of built-in gain and built-in loss that exist at the time of the revaluation.

A full analysis of the mechanics of making reverse section 704(c) allocations is well beyond the scope of this report. Nonetheless, a basic understanding of the tax consequences of some of the various possible approaches to implementing reverse section 704(c) allocations is necessary to try to answer the later-posed question whether a revaluation at a UTP should (or could) cause a corresponding revaluation at an LTP.

Section 704(c) at its most fundamental level is a provision that traces the tax consequences of contributed property having a tax basis that differs from its FMV and allocates those consequences back to the contributing partner. In doing so, it depends on being able to identify property as having been contributed and to associate the contributed property with a particular contributing partner. It therefore seems logical to try to analyze the tax consequences of a revaluation by casting a revaluation as involving some sort of deemed contribution of property to a partnership. In that regard, it would seem that there are at least two possible constructs for how a revaluation could be cast as a contribution to a partnership:

a. The undivided interest approach.

Under the undivided interest approach, each partner that has his capital account adjusted in the revaluation is treated as having contributed to the partnership an undivided interest in each asset of the partnership (with the tax bases for the undivided interests determined in accordance with the rules under section 743 for determining a partner's share of the tax basis of the partnership's assets).[38]

b. The contribution/liquidation approach.

Under the contribution/liquidation approach, the transaction is treated as if the existing partnership contributed all its assets and liabilities to a new partnership (to which any new partner is admitted) and then liquidated.[39]

Unfortunately, each of these approaches generates less-than-sensible results in many circumstances. The undivided interest approach can produce wildly inappropriate results unless all partners have the same percentage interests and no ceiling rule limitations apply, because "contributing" partners with smaller interests will run into ceiling rule limitations long before "contributing" partners with larger interests do. See the Appendix for an example.

Although the contribution/liquidation approach has considerable intuitive appeal, it, too, has several technical deficiencies. For

[37] Including proposed regulations.

[38] *See* Blake D. Ruben and Andrea R. McIntosh, "Exploring the Outer Limits of the 704(c) Partnership Built-In Gain Rule (Part 1)," 89 *J. Tax'n* 177, 183 (1998), for a discussion of the consequences of casting a revaluation as a deemed contribution of undivided interests in the partnership property by each of the participating partners.

[39] The hypothetical contribution of assets to the new partnership followed by a liquidation of the existing partnership should be considered to occur solely in determining how later reverse section 704(c) allocations would be made. Thus, the hypothetical transactions: (1) should not change the holding periods for the existing partners' interests in the partnership; (2) should not be treated as contributions in applying section 704(c)(1)(B) or section 737; and (3) should not be an occasion for making an election under section 754 or adjusting the basis of the partnership's assets under section 734 or section 743.

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example, if applied literally, it would effectively always prioritize the tax position of the latest-admitted partner relative to any of the historic partners even though any appreciation or depreciation in the property may not have occurred while some of the historic partners held their interests in the partnership.[40] Moreover, upon the deemed liquidation of the historic partnership and the deemed distribution of the interests in the "new" partnership, the built-in gain or loss that would be subject to allocation in accordance with section 704(c) would be inherited by the historic partners under reg. section 1.704-3(a)(7), which requires an apportionment that is "proportionate to the interest transferred." That apportionment would thus seem to be determined with reference to the FMV of the interests transferred (similar to the approach adopted in Rev. Rul. 84-53, 1984-1 C.B. 159, regarding the allocation of basis upon the transfer of a partnership interest). This would make little sense in many circumstances because there is no reason to believe that the historic partners' respective shares of any built-in gain or loss before the revaluation would be in proportion to the FMV of their interests.[41] The contribution/liquidation approach would also be conceptually difficult to apply if the revaluation event were not the admission of a new partner (for example, a redemption of a partnership interest or, potentially, the revaluation by a UTP) because no "new" partnership would result.

Because neither of the contribution constructs can easily be applied to determine the consequences of a revaluation, some other approach needs to be adopted. A variety of alternative approaches have been suggested by the IRS and commentators.[42] All these approaches work to prevent a partner that was not a partner in the partnership at the time property appreciated or depreciated from being allocated any of the tax consequences attributable to that appreciation or depreciation (other than as a result of the application of the ceiling rule). They also generally reach the same result when no appreciated or depreciated property has been contributed to the partnership and only a single revaluation has occurred. However, they can yield substantially different results if there are multiple layers of forward and/or reverse section 704 allocations. Without getting bogged down in the intricacies of each of these possible approaches, the balance of this section will demonstrate that even in the simple circumstance of no multiple layers of forward/reverse section 704(c) allocations, the tax consequences to the partners of a partnership can be significantly altered as a result of a revaluation, and that the introduction of multiple layers will likely only exacerbate the problem.

Although all the identified approaches for making reverse section 704(c) allocations may seem reasonable, each of them can still cause distortions in how income and loss is allocated among the partners of a partnership following a revaluation.

Example 5: Assume that Partner A and Partner B form a partnership, with A contributing $1,000 and B receiving a profits interest in return for agreeing to provide services in the future. Under the partnership agreement, the first $1,000 of income or gain is to be allocated to B, after which all income or loss is to be allocated equally between the two partners. The partnership uses $500 to purchase five nondepreciable investments for $100 apiece and retains the remaining $500 in cash. Assume that each investment appreciates in value to $300, at which point A has half of his interest redeemed for the $500 of cash. The partnership elects to do a revaluation and

[40] For example, if all the appreciation in the partnership's assets when a new partner is admitted is attributable to appreciation that existed when the property was previously contributed to the partnership, this approach would favor the newly admitted partner relative to the historic partner(s) that had not contributed the property (by effectively giving the new partner a priority share of the property's basis in computing depreciation and gain/loss on a sale).

[41] Despite the language of reg. section 1.704-3(a)(7), Treasury seems disinclined to follow it. Thus, for example, in prop. reg. section 1.704-4(c)(4)(ii)(F), Example 2 (dealing with the application of section 704(c)(1)(C) following a merger of partnerships), the amount of built-in gain attributable to a pre-merger revaluation of the assets of the partnership that terminated in the merger is shared among the partners of the terminated partnership based on their respective shares of the revaluation gain before the merger rather than in proportion to the value of the interests in the continuing partnership received upon the deemed liquidation of the terminated partnership. Although reg. section 1.704-3(a)(7) is expressly made applicable, the example sensibly applies the regulation to preserve the partners' respective shares of the built-in gain attributable to the earlier revaluation.

[42] For example, there is the layering approach described in prop. reg. section 1.704-3(a)(6), the netting approach described in Notice 2009-70, and the disparity offset method. *See, e.g.*, Elizabeth Amoni and John Schmalz, "Section 704(c): The Disparity Offset Method Provides Answers to Difficult Questions," 114 *J. Tax'n* 223 (Apr. 2011).

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allocates the $1,000 of unrealized gain to B. Several years later, the partnership sells one of its investments for $500, realizing $400 of tax gain and $200 of book gain. In accordance with the partnership agreement, the $200 of book gain is allocated $67 to A and $133 to B. The tax gain is allocated (1) $200 to B as a reverse section 704(c) allocation, and (2) the balance of $200 is allocated in the same manner as the book gain — that is, $67 to A and $133 to B. Had no revaluation occurred, the tax and book gain on the sale would have been $400 and would have been allocated entirely to B.[43]

Although B may someday be allocated tax gain equal to the remaining $800 of unrealized gain that was allocated to him as a result of the revaluation (for example, when the remaining investments are sold), the revaluation causes a significant deferral of taxable income or gain for him and a significant acceleration of taxable income or gain for A. Moreover, if the income and gain attributable to the various investments are of different types (long-term capital gain, short-term capital gain, or ordinary income), the nature of the income or gain realized by the partners will be affected by the revaluation. Finally, if the value of the remaining investments declines, the ceiling rule could cause less taxable income or gain to be allocated to B at the time of their disposition. Thus, the revaluation could theoretically affect the timing, nature, and amount of income realized by the partners before the liquidation of the partnership.

Revaluations can also cause inefficient allocations of losses. For instance, assume that in the previous example, A had only 20 percent of his interest redeemed for $200 so that the revised interests of the partners were 44.44 percent for A and 55.55 percent for B. If the partnership then spent some of the remaining $300 of cash on deductible expenses, B would be allocated 55.55 percent of the resulting tax loss but would have no basis in his partnership interest that would allow him to make use of it. Absent the revaluation, A would have been allocated all the tax loss and would have had the basis to make use of it.

[43]The same type of reallocation of taxable gain between A and B would occur if the revaluation were triggered by the admission of an additional partner.

The introduction of multiple layers of forward/reverse section 704(c) allocations is likely to further affect how income and loss is allocated among the partners of a partnership that undertakes a revaluation. As previously mentioned, because forward/reverse section 704(c) allocations allocate basis derivative items, one way to look at the different potential methods for making the allocations is that they effectively allocate basis among the partners. Although that approach can be misleading in some circumstances, it is helpful in understanding the effect that layers have on the allocations.

In general, once there are layers, a determination must be made about how the basis of the affected assets is to be allocated among those layers. Prop. reg. section 1.704-3(a)(6)(i)[44] generally provides that in making the allocation, "a partnership may use any reasonable method." Further, under reg. section 1.704-3(a)(6)(ii), different section 704(c) methods (traditional, traditional with curative allocations, or remedial) may be used for each separate layer. Obviously, giving the partnership the ability to choose which partners are effectively allocated the available basis could dramatically affect how and when the partners are allocated taxable income or loss as a result of a revaluation. For example, if a partnership already has one or more layers of forward or reverse section 704(c) allocations, the creation of a new layer as a result of a revaluation could affect how the basis derivative items are allocated in the existing layers, thereby changing the timing and perhaps the amount of income or loss realized by the partners that participated in the existing layers.

III. Revaluations in Upper-Tier Partnerships

Having reviewed the rules on revaluations and some of the economic and tax consequences associated with them, we can now turn to exploring how revaluations might work in UTPs. The IRS in Notice 2009-70 requested comments on this topic. The notice recognized two approaches — the entity approach and the aggregate approach — while acknowledging that some additional approach(es) may also be appropriate.

[44]REG-144468-05.

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Although the proposed section 751(b) regulations suggest that the aggregate approach may be the preferred approach, they do not require its use absent an LTP with hot assets that is commonly controlled with the UTP. The purpose of this section of the report is to demonstrate why neither the entity approach nor the aggregate approach is satisfactory and to propose a third approach that resolves many of the shortcomings of the other two.

A. Entity Approach

As its name would imply, the entity approach treats LTPs as distinct entities such that upon a revaluation by a UTP, its interest in an LTP is treated like any other asset. Thus, any built-in gain or loss inherent in the interest in the LTP is reflected in the capital accounts of the partners of the UTP, and subsequent reverse section 704(c) allocations are made with reference to the interest in the LTP but not with direct reference to the assets of the LTP.

Under this approach, only when the UTP realizes gain, loss, or depreciation (the basis derivative items[45]) attributable to the interest in the LTP would a reverse section 704(c) allocation be made. Because the interest in the LTP would not itself be depreciable, only book gain or loss realized for the interest in the LTP under section 731 (that is, upon a distribution by or a liquidation of the LTP) or upon a disposition of the interest would give rise to the reverse section 704(c) allocations; recognition of gain or loss at the LTP level would be irrelevant (except indirectly to the extent that it caused an adjustment to the basis of the UTP's interest in the LTP).

The entity approach is arguably more consistent with the general theory behind subchapter K than is the aggregate approach. It is also generally consistent with the hypothetical transaction that occurs upon a revaluation as described in reg. section 1.704-1(b)(2)(iv)(*f*). That regulation generally provides that upon a revaluation, the book value of a partnership's assets are adjusted to their FMVs and the partners' capital accounts are adjusted to reflect the manner in which the unrealized income, gain, loss, or deduction inherent in the partnership's property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of that property for that FMV on the date of the revaluation.

Thus, a revaluation at the UTP level is effectively treated as if there were a deemed sale of the interest in the LTP, and section 741 quite clearly adopts an entity approach for sales of interests in partnerships. Further, as others have properly noted, the entity approach generally seems to be reflected in the existing regulations under section 704(c).[46]

However, despite the textual support for the entity approach, it quite clearly produces inappropriate results in many circumstances, as demonstrated in Example 6.

Example 6: Assume Partner A and Partner B form UTP to act as the general partner of a venture capital fund, each having a 50 percent interest. UTP forms the fund (LTP). Assume, for simplicity, that LTP has only one investor, Partner C. Partner C contributes $1,000 to LTP, and UTP receives a 20 percent profit interest in LTP in return for providing investment advisory services. LTP invests the $1,000 in five separate investments costing $200 apiece. The investments appreciate to $300 apiece so that UTP's interest in LP is worth $100 (that is, 20 percent * ($1,500 - $1,000)) on a liquidation value basis. At that time, Partner D invests $100 in UTP in return for a 50 percent interest, and UTP revalues its interest in LTP to $100. As a result, the book and tax capital accounts of the three partners of UTP are as shown in Table 1.

[45] *See supra* note 26.

[46] *See* Huffman and Hortenstine, *supra* note 26, at 215.

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Table 1

Partner A		Partner B		Partner D	
Book	**Tax**	**Book**	**Tax**	**Book**	**Tax**
$50	$0	$50	$0	$100	$100

In each year thereafter, LTP sells one of its investments for the same $300 amount that it was worth at the time of D's admission to UTP. On each sale, $20 of gain is allocated to UTP. However, because the gain is not attributable to the sale of UTP's interest in LTP or to a distribution exceeding basis under section 731, it is not subject to allocation as a reverse section 704(c) allocation (that is, the gain is not a basis derivative item). As a result, the $20 of gain from each sale is allocated $5 to A, $5 to B, and $10 to D, even though it does not represent any economic appreciation following the admission of D. The gain allocated to UTP increases its book value and tax basis for its interest in LTP. Assuming that LTP makes no distributions until the sale of its last investment, at that time, D will have been allocated $50 of gain and will have a tax basis of $150 for its interest in UTP. UTP will have a book value of $200 for its interest in LTP (100 attributable to the revaluation plus $100 attributable to the realized gain allocated to UTP) and a tax basis of $100.

If LTP then liquidates and distributes $100 to UTP, UTP will realize a book loss of $100 for purposes of section 704(b). The $100 loss will be allocable $25 to each of A and B, and $50 to D. Although any tax loss realized by UTP on the liquidation of LTP would be subject to allocation as a reverse section 704(c) allocation, no tax loss is realized. Accordingly, if the traditional method were being used, the ceiling rule would operate to prevent D from being allocated any loss for tax purposes. The general result would therefore be that realized tax gain corresponding to 50 percent of all the appreciation included in the capital accounts of A and B as a result of the revaluation would be allocated to D, and no offsetting loss would be allocated to D upon liquidation of LTP because of the ceiling rule. Although D would realize an offsetting loss upon liquidation of its interest in UTP, the liquidation might not occur for many years.

The entity approach virtually ensures that partners at the UTP level that did not participate in the revaluation will be taxed on the economic appreciation/depreciation reflected in the revaluation unless those amounts are realized in a taxable transaction involving the LTP interest (or the UTP adopts the remedial method or the traditional method with curative allocations for its reverse section 704(c) allocations[47]). Accordingly, as a policy matter, the entity approach would not seem to be an appropriate manner for handling most reverse section 704(c) allocations in connection with a revaluation at the UTP level unless no other approach is workable, or in circumstances in which the LTP holds only nondepreciable assets that are all sold in the tax year in which the partnership liquidates.

B. Aggregate Approach

In general terms, the aggregate approach tries to ignore the existence of the multiple tiers of partnerships and treat a revaluation at the UTP level as if the partners of the UTP own a direct interest in the LTP. By looking through to the assets of the LTP in applying reverse section 704(c) allocations at the UTP level, the aggregate approach tries to avoid the fundamental drawback of the entity approach demonstrated earlier. For this reason, the aggregate approach is the favorite among those organizations and individuals that submitted comments to Treasury in response to Notice 2009-70 or that have

[47]The remedial method would allow the newly admitted partner (Partner D in the example) to realize a taxable loss upon liquidation of the LTP but would not rectify the timing distortions caused by the entity approach. The taxable loss, however, would likely be a capital loss that the new partner might not be able to use. Similar results could also be achieved using the traditional method with curative allocations.

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otherwise addressed the issues raised in the notice.[48]

The fundamental analytical problem with the aggregate approach is that absent some additional mechanism, there is nothing at the LTP level that would cause the appropriate amount of gain, loss, or deduction associated with the built-in gain or loss in the assets of the LTP at the time of the UTP revaluation to be allocated to the UTP when realized. If the UTP is not allocated those items, it cannot allocate them to the UTP partners that received the adjustments in their capital accounts in connection with the revaluation. Because reverse section 704(c) allocations are basically a set of rules for tracing the tax consequences associated with book-tax differences arising from a revaluation, the aggregate approach is not workable unless some method is used to track those consequences at the LTP level as well as the UTP level. To deal with this need, commentators have generally suggested that upon a revaluation at the UTP level, the LTP be allowed — and in some circumstances required — to also undergo a revaluation. Those suggestions have been reflected in the section 751(b) proposed regulations. Although such an approach may help resolve the tracing problem when the tax consequences associated with the built-in gain or loss are realized, it creates a host of additional issues and problems.

Before turning to the issues raised by having a revaluation at the UTP level give rise to a revaluation at the LTP level, it should be noted that any approach that allows such a revaluation by the LTP to be elective presumably will preclude the use of an aggregate approach if the election is not made. If the only other possible approach is the entity approach, which, as we saw, will often produce an inappropriate result, the election is seemingly an invitation to tax abuse. Thus, many advocates of the aggregate approach favor a mandatory revaluation at the LTP level except when the potential for tax abuse is fairly small.[49]

Among the more serious concerns with allowing or requiring a revaluation by an LTP upon a revaluation by the UTP are the following:

1. Economic distortions.

As discussed in Section II.B.1, revaluations can cause distortions in the economic sharing arrangement among partners. Although those distortions may be acceptable in a single partnership that (1) undergoes a fundamental change in the economic sharing arrangement among the partners and (2) can elect or not elect to undertake a revaluation, it is much harder to justify in the context of an LTP that has as a partner a UTP that has undergone a revaluation. In the latter case, there has been no change in the economic sharing arrangement among the partners of the LTP, and to require (or even allow) a revaluation that affects the economic rights of partners other than the UTP is completely inappropriate.

2. Tax distortions.

Also as discussed in Section II.B.2, revaluations can cause changes in the timing, character, and even the amount of taxable income and loss realized by partners. Those changes can be significant even under the contribution/liquidation approach and could be quite dramatic if the undivided interest approach is used in a partnership that has partners whose interests are significantly different in size. Any system that could cause these changes to the potential detriment of partners in the LTP other than the UTP simply because the UTP has undergone a revaluation also seems inappropriate.

3. Lack of arm's-length transaction.

The existing list of events that allow for a revaluation all involve circumstances in which the partnership engages in a transaction with one or more of its partners based on the FMV of the partnership (or of the partner's interest in the partnership) as determined in an arm's-length manner rather than on the historic capital account

[48] *See, e.g.*, New York State Bar Association Tax Section, "Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships" (Jan. 22, 2010); American Institute of CPAs, "Comments on Notice 2009-70: Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships" (Apr. 30, 2010); and Monte A. Jackel, "A Response to Notice 2009-70," *Tax Notes*, Sept. 14, 2009, p. 1133.

[49] *See* NYSBA, *supra* note 48, at 40; and Jackel, *supra* note 48, at 7. *See also* AICPA, *supra* note 48 (mandatory aggregate approach in limited circumstances).

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balances of the partners. If an LTP undertakes a revaluation simply because its UTP partner undertakes a revaluation, there is no event at the LTP level that requires the LTP partners to establish the FMV of the LTP in an arm's-length manner. Thus, the market check on the value of the LTP's assets used in the revaluation that would exist for the current list of revaluation events would not exist for a revaluation occasioned by a revaluation at the UTP level. Although an arm's-length event presumably occurred at the UTP level, if the UTP has many assets, there is no necessary reason why the booked-up value of the UTP's interest in the LTP would be the arm's-length value or why the partners of the LTP would agree with that value.

4. Inside/outside value differentials.

Upon a revaluation at the UTP level, the UTP's interest in the LTP would be revalued to the FMV of that interest. Although commentators like to assume that the FMV of an interest in a partnership equals the FMV of a proportionate share of the partnership's assets, that is typically not the case in the real world. Discounts for lack of marketability, minority interests, etc. typically would cause the value of an interest in a partnership to be less than the value of a proportionate share of the partnership's assets (that is, a 10 percent interest in a partnership that owns a $100 asset typically would be less than $10). Thus, a revaluation of the assets of the LTP concurrently with a revaluation at the UTP level would likely result in the UTP's share of the built-in gain or loss in the assets of the LTP being different from the amount of built-in gain or loss that the UTP had in its interests in the LTP. Obviously, this could also occur in situations in which the UTP and the LTP simply disagreed on the value of the LTP's operations. Some approach would need to be developed to deal with these discrepancies.

5. Inside/outside basis differentials.

Further complications would result if at the time of a UTP revaluation the UTP had a difference between its outside basis in its interest in the LTP and its share of the inside basis of the LTP's assets. In that situation, the revaluation for the interest in the LTP would be different from the amount of the revaluation at the LTP level that was attributed to the UTP.

6. Imperfect information.

Any coordination of revaluation events and resulting reverse section 704(c) allocations between a UTP and an LTP would require a tremendous exchange of information between the two partnerships. The LTP would obviously need to know when the UTP undertook a revaluation, as well as the amount of the revaluation attributed to the UTP's interest in the LTP. Similarly, the UTP would need to know the amount of the revaluation in the assets of the LTP attributed to the UTP, as well as the amount of gain, loss, and depreciation realized by the LTP and allocated to the UTP in a reverse section 704(c) allocation (as opposed to a section 704(b) allocation).

7. Separate revaluations by the LTP.

Further complications would arise if the LTP undertook a separate revaluation either before or after the revaluation by the UTP. For example, a revaluation by the LTP before the UTP's revaluation could upset the look-through tracing of built-in gain or loss on which the aggregate approach is premised. Although the complications caused by a separate revaluation by the LTP may well be solvable, they would likely add another layer of complexity to an area already too complex for most taxpayers and their tax advisers.

8. Different section 704(c) methods.

The use of different section 704(c) methods at the LTP and UTP levels would also raise complicated issues. Although the same method could conceivably be required at both levels in connection with the simultaneous revaluations, later revaluations by the LTP could upset the parallelism. Also, in situations in which the UTP did not control the LTP, there undoubtedly would be disputes regarding which entity would have the authority to choose the method to be used.

C. Look-Through Approach

Because neither the entity approach nor the aggregate approach yields satisfactory answers regarding how to deal with a revaluation at a UTP, the balance of this report describes and analyzes a third approach that eliminates many of the

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shortcomings of the other two approaches. The genesis of this approach lies in the mechanics of revaluations, which, as previously discussed, essentially assume a hypothetical sale of all the partnership's assets for their FMVs and an allocation of the resulting hypothetical gain or loss to the capital accounts of the partners. Thereafter, section 704(b) allocations are made by reference to the book values of the partnership's assets rather than their tax bases, much as if the partnership had repurchased the assets for their FMVs.[50] The ensuing reverse section 704(c) allocations are then intended to allocate subsequent book-tax differences in items of gain, loss, and depreciation so that the partners receiving the revaluation adjustments bear the tax consequences of the hypothetical sale and repurchase not being actual transactions.

If the analysis stopped there, the entity approach would seem to be the appropriate approach, and the misallocation of income and loss described above would occur. Although purchases of interests in partnerships are generally treated under subchapter K using an entity approach rather than an aggregate approach, a limited exception applies if the partnership has made an election under section 754. In that case, the purchasing partner gets a basis adjustment under section 743 for its proportionate share of the partnership's assets — generally comparable to what it would have gotten had it purchased its pro rata share of the assets directly.

The look-through approach applies the reverse section 704(c) allocation to a UTP's interest in an LTP by (1) computing a special book value adjustment for the UTP for each asset of the LTP in a manner similar to the type of basis adjustment that would result under section 743 if the UTP had really purchased its interest in the LTP for its FMV at the time of the UTP revaluation (a look-through adjustment);[51] (2) computing the UTP's items of gain, loss, and depreciation from the LTP for book purposes by taking into account the look-through adjustments described in (1);[52] and (3) allocating the items of gain, loss, and depreciation (as determined for tax purposes) that are allocated to the UTP from the LTP in accordance with the general rules for making reverse section 704(c) allocations to the extent that the book and tax items differ.

Example 7: Assume that Partner A and Partner B form Partnership UTP, each contributing $100 in cash in return for a 50 percent interest. UTP contributes $100 and Partner C contributes $300 to LTP in return for interests of 25 percent and 75 percent, respectively. LTP acquires two nondepreciable assets, Asset 1 and Asset 2, for $200 apiece. When Asset 1 has appreciated to $400 and Asset 2 has appreciated to $600, Partner D contributes $350 to UTP in return for a 50 percent interest. UTP elects to do a revaluation, increasing the book value for its interest in LTP to $250 and the capital accounts of A and B to $175 apiece (that is, each partner's initial tax basis of $100 increased by 50 percent of the $150 of appreciation in the interest in LTP). If UTP had purchased its LTP interest for $250 and LTP had a section 754 election in effect, UTP would have had

[50] As previously mentioned, the computations of income and loss would be somewhat different from what they would be if the partnership newly purchased the assets, because the partnership generally would not be required to start new depreciation recovery periods (except to a limited extent if the remedial method is used).

[51] How best to allocate the look-through adjustments among the assets of the LTP may be subject to some debate. The approach taken under reg. section 1.755-1(a) and (b) for allocating section 743 basis adjustments (which prioritizes allocations to ordinary income assets) does not seem to be necessary or appropriate. It would seem preferable for the look-through adjustment for a particular asset to be determined using the following four-step approach: (1) Compute the gross value of the aggregate assets of the LTP that would result in the UTP receiving an amount equal to the book value of the UTP's interest in the LTP if the LTP sold all its assets for that gross value and liquidated; (2) allocate that gross value among the assets of the LTP based on their respective FMVs; (3) for each asset, compute the amount of gain/loss that would be recognized if the asset were sold for the amount of the gross value allocated to it; and (4) multiply the amount of gain/loss determined in step 3 for that asset by the ratio of (x) — the aggregate amount of gain/loss that would be allocated to the UTP if the LTP sold all its assets for the aggregate gross value computed under step 1 — to (y) — the aggregate amount of gain/loss that would be realized by the LTP if it sold all its assets for the aggregate gross value computed under step 1.

[52] Although the basis adjustments under this approach are analogous to those under section 743, they differ in several important respects, including: (1) they would be depreciated using the same method of depreciation and the remaining recovery period for the property as was used by the LTP for the actual tax basis of the property (subject to applicable exceptions if the remedial method were used); and (2) the rule in reg. section 1.743-1(f) that subsequent basis adjustments effectively subsume prior ones would be reversed to allow for the tracking of separate layers of reverse section 704(c) allocations in the event of multiple revaluations at the UTP level.

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a section 743 basis adjustment of $50 for Asset 1 and a basis adjustment of $100 for Asset 2.

Under the look-through approach, UTP would receive corresponding look-through adjustments in the two assets. If Asset 1 is later sold for $500, UTP would be allocated $75 of taxable gain (25 percent of $300 of gain). For purposes of the reverse section 704(c) allocation, the book gain from the sale would be computed by taking into account the $50 look-through adjustment, resulting in book gain of $25. Fifty percent of that book gain would be allocated to D, and a corresponding amount of tax gain would be allocated to him. A and B each would be allocated $6.25 of the remaining book gain and a corresponding amount of tax gain under section 704(b). Also, each would be allocated as a reverse section 704(c) allocation 50 percent of the additional $50 of tax gain that would not have been realized had the look-through adjustment been an actual basis adjustment, for a total of $31.25 of tax gain.

Example 8: Assume that Partner A and Partner B form Partnership UTP, each contributing $100 in cash in return for a 50 percent interest. UTP contributes $100 and Partner C contributes $300 to LTP in return for interests of 25 percent and 75 percent, respectively. LTP acquires two depreciable assets, Asset 1 and Asset 2, for $200 apiece, and each asset is depreciable over a 10-year period. At the end of four years, when Asset 1 is still worth $200 and Asset 2 has appreciated to $600, Partner D contributes $300 to UTP in return for a 50 percent interest. UTP elects to do a revaluation, increasing the book value of its interest in LTP to $200 and the capital accounts of A and B to $150 apiece.

The look-through adjustment for Asset 1 would be $20 (that is, 25 percent * ($200 - $120)), and the look-through adjustment for Asset 2 would be $120 (that is, 25 percent * ($600 - $120)). In the following year, LTP has $20 of tax depreciation deductions for Asset 1, $5 of which is allocated to UTP, and $20 of tax depreciation deductions for Asset 2, $5 of which is allocated to UTP. For book purposes, UTP would have an additional $3.33 ($20/6) of depreciation for its look-through adjustment for Asset 1, and an additional $20 ($120/6) of depreciation for its look-through adjustment for Asset 2. Thus, UTP would be treated as having $8.33 of book depreciation for its indirect interest in Asset 1, and $25 of book depreciation for its indirect interest in Asset 2. Half of each of those amounts ($4.17 for Asset 1 and $12.50 for Asset 2) would be allocated to D, and one-quarter of those amounts ($2.08 for Asset 1 and $6.25 for Asset 2) would be allocated to each of A and B for book purposes.

For Asset 1, D would be allocated $4.17 of tax depreciation, with the balance of $0.83 of tax depreciation being divided evenly between A and B. For Asset 2, because the tax depreciation is only $5, all this depreciation would be allocated to D, with the remaining difference between D's book and tax depreciation being subject to the ceiling rule (with appropriate offsets if the remedial method or traditional method with curative allocations were applicable). The book value of UTP's interest in LTP would be decreased by its allocable share of the aggregate amount of book depreciation attributable to the assets of LTP (assuming no other items of income of deduction), from $200 to $167.67.

Example 9: Assume that Partner A and Partner B form Partnership UTP, each contributing $50 in cash in return for a 50 percent interest. UTP then purchases a 50 percent interest in Partnership LTP from one of LTP's partners for $100. At the time of UTP's purchase, LTP owns one nondepreciable asset with a value of $200 and a tax basis of $300. Later, when the asset held by LTP has appreciated in value to $400, Partner D is admitted as a 50 percent partner in UTP in return for a capital contribution of $200. UTP undergoes a revaluation, increasing its book value for its interest in LTP to $200 and creating a look-through adjustment of $50 for the asset owned by LTP ($200 minus UTP's 50 percent share of LTP's basis in the asset). Later, LTP sells its asset for $500, generating $200 of taxable gain, $100 of which is allocated to UTP. Because UTP's look-through adjustment was $50, it would realize $50 of book gain as a result of the sale. Accordingly, A, B, and D would be allocated $12.50, $12.50, and $25, respectively, of the book gain from the sale. Of the $100 of tax gain, $25 would be allocated to D, and the balance would be allocated $37.50 to each of A and B.

Upon the liquidation of LTP, UTP would be distributed $250 of cash from the sale of the asset

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and would realize $50 of tax gain under section 731 (the $250 distribution minus UTP's tax basis for its $200 interest in LTP). Because UTP would have a book value of $250 for its interest in LTP ($200 as a result of the revaluation, increased by the $50 of book gain allocated to it from the sale of the asset), no book gain or loss would be realized on the liquidation. Accordingly, each of A, B, and D would be allocated $0 of book gain from the liquidation. D would therefore be allocated no tax gain, and A and B would share the $50 of tax gain $25 apiece.

The look-through approach has numerous advantages over the entity approach and the aggregate approach, including the following:

1. Unlike the entity approach, the look-through approach takes into account book-tax differences concerning the assets of the LTP and applies reverse section 704(c) allocations to the gain, loss, and depreciation deductions allocated to the UTP from the LTP.
2. Under the look-through approach, the look-through adjustments do not affect the economic sharing arrangement among the partners of the LTP as could a revaluation at the LTP level under the aggregate approach.
3. The look-through adjustments made under the look-through approach do not affect the allocation of taxable income and loss (and items thereof) among the partners of the LTP as could a revaluation at the LTP level under the aggregate approach.
4. The look-through adjustments are based on the FMV of the interest in the LTP rather than on the FMV of the assets of the LTP as would be the case under the aggregate approach. Thus, unlike the result under the aggregate approach, differences between outside value and inside value attributable to market discount, lack of liquidity discounts, etc. would not cause a dislocation between the book-tax difference at the LTP level and the book-tax difference at the UTP level for the LTP interest.
5. The look-through adjustments are based on the FMV of the interest in the LTP as determined by the UTP (and/or its partners) and are not subject to an inconsistent valuation determined by the LTP (and/or its partners) as could be the case under the aggregate approach.
6. The look-through adjustments would not be affected by later revaluations at the LTP level. Later revaluations at the LTP level could affect the allocations of tax items to the UTP, but the reverse section 704(c) allocations at the UTP level would be made solely with reference to the look-through adjustments attributable to the revaluation at the UTP level. Thus, other than potentially affecting the amount of tax items allocated to the UTP, the reverse section 704(c) allocations would operate independently at the LTP level and the UTP level.
7. Prior revaluations by the LTP would not generate the uncertainty or complexity that they would under the aggregate approach. The reverse section 704(c) allocations at the LTP level would simply be factored into the computation of the look-through adjustments at the time of the revaluation by the UTP in a manner similar to the method provided in reg. section 1.743-1(c).
8. Although the look-through approach would require a fair amount of information sharing between the UTP and the LTP, the amount of information needed to be shared would be somewhat less than under the aggregate approach, and likely would require significantly less computational work by the LTP because the LTP would not need to make any reverse section 704(c) allocations as a result of the UTP's revaluation.

Although the look-through approach has many advantages over both the entity approach and the aggregate approach, it does have at least one significant deficiency that arises when the tax gain, loss, or deductions attributable to the assets of the LTP end up being allocated among the partners of the LTP in a manner that differs from what was contemplated when the look-through adjustments were computed.

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Table 2

Partner A		Partner B		Partner D	
Book	Tax	Book	Tax	Book	Tax
$20	$0	$20	$0	$40	$40

Example 10: Assume Partner A and Partner B form UTP to act as the general partner of a venture capital fund. UTP forms the fund, LTP, with Partner C as the sole investor. C contributes $600 to LTP, and UTP receives an interest in LTP entitling it to 20 percent of any cumulative profit solely in return for providing investment advisory services. LTP invests the $600 in three separate investments costing $200 apiece. Investment 1 later becomes worthless and is written off. The $200 loss is allocated entirely to C. Investments 2 and 3 thereafter each appreciate to $400. Accordingly, UTP's interest in LTP is worth $40 (that is, 20 percent of the cumulative appreciation of $200). At that time, Partner D invests $40 in UTP in return for a 50 percent interest, and UTP revalues its assets (the interest in LTP) to $40. As a result, the book and tax capital accounts of the three partners of UTP are shown in Table 2.

Under the look-through approach, an adjustment is made for the assets of the LTP in the amount of $40, allocated $20 to each of investments 2 and 3. If Investment 2 is then sold for $400, all of the $200 of gain would be allocated to C to reverse the $200 of loss previously allocated to it as a result of Investment 1 becoming worthless. The UTP would be allocated no book or tax income by the LTP but would still have a $20 book loss as a result of the write-off of the $20 look-through adjustment that it received for Investment 2. The book loss would be allocated 50 percent to D and 25 percent to each of A and B. Because the UTP would be allocated no taxable loss, if it used the traditional method, none of its partners would be allocated any taxable income or loss.

If the LTP thereafter sold Investment 3 for $400, the $200 gain realized on the sale would be allocated $40 to the UTP (that is, 20 percent) and $160 to C (that is, 80 percent). Because the UTP had a look-through adjustment of $20 for Investment 3, under the look-through approach, it would be treated as having $20 of book income ($40 of taxable income minus the $20 look-through adjustment). The book income would be allocated $10 to D and $5 to each of A and B. Under normal reverse section 704(c) allocation principles, D would be allocated $10 of taxable income corresponding to the $10 of book income allocated to it, and the balance of $30 of taxable income would be allocated $15 to each of A and B. Thus, D would cumulatively be allocated $10 of taxable income even though none of the assets of the UTP or the LTP experienced any change in value following the admission of D to the UTP and D received cumulative allocations of book income of $0.

The problem illustrated by the foregoing example (the unanticipated allocation problem) is the result of a fundamental difference between how the look-through approach works and how reverse section 704(c) allocations work in a single-tier structure or in a multitier structure using the aggregate approach. Generally, in the latter two structures, a revaluation effectively determines existing built-in gain or loss in each particular property and identifies it with particular partners based on the partners' economic sharing arrangement as determined assuming a hypothetical sale of all the partnership's assets at FMVs. When the tax consequences attributable to the built-in gain or loss are realized, the reverse section 704(c) allocations then cause the consequences to be borne by the particular partners.

Thus, these approaches effectively lock in how the tax consequences attributable to the built-in gain or loss attributable to each asset will be allocated (if realized). In contrast, the look-through approach attributes the look-through adjustments for a particular property to the partners whose capital accounts are adjusted in the revaluation, but it does not lock in how the tax depreciation, gain, and loss attributable to the property will be allocated. Thus, in the foregoing

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example, the look-through adjustment is divided equally between investments 2 and 3 on the assumption that because each contributes equally to the built-in gain reflected in the partners' capital accounts in the revaluation, each will produce a corresponding amount of taxable gain (assuming sales at or above the revalued book values of the investments) that will be allocated to the UTP when the built-in gain is later realized. The problem arises because the tax gain generated when the built-in gain is realized is allocated differently than was the look-through adjustment.

This can occur whenever a revaluation is undertaken by a partnership that has (1) multiple assets and (2) different sharing percentages for the partners for different layers of economic performance. In those circumstances, the amount of taxable gain or loss allocated to a partner for a particular asset may depend on the order in which the assets are disposed of. As a result, upon the sale of an asset, if the values of all the assets have not changed since the revaluation, a partner whose share of the taxable gain on the sale is less (or more) than the portion of the appreciation attributed to that partner in the revaluation will effectively get a larger (or smaller) share of the remaining appreciation in the other assets.[53]

In the foregoing example, if it were known at the time of the revaluation that the UTP would be allocated none of the gain attributable to the appreciation in Investment 2 and 20 percent of the gain attributable to the appreciation in Investment 3, there would have been no look-through adjustment for Investment 2 and a $40 look-through adjustment for Investment 3. Therefore, upon the sale of Investment 3, the UTP would have had no book income, and all the taxable income appropriately would have been allocated to A and B.

As discussed later, several approaches can be taken to eliminate or mitigate the distortions potentially caused by the unanticipated allocation problem. However, those approaches either do not completely eliminate the distortions or are so complex that the cure may be worse than the disease. As a result, perhaps the best method for dealing with the unanticipated allocation problem is to simply live with it, subject to the antiabuse rule of reg. section 1.704-3(a)(10).[54] Disregarding situations in which the unanticipated allocation problem is deliberately manipulated to inappropriately skew the allocations of taxable gain or loss, the look-through approach arguably is a reasonable method (within the meaning of reg. section 1.704-3(a)) for dealing with the tax consequences associated with revaluations by a UTP, even if it results in an unanticipated allocation problem.

In that regard, the unanticipated allocation problem conceptually is very much akin to the ceiling rule in that it causes the basic premise of section 704(c) to be violated in situations in which the UTP receives items of income, gain, loss, or deduction when the tax consequences attributable to the built-in gain or loss are realized that differ from the amounts that were reflected in the partners' capital accounts at the time of the revaluation. Moreover, the unanticipated allocation problem is seemingly an accepted result under section 743 as it applies to real basis adjustments. Accordingly, absent a deliberate abusive use, the look-through approach should be considered a reasonable approach even in those cases in which it produces the unanticipated allocation problem.

Assuming that the IRS (or a court) determines that the look-through approach is not a reasonable approach in a given circumstance because of the application of the unanticipated allocation problem or because one or more of the partners in a UTP is unwilling to risk adverse tax consequences as a result of the possibility of there being an unanticipated allocation problem, the question remains how the problem could be

[53] Similar distortions can occur for realized losses.

[54] In somewhat similar circumstances, it has been argued that under the existing regulations, allocations for assets held by an LTP are not treated as basis derivative items of the UTP and are thus not governed by the rules of section 704(c). Huffman and Hortenstine, *supra* note 26. However, that argument is premised on the application of reg. section 1.704-3(a)(9), dealing with contributions of section 704(c) property to an LTP by a UTP, and that regulation is inapplicable to a revaluation at the UTP level. Although consistency might argue in favor of adopting a similar approach in the context of revaluations by UTPs, it would likely lead to the mandatory use of the entity approach and should be rejected for that reason alone. Further, there seems to be no compelling reason why items of gain, loss, and depreciation at the LTP level should not be treated as basis derivative items for the UTP. Accordingly, this discussion assumes that the look-through approach should be tested under section 704(c) (including the antiabuse rule) and could be authorized under that section.

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rectified. One possible approach would be to treat it like a ceiling rule limitation and fix it by using remedial- or curative-type allocations. Although this approach would seem to have theoretical merit, the existing concepts of curative allocations and remedial allocations are inadequate to fully eliminate distortions caused by the unanticipated allocation problem.

For example, if the remedial allocation method were used in Example 10, Partner D would be allocated a $10 remedial item of loss upon the sale of Investment 2, and partners A and B would each receive a $5 corresponding item of gain. When considered together with the amounts of taxable gain allocated to the partners upon the sale of Investment 3, each partner would have realized the correct aggregate amount of taxable gain. However, the timing of the recognition of the gain would be distorted. D ideally should never receive any allocation of gain or loss on the stated facts, but using a remedial allocation to fix the unanticipated allocation problem results in him receiving an early allocation of loss and a later offsetting allocation of gain. Conversely, if Partner C in Example 10 were itself a UTP that had undergone a revaluation upon the admission of a new partner, use of the remedial method in conjunction with the unanticipated allocation of "extra" gain to it upon the sale of Investment 2 would result in the new partner receiving an early allocation of taxable gain that would be offset with a later allocation of a remedial loss (or less gain), which might well not be usable in the year received.

In short, using the remedial allocation method only partially fixes the unanticipated allocation problem. Moreover, any required use of the remedial allocation method in conjunction with the look-through approach would likely result in the remedial allocations fixing both the unanticipated allocation problem and any ceiling rule limitation, because it would be hard (although maybe not impossible) to separate the two reasons for there being a shortfall in basis derivative items to allocate to the partners of the UTP that did not have their capital accounts adjusted in the revaluation. Similar outcomes would likely result if curative allocations were used. Accordingly, if a complete fix for the unanticipated allocation problem is desired, a different approach is likely necessary.

The unanticipated allocation problem arises when the tax items attributable to the built-in gain (or loss) that existed at the time of a revaluation are ultimately realized and allocated in a manner that differs from the assumed allocation at the time of the revaluation. The resulting distortions can be eliminated if, at the time of the later unanticipated allocation, the original look-through adjustments are reallocated based on how the built-in gains or losses that gave rise to the look-through adjustments actually are allocated by the LTP.

To be able to appropriately reallocate the look-through adjustments to reflect how the basis derivative items attributable to the built-in gain or loss reflected in the UTP's revaluation should have been allocated had the "unanticipated" allocations been correctly anticipated, it first must be determined how the look-through adjustments would have been made had the allocations been known when the look-through adjustments were made. Absent a crystal ball or other means of clairvoyance, this determination must await the actual allocations. At that point, it would theoretically be possible to go back to the time when the original look-through adjustments were made, redo the adjustments, and then recompute the allocations of book and tax items for all the ensuing tax periods using the "correct" look-through adjustments. Such an approach could, of course, be a nightmare even for a fairly simple situations, let alone for partnerships with a multitude of assets and very long terms.

An alternative approach would be to use what will be referred to as "grossed-up look-through adjustments." Conceptually, this approach entails allocating the look-through adjustments at the time of the revaluation by the UTP as previously described (that is, as if all the assets of the LTP were simultaneously sold) and then adjusting the amount of the look-through adjustments if and when an unanticipated allocation is made, so that they coincide with the amount of the look-through adjustments that would have resulted had the adjustments been deferred until the time of the unanticipated allocation. The grossed-up look-through adjustment is used to determine the

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Table 3

Partner A		Partner B		Partner D	
Book	**Tax**	**Book**	**Tax**	**Book**	**Tax**
$30	$0	$30	$0	$60	$60

amount and allocation of the deferred look-through adjustment.

A grossed-up look-through adjustment for an LTP asset is an amount initially equal to the aggregate amount of gain (or loss, as applicable) that would be realized by the LTP for the asset if the LTP sold the asset for a price that would result in the UTP being allocated gain (or loss) equal to its look-through adjustment determined at the time of the revaluation by the UTP. Thus, if a UTP with a 20 percent interest in an LTP has a $100 look-through adjustment for an LTP asset, the grossed-up look-through adjustment of the asset would be $500.[55] The initial grossed-up look-through adjustment for the asset would then be adjusted in the same manner as the look-through adjustment of the UTP (depreciated over the same recovery period and at the same rate, etc.). In any year in which the LTP engaged in a transaction that gave rise to an unanticipated allocation problem, the UTP's look-through adjustments for the assets of the LTP would be modified to reflect the amount of gain or loss it would realize if the assets of the LTP were sold at values that would produce gain or loss equal to the then-grossed-up look-through adjustments for the assets.

Example 11: Assume Partner A and Partner B form UTP to act as the general partner of a venture capital fund. UTP forms the fund, LTP, with Partner C as the sole investor. C contributes $600 to LTP, and UTP receives an interest in LTP entitling it to 20 percent of any cumulative profit solely in return for providing investment advisory services. LTP invests the $600 in three separate investments costing $200 apiece. Investment 1 later becomes worthless and is written off. The $200 loss is allocated entirely to C. Investments 2 and 3 thereafter appreciate to $500 and $400, respectively. Accordingly, if LTP sold all its assets and liquidated, UTP would be entitled to receive $60 (that is, 20 percent of the cumulative appreciation of $300). At that time, assume Partner D invests $60 in UTP in return for a 50 percent interest, and UTP revalues its assets (the interest in LTP) to $60. As a result, the book and tax capital accounts of the three partners of UTP are as shown in Table 3.

If the look-through approach were used, UTP initially would receive a $60 look-through adjustment for the assets of LTP, allocated $36 to Investment 2 and $24 to Investment 3 (that is, in proportion to their respective amounts of appreciation). Because UTP is entitled to 20 percent of the cumulative profit generated by LTP, the $60 look-through adjustment at the UTP level would equate to $500 of total appreciation in the remaining assets of LTP ($200 to offset the loss on Investment 1 plus an additional $300 so that the UTP's share of cumulative gain/appreciation would equal $60), allocated $300 to Investment 2 and $200 to Investment 3. Accordingly, the grossed-up look-through adjustment for Investment 2 would be $300, and the grossed-up look-through adjustment for Investment 3 would be $200.[56]

To determine whether any of UTP's look-through adjustments must be reallocated, the actual order of sale of investments 2 and 3 would be taken into account, and the look-through adjustments for the two investments would be modified to reflect the amount of gain or loss that would be allocated to UTP if the assets were sold at that time for amounts that would produce gain or loss equal to the assets' respective grossed-up look-through adjustments. Thus, if Investment 2 were sold first for $600, the reallocated look-

[55]More specifically, the grossed-up look-through adjustment for an asset is the amount determined for that asset at the end of step 3, *supra* note 51.

[56]The grossed-up look-through adjustments in this example equal the appreciation in each of the LTP's assets only because it was assumed for simplicity that the FMV of UTP's interest in LTP equaled its share of the FMV of the assets of LTP. More typically, those adjustments would be based on the FMV of the UTP's interest in the LTP taking into account any appropriate discounts for such things as lack of marketability.

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through adjustment would be determined at the time of sale by treating Investment 2 as if it were sold for $500, producing a gain equal to its grossed-up look-through adjustment of $300.

At the LTP level, the first $200 of gain would be allocated to C to reverse the $200 loss that it was allocated from Investment 1, and the balance would be allocated $80 to C (80 percent) and $20 to UTP (20 percent). Because UTP would be allocated only $20 of that gain, its original look-through adjustment for Investment 2 would be reduced from $36 to $20. UTP's look-through adjustment for Investment 3 would be recomputed assuming a sale of Investment 3 for $400 following the sale of Investment 2 (producing gain equal to its grossed-up look-through adjustment of $200). The gain from that hypothetical sale would be allocated $160 to C (80 percent) and $40 to UTP (20 percent). Thus, UTP's look-through adjustment for Investment 3 would be increased from $24 to $40. The net result would be a reallocation of $16 of the original look-through adjustments from Investment 2 to Investment 3.

Importantly, the reallocation of the look-through adjustments is done based on hypothetical sales for amounts sufficient to produce gain (or loss) equal to the assets' respective grossed-up look-through adjustments, not the actual sale price(s) for the assets. Once the reallocation is done, the standard look-through approach is used. Thus, upon the sale of Investment 2 for $600, there would be $200 of cumulative tax gain, so UTP would be allocated $40 of tax gain from the sale. Because UTP had a revised look-through adjustment of $20 for Investment 2, it would have $20 of book income. Accordingly, D would be allocated $10 of book and tax income, and each of A and B would be allocated $5 of book gain and $15 of tax income/gain.

If Investment 3 were then sold for $400, UTP would be allocated $40 of tax gain and would have no book gain once its $40 look-through adjustment was taken into account. D would be allocated no book and tax gain, and A and B would each be allocated no book gain and $20 of tax gain. Combining the results of the two sales, D would have $10 of book and tax gain, and each of A and B would have $5 of book gain and $35 of tax gain (with the "extra" tax gain equaling the amount of the revaluation adjustment to the LTP interest).

Two points of particular interest: First, the aggregate amount of UTP's look-through adjustments remains the same; it is just allocated between the investments in different proportions. Second, the look-through adjustment attributable to Investment 2 is adjusted down from $36 to $20 even though the aggregate amount of taxable gain allocated to UTP from the sale is $40. This point demonstrates that the need for a reallocation of the look-through adjustments is conceptually different from a ceiling rule limitation because it is not the result of the tax gain being smaller than the look-through adjustment.

The reallocation of look-through adjustments based on grossed-up look-through adjustments rectifies the unanticipated allocation problem, but it does so at the cost of considerable complexity and administrative burden. Although the foregoing example is relatively straightforward, appropriately reallocating look-through adjustments in situations in which there may be multiple layers of look-through adjustments caused by multiple revaluations by the UTP or LTPs with many assets could become a colossal task. Ultimately, the question is whether the cost is worth it. Fortunately, even if the answer is yes, because the unanticipated allocation problem is likely only to be significant in partnerships that have (1) different sharing arrangements for different tranches of economic performance and (2) multiple properties, the need to reallocate look-through adjustments is probably limited. Even in those circumstances, however, because of the complexity of the approach, it would seem preferable to use the general look-through approach and rely on the antiabuse rule of reg. section 1.704-3(a)(10) to police potential abuses as discussed earlier. Presumably, that rule would need to be invoked only if the UTP and the LTP were commonly controlled or if there was other evidence of collusion between the two partnerships.

One final observation regarding the look-through approach is that it does not satisfy one of the seeming objectives of the proposed section 751(b) regulations. As previously mentioned, those proposed regulations mandate that an LTP

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undertake a revaluation in some circumstances in which the UTP makes a distribution to one or more of its partners and the LTP owns section 751 property (unrealized receivables or substantially appreciated inventory). By doing so, the partners' respective shares of built-in gain or built-in loss in the section 751 property and in the other assets of the LTP are locked in (subject to ceiling rule constraints) and will not be subject to change in the future. Presumably, the section 751(b) proposed regulations take this approach to ensure that once an analysis is done to determine whether the partners' respective shares of gain or loss attributable to section 751 property have been determined in connection with a distribution, there will be no redetermination of those shares attributable to the assets still held in an LTP.

Although that approach can be seen as an antiavoidance provision, it is nowhere mandated (or even suggested) under section 751(b), even in a single-tier structure. Moreover, it is fundamentally inconsistent with how profits and losses of a partnership may be allocated among its partners. Absent a distribution that triggers the recognition of income under section 751(b), a partnership is generally able to change how different types of income or loss are allocated among its partners as long as the allocations meet the substantiality prong of the substantial economic effect test of section 704(b).

Thus, a partnership that sells capital gain assets and allocates the gain among its partners is generally not constrained in how it allocates gain from other assets in subsequent periods. The proposed section 751 regulations, however, apply a different paradigm when the partners' shares of unrealized ordinary income or loss are changed (or might be changed) as a result of a distribution to the partners. By mandating a revaluation, those proposed regulations require that any built-in gain or built-in loss in the non-distributed assets be allocated (when realized) to the partners under section 704(c) principles in the exact amounts in which the partners shared at the time of the distribution. Although that approach would seem questionable even as it would apply to a UTP, applying it to an LTP with the resulting potential effect on the economics and tax consequences to the partners other than the UTP that had no role in the section 751(b) distribution seems entirely inappropriate.

IV. Conclusion

As can be seen from the foregoing discussion, revaluations at UTPs present complicated conceptual problems. Any approach for dealing with these problems should have two primary objectives. First, it should comply with the primary directive of section 704(c) that the tax consequences attributable to variations between the adjusted tax basis of property and its FMV at the time of the revaluation should be borne by the partners that have their capital accounts adjusted as a result of the revaluation. Second, it should not affect the economic or tax sharing arrangements among the existing members of the LTP.

Neither of the two approaches usually suggested for dealing with revaluations by a UTP — the entity approach and the aggregate approach — meet both of those objectives. In all but the simplest cases, the entity approach will not result in the partners that receive the adjustments to their capital accounts in the revaluation being allocated the associated tax consequences. Although the aggregate approach generally will produce allocations of the tax consequences of the built-in gain or loss among the partners of the UTP that are in line with the principles of section 704(c), it will often affect the economic and tax sharing arrangement among the partners of the LTP even though no adjustments were otherwise made to their economic sharing arrangements. Moreover, the aggregate approach does not adequately address a host of technical issues such as the consequences of differences between the UTP's basis in its interest in the LTP and its share of the basis of the LTP assets and the consequences of separate revaluations undertaken by the LTP either before or after the revaluation by the UTP. It also would result in revaluations at the LTP level that are not derived from an arm's-length transaction between the LTP and one of its partners, which is the hallmark of the other transactions that give rise to allowable revaluations under the section 704(b) regulations.

The look-through approach generally meets both objectives for dealing with revaluations at a UTP and resolves many of the technical issues that plague the aggregate approach. Further, it typically

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Table 4

Partner A (60%)		Partner B (15%)		Partner C (25%)	
Book	Tax	Book	Tax	Book	Tax
$960	$480	$240	$120	$400	$400

would be considerably easier to administer than the aggregate approach. Its one significant identified deficiency would seem to be the unanticipated allocation problem. However, because that problem would arise only under limited circumstances and is, by its nature, unanticipated, the occasional distortions it could cause might best be viewed in a manner similar to those caused by the ceiling rule — as a circumstance in which some of the tax consequences associated with the variations between the revalued book values of the partnership's assets and their FMVs are borne by partners that did not have their capital accounts adjusted in the revaluation despite the parties' efforts to avoid that result. Alternatively, remedial or curative allocations could be mandated under the look-through approach to partially remedy the distortions caused by the unanticipated allocation problem, or a more complete remedy could be had by using the grossed-up look-through adjustment approach, but at the cost of significant complexity.

V. Appendix

The following example demonstrates how the undivided interest approach for analyzing partnership revaluations is likely to dramatically distort the allocations of basis derivative items associated with the appreciation/depreciation of the assets reflected in the revaluation.

Example: Suppose Partner A contributes $800 and Partner B contributes $200 to a new partnership in return for interests of 80 percent and 20 percent, respectively. The partnership buys property for $1,000 that is depreciable over 10 years in equal annual amounts of $100. For each year, assume that revenue exactly equals expenses other than depreciation. After four years, when the property has an adjusted tax basis of $600 and a value of $1,200, Partner C is admitted to the partnership with a 25 percent interest in return for a capital contribution of $400. The partnership undergoes a revaluation and elects to use the traditional method for making the resulting reverse section 704(c) allocations. The resultant book and tax capital accounts are shown in Table 4.

Under the undivided interest approach, A would be treated as having contributed a property with an FMV of $960 and a tax basis of $480, and B would be treated as having contributed a property with an FMV of $240 and a tax basis of $120.

In the fifth year, the book depreciation on A's contributed undivided interest in the property would be $160 (that is, $960/6), and the tax depreciation would be $80 (that is, $480/6). The book depreciation would be allocated $96 to A (60 percent), $24 to B (15 percent), and $40 to C (25 percent). Because B and C are both noncontributing partners for this property, they would be allocated tax depreciation equal to their shares of book depreciation, and the remaining tax depreciation of $16 would be allocated to A.

The book depreciation on B's contributed undivided interest in the property would be $40 (that is, $240/6), and the tax depreciation would be $20 (that is, $120/6). The book depreciation would be allocated $24 to A (60 percent), $6 to B (15 percent), and $10 to C (25 percent). Because A and C are both noncontributing partners for this property, they should be allocated tax depreciation equal to their shares of book depreciation. However, the tax depreciation is less than their combined shares of book depreciation. Accordingly, the ceiling rule would apply, and because the partnership used the traditional method in making its reverse section 704(c) allocations, A would be allocated $14.12 (that is, $20 * 60 percent/(60 percent + 25 percent)) of the tax depreciation, and C would be allocated $5.88 (that is, $20 * 25 percent/(60 percent + 25 percent)). As a result, the total book and tax depreciation from the "two" properties would be allocated as follows in Table 5.

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Table 5

	Partner A (60%)		Partner B (15%)		Partner C (25%)	
	Book	Tax	Book	Tax	Book	Tax
Property A	$96	$16	$24	$24	$40	$40
Property B	$24	$14.12	$6	$0	$10	$5.88
Total	$120	$30.12	$30	$24	$50	$45.88
Percentage	60%	30.12%	15%	24%	25%	45.88%

This example demonstrates two important points raised by the Undivided Interest Approach:

First, the newly admitted partner — Partner C in the example — can be allocated less tax depreciation than book depreciation as a result of the application of the ceiling rule even though there is more than enough tax depreciation on the partnership's revalued assets to match C's allocated book depreciation. This results from the fact that the ceiling rule applies separately for each of the historic partners that is considered to have contributed an undivided interest in the partnership's assets.

Second, in situations in which the historic partners have differing percentage interests, the revaluation can cause a shift of depreciation from partners with larger percentage interests to the partners with smaller percentage interests as a result of the application of the ceiling rule. This occurs because, as between the "contributing" partners, the ceiling rule will typically come into play sooner for the deemed contribution from the smaller partner because the larger partner has a larger share of the basis of the assets and needs to allocate only a relatively small share of the depreciation for its "contributed" undivided interests to the smaller partner. In the example, this phenomenon actually results in Partner B receiving more depreciation than he would have received had Partner C never been admitted to the partnership, and it results in B being allocated 44.35 percent of the total tax depreciation allocated to the two historic partners, rather than the 20 percent one might expect.

The foregoing distortions caused by the undivided interest approach are, at best, counterintuitive. The first distortion — that the new partner is subject to ceiling rule limitations separately for the deemed contributions by each of the historic partners — could possibly be rationalized as nothing more than yet another example of distortions caused by the application of the ceiling rule. The second distortion, however, seems entirely unjustified in that it reallocates depreciation among existing partners even though their relative interests have not changed — a result that conceivably could be prohibited in some circumstances by the antiabuse rule in reg. section 1.704-3(a)(10) or rejected under the general test of reg. section 1.704-3(a)(1) that the allocation must be reasonable. ■

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