Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part III–Bringing in the Public and Management and Partnership Allocations)

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Deborah Fields, Holly Belanger and Eric Lee, in Part III, examine significant U.S. federal income tax issues raised by bringing in the initial public unitholders and management and allocating income and deductions to the PTP's initial unitholders.

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I. Introduction

This article is the third installment of a multiple-part primer regarding the unique and complex set of U.S. federal income tax issues associated with the formation and operation of a natural resources publicly traded partnership (PTP).[1] The primer focuses on natural resources PTPs, such as exploration and production ("E&P" or "upstream"), pipeline ("midstream"), and refining or marketing ("downstream") companies. Nonetheless, many of the issues discussed in this primer are common to all PTPs (including PTPs the activities of which are financial in nature), as well as to partnerships in general.

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Parts I and II of this primer (hereinafter referred to as "Part I" and "Part II," respectively) were published in previous issues of this publication.[2] Part I and Part II provided the following, among other things:

- Background information regarding natural resources PTPs
- Why a PTP may want to be classified as a partnership for U.S. federal income tax purposes and discussed the requirements that must be satisfied in order for a natural resources PTP to be classified as such
- Several basic concepts that are critical to understanding the U.S. federal income tax issues PTPs confront (such as "fungibility" and the "tax shield"[3])
- Certain structural issues a sponsor may want to consider in forming a PTP—such as whether to

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legally organize the PTP as a limited partnership or a limited liability company (LLC) and whether to have the PTP hold property directly or through a lower-tier entity

- The concept of the "Code Sec. 704(b) capital account" of each unitholder
- Different ways the sponsor can structure the PTP's acquisition of property and the different U.S. federal income tax consequences that can stem from how the acquisition is structured

This third installment of the primer finishes the discussion of the formation transaction by addressing significant U.S. federal income tax issues raised by bringing in the initial public unitholders and management. This installment then turns to how the PTP allocates income and deductions to its initial unitholders. As is explained in that discussion, the U.S. federal income tax rules governing allocations are very complicated but can play a critical role in ensuring that the public units are fungible in supporting the tax shield associated with the public units and in maintaining the economic arrangement between the public unitholders and the sponsor.

II. Additional Formation Issues–Bringing in the Public and Management

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The initial public investors in a PTP typically will acquire limited partnership units (or common units) in exchange for cash in an initial public offering (IPO). The public's contribution of cash for units usually is structured to qualify for tax-free treatment under Code Sec. 721(a).[4] As a result, each public unitholder typically will have an initial basis in its PTP units equal to the amount of money he or she contributed, plus the amount of the PTP's debt that is allocated to him or her,[5] while his or her initial Code Sec. 704(b) capital account typically will reflect the amount of money contributed.[6]

As was explained in Part I, PTPs have been raising an increasing share of capital through private placement or "PIPE" transactions—*i.e.*, Private Investment in Public Entities. In a PIPE transaction, large investors, such as institutional investors and investment funds, typically negotiate directly with the PTP to purchase a large volume of the same common units issued to public investors, but at a discounted rate. In some situations, a PIPE transaction might be used to raise initial capital for the PTP; however, in many situations, a PIPE transaction or a secondary public offering (SPO) might be used to raise additional capital well after the PTP has been established. Because a PIPE transaction involves a contribution of money by a private investor to the PTP in exchange for units, the transaction (like an IPO) can be structured to be tax-free under Code Sec. 721(a). Nonetheless, the application of the partnership tax rules to PIPE transactions can raise complexities:

- In the case of a discounted offering, the PIPE investor's initial Code Sec. 704(b) capital account reflects the amount actually paid for its units—not the fair market value of the units. Because the investor's units will be eligible to trade on the public market, they must be fungible with other common units that were issued at fair market value.[7] As such, each of the investor's units must have the same Code Sec. 704(b) capital account per unit as the other common units. Thus, PTP agreements often provide for special allocations of income and gain to be made to the units held by the PIPE investors to, in effect, equalize their capital accounts (on a per unit basis) with those of the other common unitholders. These "economic uniformity allocations" can have a tax cost to the PIPE unitholders and are discussed in greater depth in section III.A.1.c of this installment, below.
- If a PIPE transaction (or SPO) is used to raise additional capital after the PTP has been established, the admission of new partners may require the partnership's assets and the partners' Code Sec. 704(b) capital accounts to be revalued and may result in an additional "layer" of built-in gain or loss in the partnership's property under Code Sec. 704(c).[8] The issues associated with admitting new partners to an existing PTP will be discussed in the next installment of this primer.

While the initial investors in a PTP typically acquire their units for cash, management may acquire its interests in exchange for services. As was explained in Part I, until recently, it was common for natural resources PTPs to provide incentive interests—such as incentive distribution rights (IDRs), management incentive units and management incentive interests (MIUs and MIIs), and subordinated units—to management at the time of formation.[9] While incentive interests are still present with most PTPs, they have become less popular in newly formed PTPs, with most E&P PTPs being formed without incentive interests.[10] This is at least partially because of the

strain that incentive interests can place on the public's yield and the negative impact such interests can have on the PTP's cost of capital. Because incentive interests typically provide management with a right to increasing distributions of net cash flow as the public shareholders receive greater amounts of per-share quarterly distributions, the PTP must be able to produce a correspondingly higher amount of net cash in order to maintain its distributions to the public unitholders. Many sponsors have decided that they would prefer to part with the additional return in favor of additional certainty with respect to the ability to make distributions to investors.

Nonetheless, to the extent that a PTP does decide to issue incentive interests to management, it may want to consider a number of U.S. federal income tax issues. For example, although the issuance of an interest in the future profits of a partnership in exchange for services often can be structured so that it is not a taxable event for the partnership or the recipient, it is somewhat unclear whether the issuance of incentive interests in PTPs can qualify for this treatment—notwithstanding good arguments that such treatment ought to be available.[11]

In addition, in many situations, the holder of a profits interest is treated as a partner and, like other partners, is subject to tax on its distributive share of partnership items.[12] By becoming a partner, however, a person can lose his or her status as an employee for U.S. federal tax purposes.[13] As a result, the person may end up trading in having U.S. federal income tax withheld in favor of having to make quarterly estimated tax payments and having to include his or her share of the PTP's items on his or her U.S. federal income tax return. He or she also may lose the ability to participate in certain "employee-only" fringe benefits (such as receiving employer-provided health insurance on a tax-free basis) and may bear increased compliance burdens from a state perspective (such as potentially having to pay state taxes in more jurisdictions). This may come as an unwelcome surprise to some management personnel who are used to being classified as employees.[14]

Further, the PTP and management may want to consider the impact of issuing incentive interests on management's tax basis in its interests and its Code Sec. 704(b) capital accounts. Because management typically will not contribute cash or property in exchange for incentive interests, the initial tax basis and Code Sec. 704(b) capital accounts attributable to such interests typically will be zero. As such, while the incentive interests may be entitled to share in the PTP's distribution of net cash from operations, management may not have sufficient capital account or tax basis to support such distributions.[15] In an effort to remedy this, a PTP partnership agreement typically requires a "priority allocation" of gross income to be made to the holders of the incentive interests to match the amount of cash to which the holders are entitled. Because a priority allocation usually is an allocation only of gross income, such allocation typically does not include any items of depreciation, depletion or amortization (DD&A) and, thus, does not reduce the tax shield available to the public unitholders.[16]

Finally, if the incentive interests are convertible into common units that are tradable on the public market,[17] the PTP may want to consider the implications of a future conversion (*i.e.*, a recapitalization of the interests from incentive interests to common units). The recapitalization typically will not, by itself, be a taxable event, but will merely reflect a change in the holder's entitlements under the PTP partnership agreement.[18] As such, the holder's historic tax basis and Code Sec. 704(b) capital account typically will carry over to his or her common units. Nonetheless, if the initial Code Sec. 704(b) capital account for the incentive interests was zero, it is likely that, following the conversion, the per unit Code Sec. 704(b) capital accounts of the former incentive interest holders will not match the per unit capital account balances of the public unitholders. Thus, it may be necessary to make an allocation to the incentive units at the time of the conversion to make the per unit capital accounts of the converted units equal to those of other common units. This allocation often will fall under the provision in the PTP partnership agreement that governs economic uniformity allocations to PIPE units (discussed below).

III. Allocating Partnership Items to Initial Unitholders

Subchapter K of the Internal Revenue Code contains very complicated rules for determining how a partnership can allocate tax items to its partners. In any partnership, the manner in which items of income, gain, loss, deduction and credit are allocated is important to the partners given the potential impact such allocations can have on the partners' tax liabilities. In the PTP context, the allocation rules can have even greater significance. As is explained below, the allocation rules can play a key role in ensuring that

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units that trade on the public markets are fungible, can affect the tax shield of the PTP's units, and can help maintain the economic "deal" between the sponsor and the public investors.

The discussion below begins by summarizing the basic rules that apply in allocating the PTP's tax items to its initial unitholders. Then, it addresses the significant complexities that arise when a PTP is engaged in the oil and gas business and has property that is subject to the allowance for depletion.

We also note that allocation issues can be raised when the partners of the PTP change their economic arrangement at some time after the formation transaction, such as, for example, if the PTP issues units to new partners to raise additional capital. These issues will be discussed in the next installment of the primer.

A. General Rules for Allocating Partnership Items

The partnership allocation rules are intended to provide partners with significant flexibility in how they share items of partnership income, gain, loss, deduction and credit. In this regard, Code Sec. 704(a) provides that each partner's distributive share of a partnership's items of income, gain, loss, deduction and credit generally is determined in accordance with the partnership agreement. Thus, the provisions in a PTP's partnership (or operating) agreement typically are the starting point in determining how items are allocated.

Nonetheless, there are important limitations to this general allocation rule. Code Sec. 704(b) provides that allocations are determined in accordance with the partner's "interest in the partnership (determined by taking into account all facts and circumstances)," instead of the partnership agreement, if the allocation to a partner under the partnership agreement does not have "substantial economic effect."[19] Further, Code Sec. 704(c) provides rules for allocating tax items with respect to certain property that is contributed to the partnership by a partner when the fair market value of such property differs from its adjusted tax basis on the date of contribution ("Code Sec. 704(c) property").[20] The discussion below provides a very high level summary of aspects of the rules of Code Sec. 704(b) and (c) that are relevant to a PTP's allocations to its initial unitholders.[21]

1. Code Sec. 704(b)

As a very general matter, the Code Sec. 704(b) rules are intended to ensure that a partnership's tax items are allocated in a manner that is consistent with how partners share in such items as an economic matter. Once a partner's economic entitlements under Code Sec. 704(b) are determined, the accompanying tax items generally follow the Code Sec. 704(b) allocations.[22]

The Code Sec. 704(b) rules, in effect, require the creation of a Code Sec. 704(b) balance sheet, sometimes colloquially referred to as the "fair value" balance sheet. This is a misnomer in that the Code Sec. 704(b) rules do not operate like the mark-to-market rules (*i.e.*, the partnership generally does not restate its Code Sec. 704(b) books to fair value annually). Instead, when a partnership acquires property, whether by contribution or purchase, the property generally is reflected on the partnership's Code Sec. 704(b) balance sheet at its then fair market value.[23] The partnership generally continues to carry the property at this value and does not restate such value unless there is a subsequent change in the economic arrangement of the partners.[24]

The Code Sec. 704(b) regulations provide three ways an allocation of partnership items that is set forth in the partnership agreement, such as DD&A, can be respected. The first is that the allocation has substantial economic effect (SEE); most PTPs rely on this standard.[25] The second is that, under all of the facts and circumstances, the allocations are in accordance with the partner's interest in the partnership (PIP).[26] Third, specific types of allocations can be deemed to be in accordance with PIP under one of a number of special rules.[27] The discussion below first briefly summarizes the SEE requirement and the PIP rules and then addresses certain practical implications of these rules in the PTP context.

a. Can You SEE the Light? Determining whether an allocation has SEE involves two conjunctive tests. To be respected, (1) an allocation must have economic effect[28] and (2) the economic effect of such allocation must be "substantial."[29]

Economic Effect. The economic effect part of the SEE standard seeks to ensure that, in the event there is an economic benefit or economic burden that corresponds to an allocation of tax items, the partner to whom the allocation is made receives such benefit or bears such burden.[30] The regulations under Code Sec. 704(b) provide a mechanical test for determining whether an allocation has economic effect. Under this test, a partnership's allocations generally are considered to have economic effect if, for the full term of the partnership, the partnership agreement:

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- requires the partnership to establish and maintain capital accounts for the partners under the rules of Code Sec. 704(b);[31]
- requires the partnership to liquidate according to the positive Code Sec. 704(b) capital accounts of the partners;[32] and
- contains either an unlimited, unconditional capital account deficit restoration obligation (DRO) or a qualified income offset provision (QIO).[33]

The partnership agreement for a PTP typically will be drafted to include provisions satisfying the above requirements.

As was indicated above, the economic effect test requires a partnership to establish and to maintain capital accounts for its partners under Code Sec. 704(b) and to liquidate according to those positive capital accounts. A partner's Code Sec. 704(b) capital account functions much like a bank account. The balance in such account governs the partner's entitlement to the partnership's assets. Thus, under the SEE rules, the partnership must look to the balance in this account to measure the economic entitlement of each partner and must try to prevent the balance in each partner's capital account from becoming negative by more than the amount for which the partner is economically "on the hook" *(i.e.*, the balance in the partner's account cannot be overdrawn beyond the partner's obligation to repay the partnership).[34]

Substantiality. While the economic effect test is mechanical in nature, the test for substantiality is more subjective. The Code Sec. 704(b) regulations generally provide that the economic effect of an allocation is "substantial" if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.[35] The fact that the definition of "substantial" uses the term "substantially" is circular and is not particularly helpful in understanding the meaning of "substantial." The regulations, however, identify three instances in which allocations are *not* considered to be substantial:

- **Overall economic effect test.** The regulations generally provide that an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement; and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not in the partnership agreement.[36] In other words, an allocation generally is not substantial if it results in at least one partner being better off on an after-tax basis, but no other partner being worse off, as compared to the results if the allocation were not in the partnership agreement. This test is sometimes colloquially referred to as the "some helped, none hurt" test.
- **Shifting tax consequences.** The regulations also generally provide that allocations during a partnership's tax year are not substantial if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that (1) the net increases and decreases in the partners' respective capital accounts for such year will not differ substantially from the net increases and decreases that would be recorded in such partners' capital accounts for such year if the allocations were not contained in the partnership agreement; and (2) the total tax liability of the partners (for their respective tax years in which the allocations are taken into account) will be less than if the allocations were not contained in the partnership agreement.[37] In other words, an allocation set forth in a partnership agreement generally will not be respected if each partner's Code Sec. 704(b) capital account at the end of the year is equal to the capital account that would have resulted without the special allocation, but the aggregate tax liability of the partners is less than would have been the case without the special allocation. This test is designed to prevent taxpayers from making allocations based on the character of items (*e.g.*, allocating capital losses to some partners and ordinary losses to others or allocating tax-exempt income to some partners and taxable income to others) in situations in which there is a strong likelihood that the actual dollars received by the partners will not be affected.
- **Transitory allocations.** The regulations further generally provide that, if a partnership agreement provides for the possibility that one or more "original" allocations will be largely offset by one or more "offsetting" allocations over the course of a number of tax years, the economic effect of the original and offsetting allocations will not be substantial if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that (1) the net increases and decreases

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in the partners' respective capital accounts for the tax years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded if the original and offsetting allocations were not contained in the partnership agreement; and (2) the total tax liability of the partners (for their respective tax years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement. This is similar to the test for shifting allocations, but looks to whether allocations made to a partner in the current year will be reversed by offsetting allocations in subsequent years, such that the overall economic returns of the partners will not be affected (*e.g.*, there is a strong likelihood that allocations of net taxable loss will be offset by subsequent allocations of net income).[38] The regulations, however, generally presume that the original and offsetting allocations are not insubstantial under the transitory allocation rule if, at the time the allocations become part of the partnership agreement, there is a strong likelihood the offsetting allocations will not be made within five years of the original allocations (on a first-in, first-out basis).[39]

b. PIP. As was indicated above, Code Sec. 704(b) generally provides that an allocation is determined in accordance with PIP, instead of the partnership agreement, if the allocation to a partner under the partnership agreement does not meet the SEE requirements (or the partnership agreement fails to provide for the allocation). Very generally, PIP reflects the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction or credit (or item thereof) that is allocated.[40] The determination of PIP takes into account all of the facts and circumstances relating to the economic arrangement of the partners.[41] The regulations provide the following nonexclusive list of factors to consider in making this determination:

- The partners' relative contributions to the partnership
- The interests of the partners in economic profits and losses
- The interests of the partners in cash flow and other nonliquidating distributions
- The rights of the partners to distributions of capital upon liquidation[42]

Applying this facts-and-circumstances determination can be very complicated. For example, a partner's interest in a particular item of partnership income, gain, loss, deduction or credit may be different than the partner's overall interest in the partnership.[43]

c. Practical Application. For all of the complexity of the Code Sec. 704(b) rules, the allocation provisions in PTP agreements tend to be fairly straightforward. As was indicated above, most PTP agreements are drafted so as to satisfy the SEE standard and contain very few special allocations. The public unitholders in a PTP typically share in the net income or loss of the partnership based on their percentage ownership of the PTP and these "straight-up" allocations typically are used in computing the tax shield.

Nonetheless, as was mentioned above, a PTP's partnership agreement often will contain special "priority" and "economic uniformity" allocation provisions to the extent the PTP has issued incentive interests to management for services or has issued units to large investors at a discount in a PIPE transaction. As described above, a priority allocation is necessary to the extent incentive interests are entitled to distributions of the PTP's cash flow, but the Code Sec. 704(b) and tax basis of such interests are zero. The priority allocation generally requires the PTP to allocate an amount of gross income to the holders of the incentive interests to match their entitlements to cash distributions. Such allocation generally does not include any items of DD&A and, thus, does not reduce the tax shield available to the public unitholders.

Similarly, an economic uniformity allocation is necessary to the extent the PTP has issued common units at a discount (*e.g.,* a PIPE interest) or incentive interests that are converting into common units. This is because, absent such provisions, there may be different Code Sec. 704(b) capital accounts associated with these units than with other common units. Because Code Sec. 704(b) capital accounts affect how items are allocated for tax purposes, they affect the "economics" associated with unit ownership. As such, each unit that is capable of being traded in the public markets must have the same Code Sec. 704(b) capital account in order for all such units to be fungible.

As a practical matter, PTPs tend to use one or a combination of the following approaches to economic uniformity allocations:

- **Special allocation of gross income or gross loss.** This approach involves allocating the PIPE units or incentive interests an amount of gross income in the amount of the difference between the current per unit Code Sec. 704(b) capital accounts of such units and the per unit Code Sec. 704(b)

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capital accounts of the other public units. The allocation typically does not include any items of DD&A and, therefore, does not reduce the tax shield with respect to the public units. In cases in which the per unit capital accounts of the PIPE units or incentive interests need to be increased, this approach can result in allocating ordinary income to the holder of such units, with no offsetting allocation of items of deduction. Thus, this approach can involve an immediate tax cost to the holders of the PIPE units and incentive interests. This is the most common approach taken to ensure the fungibility of PIPE units.

- **Special allocation of Code Sec. 704(b) gain or loss, including unrealized gain or loss in the PTP's assets, to the holders of PIPE units.** Some economic uniformity allocations provide for an allocation of the PTP's income or gain, including any unrealized gains or losses in the assets of the partnership from the revaluation of the PTP's assets under Code Sec. 704(b).[44] Such an allocation typically is drafted so that the holders of the PIPE units or incentive interests have their Code Sec. 704(b) capital accounts "filled up" (or down) to the appropriate per unit amount and are taxed on the amount of unrealized gain (or loss) allocated to their units over time under the principles of Code Sec. 704(c) (described below), rather than taking into account income immediately.

Regardless of which of these approaches is followed, the special allocation can involve a tax cost to the holder of the PIPE unit or incentive interest. For example, assume that a large investor acquires units at a discount in a PIPE transaction. If a special allocation of gross income is made in the year the units are issued to the investor, the investor will take into account such allocation immediately. Nevertheless, the investor probably still will have saved more money from acquiring the units at a discount than it will pay in tax on the gross income allocation. If the partnership agreement instead provides for an allocation that includes unrealized Code Sec. 704(b) gain (rather than gross income), the investor still will have to take into account such gain, but the gain is deferred until the corresponding tax items are recognized under Code Sec. 704(c)—making the tax cost less burdensome.

2. "Forward" Code Sec. 704(c)

While the Code Sec. 704(b) rules generally are designed to ensure that the allocation of tax items follows how related Code Sec. 704(b) "book" items are allocated, this general scheme breaks down if the amount of a particular Code Sec. 704(b) item is different than the amount of the associated tax item because of a difference between the Code Sec. 704(b) value of property and the property's tax basis. For example, DD&A calculated with respect to the Code Sec. 704(b) value of property may differ significantly from DD&A calculated with respect to the tax basis of such property if the property was contributed to the partnership in a tax-free transaction at a time when the property's fair market value was different than its tax basis.[45] Code Sec. 704(c) comes into play to provide rules for dealing with differences between a property's value and its tax basis at the time the property is contributed ("forward Code Sec. 704(c)") or at the time the partnership changes its economic arrangement, for example, by issuing interests to new partners ("reverse Code Sec. 704(c)").[46]

The discussion below first provides some general background regarding forward Code Sec. 704(c) and its application to the initial unitholders of PTPs. Next, it addresses the methods a partnership can use in allocating items under Code Sec. 704(c) and explains why most (if not all) natural resources PTPs use the "remedial method." Then, it discusses special rules applicable when a sponsor (or other partner) contributes property at a time when the fair market value of such property is less than the property's tax basis (*i.e.*, the property is "built-in loss property"). The reverse Code Sec. 704(c) rules will be discussed in the next installment of this primer.

a. In General. Code Sec. 704(c)(1)(A) provides that income, gain, loss and deduction with respect to property contributed to the partnership by a partner will be shared among the partners 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. Code Sec. 704(c) generally is applied on a property-by-property basis.[47]

According to the Code Sec. 704(c) regulations, the purpose of Code Sec. 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss.[48] For example, if a partnership sells property that was contributed to the partnership by a partner, the partnership is generally required to allocate the gain (or loss) recognized on the sale of such property to the contributing partner to the extent of the appreciation (or depreciation) inherent in the property

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at the time of contribution. These allocations of partnership items attributable to pre-contribution gain or loss are commonly referred to as "forward Code Sec. 704(c) allocations."

The depiction of Code Sec. 704(c) as an anti-abuse rule does not completely describe its role in a PTP. In the case of a PTP, the rules of Code Sec. 704(c) can help maintain the economic arrangement between the sponsor and the public investors by giving the public investors the tax effect of the PTP's property having a tax basis equal to its Code Sec. 704(b) value. Consider the following simple example:

Example 1. At the formation of a PTP, the sponsor contributes a pipeline with a fair market value of \$100x and a tax basis of \$40x. The contribution is structured to qualify as a tax-free contribution.[49] The public investors contribute, in the aggregate, \$100x of cash that will be used by the PTP in its operations.[50] Based on the relative capital contributions of the partners, the sponsor and the public investors (in the aggregate) share in the partnership's net income or loss on a 50/50 basis.

If the partnership immediately sells the pipeline for its \$100x value, the public partners will not have been enriched as an economic matter. That is, they will have gone from having a 50-percent share of a pipeline worth \$100x to having a 50-percent share in the \$100x of cash received on the sale of the pipeline. The fact that the public partners have realized no gain as an economic matter is borne out by the lack of Code Sec. 704(b) gain on the sale (*i.e.*, the \$100x realized on the sale was the same as the Code Sec. 704(b) basis of the property). However, because the partnership's tax basis in the property was only \$40x, the partnership has recognized \$60x of tax gain on the sale.[51] Unless the public investors have struck a very poor deal with the sponsor, they likely would not anticipate being taxed on any portion of the \$60x tax gain. As is described in more detail below, Code Sec. 704(c) helps secure this result; in effect, Code Sec. 704(c) mandates that the \$60x of tax gain that existed when the property was contributed to the partnership be allocated to the sponsor.

The rules of Code Sec. 704(c) also can help the sponsor support the DD&A deductions available to the public's units and the tax shield of those units. As was explained in Part I of this primer, the larger the amount of DD&A deductions, the higher the amount of the tax shield—and the more attractive the PTP units may be perceived to be in the marketplace.[52] Consider the following example:

Example 2. Assume the same facts as in Example 1, but with the following additional facts. The pipeline has 10 years remaining in its useful life at the time the sponsor contributes it to the partnership. The pipeline is being recovered using the straight-line method such that, each year, the partnership is subject to \$10x of Code Sec. 704(b) depreciation (1/10 of \$100x book basis) and \$4x of tax depreciation (1/10 of \$40x tax basis).[53]

In this situation, as an economic matter, the pipeline will depreciate by \$100x over the 10-year period, with the public investors bearing the burden of \$50x of that depreciation. Correspondingly, if the sponsor had contributed "full basis" property to the PTP, there would have been \$50x of tax depreciation deductions to allocate to the public investors. However, because the sponsor contributed property that had a tax basis of only \$40x, for U.S. federal income tax purposes, the partnership has only \$40x of tax basis to depreciate. Consequently, although the public investors (in the aggregate) might reasonably expect to be allocated \$50x of tax depreciation deductions over the period, only \$40x of tax depreciation deductions appears to be available. As is explained below, the Code Sec. 704(c) regulations provide a mechanism by which a PTP can address the "shortfall" in tax depreciation relative to book depreciation available to the public investors.

b. Code Sec. 704(c) Methods. How a partnership allocates the DD&A deductions from, or gain or loss recognized on the disposition of, Code Sec. 704(c) property turns upon which "Code Sec. 704(c) method" it employs. The Code Sec. 704(c) regulations generally provide that a partnership must allocate its items of income, gain, loss and deduction using a "reasonable method" that is consistent with the purpose of Code Sec. 704(c).[54] The regulations provide three primary methods that are generally considered to be reasonable: the traditional method, the traditional method with curative allocations and the remedial method.[55] The choice of method can be made on a property-by-property basis[56] and can be a significant negotiating point in the formation of many partnerships. As is explained below, however, natural resources PTPs typically employ

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the remedial method. To understand the purpose for that choice, some background regarding the three methods may be helpful.

Traditional Method. Under the traditional method, if a partnership recognizes gain or loss on the sale of property that was contributed to the partnership at a time when the property's tax basis differed from its value, the built-in gain or loss inherent on the date of contribution is allocated to the contributing partner—*i.e.*, the partner who contributed the property.[57] If the partnership sells a portion of, or an interest in, Code Sec. 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner.

For Code Sec. 704(c) property that is subject to DD&A, the allocation of DD&A deductions under the traditional method takes into account any built-in gain or loss on the property.[58] The regulations indicate that tax allocations of cost recovery deductions with respect to Code Sec. 704(c) property to the noncontributing partners generally must, to the extent possible, equal book allocations from the property to those partners.[59] In other words, for built-in gain property, the contributing partner, in effect, takes into account built-in gain on the date of contribution by foregoing a share of the tax deductions generated by the property.

Under the traditional method, however, a partnership can only allocate the tax items that it actually has for the year. If the partnership does not have sufficient tax items from a contributed property to "match" the noncontributing partners' Code Sec. 704(b) allocations from such property, the partnership's ability to make the noncontributing partners whole is limited. This limitation is referred to as the "ceiling rule." The application of the ceiling rule can be illustrated by the following example.

Example 3. Assume the same facts as in Example 2 above. That is, the sponsor contributed Code Sec. 704(c) property (a pipeline) with a fair market value of $100x and a tax basis of $40x. The sponsor and the public investors (in the aggregate) share in the partnership's net income or loss on a 50/50 basis. The pipeline generates $10x of Code Sec. 704(b) book depreciation and $4x of tax depreciation during the year. If the PTP selects the traditional method with respect to the property, the PTP would allocate all of its tax depreciation for such year ($4x) to the public investors to match, to the extent possible, the allocation of the corresponding Code Sec. 704(b) book depreciation to those investors for such year ($5x). Because the property only generates $4x of depreciation deductions for tax purposes, however, only $4x of depreciation deductions can be allocated to those investors—notwithstanding that their share of the property's depreciation is $5x as an economic matter. Therefore, under the traditional method of Code Sec. 704(c), the public investors would experience a "shortfall" in the tax depreciation allocated to them of $1x.

If a PTP were to use the traditional method of Code Sec. 704(c) and were subject to the ceiling rule, the investors may have to wait until they sell their PTP units or the PTP liquidates to be made whole. This limits both the amount of tax deductions currently available to the public investors and the tax shield associated with their units. Thus, PTPs typically do not adopt the traditional method.

Traditional Method with Curative Allocations. The Code Sec. 704(c) regulations allow a partnership using the traditional method with curative allocations ("the curative method") to make reasonable curative allocations to reduce or eliminate disparities between the book and tax items of noncontributing partners. In other words, to the extent that there are insufficient tax items to allocate to the noncontributing partner (*i.e.,* there is a ceiling rule issue), the partnership can attempt to "cure" the shortfall.[60] This cure comes in the form of allocating other tax items that can be expected to have the same effect on each partner's tax liability as the tax item limited by the ceiling rule.[61] For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of Code Sec. 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up that difference, even though the corresponding book depreciation with respect to such property is allocated to the contributing partner.[62]

Example 4. Assume the same facts as Example 3, above, except that the partnership uses the curative method with respect to the pipeline. The partnership would be able to allocate to the public investors $4x of tax depreciation deductions from the pipeline, plus $1x of tax depreciation deductions from other partnership

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property. Thus, the tax deductions allocated to the public investors would match their share of book deductions. The use of the curative method, in effect, allows the partnership to take $1x of the sponsor's tax depreciation from the other property to cure the ceiling rule problem with respect to the pipeline.

The downside to the curative method is that the cure is limited to the partnership's available equivalent items. Although a partnership may make additional allocations in a later year to cure a shortfall in a prior year, if there are insufficient appropriate items, the noncontributing partner will still be subject to the shortfall.[63] Thus, the curative method is not usually adopted by PTPs.

Remedial Method. PTPs typically have chosen to utilize the third method set forth in the regulations—the remedial method. While the traditional method never fixes a ceiling rule problem and the curative method may fix the problem, the remedial method by definition ensures that a noncontributing partner receives tax items to match its Code Sec. 704(b) allocations. In other words, it always fixes a ceiling rule problem.

As with the other methods, the remedial method begins by allocating tax DD&A deductions with respect to Code Sec. 704(c) property to the noncontributing partners, to the extent possible, to equal book allocations from the property to those partners.[64] To the extent that there is a shortfall (or a ceiling rule issue), the partnership creates and allocates offsetting notional tax items in the amount of the shortfall. Thus, the partnership may allocate a notional DD&A deduction to the noncontributing partner and an offsetting amount of notional ordinary income to the contributing partner.[65] These notional items have the same effect as actual items on the amount of the partner's taxable income and his or her tax basis in the partnership interest.[66] Because the remedial method uses notional items, the remedial method is not dependent on the partnership having appropriate tax items in a particular year and, thus, always solves a ceiling rule problem.

The remedial method also gives a noncontributing partner a closer economic approximation of having purchased a share of the partnership's assets than the other Code Sec. 704(c) methods. It does this by changing the way the Code Sec. 704(b) basis of the property is recovered with regard to built-in gain property. The recovery of a property's Code Sec. 704(b) basis generally is based on the recovery of the remaining tax basis in the property.[67] The remedial method, however, requires that built-in gain property be broken into two parts for Code Sec. 704(b) purposes.[68] The amount of the Code Sec. 704(b) basis up to the tax basis of the property continues to be recovered over the remaining recovery period for the property (the "step-in-the-shoes" component).[69] However, the amount of Code Sec. 704(b) basis in excess of the tax basis of the property (referred to as "excess book basis") is recovered over any recovery period and depreciation method available to the partnership for newly purchased property (of the same type as the contributed property).[70] This has the effect of slowing down the Code Sec. 704(b) DD&A with respect to the property, as if the noncontributing partner had acquired the excess book basis portion of the property in a sale transaction and contributed it to the partnership.

Example 5. Assume the same facts as the previous examples, except that the partnership uses the remedial method with respect to the pipeline. That is, the sponsor contributed a pipeline with a fair market value of $100x and a tax basis of $40x. The pipeline has 10 years remaining in its useful life at the time of the contribution and is being recovered using the straight-line method. In addition, assume that if the pipeline were a newly purchased asset that was placed in service at the time of the contribution to the partnership, the pipeline would be recovered over 15 years using the straight-line method.

The first $40x of the Code Sec. 704(b) basis of the pipeline would continue to be recovered over the remaining 10 years in the recovery period—*i.e.*, $4x each year for 10 years (the step-in-the-shoes component). The remaining $60x excess book basis would be recovered using any recovery period and depreciation method available to the partnership for newly purchased property (of the same type as the contributed property). Thus, the $60x of excess book basis would be depreciated over 15 years using the straight-line method and would result in an additional $4x of Code Sec. 704(b) depreciation each year for 15 years. Thus, the recomputed Code Sec. 704(b) depreciation with respect to the pipeline would be $80x over the first 10

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year-period (*i.e.*, $8x in each of years 1 through 10) and $20x over the following five-year period (*i.e.*, $4x in each of years 11–15).

The public investors (in the aggregate) would be allocated one-half of the Code Sec. 704(b) depreciation over the entire life of the property: $40x over the first 10-year period ($4x per year) and $10x over the next five-year period ($2x per year). The $50x total Code Sec. 704(b) depreciation allocated to such investors over the 15-year period reflects the public investors' share of the lost economic value of the pipeline.

In this example, the partnership would allocate the entire $40x of tax depreciation available in the first 10-year period to the public investors (*i.e.*, $4x per year), consistent with the public investors' share of book depreciation in such period. As a result of changing the rate at which the Code Sec. 704(b) book basis is depreciated under the remedial method, the partnership has no ceiling rule issue in the first 10 years as the public investors are allocated tax depreciation ($40x) equal to their share of the Code Sec. 704(b) depreciation ($40x).

For the next five-year period, however, the partnership does not have any tax depreciation to allocate to the public investors to match their $10x share of Code Sec. 704(b) book depreciation. As a result, for years 11–15, the partnership would make remedial allocations of tax depreciation to the public investors of $10x (*i.e.*, $2x per year). Thus, the public investors (in the aggregate) ultimately would be allocated tax deductions reflecting their $50x share of the pipeline's economic depreciation. The partnership would make corresponding remedial allocations of ordinary income to the sponsor totaling $10x in years 11–15 (*i.e.*, $2x per year); however, this remedial income at least would be deferred until such years.

Sponsors of natural resources PTPs invariably choose to use the remedial method to make sure that the public unitholders receive tax allocations commensurate with the partnership's assets having a tax basis equal to value at the time of contribution. The sponsor, in effect, pays for making the public unitholders whole by accelerating its recognition of precontribution gain with respect to the property through the receipt of remedial income. It is common for sponsors to model the projected amounts of remedial income and remedial deductions both in determining how to transfer property to the PTP (*e.g.*, by sale or by contribution) and in computing the tax shield of the public's units.[71] As will be discussed in the next installment of this primer, such modeling also can help the sponsor understand how future unit issuances may affect it and the other unitholders.

c. Special Rules for Built-in Loss Property. Special rules apply when a partner contributes to a partnership property that has a tax basis in excess of value (*i.e.*, built-in loss property). Code Sec. 704(c)(1)(C)(i) generally provides that, if built-in loss property is contributed to a partnership, the built-in loss is only taken into account for purposes of determining the tax items allocated to the contributing partner.[72] In other words, the excess of the property's basis over its value at the time of contribution is only available in determining any gain or loss on the sale of the property, or any DD&A on the property, that is allocated to the contributing partner. The noncontributing partners cannot share in the "excess" basis.

This may not seem like much of a change over the way in which Code Sec. 704(c) otherwise would apply to built-in loss property.[73] However, Code Sec. 704(c)(1)(C)(ii) adds that, in determining the amount of items allocated to other partners, the basis of the property in the hands of the partnership is treated as equal to the property's fair market value at the time of contribution. This implies that the partnership is required to "carve off" the excess basis and hold it aside solely for the benefit of the contributing partner. Indeed, the Conference Report description of Code Sec. 704(c)(1)(C) states that, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the contributed built-in loss property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[74] Thus, the possible loss of any excess basis must be considered before a property contributing partner's interest (*e.g.,* the sponsor's interest) is transferred.

It is also important to recognize that Code Sec. 704(c)(1)(C) leaves many questions unanswered. For example, it is currently unclear how a partnership accounts for the excess basis on its books and what

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impact future changes in the value of the property may have. The IRS and the Treasury have not yet issued guidance on such issues.

B. Special Considerations with Oil and Gas Properties

Determining how to allocate tax items among the unitholders of a PTP can become even more complicated if the PTP holds oil and gas property that is subject to the allowance for depletion. Unlike depreciation, cost recovery through depletion does not have a specific timing component to it. Instead of recovering basis over a useful life, depletion allows a taxpayer to recover basis as a function of the production of oil and gas from the property, under whichever of two depletion calculation methods produces the higher deduction for the tax year.[75] The two permissible methods of calculating depletion are the cost method, which recovers basis as a function of the portion of the oil and gas reservoir recovered during the year, and the percentage method, which is a function of the income derived from the oil and gas property.[76] A full discussion of the tax rules applicable to depletion is beyond the scope of this primer. However, the discussion below provides general background regarding how the partnership rules address depletion. In addition, it addresses at a high level the complexities and uncertainties associated with depletion in the PTP context.

1. Background

Much of the complexity surrounding the application of the oil and gas partnership rules to a PTP stems from the basic approach Congress took in repealing percentage depletion for certain large producers of oil and gas.[77] In the case of a partnership holding oil and gas property, Congress chose to look to the individual partners to determine whether percentage depletion is available. This means that, rather than the partnership depleting the property as a separate entity, the partners compute the depletion allowance individually.[78] To accomplish this, each partner is treated as holding separately a share of the basis in the oil and gas property.[79] In addition, each partner separately keeps records of his share of the basis in each oil and gas property of the partnership, adjusts such share of basis for any depletion taken on such property, and uses such basis each year in computing his cost depletion or his gain or loss on the disposition of such property by the partnership.[80] Therefore, unlike other natural resources properties owned by partnerships, oil and gas properties are treated as if they are held outside the partnership by the partners.[81]

2. Code Sec. 704(b) Issues with Oil and Gas Property

The fact that partnerships are treated, for tax purposes, as if they do not hold their oil and gas properties presents unique challenges in partnership accounting, particularly with regard to the maintenance of the partners' Code Sec. 704(b) capital accounts. In order to reflect the economic arrangement of the partners, the Code Sec. 704(b) capital accounts need to reflect the way in which the partners share in items of partnership income, gain, loss and deduction. In the case of the depletion allowance for oil and gas property, however, technically there is no item of partnership deduction to take into account—the depletion deduction is outside the partnership at the partner level. Nevertheless, depletion deductions have a very real impact on the partners' economic deal.

The partnership capital account maintenance regulations offer two possible options to address this issue. First, a partnership can make downward adjustments to the partners' Code Sec. 704(b) capital accounts to take into account the actual depletion taken by the partners.[82] The partnership, however, might not have access to the actual depletion taken by the partners. Indeed, it is common for partners not to share information with other partners. This often makes the use of this approach impractical.

The second approach is for the partnership to independently determine an amount of depletion for the partners, solely for purposes of maintaining Code Sec. 704(b) capital accounts. This is referred to as "simulated depletion."[83] This approach allows the partnership to calculate depletion at the entity level for purposes of maintaining the partners' Code Sec. 704(b) capital accounts, without requiring the partners to share information with each other. The partnership can choose to use either the cost method or the percentage depletion method for purposes of maintaining simulated depletion.[84] The partnership makes this choice on a property-by-property basis in the first partnership tax year for which it is relevant for the property. The partnership's choice then is binding for all partnership tax years during which the property is held by the partnership.[85] The

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choice of method can be an issue that is negotiated by the parties in forming a partnership. Most oil and gas PTPs tend to choose the method that results in the largest depletion deductions for the public unitholders (and, therefore, maximizes the tax shield).[86]

If the partnership maintains its Code Sec. 704(b) capital accounts using simulated depletion, the partnership makes downward adjustments to the capital accounts of the partners for the simulated depletion allowance with respect to each oil or gas property of the partnership in the same proportion as such partners (or their predecessors in interest) were properly allocated the adjusted tax basis of such property.[87] The regulations under Code Sec. 613A provide a set of basic rules for allocating basis by a partnership to its partners. As a general matter, each partner's proportionate share of the basis in oil and gas property is determined in accordance with the partner's proportionate interest in partnership *capital* at the time of the allocation.[88] Alternatively, each partner's share of the basis in oil and gas property can be determined in accordance with the partner's proportionate interest in partnership *income* if both of the following requirements are met:

- The partnership agreement provides that a partner's share of the adjusted basis of one or more properties is determined in accordance with his or her proportionate interest in partnership income.
- At the time of allocation under the partnership agreement, the share of each partner in partnership income is reasonably expected to be substantially unchanged throughout the life of the partnership, other than changes merely to reflect the admission of a new partner, an increase in a partners' interest in consideration for money, property, or services, or a partial or complete withdrawal of an existing partner.[89]

A partner's interest in the partnership's capital or income is determined by taking into account all of the facts and circumstances relating to the economic arrangement of the partners.[90] The regulations suggest that this determination also should take into consideration the factors for determining a partner's interest in a partnership (*i.e.,* PIP), discussed above.[91]

These basic rules may be sufficient for the large number of oil and gas partnerships that are essentially "straight up" or *pro rata* business deals. For example, if A and B each contributes $100x to form a 50/50 partnership that uses the cash to buy an oil and gas property for $200x, the partnership likely would allocate each partner $100x of depletable basis in the oil and gas property. Each partner would then track independently the depletion of his or her separate basis.

The basic rules, however, suffer from two major weaknesses when applied outside of this simple context. First, because partnerships are limited to sharing depletion according to the capital or income interests of the partners, they may lack the flexibility in making allocations that partnerships generally have under Code Sec. 704(b). Particularly in a partnership in which each partner's share of partnership income may vary over time, a rule that requires basis to be allocated according to a partner's share in capital may seemingly preclude sharing in depletion in a manner other than *pro rata* to contributed capital. Whether or not a partnership with more complicated allocation provisions is limited to allocating depletable basis *pro rata* to contributed capital depends on how the "facts and circumstances test" in the Code Sec. 613A regulations is interpreted.

A second concern is that the Code Sec. 613A regulations can be difficult to apply if the partnership agreement contains complex allocations. Determining a partner's interest in income or capital based on all of the facts and circumstances can be burdensome. If the Code Sec. 613A(e) determination of a partner's interest is intended to be similar to the determination of PIP, the appropriate allocation of basis in a complex partnership arrangement may not be apparent.

To avoid these difficulties, the regulations allow for basis to be allocated under the principles of Code Sec. 704(b). More specifically, the Code Sec. 613A regulations provide that an allocation of the basis in oil and gas property is deemed to be in accordance with a partner's proportionate interest in partnership capital or income if the allocation satisfies the requirements of Reg. §1.704-1(b)(4)(v).[92] The Code Sec. 704(b) regulations generally provide that, if the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners, taking Code Sec. 704(c) into account, that allocation will be recognized as being in accordance with the partners' interests in partnership capital under Code Sec. 613A(c)(7)(D), provided that (1) the allocation does not give rise to capital account adjustments

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for simulated depletion, the economic effect of which is insubstantial, and (2) all other material allocations and capital account adjustments under the partnership agreement are recognized under Code Sec. 704(b).[93] Therefore, if the partnership's other allocations are respected under the general Code Sec. 704(b) SEE rules, the partnership may have some flexibility in allocating the basis of the partnership's oil and gas property.

3. Code Sec. 704(c) Issues with Oil and Gas Property

Further complexity arises if oil and gas property is contributed to a PTP with a built-in gain or loss. The Code Sec. 704(c) rules addressing oil and gas property are sparse at best and leave several important questions unanswered.

The Code Sec. 613A regulations provide that, if oil and gas property with a fair market value different from tax basis is contributed to a partnership, the partnership must take Code Sec. 704(c) into account in allocating the tax basis of the property among the partners.[94] Other than this sentence, neither the regulations nor any published guidance of which we are aware sheds light on the application of Code Sec. 704(c) to oil and gas property.

As was explained above, regardless of which Code Sec. 704(c) method the partnership uses, the partnership first must determine each partner's share of the Code Sec. 704(b) basis in each partnership oil and gas property. Then, the partnership allocates the available tax basis to the noncontributing partners to the extent of the partners' shares of the partnership's Code Sec. 704(b) basis in the property. However, if there is a ceiling rule issue (that is, if the tax basis of the property is not sufficient to match the noncontributing partners' allocation of Code Sec. 704(b) basis from such property), the application of Code Sec. 704(c) can be uncertain.

If a partnership chooses the traditional method under Code Sec. 704(c), the result appears to be fairly straightforward. The partners determine their tax gain or loss on the sale of the property, or their tax depletion from the property, based on how the available tax basis in the property is allocated under Code Sec. 704(c). To the extent the noncontributing partner suffers a shortfall in basis, as with the application of the traditional method to other kinds of property, the noncontributing partner has to wait until its interest is sold or the partnership liquidates to be made whole.

Example 6. Assume the same facts as in Example 3, except that the contributed property is an oil and gas producing property. In other words, the sponsor contributed to the partnership a working interest with a fair market value of \$100x and a tax basis of \$40x. Based on the relative capital contributions of the partners, the sponsor and the public investors (in the aggregate) have agreed to share in the partnership's net income or loss on a 50/50 basis. The partners have agreed that the partnership will adjust their Code Sec. 704(b) capital accounts for simulated cost depletion, rather than the actual depletion. For allocations pursuant to Code Sec. 704(c), the partners have agreed to use the traditional method.

The first step in determining the partner's entitlement to depletion is to allocate the Code Sec. 704(b) basis of the working interest. Because the sponsor and the public investors (in the aggregate) have contributed capital and have agreed to share in the partnership's net income or loss on a 50/50 basis, the sponsor and the public investors (in the aggregate) would each be allocated \$50x of the Code Sec. 704(b) basis of the property.

Having allocated the \$100x Code Sec. 704(b) basis of the working interest, the partnership must next allocate the \$40x tax basis of the property among the partners. In order to allocate the tax basis according under the rules of Code Sec. 704(c), the available tax basis first would be allocated to the public (the group of partners who are the noncontributors of the working interest) up to their allocated share of Code Sec. 704(b) basis. Under these facts, the public is allocated \$50x of the Code Sec. 704(b) basis in the working interest and is, therefore, entitled to a matching allocation of \$50x of tax basis. However, the partnership only has \$40x of available tax basis. Therefore, the entire \$40x of tax basis in the working interest would be allocated to the public investors and the sponsor would be allocated \$0 of tax basis in the property.

Because the partners decided to use the traditional method, the partnership would not do anything more to deal with the shortfall

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in the tax basis that is available to allocate to the public partners. The public partners would determine their tax depletion by looking to the $40x tax basis allocated to them under Code Sec. 704(c). This would be in spite of whatever the partnership calculates as the simulated depletion of the partners, which would be based on the $50x Code Sec. 704(b) basis in the property that each partner has been allocated.

As was indicated above, however, most (if not all) natural resources PTPs use the remedial method.[95] In this case, the picture becomes a bit more blurry. The failure to provide any guidance on how to apply the remedial method to partnership oil and gas property has left an internal inconsistency in the regulations. On the one hand, the Code Sec. 704(c) regulations focus on providing guidance regarding the proper allocation of a partnership's items of income, gain, loss and deduction. On the other hand, the Code Sec. 613A regulations effectively remove from the partnership the oil and gas property and any associated items of income, gain, loss and deduction and treat these items as belonging to the partners. This inconsistency creates ambiguity as to what the proper mechanism is for applying the remedial method. The key question left unaddressed is whether the remedial method is best viewed as resulting in the allocation of notional items of partnership income, gain, loss or deduction or as a mechanism to allocate notional basis among the partners. As is explained below, neither view is ideal in all circumstances.[96]

a. Allocations of Deductions. The regulations describing the remedial method contemplate that such method will be used to allocate items of partnership income, gain, loss and deduction among the partners.[97] Applying the remedial method to an oil and gas property in a manner similar to other types of property means allocating notional items of depletion deductions to the noncontributing partners, with offsetting allocations of remedial income to the contributing partner, to remedy the impact of a shortfall in the tax basis available for the noncontributing partners. Such an approach follows the application of the remedial method to other types of Code Sec. 704(c) property. Presumably, a simplified view of this approach would be as follows:

1. The partnership determines the simulated depletion for the noncontributing partner from an oil and gas property under the partnership's simulated depletion methodology (*i.e.*, Code Sec. 704(b) depletion).
2. Then, the noncontributing partner calculates its tax depletion based on the tax basis allocated to the noncontributing partner by the partnership. It is possible that this may be under a different depletion method than the partnership uses for simulated depletion purposes.
3. Next, the partnership allocates an amount of remedial depletion deductions to the noncontributing partner to the extent that the simulated depletion computed by the partnership is higher than the tax depletion calculated by the noncontributing partner. The partnership allocates the offsetting item of ordinary income to the contributing partner.

This highlights that using the remedial method to allocate deductions requires the partnership to be able to calculate the amount of the necessary notional items—the "shortfall" to the noncontributing partners. In order to marry the total amount of Code Sec. 704(b) simulated depletion the partnership has calculated with the tax depletion calculated by the noncontributing partner, the partnership must have access to the tax depletion calculations of the partners. As was indicated above, this sharing of information may be unattractive to some partners.

Moreover, some partnerships may find it difficult under this method to predict how the unrealized gains or losses subject to Code Sec. 704(c) are "burned off." Specifically, if Code Sec. 704(b) simulated depletion is determined under the cost method and the noncontributing partner's tax depletion is determined under the percentage method, the amount of the remedial deduction may not bear any rational relationship to the reduction in the built-in gain or loss in the property.[98] This can make it difficult for contributors of property, such as sponsors of PTPs, to accurately model their possible exposure to future remedial income.

Example 7. Assume the same facts as Example 6, except that the partners have chosen to use the remedial method. Assume also that the partners view Code Sec. 704(c) as a mechanism to allocate remedial depletion deductions and income (rather than additional basis) to the partners.

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Under this approach, to determine the total depletion deductions allocable to the partners, the partnership must first calculate the Code Sec. 704(b) simulated cost depletion of the partners. For simplicity sake, assume that the Code Sec. 704(b) simulated cost depletion for year 1 is $10x (or a 10-percent recovery for the year). This means that each of the partners would be allocated $5x of Code Sec. 704(b) simulated cost depletion. This also means that the public investors, as the noncontributors of the property, would be entitled to $5x of total tax depletion deductions for the year.

How the $5x of tax depletion deductions is determined for the public partners, however, may not be clear to the partnership at the outset. As in Example 6, the public partners would determine their tax depletion on the $40x of tax basis allocated to them. The partnership then would allocate remedial deductions to the public, with offsetting remedial income to the sponsor, for the difference between the public investors' $5x simulated depletion and the tax depletion calculated on the $40x of tax basis. Therefore, if the public investors calculate $4x of cost depletion on the allocated tax basis, the partnership would allocate them $1x of remedial depletion deductions. However, if the public investors had determined that, based on the partnership's income allocations, $4.25x of percentage depletion would have been available to them, the partnership would allocate to them $0.75x of remedial depletion deductions. This highlights that the application of this approach requires the partnership to know what tax depletion the noncontributing partners have calculated on their allocated tax basis. This also shows that the contributing partner may find it difficult to track the remaining Code Sec. 704(c) built-in gain or loss in the property because it may not be able to predict how much remedial income it would be allocated in any given tax year.

b. Allocations of Basis. As mentioned above, the only reference in the Code Sec. 613A regulations to the application of Code Sec. 704(c) is the sentence that provides that, if oil and gas property with a fair market value different from tax basis is contributed to a partnership, the partnership must take Code Sec. 704(c) into account in allocating the tax basis of the property among the partners.[99] If Code Sec. 704(c) is intended to apply to oil and gas property as a means of allocating basis, it may follow that an appropriate approach to the application of the remedial method to contributed oil and gas property is for the remedial method to be a basis allocation mechanism. This approach would generally entail the following steps:

1. The partnership would first allocate among the partners the Code Sec. 704(b) basis in the property for purposes of simulated depletion.
2. The partnership would then allocate the available tax basis to the noncontributing partners to match, to the extent possible, the partners' allocations of Code Sec. 704(b) basis.
3. To the extent that there is insufficient tax basis to allocate to the noncontributing partners to match their Code Sec. 704(b) basis allocations from a property, the partnership would allocate an amount of notional basis equal to the amount of the shortfall. The contributing partner would then be allocated an offsetting notional amount of "negative basis."
4. Finally, the noncontributing partner would determine its tax depletion from the property based on the combination of the allocated tax basis and the additional remedial basis allocation. Specifically, the noncontributing partner would determine whether to use cost depletion or percentage depletion by looking to the combined tax and remedial basis in the property. The contributing partner would recognize ordinary income as the remedial basis allocated to the noncontributing partners was depleted through the "recovery" of the contributing partner's "negative basis" amount.[100]

This approach attempts to be consistent with the only guidance available on the application of Code Sec. 704(c) to oil and gas property and may be more consistent with the remedial method's attempt to put the noncontributing partner in a similar tax position as if the partner had purchased a share of the underlying assets of the partnership. If the noncontributing partners had purchased a share of the partnership's oil and gas property, the noncontributing partners would determine their tax depletion based on having a basis in the property equal to the property's fair market value. The remedial basis approach approximates this result in

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that the noncontributing partners determine their tax depletion on a combined basis in the amount of their share of the property's fair market value at the time they enter partnership.

By taking the remedial basis allocation into account, the noncontributing partners' initial combined tax basis in any partnership oil and gas property would equal their Code Sec. 704(b) basis allocations. This may make it more likely, at least in the early years of the partnership, that the method for determining Code Sec. 704(b) simulated depletion and tax depletion would be the same. It also may make the contributing partner's remaining Code Sec. 704(c) built-in gain or loss easier to track. However, as with the allocation approach described above, the remedial basis approach requires some level of coordination between the partners and the partnership to ensure that the appropriate amount of remedial income and deduction is taken each year. That is, the partnership must know how the remedial basis is being recovered by the noncontributing partner to determine the offsetting recovery of the contributing partner's negative basis amount.

Finally, we note that it could be argued that the remedial basis approach conflicts with Code Sec. 612. Code Sec. 612 provides that the basis on which depletion is to be allowed in respect of any property is the adjusted basis provided in Code Sec. 1011 for the purpose of determining the gain or loss upon the sale or other disposition of such property. Under the remedial basis approach, the noncontributing partners would be determining their depletion allowances using the basis provided in Code Sec. 1011, as well as an additional amount of notional basis created under the remedial method.

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Example 8. Assume the same facts as Example 7, except that the partners view the remedial method of Code Sec. 704(c) as a mechanism for allocating remedial tax basis. As in Example 7, the partnership would allocate $50x of Code Sec. 704(b) basis in the property to each of the partners. The partnership then would allocate the entire $40x of available tax basis to the public investors, as the noncontributing partners. However, under the remedial basis approach the partnership would then allocate a notional $10x of remedial basis to the public partners to make up the difference between their Code Sec. 704(b) basis allocation and the available tax basis. The sponsor would be allocated a notional $10x of "negative" tax basis in the property.

The public investors would determine their tax depletion as if they had been allocated $50x of tax basis in the property. The sponsor, as the contributor of the property, would recover the $10x of negative basis as "negative depletion" or ordinary income. This approach provides the sponsor with an additional level of certainty, in that the total amount of remedial income to be recognized is determined up front, the $10x of negative basis allocated to the sponsor. However, this approach shows that some level of coordination between the partners is still necessary (or certain assumptions must be made) for the sponsor to determine how much of the negative basis the sponsor will recover in any specific tax year.

IV. Conclusion

This installment of the primer continued the discussion of forming a natural resources PTP and addressed the allocation of tax items to the PTP's initial unitholders. As was explained above, the allocation rules of Subchapter K are extremely complex. Moreover, additional issues are raised when a PTP holds oil and gas properties that are subject to the allowance for depletion. Nonetheless, the allocation rules can be very important in the PTP context. How the partnership allocates tax items not only can affect each partner's tax liability, but also can help ensure fungibility of units that trade in the public markets; support DD&A deductions to the public unitholders; and maintain the economic arrangement among the sponsor, the public unitholders, and the other partners. PTPs commonly use special economic uniformity allocations and the remedial method of Code Sec. 704(c) to achieve some of these goals.

The next installment of this primer will address significant tax issues (including additional allocation issues) that can arise after the formation of the PTP. Thus, for example, it will address certain key consequences of the PTP raising additional capital through SPOs or future PIPE transactions. It also will address issues raised by the trading of PTP units in the public markets.

Endnotes

[*] The authors wish to express appreciation to Carol Kulish Harvey and Robert Swiech, also with the WNT Passthroughs Group, for their significant contribution to this article. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax advisor. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

[1] This primer is limited in scope to a discussion of certain U.S. federal income tax issues. It does not address other issues, such as legal, regulatory or accounting issues. This primer is not intended to provide advice to investors as to the tax consequences of investing in a PTP. The tax consequences to each investor may vary depending upon such investor's particular facts and circumstances. A potential investor should seek advice from his or her own tax counsel regarding the tax consequences of investing in a particular PTP.

[2] Part I of the primer was published in the December 2009 issue of TAXES—The Tax Magazine. Deborah Fields, Holly Belanger, Eric Lee & Robert Sweich, *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part I),* Taxes, Dec. 2009, at 21. Part II of the primer was published in the February 2010 issue of TAXES—The Tax Magazine. Deborah Fields, Holly Belanger & Eric Lee, *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part II),* Taxes, Feb. 2010, at 71.

[3] As was explained in Part I, the tax shield reflects the amount of distributions a partner receives compared to the amount of taxable income that the partner is allocated. As a general matter, a bigger tax shield reflects a smaller ratio of taxable income to distributions. The amount of the tax shield may be relevant in an investor's decision whether to purchase (or to continue to hold) a particular PTP's units. As indicated in note 1, this primer is not intended to, and does not, provide investment advice.

[4] Code Sec. 721(a) generally provides that no gain or loss is recognized by a partnership or any of its partners upon the contribution of property to a partnership in exchange for an interest in the partnership. *See* Part II for a discussion of Code Sec. 721(a), the general consequences of structuring a contribution to qualify for tax-free treatment under that section, and significant exceptions to tax-free treatment.

[5] For the basis consequences of a transaction described in Code Sec. 721(a), *see* the discussion of Code Sec. 722 in Part II. Code Sec. 752(a) generally provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, is considered a contribution of money by such partner to the partnership. Conversely, Code Sec. 752(b) generally provides that any decrease in a partner's share of partnership liabilities, or any decrease in a partner's share of individual liabilities by reason of the partnership's assumption of such individual liabilities, is treated as a distribution of money by the partnership to the partner. Thus, increases and decreases in a partner's share of partnership liabilities can affect that partner's basis in the partnership.

[6] Reg. §1.704-1(b)(2)(iv)(b). In the unlikely event that the investor contributes property to the PTP, the investor's initial Code Sec. 704(b) capital account will be credited with the fair market value of such property (net of any liabilities assumed by the partnership). The partner's Code Sec. 704(b) capital account thereafter will be adjusted based on the partner's allocable share of the partnership's items of income, gain, loss and deduction for each year, as well as any distributions or additional contributions made during the year. *See* Part II for a discussion of the Code Sec. 704(b) capital account, including why the initial capital account is significant.

[7] *See* Part I for a discussion of why the publicly traded units of a PTP must be fungible.

[8] As will be explained in the next installment of this primer, the admission of new partners to an existing PTP, in effect, is similar to the formation of a new venture between the existing PTP and the new partners, with the existing PTP contributing to the new venture the PTP's existing property at the property's value on the date of the admission.

[9] *See* Part I for a general discussion of the economic rights typically associated with the various kinds of incentive units. As explained in that discussion, IDRs are typically granted to the general partner (*i.e.*, the sponsor) as an additional return for the general partner's management of the PTP; MIUs and MIIs generally are issued to the key management personnel of the PTP for their efforts in managing and growing the PTP's business; and subordinated units generally are common units with distribution rights that are subordinated to the PTP's other common units and may be issued to key management personnel of the PTP.

[10] *See* Wachovia Capital Markets, LLC, *MLP Primer—Third Edition: Everything You Wanted to Know about MLPs, But Were Afraid to Ask 15* (July 14, 2008), *www.naptp.org/documentlinks/071508wacoviaprimer.pdf* ("Wachovia Report").

[11] Rev. Proc. 93-27, 1993-2 CB 343. Rev. Proc. 93-27 provides a safe harbor under which a service partner can be issued a partnership profits interest without incurring a U.S. federal income tax liability, provided certain requirements are met. However, there is some measure of uncertainty about whether the issuance of an incentive interest in a PTP in exchange for services can fall within such safe harbor. Rev. Proc. 93-27 excluded the issuance of a *limited partner* interest in a PTP from its safe harbor. While incentive interests are generally considered to be limited partner interests, the exclusions from the safe harbor focus on partnership interests for which a partner has a readily ascertainable fair market value, such as the publicly traded common units in a PTP. As such, it appears that the typical incentive interest ought not to be excluded from the safe harbor to the extent it is not tradable and, thus, may not have a readily ascertainable fair market value. However, proposed rules issued in 2005 would expand the exclusion to all interests in a PTP issued in exchange for services. Notice 2005-43, 2005-1 CB 1221. If these proposed rules were ever issued in final form, the general treatment of the issuance of incentive interests by PTPs may change. For issues relating to the issuance of an interest in partnership profits that is subject to vesting, *see* Rev. Proc. 2001-43, 2001-2 CB 191.

[12] Rev. Proc. 93-27. The U.S. House of Representatives has passed legislation on several occasions that would change the treatment of certain profits interests. *See, e.g.*, Tax Extenders Act of 2009, H.R. 4213, 111th Cong., 1st Sess.; Alternative Minimum Tax Relief Act of 2008, H.R. 627, 110th Cong., 2d Sess.; and Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong., 1st Sess. Among other things, such legislation would tax income allocated to service partners in the investment management business as ordinary income, regardless of the character of the income at the partnership level. The legislation is broadly drafted and could apply beyond the traditional investment management context in certain circumstances. The Obama Administration has included a similar proposal in its budget; however, the Administration's proposal would apply to all profits interests (even beyond the investment management context). The Senate has not yet acted on this so-called carried interest legislation.

[13] *See, e.g.*, Rev. Rul. 69-184, 1969-1 CB 256.

[14] A discussion of the specific tax consequences of an employee becoming a partner is beyond the scope of this primer. For a discussion of these issues, *see* James Sowell, *Partners and the SECA Tax*, *in* Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2009 (864 PLI/Tax 1411).

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[15] Code Sec. 731(a)(1) generally provides that, in the case of a distribution by a partnership to a partner, gain is not recognized to the partner, except to the extent that any "money" distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Thus, as a very general matter, a partner must have adequate basis in order to receive a distribution of money on a tax-free basis. While a full discussion of the rules applicable to distributions is beyond the scope of this primer, note that certain marketable securities are treated as "money" for purposes of Code Sec. 731(a) and that, as was explained in Part II of this primer, certain "debt shifts" can be treated as distributions of money. In addition, there are other situations in which distributions can be taxable, notwithstanding Code Sec. 731(a)(1) (such as when the distribution is part of a "disguised sale"). In order to comply with the "economic effect" rules described below, a partner's capital account generally will be reduced by the amount of money distributed. *See* Reg. §1.704-1(b)(iv)(a). *But see infra* note 33 regarding potential implications arising if the partner's capital account becomes negative.

[16] As indicated *supra* note 3, the tax shield may be significant to current public unitholders as well as to potential investors in the PTP's units.

[17] *See* Part I for a more detailed discussion of typical convertibility terms.

[18] *See, e.g.,* Rev. Rul. 95-55, 1995-2 CB 313 (conversion of a general partnership interests to limited liability partnership interests generally not a taxable event); Rev. Rul. 95-37, 1995-1 CB 130 (conversion of a general partnership interest to a limited liability company interest generally not a taxable event); and Rev. Rul. 84-52, 1984-1 CB 157 (conversion of general partner interests to limited partner interests generally not a taxable event).

[19] The rules of Code Sec. 704(b) also can apply if the partnership agreement is silent as to how partnership items are allocated. That is, in such a situation, allocations are made based upon the "partner's interest in the partnership."

[20] The principles of Code Sec. 704(c) also apply to allocations of certain tax items relating to property that has been revalued for Code Sec. 704(b) purposes. Reg. §1.704-3(a)(6)(i). The next installment of this primer will address revaluations and the resulting Code Sec. 704(c) consequences.

[21] The rules of Code Secs. 704(b) and 704(c) are extremely lengthy and complex. A detailed discussion of these rules is beyond the scope of this article.

[22] As indicated in the text, this general rule does not apply, however, if allocations of tax items are required to be made under Code Sec. 704(c).

[23] *See generally* Reg. §1.704-1(b)(2)(iv)(b).

[24] Reg. §1.704-1(b)(2)(iv)(f). In the case of property subject to DD&A, the property's Code Sec. 704(b) value also may be relevant in determining the amount of DD&A that can be taken for U.S. federal income tax purposes. Reg. §1.704-1(b)(2)(iv)(g)(3) generally provides that the amount of Code Sec. 704(b) book DD&A for a period with respect to an item of partnership property must be the amount that bears the same relationship to the Code Sec. 704(b) book value of such property as the DD&A for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. As discussed in text *infra*, special rules apply in the case of property subject to the remedial allocation method of Code Sec. 704(c). In addition, as will be discussed in the next installment of this primer, the revaluation of a property for Code Sec. 704(b) purposes can affect the amount of Code Sec. 704(b) book DD&A from such property and the manner in which the property's DD&A for tax purposes is allocated among the partners.

[25] Reg. §1.704-1(b)(1)(i).

[26] *Id.*

[27] *Id.* These special rules are set forth in Reg. §§1.704-1(b)(4) and §1.704-2. Certain of these special rules relate to allocations with respect to oil and gas property and are referenced in the discussion *infra* section III.B.

[28] Reg. §1.704-1(b)((2)(i).

[29] *Id.*

[30] Reg. §1.704-1(b)(2)(ii)(a).

[31] Reg. §1.704-1(b)(2)(ii)(b)(1).

[32] Reg. §1.704-1(b)(2)(ii)(b)(2).

[33] Reg. §1.704-1(b)(2)(ii)(b)(3); Reg. §1.704-1(b)(2)(ii)(d). In general, a QIO provision provides that the partnership, in allocating current items of loss and deduction, takes into account certain future deductions and distributions that are reasonably expected to be made to a partner and, if the partner unexpectedly receives a distribution that causes him to have a deficit capital account, the partner, as soon as possible, is allocated items of partnership income or gain (including gross partnership income) to eliminate the deficit.

[34] A partner may be considered to be "on the hook" for a deficit capital account, for example, to the extent the partner is required to pay the partnership the amount by which the partner's Code Sec. 704(b) capital account is negative or the partnership is required to allocate an amount of income to the partner in the future to restore the negative balance. *See, e.g.*, Reg. §1.704-2(f).

[35] Reg. §1.704-1(b)(2)(iii)(a).

[36] *Id.*

[37] Reg. §1.704-1(b)(2)(iii)(b).

[38] Reg. §1.704-1(b)(2)(iii)(c).

[39] *Id.* In assessing whether the allocations will be offset within five years, the regulations presume that the fair market value of the partnership's property is its Code Sec. 704(b) balance sheet value. *Id.* As a result, original allocations can be offset with later allocations of Code Sec. 704(b) gain recognized on the sale of partnership property without being considered insubstantial, because it is presumed that there will be no such gain to allocate.

[40] Reg. §1.704-1(b)(3)(i).

[41] *Id.*

[42] Reg. §1.704-1(b)(3)(ii).

[43] Reg. §1.704-1(b)(3)(i).

[44] Revaluing assets for purposes of Code Sec. 704(b) will be discussed in the next installment of this primer.

[45] *See* Part II of the primer for a discussion of tax-free contributions of property to partnerships.

[46] As indicated *supra* note 8, the admission of new partners to an existing PTP, in effect, is similar to the formation of a new venture between the existing PTP and the new partners, with the existing PTP contributing to the new venture the PTP's existing property at the property's value on the date of the admission. As will be discussed in the next installment of this primer, the gain or loss inherent in the property at such time can give rise to a layer of Code Sec. 704(c) gain or loss.

[47] Reg. §1.704-3(a)(2). In certain limited situations, a partnership may aggregate specific properties for purposes of applying Code Sec. 704(c). Reg. §1.704-3(e)(2). In addition, certain investment partnerships, including some financial services PTPs, are allowed to apply Code Sec. 704(c) on an aggregate basis across the partnership's qualifying financial properties. Reg. §1.704-3(e)(3). A discussion of the Code Sec. 704(c) aggregation rules is beyond the scope of this article.

[48] Reg. §1.704-3(a)(1).

[49] *See* Part II of the primer for a discussion of contributions of property that are structured as tax-free transactions.

[50] As discussed in Part II of the primer, the use of the public's cash can be important to the characterization of the formation transaction. If cash is distributed to Sponsor within two years of the Sponsor's contribution of property, the transaction would need to be analyzed under the disguised sale rules of Code Sec. 707(a)(2)(B).

[51] Calculated as \$100x of sales proceeds over the \$40x tax basis of the property.

[52] As indicated *supra* note 1, this primer is not intended to, and does not, provide investment advice to investors.

[53] As is indicated in text *infra*, the recovery of a property's Code Sec. 704(b) basis generally is based on the recovery of the remaining tax basis in the property, with special rules applicable when the partnership uses the remedial method.

[54] Reg. §1.704-3(a)(1).

[55] Even the three methods discussed in the regulations are subject to an anti-abuse rule that can apply in situations in which the application of the method is unreasonable. Reg. §1.704-3(a)(10).

[56] Reg. §1.704-3(a)(1). Note that the Code Sec. 704(c) regulations provide certain limited

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exceptions pursuant to which the Code Sec. 704(c) rules do not have to be applied on a property-by-property basis. Reg. §1.704-3-(e). Moreover, the Code Sec. 704(c) rules do not contain a definition of "property." There may be situations in which the appropriate unit of "property" to which Code Sec. 704(c) is to apply is uncertain.

[57] Reg. §1.704-3(b)(1).

[58] *Id.*

[59] *Id.*

[60] Reg. §1.704-3(c)(1).

[61] Reg. §1.704-3(c)(3)(iii)(A).

[62] Reg. §1.704-3(c)(1). The regulations indicate, however, that it would not be reasonable to cure the shortfall in depreciation, for example, with dividend or interest income because these items do not have the same tax effect. Reg. §1.704-3(c)(3)(iii)(A).

[63] Reg. §1.704-3(c)(3)(ii).

[64] Reg. §1.704-3(d)(1).

[65] *Id.*

[66] Reg. §1.704-3(d)(4)(ii).

[67] Reg. §1.704-1(b)(2)(iv)(g)(3). *See supra* note 54.

[68] Reg. §1.704-3(d)(2).

[69] *Id.*

[70] *Id.*

[71] *See* Part II of the primer for a discussion of selling versus contributing property to the PTP.

[72] Code Sec. 704(c)(1)(C) applies to contributions of built-in loss property after October 22, 2004.

[73] While not specifically addressed in the statute, it does not appear that Code Sec. 704(c)(1)(C) is intended to apply to any unrealized loss created as a result of a revaluation of a property by the partnership. The application of the Code Sec. 704(c) rules to a revaluation of partnership property will be discussed in the next installment of the primer.

[74] H.R. Conf. Rep. No. 108-548, pt. 1, at 283, 108th Cong. (2004). However, it should be noted that the legislative history to Code Sec. 704(c)(1)(C) indicates that it is not intended to apply to a transaction governed by Code Sec. 381. H.R. Conf. Rep. No. 108-755, at note 546, 108th Cong. (2004).

[75] *See generally* Reg. §1.611-1(a)(1).

[76] *Id.*

[77] Code Sec. 613A, enacted in 1975, repealed percentage depletion on oil and gas for taxpayers that do not meet the independent producer and royalty owner test of Code Sec. 613A(c). The test generally imposes a cap on the amount of the taxpayer's average daily production of oil and gas.

[78] Code Sec. 613A(c)(7)(D).

[79] *Id.*

[80] *Id.*

[81] The approach that the Internal Revenue Code takes toward partnerships holding oil and gas properties could be viewed as reflecting the basic economics of traditional oil and gas partnerships. In many ways, the partnership rules that deal with oil and gas properties reflect the fact that a large number of oil and gas partnerships are formed for the joint operation of oil and gas properties, often without the formation of an entity for state law purposes. These joint operating arrangements frequently seek to elect to be excluded from the Subchapter K partnership tax rules entirely. Under Reg. §1.761-2, certain unincorporated organizations can elect to be excluded from the rules of Subchapter K of the Internal Revenue Code. One such eligible unincorporated organization is an arrangement to jointly produce, extract, or use property. Reg. §1.761-2(a)(3).

[82] Reg. §1.704-1(b)(2)(iv)(k)(3).

[83] Reg. §1.704-1(b)(2)(iv)(k)(2).

[84] *Id.*

[85] *Id.* For example, if a partnership chooses to use cost depletion for purposes of Code Sec. 704(b), the partnership must continue to use cost depletion for all tax years in which the property is held by the partnership.

[86] In determining the amount of simulated percentage depletion available, the regulations provide that the partnership is to assume that all partners are entitled to take percentage depletion and have elected to expense all intangible drilling costs. Reg. §1.613A-3(e)(3)(iii)(C)(1) and (2).

[87] Reg. §1.704-1(b)(2)(iv)(k)(2). While the regulation refers to the allocations of the tax basis in the property, for a discussion of the impact of a tax basis that differs from the Code Sec. 704(b) basis, *see* section III.B.3 below.

[88] Reg. §1.613A-3(e)(2)(ii).

[89] *Id.*

[90] Reg. §1.613A-3(e)(4).

[91] *Id.* (*citing* Reg. §1.704-1(b)(3)(ii)).

[92] Reg. §1.613A-3(e)(5).

[93] Reg. §1.704-1(b)(4)(v). While the regulation refers to an allocation of tax basis, the regulations further provide that, if oil and gas property is reflected on the partnership's Code Sec. 704(b) balance sheet at a value that differs from its tax basis, the rules should be applied with respect to the property's Code Sec. 704(b) basis. Reg. §1.704-1(b)(2)(iv)(k)(4).

[94] Reg. §1.613A-3(e)(5).

[95] An argument could be made that the remedial method cannot be applied in the case of an oil and gas property because of the nature of the remedial method. As described in the Code Sec. 704(c) regulations, remedial allocations are determined by the partnership by comparing the Code Sec. 704(b) and tax allocations made by the partnership with regard to property subject to Code Sec. 704(c). Reg. §1.704-3(d)(1). In the case of oil and gas property, the partnership does not make any tax allocations with respect to the property. Because the partnership has no basis upon which to base a remedial allocation, there is a potential issue regarding whether the remedial method may be applied to an oil and gas property. However, the Code Sec. 704(c) regulations do not carve out oil and gas property from the availability of the remedial method and the application of the method appears to be in furtherance of the purpose of Code Sec. 704(c) in preventing the shifting of built-in gains or losses away from a contributing partner. As such, we assume in this primer that the remedial method is available to partnerships holding oil and gas property.

[96] This article does not express a view as to which approach may be preferable in a given situation.

[97] Reg. §1.704-3(d)(1).

[98] This is, in part, because cost depletion is determined with regard to the basis in the property, while percentage depletion is determined without regard to the basis of the property.

[99] Reg. §1.613A-3(e)(5).

[100] By allocating the full amount of remedial deduction and income to be recognized on the property, the remedial basis approach can make it easier for a sponsor to track the remaining Code Sec. 704(c) built-in gain or loss in an asset.

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