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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

REG-139796-02

RIN 1545-BB10

Section 704(b) and Capital Account Revaluations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking

SUMMARY: This document contains proposed regulations relating to the capital account maintenance rules under section 704 of the Internal Revenue Code. These regulations expand the rules regarding a partnership's right to adjust capital accounts to reflect unrealized appreciation and depreciation in the value of partnership assets.

DATE: Written or electronic comments and requests for a public hearing must be received by September 30, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-139796-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG-139796-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically via the internet by submitting comments directly to the IRS internet site at www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Craig Gerson at (202) 622-3050; concerning submissions, the hearing, and/or placement on the building access list to attend the hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 704(b) of the Internal Revenue Code provides that a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership if the partnership agreement does not provide as to the partner's distributive shares of these items, or the allocation to a partner of these items under the agreement does not have substantial economic effect. Regulations under section 704 provide extensive rules for determining whether allocations under an agreement have substantial economic effect. One requirement for finding substantial economic effect is that the partnership maintains partners' capital accounts in accordance with certain rules. Compliance with these capital account maintenance rules, and other related rules, provides taxpayers a safe harbor under which the IRS will respect a partnership agreement's allocations.

Under the capital account maintenance rules of §1.704-1(b)(2)(iv), partnership property is generally reflected on the partnership's books at historic cost, rather than at fair market value. However, newly contributed property is reflected in the capital accounts of the partners at fair market value, rather than the contributing partner's cost; that is, the contributed property is essentially revalued at the time of contribution. §1.704-1(b)(2)(iv)(d)(1). In addition, under §1.704-1(b)(2)(iv)(f), a partnership is permitted to, and generally does, revalue its assets to their current fair market values if there is a contribution to the partnership by a new or existing partner as consideration for an interest in the partnership or a distribution from the partnership to a retiring or continuing partner as consideration for an interest in the partnership. Also, a revaluation is permitted under generally accepted industry accounting practices if substantially all of a partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

Commentators have suggested that there are additional situations beyond those described in §1.704-1(b)(2)(iv)(f) where revaluations are useful to properly reflect a partnership's economic arrangements. In particular, several commentators have noted that the section 704 regulations do not specifically permit a revaluation of partnership property in connection with the admission of a service partner because the service partner does not contribute property. Those commentators argue that a revaluation upon the admission of a service partner allows a partnership to allocate the existing partnership capital to the other partners. In this manner, the partnership keeps its capital accounts consistent with an intent to provide the service partner with only a profits interest. See Rev. Proc. 93-27 (1993-2 C.B. 343) and Rev. Proc. 2001-43 (2001-2 C.B. 191).

Explanation of Provisions

1. Revaluations of Property Under Section 704 on Provision of Services

The proposed regulations expand the circumstances under which a partnership is specifically permitted to increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books. Specifically, the proposed regulations allow revaluations in connection with the grant of an interest in the partnership (other than a de minimis interest) on or after the date final regulations are published in the **Federal Register** as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

2. Possible Expansion of Regulations

The IRS and the Treasury Department are considering further increasing the number of situations in which revaluations of partnership property are permitted. One approach under consideration would allow revaluations any time there is more than a de minimis bona fide change in the manner in which partners agree to share profits or losses.

Comments are requested concerning whether the regulations should adopt this standard or another standard for revaluations.

3. Other Future Guidance

The IRS recently issued proposed regulations on the taxation of noncompensatory partnership options and is currently studying the taxation of compensatory partnership options. This notice of proposed rulemaking concerning revaluations is not intended to provide guidance regarding when a partnership interest is considered to be granted.

Effective Date

The regulations are proposed to apply to the grant of an interest in a partnership (other than a de minimis interest) on or after the date final regulations are published in the **Federal Register** as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

Special Analysis

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are

timely submitted to the IRS. The IRS and the Treasury Department request comments on the proper scope of the rule allowing revaluations. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Craig Gerson, Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record keeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 continues to read in part as follows:

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.704-1 is amended as follows:

1. Paragraph (b)(2)(iv)(f)(5)(iii) is redesignated as paragraph (b)(2)(iv)(f)(5)(iv).
2. New paragraph (b)(2)(iv)(f)(5)(iii) is added.

§1.704-1 Partner's distributive share.

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(b) * * *

(2) * * *

(iv) * * *

(f) * * *

(5) * * *

(iii) In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after the date final regulations are published in the **Federal Register** as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

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Judith B. Tomaso,
Acting Deputy Commissioner of Internal Revenue.