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## Section 1245.—Gain From Dispositions of Certain Depreciable Property

*26 CFR 1.1245-1: General rule for treatment of gain from dispositions of certain depreciable property.*

### T.D. 8730

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

### Allocations of Depreciation Recapture Among Partners in a Partnership

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the allocation of depreciation recapture among partners in a partnership. The final regulations amend existing regulations to require that gain characterized as depreciation recapture be allocated, to the extent possible, to the partners who took the depreciation or amortization deductions. The final regulations affect partnerships (and their partners) that sell or dispose of certain depreciable or amortizable property.

DATES: These regulations are effective August 20, 1997.

For dates of applicability of these regulations, see §§ 1.704-3(f) and 1.1245-1(e)(2)(iv).

FOR FURTHER INFORMATION CONTACT: Daniel J. Coburn, (202) 622-3050 (not a toll-free number)

SUPPLEMENTARY INFORMATION:

#### *Background*

This document amends the Income Tax Regulations (26 CFR part 1) relating to the characterization and allocation of depreciation recapture among partners in a partnership. Section 1245 of the Internal

Revenue Code requires taxpayers to recharacterize as ordinary income some or all of the gain on the disposition of certain types of business properties. The amount recharacterized as ordinary income (depreciation recapture) is the lesser of (1) the gain realized on the disposition, or (2) the total deductions allowed or allowable for depreciation or amortization from the property.

On December 12, 1996, the IRS published in the **Federal Register** (61 F.R. 65371) a notice of proposed rulemaking (REG-209762-95) to provide guidance on partnership allocations of depreciation recapture. Although a public hearing was scheduled for March 27, 1997, the IRS cancelled the hearing because it received no requests to speak.

#### *Explanation of Provisions*

##### *I. General Background*

The regulations provide guidance on allocating depreciation recapture among partners, including depreciation recapture attributable to contributed property.

The regulations provide that a partner's share of depreciation recapture is equal to the lesser of (1) the partner's share of total gain arising from the disposition of the property (gain limitation) or (2) the partner's share of depreciation or amortization from the property (as defined in paragraph (e)(2)(ii) of the regulations). This rule seeks to insure, to the extent possible, that a partner recognizes recapture on the disposition of property in an amount equal to the depreciation or amortization deductions from the property previously taken by the partner. Any depreciation recapture that is not allocated to a partner due to the gain limitation is allocated among those partners whose shares of total gain on the disposition of the property exceed their shares of depreciation or amortization from the property. This unallocated depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain on the disposition of the property.

The regulations provide special rules for determining a partner's share of depreciation or amortization from contributed property subject to section 704(c). Under the regulations, a contributing partner's share of depreciation or amortization includes depreciation or amortization allowed or allowable prior to contribution.

In addition, the regulations provide that curative and remedial allocations generally reduce the contributing partner's share of depreciation or amortization and increase the noncontributing partners' shares of depreciation or amortization.

## II. Changes in Response to Comments

In response to comments, the regulations clarify the effect of curative and remedial allocations on the partners' shares of depreciation or amortization from contributed property. The examples now demonstrate that curative and remedial allocations can reduce the contributing partner's share of depreciation or amortization to zero, but not below zero. Once the contributing partner's share of depreciation or amortization has been reduced to zero, the curative or remedial allocations do not affect the contributing partner's share of depreciation or amortization. However, the curative or remedial allocations continue to affect the noncontributing partners' shares of depreciation or amortization.

The regulations have also been revised to make it clear that these amendments to the section 1245 regulations only affect how the depreciation recapture recognized by the partnership is allocated among the partners; they do not affect the computation of depreciation recapture at the partnership level. The regulations recognize that even absent a gain limitation, remedial and curative allocations may cause the total of the partners' shares of depreciation to exceed the amount of depreciation recapture recognized at the partnership level. In such a case, the partnership's depreciation recapture with respect to the contributed property is to be allocated among the partners in proportion to their relative shares of depreciation or amortization with respect to that property. However, no partner's share of depreciation recapture from the property can exceed that partner's share of the total gain arising from the disposition of the property.

Example 2 of paragraph (e)(2)(iii) of the regulations has also been revised to demonstrate more thoroughly how recapture is allocated when a partner's share of depreciation recapture is capped by the partner's share of gain from the disposition of the property. As illustrated in the example, some partnerships may find it necessary to make multiple reallocations

of depreciation recapture from a property if allocations under the general rule (allocations in proportion to the remaining partners' shares of gain from the disposition of the property) cause a remaining partner's share of depreciation to exceed the partner's share of gain from the disposition of the property.

One commentator requested that the regulations allow but not require that partnerships allocate depreciation recapture in proportion to the partners' shares of the gain from the disposition of the property. This change was not made because the IRS and Treasury continue to believe that matching depreciation recapture allocations to depreciation allocations most appropriately carries out the policies underlying section 1245.

A number of terminology and stylistic changes have also been made to these regulations. These changes were made for purposes of economy and should not be interpreted as substantive changes.

## Special Analyses

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

## Drafting Information

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

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## Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended 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 1.704-3 is amended by:

(1) Adding new paragraph (a)(11).

(2) Revising paragraph (f).

The addition and revision read as follows:

### §1.704-3 Contributed property.

(a) \* \* \*

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

\* \* \* \* \*

(f) *Effective date.* With the exception of paragraph (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to §1.704-1(b)(2)(iv)(f) on or after December 21, 1993. Paragraph (a)(11) of this section applies to properties contributed by a partner to a partnership on or after August 20, 1997. However, partnerships may rely on paragraph (a)(11) of this section for properties contributed before August 20, 1997, and disposed of on or after August 20, 1997.

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

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

\* \* \* \* \*

(e) \* \* \*

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section 1245(a)(1) by the partnership is equal to the lesser of the partner's share of total gain from the disposition of the property (gain limitation) or the partner's share of depreciation or amortization with respect to the property (as determined under paragraph (e)(2)(ii) of this section). Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph

(e)(2)(i) (excess depreciation recapture) is allocated among the partners whose shares of total gain from the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Excess depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property that is allocated to the partners who are not subject to the gain limitation. See *Example 2* of paragraph (e)(2)(iii) of this section.

(ii)(A) Subject to the adjustments described in paragraphs (e)(2)(ii)(B) and (e)(2)(ii)(C) of this section, a partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.

(B) If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(C)(1) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property is contributed

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

contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partner with respect to that property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations. See *Example 3*(iii) of paragraph (e)(2)(iii) of this section.

(3) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any remedial allocations. (See §1.704-3(d) for a description of the remedial allocation method.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of income to the contributing partner with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to that property. See *Example 3*(iv) of paragraph (e)(2)(iii) of this section.

(4) If, under paragraphs (e)(2)(ii)(C)(2) and (e)(2)(ii)(C)(3) of this section, the partners' shares of depreciation or amortization with respect to a contributed property exceed the adjustments reflected in the adjusted basis of the property under §1.1245-2(a) at the partnership level, then the partnership's gain recognized under section 1245(a)(1) with respect to that property is allocated among the partners in proportion to their relative shares of depreciation or amortization (subject to any gain limitation that might apply).

(5) This paragraph (e)(2)(ii)(C) also applies in determining a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704-1(b)(2)(iv)(f).

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

*Example 1. Recapture allocations.* (i) *Facts.* A and B each contribute \$5,000 cash to form AB, a

general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for \$5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation). (To simplify this example, AB's depreciation deductions are determined without regard to any first-year depreciation conventions.)

(ii) *Year 1.* In its first year of operations, AB has \$1,000 of depreciation from the partnership equipment. In accordance with the partnership agreement, AB allocates 90 percent (\$900) of the depreciation to A and 10 percent (\$100) of the depreciation to B. At the end of the year, AB sells the equipment for \$5,200, recognizing \$1,200 of gain (\$5,200 amount realized less \$4,000 adjusted tax basis). In accordance with the partnership agreement, the first \$800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining \$400 of gain is allocated \$200 to A and \$200 to B.

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

*Example 2. Recapture allocation subject to gain limitation.* (i) *Facts.* A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75 percent to A and 25 percent to B. ABC purchases depreciable personal property for \$300 and subsequently allocates \$100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to \$0. ABC then sells the property for \$440. ABC allocates \$330 of the gain to A (75 percent of \$440) and allocates \$110 of the gain to B (25 percent of \$440). No gain is allocated to C.

(ii) *Application of gain limitation.* Each partner's share of depreciation with respect to the property is \$100. C's share of the total gain from the disposition of the property, however, is \$0. As a result, under the gain limitation provision in paragraph (e)(2)(i) of this section, C's share of section 1245(a)(1) gain is limited to \$0.

(iii) *Excess depreciation recapture.* Under paragraph (e)(2)(i) of this section, the \$100 of section 1245(a)(1) gain that cannot be allocated to C under the gain limitation provision (excess depreciation recapture) is allocated to A and B (the partners not subject to the gain limitation at the time of the allocation) in proportion to their relative shares of total gain from the disposition of the property. A's relative share of the total gain allocated to A and B is 75 percent (\$330 of \$440 total gain). B's relative share of the total gain allocated to A and B is 25 percent (\$110 of \$440 total gain). However, under the gain limitation provision of paragraph (e)(2)(i) of this



section, B cannot be allocated 25 percent of the excess depreciation recapture (\$25) because that would result in a total allocation of \$125 of depreciation recapture to B (a \$100 allocation equal to B's share of depreciation plus a \$25 allocation of excess depreciation recapture), which is in excess of B's share of the total gain from the disposition of the property (\$110). Therefore, only \$10 of excess depreciation recapture is allocated to B and the remaining \$90 of excess depreciation recapture is allocated to A. A is not subject to the gain limitation because A's share of the total gain (\$330) still exceeds A's share of section 1245(a)(1) gain (\$190). Accordingly, all \$110 of the total gain allocated to B is treated as ordinary income (\$100 share of depreciation allocated to B plus \$10 of excess depreciation recapture) and \$190 of the total gain allocated to A is treated as ordinary income (\$100 share of depreciation allocated to A plus \$90 of excess depreciation recapture).

*Example 3. Determination of partners' shares of depreciation with respect to contributed property.* (i) *Facts.* C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of \$800 and a fair market value of \$2,800. Prior to the contribution, C claimed \$200 of depreciation from C1. At the time of the contribution, C1 is depreciable under the straight-line method and has four years remaining on its 5-year recovery period. D contributes \$2,800 cash, which CD uses to purchase depreciable personal property D1, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions.)

(ii) *Traditional method.* C1 generates \$700 of book depreciation (1/4 of \$2,800 book value) and \$200 of tax depreciation (1/4 of \$800 adjusted tax basis) each year. C and D will each be allocated \$350 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, D will be allocated the entire \$200 of tax depreciation from C1 in year 1. D1 generates \$400 of book and tax depreciation each year (1/7 of \$2,800 book value and adjusted tax basis). C and D will each be allocated \$200 of book and tax depreciation from D1 in year 1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is \$200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is \$200 (the amount of tax depreciation allocated to D). C and D each have a \$200 share of depreciation with respect to D1. At the end of four years, C's share of depreciation with respect to C1 will be \$200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 will be \$800 (four years of \$200 depreciation per year). At the end of four years, C and D will each have an \$800 share of depreciation with respect to D1 (four years of \$200 depreciation per year).

(iii) *Effect of curative allocations.* (A) *Year 1.* If the partnership elects to make curative allocations

under §1.704-3(c) using depreciation from D1, the results will be the same as under the traditional method, except that \$150 of the \$200 of tax depreciation from D1 that would be allocated to C under the traditional method will be allocated to D as additional depreciation with respect to C1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 will be reduced to \$50 (the total depreciation taken by C prior to contribution (\$200) decreased by the amount of the curative allocation to D (\$150)). D's share of depreciation with respect to C1 will be \$350 (the depreciation allocated to D under the traditional method (\$200) increased by the amount of the curative allocation to D (\$150)). C and D will each have a \$200 share of depreciation with respect to D1.

(B) *Year 4.* At the end of four years, C's share of depreciation with respect to C1 will be reduced to \$0 (the total depreciation taken by C prior to contribution (\$200) decreased, but not below zero, by the amount of the curative allocations to D (\$600)), and D's share of depreciation with respect to C1 will be \$1,400 (the total depreciation allocated to D under the traditional method (\$800) increased by the amount of the curative allocations to D (\$600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than \$1,000 (CD's tax depreciation (\$800) plus C's tax depreciation prior to contribution (\$200)). Under paragraph (e)(2)(ii)(C)(4) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is \$0, and D's share of depreciation with respect to C1 is \$1,400, all of CD's \$1,000 of section 1245(a)(1) gain will be allocated to D. At the end of four years, C and D will each have an \$800 share of depreciation with respect to D1 (four years of \$200 depreciation per year).

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

(\$200) decreased by the amount of the remedial allocation of income (\$100)). C and D will each have a \$200 share of depreciation with respect to D1.

(B) *Year 5.* At the end of five years, C's share of depreciation with respect to C1 will be \$0 (the total depreciation taken by C prior to contribution (\$200) decreased, but not below zero, by the total amount of the remedial allocations of income to C (\$600)). D's share of depreciation with respect to C1 will be \$1,400 (the total depreciation allocated to D under the traditional method (\$800) increased by the total amount of the remedial allocations of depreciation to D (\$600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than \$1,000 (CD's tax depreciation (\$800) plus C's tax depreciation prior to contribution (\$200)). Under paragraph (e)(2)(ii)(C)(4) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is \$0, and D's share of depreciation with respect to C1 is \$1,400, all of CD's \$1,000 of section 1245(a)(1) gain will be allocated to D. At the end of five years, C and D will each have a \$1,000 share of depreciation with respect to D1 (five years of \$200 depreciation per year).

(iv) *Effective date.* This paragraph (e)(2) is effective for properties acquired by a partnership on or after August 20, 1997. However, partnerships may rely on this paragraph (e)(2) for properties acquired before August 20, 1997, and disposed of on or after August 20, 1997.

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Michael P. Dolan,  
*Acting Commissioner of  
Internal Revenue.*

Approved July 8, 1997.

Donald C. Lubick,  
*Acting Assistant Secretary of  
the Treasury.*

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