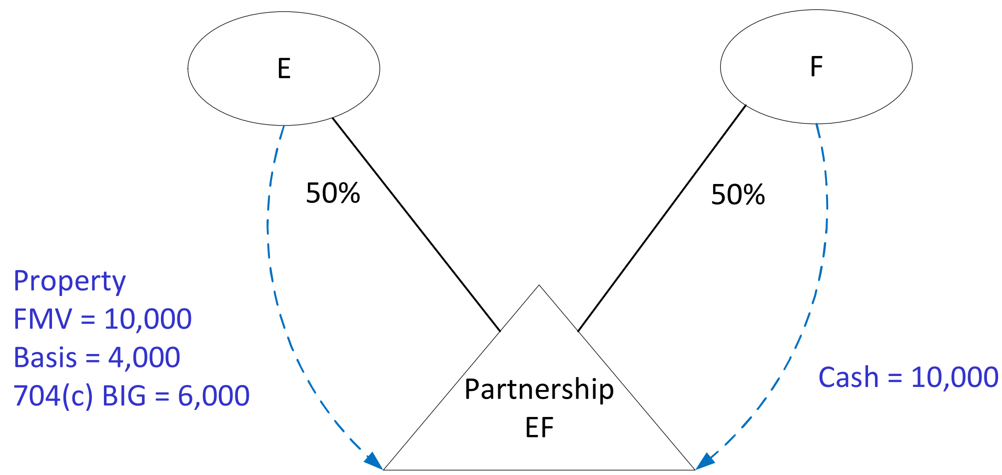
Treas. Reg. § 1.704-3(c)(4), Example 1

Traditional Method with Curative Allocations for Making 704(c) Allocations



(i)Facts. E and F form partnership EF and agree that each will be allocated a 50 percent share of all partnership items and that EF will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section. E contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The equipment has 10 years remaining on its cost recovery schedule and is depreciable using the straight-line method. At the time of contribution, E has a built-in gain of $6,000, and therefore, the equipment is section 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale. In EF's first year, the revenue generated by the equipment equals EF's operating expenses. The equipment generates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year EF sells all the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method of paragraph (b) of this section, E and F would each be allocated $350 of income from the sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would all be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

E		F		
Book	**Tax**	**Book**	**Tax**	
$10,000	$4,000	$10,000	$10,000	Initial Contribution
<500>	<0>	<500>	<400>	Depreciation
350	350	350	350	Sales Income
9.850	4,350	9,850	9,950	

(ii)Reasonable curative allocation. Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E under paragraph (c) of this section an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		**F**		
Book	**Tax**	**Book**	**Tax**	
$10,000	$4,000	$10,000	$10,000	Initial Contribution
<500>	<0>	<500>	<400>	Depreciation
350	450	350	250	Sales Income
9.850	4,450	9,850	9,850	

(iii)Unreasonable curative allocation. (A) The facts are the same as in paragraphs (i) and (ii) of this Example 1, except that E and F choose to allocate all the income from the sale of the inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF's first year as follows:

E		**F**		
Book	**Tax**	**Book**	**Tax**	
$10,000	$4,000	$10,000	$10,000	Initial Contribution
<500>	<0>	<500>	<400>	Depreciation
350	700	350	0	Sales Income
9.850	4,700	9,850	9,600	

(B) This curative allocation is not reasonable under paragraph (c)(3)(i) of this section because the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule.