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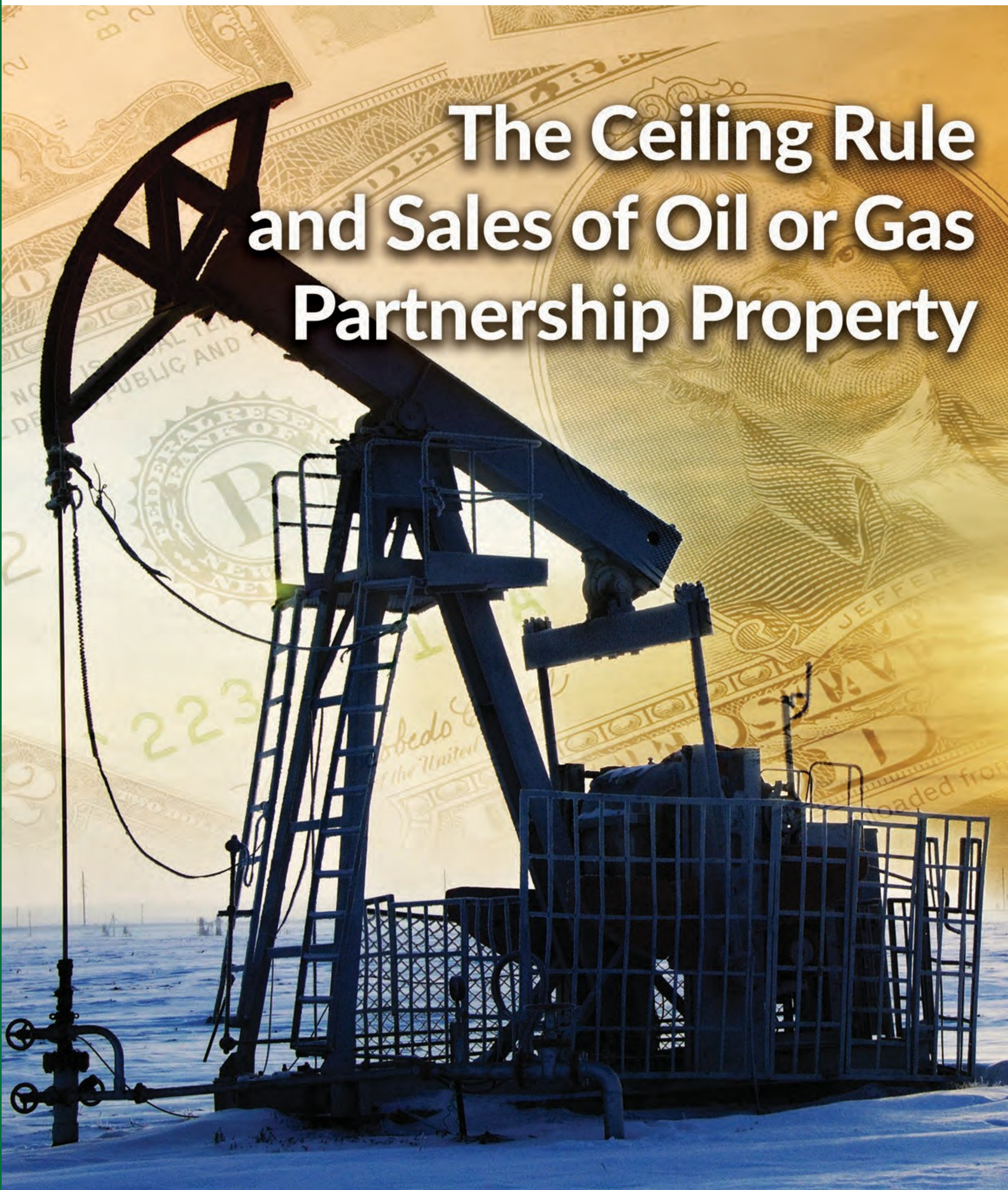

The Ceiling Rule and Sales of Oil or Gas Partnership Property

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The Ceiling Rule and Sales of Oil or Gas Partnership Property

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In this article, the authors discuss the partnership rules applicable to oil and gas property sales, and how the choice of section 704(c) method affects partnership sharing from sales of oil or gas property — particularly situations in which the partnership uses the traditional method for section 704(c).

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As the oil and gas market has evolved over time, so too has the variety of investments in the oil and gas industry. In particular, as private equity has come to view oil and gas operations as just another portfolio opportunity, it has exposed a new group of taxpayers to the peculiar world of oil and gas tax rules. In many cases these taxpayers have brought new ideas and struck new deals outside of the traditional hallmarks of oil and gas partnership transactions.

This evolution is particularly evident when looking at the investors' choices of section 704(c) methods. Section 704(c) is intended to prevent the shift of tax items among partners regarding pre-contribution gain or loss,[1] and the specific method used can be a key negotiation point. The historic model of an oil and gas partnership involves two companies entering into a joint operating agreement (JOA) — a contractual arrangement treated as a partnership for U.S. federal income tax purposes, in which no state law partnership is formed.[2] JOAs have frequently adopted the "keep-your-own" method for section 704(c), whereas the partners do not share the cost recovery on the properties they contribute to the JOA.[3] This method originally became the industry standard because the parties have tended to keep each other at arm's length.

As oil companies began accessing capital from institutional and retail investors, they found that the section 704(c) remedial method[4] ensured that their investors received sufficient depletion tax deductions to help achieve an attractive after-tax yield on their investments, particularly if the partnership held mature contributed properties with a low tax basis. When those retail investments come from the public markets in the form of a publicly traded partnership, the

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[1] A partnership may also revalue its partnership assets in connection with specific revaluation events (*e.g.*, the admittance of a new partner) under reg. section 1.704-1(b)(2)(iv)(f). Revaluations lock in allocations of built-in gains (or losses) that have arisen but have not yet been realized by the partnerships before a transaction that gives rise to revaluation.

[2] Under section 761(a), some unincorporated organizations may elect out of the partnership tax rules; however, these arrangements are few in number because of the difficulties of meeting section 761(a) election eligibility.

[3] Under the keep-your-own method, as traditionally used, all the economics of contributed property are allocated back to the contributor until the property is sold. Under this approach, section 704(c) would apply to any gain or loss recognized on the eventual sale of the contributed property, but would not affect any allocations of depreciation, depletion, and amortization regarding contributed property, because no allocation of section 704(b) depreciation, depletion, and amortization is made to a noncontributing partner. *See*, *e.g.*, LTR 200530013; LTR 9540034; T.D. 8500, 1994-1 C.B. 183 (Dec. 22, 1993).

[4] The section 704(c) remedial method uses offsetting notional items of income and deduction to generally put the investors in the same position as if the property had a tax basis equal to its fair market value.

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section 704(c) remedial method is also key to maintaining the fungibility[5] of the PTP's units.[6]

While many oil companies have been willing to recognize income more quickly under the section 704(c) remedial method as a cost of acquiring capital, other sponsors of oil and gas investments have chosen the section 704(c) traditional method, which limits the investors' benefit to the sponsor's tax basis in contributed property. This could be because the sponsor has newly acquired the working interest, such that it has a sufficiently high initial tax basis, or simply because they've chosen a different economic arrangement with their investors.

Sponsors and practitioners have historically focused on the unique partnership oil and gas depletion rules when choosing a section 704(c) method, with the possible future sale of the property a mere afterthought. However, sponsors seeking an exit from their investments in oil and gas interests will have to contend with the complex partnership rules applicable to oil and gas property sales as well. In this article, we focus on those rules and how the choice of section 704(c) method affects partnership sharing from sales of oil or gas property — particularly situations in which the partnership uses the traditional method for section 704(c).

Basic Rules of Oil and Gas Partnership Property

The road to convoluted tax rules is often paved with good intentions, and a good example is the odd system for accounting for oil and gas property in a partnership. In 1975 Congress repealed percentage depletion on oil and gas properties, except when a taxpayer is an "independent" producer or royalty owner.[7] Whether a taxpayer is considered independent for this purpose is partially determined by comparing its average daily production with its depletable oil or gas quantity.[8] Given the prevalence of co-ownership of oil and gas properties (whether in actual state law partnerships or less formal joint ventures that are treated as partnerships for federal income tax purposes), there was a risk of taxpayers using partnerships to divide their production among various entities to create multiple independent producer exceptions.

To avoid this issue, section 613A treats a partnership interest as a partial interest in the production from the oil and gas property held by the partnership.[9] For purposes of the exception, a taxpayer's production from partnership oil and gas property is determined by multiplying the total production of that property by the taxpayer's percentage participation in the revenues from that property.[10] This approach initially caused major headaches for partnerships, which were calculating depletion on their properties at the partnership level, while the test for the independent producer exception was applied at the partner level. To "prevent instances of unintended hardship," Congress amended section 613A again in 1976, this time adopting a full aggregate approach to partnership oil and gas property.[11]

Since the 1976 amendment, section 613A(c)(7)(D) has provided that the depletion allowance is computed separately by the partners and not by the partnership. To allow partners to separately figure out their depletion, section 613A(c)(7)(D) essentially treats the partners as holding their shares of partnership oil and gas property directly. The partnership allocates to

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[5] Fungibility generally means that the economics of the units on the public market are identical, regardless of the seller's tax attributes. Because a buyer of a partnership interest steps into the shoes of the selling partner's section 704(c) position under reg. section 1.704-3(a)(7), the section 704(c) remedial method and section 743(b) basis adjustments allow the buyer's units to have the same total tax attributes even when the seller's units have different section 704(c) positions.

[6] For a discussion of the U.S. federal income tax issues associated with the formation and operation of natural resources PTPs, including the keep-your-own and remedial section 704(c) methods, see generally Deborah Fields et al., "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*, at 21 (Dec. 2009); Fields et al., "Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part II — Property Acquisitions)," *Taxes*, at 71 (Feb. 2010); Fields, Holly Belanger, and 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 III — Bringing in the Public and Management and Partnership Allocations)," *Taxes*, at 33 (May 2010); and Fields, Belanger, and Lee, "Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part IV — Secondary Offerings and the Impact of Public Trading)," *Taxes*, at 25 (Oct. 2010).

[7] Section 613A, enacted as P.L. 94-12, section 501(a); H.R. Conf. Rep. No. 94-120, at 67 (1975).

[8] Section 613A(c)(1).

[9] Section 613A(c)(2)(B).

[10] *Id.*

[11] H.R. Conf. Rep. No. 95-1515, at 500 (1976).

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each partner his proportionate share of the adjusted basis in the oil and gas property, which the partner then uses to separately determine his depletion on the property (and, as discussed more fully later, gain or loss on the sale of partnership oil or gas property).[12] The partners are required to separately track their adjusted bases in the property, as affected by their separate depletion calculations.[13] If the partnership needs to know *its* adjusted basis in the property (for example, if the property is distributed or sold by the partnership), its basis is the sum of the partners' adjusted bases in the oil and gas properties.[14]

How Basis in Oil and Gas Property Is Allocated by a Partnership

Initial Allocations

Section 613A(c)(7)(D) provides that a partner's proportionate share of the adjusted basis of partnership property is determined in accordance with his interest in partnership capital or income. The allocation is done on a property-by-property basis, and it isn't necessary for each property to be allocated in the same manner (that is, one property can be allocated based on shares of partnership capital and another can be allocated based on shares of partnership income).[15] A partner's interest in partnership capital or income is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.[16] The factors used to determine a partner's interest in a partnership (commonly referred to as PIP) under section 704(b) are relevant for making the determination.[17] Those factors are:

- the partners' relative contributions to the partnership;
- the interests of the partners in economic profits and losses (if different than those in taxable income or loss);
- the interests of the partners in cash flow and other non-liquidating distributions; and
- the rights of the partners to distributions of capital upon liquidation.[18]

The section 613A regulations specify that a partner's proportionate share of basis is determined in accordance with her proportionate interest in partnership capital at the time of the allocation unless both:

- the partnership agreement provides that a partner's share of the adjusted basis of one or more properties is determined in accordance with her proportionate interest in partnership income; and
- at the time basis is allocated, the share of each partner in partnership income is reasonably expected to be substantially unchanged throughout the life of the partnership (other than changes that result from a change in the membership of the partnership, or when a partner's interest changes as the result of a contribution of capital or services).[19]

This baseline allocation rule is much more restrictive than most of the rules for partnership allocations. However, the regulations provide a "special" rule that provides oil and gas partnerships with additional flexibility in allocating basis.[20] If the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners,[21] that allocation will be recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), provided that:

- the allocation does not give rise to capital account adjustments for simulated depletion (discussed later), the economic effect of which is insubstantial; and

[12] Section 613A(c)(7)(D) specifies that the initial basis allocation is made on the date of acquisition of the property.

[13] Reg. section 1.613A-3(e)(6)(i).

[14] Although depletion is a partner-level computation, the capital account maintenance rules require each partner's capital account to be adjusted for depletion using either simulated depletion or actual depletion. Reg. section 1.704-1(b)(2)(iv)(k).

[15] Reg. section 1.613A-3(e)(2)(ii).

[16] Reg. section 1.613A-3(e)(4).

[17] *Id.*

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

[19] Reg. section 1.613A-3(e)(2)(ii).

[20] Reg. section 1.613A-3(e)(5).

[21] And is not otherwise governed by section 704(c).

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- all other material allocations and capital account adjustments under the partnership agreement are recognized under section 704(b).[22]

If the partnership's allocation fails either requirement, it must revert to the more restrictive baseline allocation rule.[23] However, this special rule generally allows oil and gas partnerships to share the economics of partnership oil or gas property much the same as with any other kind of partnership property.

Reallocations and Revaluations

If the tax fiction is to treat partners as if they held their shares of partnership oil or gas property directly, it is also necessary to address what happens when the sharing of partnership oil or gas property changes. The adjusted basis in partnership oil or gas property is reallocated among the partners upon the admission of a new partner, an increase in an existing partner's interest in connection with a contribution of capital or services to the partnership, or a partial or full redemption of an existing partner.[24] Although the current regulations do not expressly identify recapitalizations as a basis for revaluation, it appears that mere changes in how partners choose to share profits from a partnership may also give rise to a basis reallocation absent a change in partnership capital.[25] This approach generally would be consistent with the rules for when a partnership may revalue its assets and restate the capital accounts of the partners.[26] Similarly, as with a partner's section 704(b) capital account, a taxpayer that buys a partnership interest from an existing partner steps into that partner's shoes regarding the allocated basis in partnership oil or gas property.[27]

In the event of a reallocation of the adjusted basis in oil or gas property, the partnership is required to determine the aggregate basis of the partners in the property before effectuating the reallocation. Whether it is a reduction of the existing partners' shares to accommodate a new or increased partnership interest, or an increase in the shares of remaining partners resulting from a full or partial redemption of a partner, basis is reallocated in proportion to how it was shared before the change.[28] To determine the aggregate adjusted basis in partnership oil or gas property, a partnership may rely on:

- written data provided by the partners that establishes either the partners' adjusted bases or the depletion deductions regarding the property;[29] or
- in the absence of written data, the partnership must make specific assumptions about its partners in calculating the aggregate adjusted basis in the oil or gas property.[30]

The partnership is allowed to rely on written data for some partners, while calculating other partners' bases based on assumptions.[31]

If a partnership undertakes a revaluation of its properties and the capital accounts of its partners under section 704(b), the amount of the revaluation of the section 704(b) basis of partnership oil or gas property is allocated among the partners based on the same principles as the allocation of revaluation gains or losses in other kinds of property.[32] As with revaluations of other kinds of property, a section 704(b) revaluation of

[22] Reg. section 1.704-1(b)(4)(v).

[23] *Id.*

[24] Reg. section 1.613A-3(e)(3).

[25] The proposed regulations issued in 2014 added partnership recapitalizations to the list of revaluation events. *See* REG-151416-06, 79 F.R. 65151, 65157, and 65159 (2014). However, those proposed regulations have not yet been finalized.

[26] *See, e.g.*, reg. section 1.704-1(b)(2)(iv)(f).

[27] Reg. section 1.613A-3(e)(6)(iv).

[28] Reg. section 1.613A-3(e)(3)(ii)(C); reg. section 1.613A-3(e)(3)(iv)(A).

[29] Reg. section 1.613A-3(e)(3)(iii)(B).

[30] Reg. section 1.613A-3(e)(3)(iii)(C). Those assumptions are:
- the partners deducted their share of partnership intangible drilling costs under section 263(c) (assuming that the partnership had not elected to capitalize intangible drilling costs);
- the partners were not subject to the 65 percent of income limitation of section 613A(d)(1) regarding their depletion allowance under section 611; and
- the partners were not subject to the taxable income limitation of section 613(a) the depletable quantity limitations of section 613A(c), the prohibition in former section 613A(c)(9), or the exclusions for retailers and refiners of section 613A(d)(2), (3), and (4).

The partnership is allowed to rebut the assumption that a withdrawing partner was not subject to the retailers and refiners exclusions of section 613A(d)(2), (3), and (4) if it has knowledge that the withdrawing partner was subject to the exclusions. Reg. section 1.613A-3(e)(3)(iv)(B).

[31] Reg. section 1.613A-3(e)(3)(iii)(A).

[32] Reg. section 1.613A-3(e)(5); reg. section 1.704-1(b)(4)(i).

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partnership oil or gas property will be subject to the principles of section 704(c). The application of section 704(c) to partnership oil or gas property is discussed later.

How Oil and Gas Depletion Affects Section 704(b) Capital Accounts

Partnership oil or gas property presents an interesting problem for section 704(b) capital account maintenance. The section 704(b) rules require that partner capital accounts reflect the partners' shares of partnership income, gain, loss, and deduction.[33] When partners are treated as if they hold and deplete their partnership oil or gas property directly, there is no way, without a special mechanism, for the partnership to ensure that partner section 704(b) capital accounts reflect the depletion of partnership oil or gas property. This prevents the section 704(b) capital accounts of the partners from accurately representing the economic arrangement of the partners.

The section 704(b) regulations provide two possible solutions to this problem. If the partnership has access to the actual depletion deductions taken by the partners, it may use the actual depletion numbers to adjust partner capital accounts.[34] However, it may not be realistic for the partnership to obtain the actual depletion numbers from its partners in a timely manner, particularly in larger partnerships with many unrelated partners.

Alternatively, the partnership can calculate its "simulated" depletion and use the simulated depletion numbers to adjust section 704(b) capital accounts.[35] The partnership can deplete its oil or gas property under either the cost or percentage depletion methods, without regarding the possible application of the section 613A limitation on percentage depletion at the partner level.[36] The choice of either simulated cost or simulated percentage depletion is made on a property-by-property basis, and the choice is binding on the partnership going forward.[37]

The choice of a partnership depletion method for section 704(b) capital accounts may be negotiated among partners. The method chosen by the partners is often specified in the partnership agreement, leaving no discretion to the managing member or general partner to deviate from that choice.

Section 704(c) and Contributed Property

The allocation of basis in partnership oil or gas property is more complicated, and more uncertain, when that property is contributed property subject to section 704(c). Section 613A(c)(7)(D) states that section 704(c) applies to the allocation of basis.[38] However, neither the statute nor the regulations provide any meaningful guidance on *how* section 704(c) is intended to apply to the basis allocation.

The general purpose of section 704(c) is to prevent the shifting of tax consequences among partners regarding pre-contribution gain or loss.[39] To accomplish this, section 704(c) requires partnerships to allocate income, gain, loss, and deduction regarding property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.[40] While section 704(c) is described as an antiabuse rule, economically it attempts to place noncontributing partners approximately in the same place they would be if the contributed property had a tax basis equal to its value. Seen in this light, the application of section 704(c) to the allocation of basis in partnership oil or gas property becomes apparent.

The first step in allocating basis in partnership oil or gas property is to allocate the section 704(b) basis of the property among the partners under the rules discussed earlier. The second step is to allocate the adjusted tax basis of the property first to any noncontributors of the property up to their share of the section 704(b) basis of the property. Any remaining tax basis can then be allocated to

[33] *See generally* reg. section 1.704-1(b)(2)(iv).

[34] Reg. section 1.704-1(b)(2)(iv)(k)(3).

[35] Reg. section 1.704-1(b)(2)(iv)(k)(2).

[36] *Id.*

[37] *Id.*

[38] *See also* reg. section 1.704-1(b)(4)(v) ("In the case of an oil or gas property contributed to a partnership by a partner, section 704(c) is taken into account in determining the partner's share of the adjusted basis.").

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

[40] *Id.*

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the contributors of the property. The partners would then use their allocated tax basis in determining their tax depletion for the year. Therefore, section 704(c) operates to allow a noncontributing partner — as closely as possible — to be treated as holding an oil and gas property with a tax basis — as closely as possible — equal to its section 704(b) value.

Revaluations and the establishment of "reverse" section 704(c) layers create a different set of complexities with oil or gas property than they do with other kinds of property. Each new section 704(c) layer means a new reallocation of the tax basis in the oil or gas property, resulting in the partners essentially having a net tax basis position that considers all the section 704(c) layers. A change in a partner's net tax basis allocation could affect whether she uses the cost or percentage depletion method (assuming that it is available to her), which is an additional layer of complexity that isn't present with other kinds of partnership property. The availability of percentage depletion allowed in excess of tax basis could place a property contributor in a much different position than a contributor of other kinds of section 704(c) property.[41]

When the tax basis of the partnership oil or gas property is insufficient to match the noncontributing partners' allocation of section 704(b) basis (that is, the ceiling rule), it appears that the same section 704(c) methods are available. A partnership using the traditional method would take no further action to correct the ceiling rule shortfall in basis, and the noncontributing partner would determine its tax depletion based on that basis amount.[42] Below, we will detail the mechanics of how the ceiling rule affects the partners when the partnership sells oil and gas property.

Note that many oil and gas partnerships choose the remedial method to avoid the impact of the ceiling rule. There is some uncertainty as to whether the remedial method should be applied to the allocation of tax basis or create an allocation of deductions.[43] While it is not free from doubt, it appears that the better application of the remedial method may be to stay consistent with the basis allocation construct. Under that approach, the remedial method applies by creating remedial basis for the noncontributing partner, with offsetting negative basis in the hands of the contributor.[44] The remedial method is particularly useful when a partnership anticipates having several section 704(c) layers stemming from multiple revaluations of the property. However, because our primary focus is on partnerships that choose the traditional method, a comprehensive discussion of the application of the remedial method to oil or gas property is beyond the scope of this article.

Sales of Partnership Oil and Gas Property and Section 704(c)

As discussed, under the section 704(b) and section 613A regulations, partnership oil and gas property is treated as if it is held directly by the partners, outside of the partnership. While this results in additional complexity for the partnership in managing the depletion of the property, it presents a unique challenge when partnership oil and gas property is sold.

To put it into context, when non-oil-and-gas property is sold by a partnership, the partnership

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[41] There is some uncertainty as to whether a partner's taking of percentage depletion in excess of cost depletion could take into account, under section 704(c), where the partnership uses simulated cost depletion for maintaining partner section 704(b) capital accounts. However, this issue is beyond the scope of this article and has not been addressed in any guidance issued to date.

[42] *See, e.g.*, reg. section 1.704-3(b)(1) for a description of the traditional method.

[43] It is also unclear how the section 704(c) curative method would apply to oil and gas property (that is, a curative allocation of basis in another oil or gas property versus a curative allocation of deduction). The section 704(c) regulations provide that to be considered reasonable, a curative allocation must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. Reg. section 1.704-3(c)(3)(iii)(A). While the section 704(c) regulations never contemplated their application to oil and gas depletion, query whether tax basis in other partnership oil and gas property should be viewed as a "tax item" for this purpose, and if so, whether it is the *only* tax item that has substantially the same effect as the tax basis subject to the ceiling rule limitation. Also, the fact that percentage depletion is not determined by reference to the tax basis in the property presents an additional complication in applying the curative method. Specifically, an unanswered question is whether a partnership can or should consider the availability of percentage depletion to a noncontributing partner in applying the curative method.

[44] *See, e.g.*, reg. section 1.704-3(d) for the general rules for applying the remedial method. However, the drafters of the regulations do not appear to have contemplated how they could apply to oil or gas property.

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determines the amount of gain or loss recognized on the sale for both section 704(b) and tax purposes, and then allocates that gain or loss among the partners. When the property is subject to section 704(c), the partnership's tax gain or loss on the sale is allocated to consider the partners' shares of the underlying built-in gains or losses in the property.

In contrast, if the partners are treated as separately depleting the tax basis in oil and gas property outside of the partnership, then the partnership is theoretically not in a position to determine the exact tax gain or loss on the sale of the property.[45] Rather, the partnership can only allocate the amount realized on the sale to each partner, which is then responsible for determining the partner's own gain or loss on the sale, taking into account limitations regarding its depletion allowance under section 611 and any elections it made to capitalize intangible drilling costs.[46]

It becomes readily apparent that there would be substantial opportunity for abuse when partners can separately allocate the basis in an asset and the amount realized when that asset is sold. For example, the amount realized could be allocated away from a partner who has a high basis allocation to create tax loss for that partner, even when the partnership would have realized a gain on the sale.

Therefore, the section 704(b) rules for oil and gas property sales are designed to minimize that potential for abuse by restricting how a partnership can allocate the amount realized on the sale of partnership oil and gas property.

[45] While it is beyond the scope of this article, the aggregate approach envisioned by reg. section 1.613A-3(e) presents an interesting dilemma in applying section 163(j). Reg. section 1.163(j)-6 adopts an entity approach to determining how the interest limitation applies, but the existing guidance does not provide any specific guidance on oil and gas partnerships. For example, while a mechanical application of reg. section 1.163(j)-6(d) would seemingly include the gain or loss on the sale of oil and gas property in the *partner's* adjusted taxable income rather than the *partnership's* ATI, this can create significantly different results for oil and gas partnerships under section 163(j) that likely were not intended by either Congress or the drafters of the regulations. While it is always possible that specific guidance could be issued to address the application of section 163(j) to oil and gas partnerships, in its absence query whether the simulated gain and loss items discussed later should be considered in the partnership's section 163(j) determination.

[46] *See*, *e.g.*, reg. section 1.613A-3(e)(6)(iii).

General Rules for Sales of Partnership Oil and Gas Properties

When a partnership sells oil and gas property that is not subject to section 704(c) (for example, if it was purchased by the partnership and never subject to a section 704(b) revaluation), the section 704(b) regulations provide fairly straightforward allocation rules. The regulations take a hybrid approach to sales of oil and gas properties by taking into account whether the sale would result in gain or loss at the partnership level in determining how the amount realized is allocated to the partners.[47] For example, if the partnership has been following the simulated depletion method, the simulated gain or loss of the partnership (determined by comparing the amount realized on the sale with the partnership's aggregate simulated adjusted basis in the property) will then determine how the amount realized is allocated to the partners to determine their gains or losses.[48] How the simulated gain or loss affects the allocation of the amount realized on the sale will differ slightly, depending on whether the sale results in a simulated gain or loss.

Sale for a Simulated Gain

The section 704(b) regulations appear to provide a two-step process for allocating the amount realized when there is a simulated gain on the sale of an oil and gas property. The regulations' references to the two steps are somewhat disjointed and hard to follow, but provide a result that avoids abuse while maintaining flexibility in how the partners choose to share in gains from the sale of partnership oil and gas property.

Step 1: Recovery of Basis. As outlined in the section 704(b) regulations, the first step considers how the basis in the property was allocated by the partnership. The regulations describe the first step as follows: "the portion of the total amount realized by the partnership upon the taxable disposition of such property that represents recovery of its simulated adjusted tax basis therein will be allocated to the partners in the same proportion as the aggregate adjusted tax basis of such property

[47] Reg. section 1.704-1(b)(2)(iv)(k)(2).

[48] *Id.* For purposes of this article, we will focus only on the rules applicable to simulated depletion. However, similar rules apply when actual depletion information is used.

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was allocated to such partners (or their predecessors in interest)."[49] This means the amount realized from the sale is first allocated among the partners in the amount of their simulated adjusted basis in the sold property, as a recovery of that basis.[50]

By tying this first portion of the amount realized to the allocation of simulated basis, the regulations prevent partners from artificially creating or shifting gains on the sale of oil and gas property. Essentially, the first step limits the flexibility in making allocations of the amount realized to the actual economic gain on the sale of the property, as if it were treated as held by the partnership.

Step 2: Partnership Agreement. It follows that the second step involves the allocation of the portion of the amount realized that represents the economic gain on the sale. In somewhat ambiguous language, the second step allows the partnership to allocate the excess amount realized according to the terms of the partnership agreement, provided that:

1. the allocations meet the substantiality requirements of section 704(b); and
2. all the other allocations and capital account adjustments are respected under section 704(b).[51]

The regulations further provide that the "capital accounts of the partners shall be adjusted upward by the amount of any simulated gain in proportion to such partners' allocable shares of the portion of the total amount realized from the disposition of such property that exceeds the partnership's simulated adjusted basis in such property."[52] In other words, the second portion of the amount realized is equal to a partner's allocable share of simulated gain. Therefore, the two-step process allows partners to retain significant flexibility in determining how they share in the gain on the sale of partnership oil and gas property, but only to the extent that there would have been gain at the partnership level. In short, the regulations allow the partners flexibility in allocating the partnership's simulated gain, without the risk of abusive creation of gains or losses at the partner level.

While this two-step approach is not made entirely clear in the regulatory language cited earlier, it is spelled out more plainly in an example provided in the regulations.

Example 1: Simulated Gain

In the example provided by the regulations, DG and JC form a general partnership to drill oil wells.[53] DG contributes an oil lease, which has an FMV and adjusted tax basis of $100,000, to the partnership, and JC contributes $100,000 in cash for drilling operations (as shown in Table 1). Both capital accounts are credited with $100,000. The partnership agreement provides that:

- all additional cash requirements of the partnership will be borne equally;
- the deductions attributable to the property (including money) contributed by each partner will be allocated to that partner;
- all other income, gain, loss, and deductions (and items thereof) will be allocated equally; and
- all cash from operations will be distributed equally. All allocations of income, gain, loss, and deduction have substantial economic effect and allocation of the entire depletable basis to DG in accord with the partners' interest in partnership capital.

For the partnership's first tax year, the simulated depletion deduction regarding the lease is $10,000 (as shown in Table 2). Since DG properly was allocated the entire depletable basis of the lease, the partnership's $10,000 simulated depletion deduction is allocated to DG and will reduce his capital account accordingly. If (before any additional simulated depletion deductions) the lease is sold for $100,000, the first $90,000 (that is, the partnership's simulated adjusted basis in the lease) of the amount realized on the sale is allocated to DG (as shown in Table 3). The partnership agreement allocates the remaining $10,000 amount realized equally between JC and DG, and the partners' capital accounts are adjusted upward by their allocable share of the partnership's simulated gain.

[49] Reg. section 1.704-1(b)(4)(v).

[50] *Id.*

[51] *Id.*

[52] Reg. section 1.704-1(b)(2)(iv)(k)(2).

[53] Reg. section 1.704-1(b)(5), Example 19(iv).

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Table 1. Partnership Balance Sheet (in Thousands)

	Opening Balance Sheet		Year 1 Simulated Depletion and Assumed Tax Depletion		Ending Balance Sheet	
	Section 704(b)	Tax	Section 704(b)	Tax	Section 704(b)	Tax
Oil Lease	$100	$100	$(10)	$(10)	$90	$90
Cash	$100	$100	$0	$0	$100	$100
Total Assets	**$200**	**$200**	**$(10)**	**$(10)**	**$190**	**$190**
DG	$100	$100	$(10)	$(10)	$90	$90
JC	$100	$100	$0	$0	$100	$100
Total Equity	**$200**	**$200**	**$(10)**	**$(10)**	**$190**	**$190**

Table 2. Partnership's Initial Allocation of Oil and Gas (O&G) Basis and Determination of Depletion (in Thousands)

	Partnership Initial Allocation to Partners		Partners' Year 1 Depletion		Partners' Ending Simulated and Adjusted Tax Basis	
	Section 704(b)	Tax	Section 704(b)	Tax	Section 704(b)	Tax
DG	$100	$100	$(10)	$(10)	$90	$90
JC	$0	$0	$0	$0	$0	$0
O&G Prop.	$100	$100	$0	$0	$90	$90

Table 3. Realized Section 704(b) Simulated Gain — Sales Price of $100,000 (in Thousands)

	Total	DG	JC
(i) To the extent of simulated basis	$90	$90	$0
(ii) In accordance with partnership agreement	$10	$5	$5
Amount Realized ((i) + (ii))	$100	$95	$5
Less Simulated Basis*	$(90)	$(90)	$(0)
Realized Simulated Gain*	$10	$5	$5

*Assuming that the partnership's remaining adjusted tax basis is the same as the partnership's simulated basis, the assumed tax gain would be the same as the simulated gain.

Table 4. Realized Section 704(b) Simulated Loss — Sales Price of $50,000 (in Thousands)

	Total	DG	JC
(i) To the extent of simulated basis	$50	$50	$0
(ii) In accordance with partnership agreement	$0	$0	$0
Amount Realized ((i) + (ii))	$50	$50	$0
Less Simulated Basis*	$(50)	$(90)	$(0)
Realized Simulated Loss*	$(40)	$(40)	$0

*Assuming that the partnership's remaining adjusted tax basis is the same as the partnership's simulated basis, the assumed tax loss would be the same as the simulated loss.

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Table 5. Partnership Balance Sheet — Sales Price of $50,000 (in Thousands)

	Balance Sheet Adj. for Year 1 Depletion		Sale		Ending Balance Sheet	
	Section 704(b)	Tax	Section 704(b)	Tax	Section 704(b)	Tax
O&G Prop.	$90	$90	$(90)	$(90)	$0	$0
Cash	$100	$100	$50	$50	$150	$150
Total Assets	**$190**	**$190**	**$(40)**	**$(40)**	**$150**	**$150**
DG	$90	$90	$(40)	$(40)	$50	$50
JC	$100	$100	$0	$0	$100	$100
Total Equity	**$190**	**$190**	**$(40)**	**$(40)**	**$150**	**$150**

Sale for a Simulated Loss

The same hybrid approach applies when there is a simulated loss at the partnership level, based on the aggregate simulated adjusted basis of the partners. However, the section 704(b) rules allow partners less flexibility in how the amount realized is shared when there is a simulated loss, because only the first step is applied. As such, in the event of a simulated loss at the partnership level, the entire amount realized on the sale is allocated in proportion to the partners' simulated adjusted basis in the property.[54] The partners' section 704(b) capital accounts are reduced by the simulated loss that results from comparing the allocated amount realized with the partners' simulated basis in the property.[55]

Example 2: Simulated Loss

To illustrate, if the partnership in Example 1 had sold the property for $50,000, the entire $50,000 amount realized on the sale of the lease would be allocated to DG (as shown in Table 4). The partners' capital accounts would be adjusted downward by the partnership's $40,000 simulated loss ($50,000 sales price less $90,000 simulated adjusted basis) in proportion to the partners' allocable shares of the total amount realized from the property that represents recovery of the partnership's simulated adjusted basis therein (as shown in Table 5). Accordingly, DG's capital account would be reduced by that $40,000.

Summary

When the property sold is not subject to section 704(c), the allocation of the amount realized determined above would be used by the partner in determining their separate tax gain or loss on the sale of the property. When a partner's simulated section 704(b) basis and allocated tax basis match,[56] the hybrid approach taken in the section 704(b) rules generally harmonizes the partner's economic and tax gains or losses. This approach breaks down when a partner's allocation of tax basis does not equal his allocation of simulated section 704(b) basis.

Impact of Section 704(c)

As discussed, the principles of section 704(c) come into play in determining how partnership tax basis in oil and gas property is allocated among the partners.[57] While many oil and gas partnerships elect to use the remedial method under section 704(c) to avoid the possible impact of the ceiling rule, this article focuses on oil and gas partnerships that apply the traditional method. As a result of following the traditional

[54] *Id.*

[55] *Id.* While the regulation describes this as an allocation of the partnership's simulated loss to the partners, for purposes of consistency with the overall scheme of the basis in oil and gas property being held by the partners we are describing this as each partner suffering a separate simulated loss on their share of the property.

[56] A notable exception being when a partner's tax depletion method does not match the method used by the partnership for simulated depletion.

[57] Reg. section 1.704-1(b)(4)(v).

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method, noncontributing partners may face a ceiling rule limitation on the amount of tax basis that can be allocated to them.

Example 3: Initial Basis Allocation Illustrating Ceiling Limitation

Connie and Nanna form partnership Co-Nan and agree that each will be allocated a 50 percent share of all partnership items and that Co-Nan will make allocations under section 704(c) using the traditional method. Connie contributes an oil and gas property with an FMV of $100 and an adjusted tax basis of $40. Nanna contributes cash of $100 to the partnership (as shown in Table 6).

The partnership elects the simulated cost depletion method and elects the traditional section 704(c) method regarding the contributed oil and gas property. The partnership allocates the simulated basis of the oil and gas property in accordance with each partner's proportionate interest in partnership capital (that is, 50 percent each to Connie and Nanna), and assumes for purposes of determining its adjusted tax basis in each oil and gas property that each partner can take the greater of cost or percentage depletion regarding their share of adjusted tax basis of each oil and gas property. The partnership extracts half of the available reserves in its first year of operations. Assume, for purposes of this example, that the percentage depletion does not exceed cost depletion for each partner.

For purposes of the depletion allowance, the partnership makes an upfront allocation of basis to each partner. In accordance with their percentage interest in capital, the partnership allocates $50 of simulated basis each to Connie and Nanna (as shown in Table 7). Because the contributed oil and gas property has a section 704(b) book value that differs from tax, the partnership must allocate the tax basis of the property taking into account section 704(c) principles. The partnership allocates all $40 of tax basis to Nanna (that is, the noncontributing partner) and zero tax basis to Connie. The upfront allocation of tax basis reflects the $10 of ceiling limit (that is, the extent to which the simulated basis ($50) allocated to Nanna (the noncontributing partner) exceeds her tax basis ($40)) that Nanna will ultimately bear, assuming that the partnership has no further reallocation events. Because the difference between each partner's simulated basis and tax basis reflects the ceiling limit over the life of the oil and gas property and may not reflect the remaining section 704(c) gains and losses, it is generally helpful for the partnership to track each partner's section 704(b) or tax disparity from inception (as shown in Table 8). This information would be helpful in the event of subsequent revaluations or dispositions of oil and gas property.

Connie and Nanna separately compute their tax depletion regarding their allocated share of the adjusted tax basis of the oil and gas property. Connie will base her tax depletion calculation on having been allocated zero tax basis as the contributor of the property, while Nanna will use the full $40 in tax basis in calculating her depletion allowance. The partnership makes downward adjustments to the section 704(b) capital accounts of the partners for simulated depletion, based on each partner's equal $50 simulated basis in the property. The partnership would also make downward adjustments in determining the tax capital account of each partner equal to her allowable depletion to the extent of the adjusted tax basis allocated to that partner.[58]

[58] It should be noted that under updates to the IRS's 2020 Instructions for Form 1065 and the Partner's Instructions for Schedule K-1 (Form 1065) regarding Item L (Partner's Capital Account Analysis), a partnership is now required to report the tax basis capital accounts of its partners in Item L, and a partner's tax basis capital is reduced for "the partner's distributive share of tax deductions of any partnership oil and gas property, but not exceeding the partner's share of the adjusted tax basis of that property." Notwithstanding that section 703(a)(2)(F) provides that the depletion deduction regarding oil and gas property is not allowed at the partnership level, the reduction would seemingly align its tax basis capital more closely with its outside basis under section 705 principles.

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Table 6. Partnership Balance Sheet

	Opening Balance Sheet			Year 1 Simulated Depletion and Assumed Tax Depletion			Year 1 Ending Balance Sheet		
	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T
O&G Prop.	$100	$40	$60	$(50)	$(20)	$(30)	$50	$20	$30
Cash	$100	$100	$0	$0	$0	$0	$100	$100	$0
Total Assets	**$200**	**$140**	**$60**	**$(50)**	**$(20)**	**$(30)**	**$150**	**$120**	**$30**
Connie	$100	$40	$60	$(25)	$0	$(25)	$75	$40	$35
Nanna	$100	$100	$0	$(25)	$(20)	$(5)	$75	$80	$(5)
Total Equity	**$200**	**$140**	**$60**	**$(50)**	**$(20)**	**$(30)**	**$150**	**$120**	**$30**

Table 7. Partnership's Initial Allocation of O&G Basis and Determination of Depletion

	Partnership Initial Allocation to Partners			Partners' Year 1 Depletion			Partners' Year 1 Ending Simulated and Adjusted Tax Basis		
	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T
Connie	$50	$0	$50	$(25)	$0	$(25)	$25	$0	$25
Nanna	$50	$40	$10	$(25)	$(20)	$(5)	$25	$20	$5
O&G Prop.	$100	$40	$60	$(50)	$(20)	$(30)	$50	$20	$30

Table 8. Year 1 Section 704(b)/ Tax Disparity Roll-Forward

Ending	Beginning	CY Change
Connie $35	$60	$(25)
Nanna (5)	$0	$(5)
O&G Prop. $30	$60	$(30)

This ceiling rule limitation on the basis allocated to the noncontributing partner presents an interesting problem when the property is sold. If the partnership allocates the amount realized on the sale of the oil and gas property to the partners to separately determine their gain or loss on the sale, then Nanna would not have enough tax basis to match her section 704(b) basis.

If section 704(c) affects oil and gas property only as a basis allocation mechanism, then it would seem to follow that a ceiling rule limitation on basis allocations could result in additional tax gain being realized by a noncontributing partner on the sale of property, shifted from the contributing partner, than would be possible for the sale of other kinds of partnership property.

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Table 9. Illustration of Shift in Gain Caused by Only Applying Section 704(c) to Basis Allocations — Partnership Sells the Property Immediately After Formation

	Partnership Simulated and Adjusted Tax Basis			Allocation of Sales Proceeds 50/50 for Both Section 704(b) and Tax			Partner's Simulated and Tax Gain or Loss		
	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T
Connie	$50	$0	$50	$50	$50	$0	$0	$50	$50
Nanna	$50	$40	$10	$50	$50	$0	$0	$10	$10
O&G Prop.	$100	$40	$60	$100	$100	$0	$0	$60	$60

Had the partnership sold section 704(c) property other than an oil and gas property with an FMV of $100 and a tax basis of $40, the entire $60 tax gain would have been allocated to contributor Connie. However, assuming — arguendo — that the amount realized by Nanna for tax purposes is equal to her allocation of the amount realized under section 704(b), this would cause an immediate shift of $10 tax gain from Connie to Nanna (as shown in Table 9).

This shifting of tax gain or loss to a noncontributing partner would be contrary to the intent of section 704(c), and likely not what the drafters of the rules had in mind. It requires following a trail of breadcrumbs through the regulations, but it does appear that the section 704(b) regulations provide a mechanism to prevent a ceiling rule limitation on basis allocations from shifting gains or losses to noncontributing partners.

As with the approach designed to prevent creating and shifting gains or losses discussed earlier, it appears that the solution taken in the regulations involves the allocation of the amount realized on the sale of partnership oil and gas property. The section 704(b) regulations provide that the "partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property will, except to the extent governed by section 704(c) (or related principles under [section 1.704-1(b)(4)(i)[59]]), be determined under" section 1.704-1(b)(4)(v). While subtle, this provision appears to indicate that section 704(c) is intended to apply in determining the partners' shares of the amount realized on the sale of partnership oil and gas property.

The regulations fail to provide any additional discussion of how section 704(c) should apply to the amount realized on a sale of partnership oil and gas property, and the government has provided no further guidance on this issue. Therefore, taxpayers are left to follow the general commandment of the section 704(c) regulations: Apply a reasonable method that is consistent with the purpose of section 704(c).[60]

We believe that the most reasonable approach would be to determine a separate allocation of the amount realized for section 704(b) and tax purposes. Such an approach would mirror how section 704(c) applies to require separate allocations of gain or loss for section 704(b) and tax purposes on the sale of other forms of partnership property. At the same time, this would respect the overall approach taken in the regulations to partnership oil and gas property as being held directly by the partners.

Mechanically, it appears reasonable to follow a similar method provided under the section 704(b) regulations for allocating tax gains, whereby a noncontributor is first allocated an amount realized for tax purposes to recover the partner's adjusted tax basis in the property, followed by an additional amount realized to match the partner's section 704(b) allocation under step 2 above. All the remaining amount realized would then be allocated to the contributing partner under this approach.

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[59] Allocations to reflect section 704(b) revaluations.

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

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Table 10. Partnership Balance Sheet — Sales Price of $50

	Opening Balance Sheet			Year 2 Sale			Ending Balance Sheet		
	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T
O&G Prop.	$50	$20	$30	$(50)	$(20)	$(30)	$0	$0	$0
Cash	$100	$100	$0	$50	$50	$0	$150	$150	$0
Total Assets	**$150**	**$120**	**$60**	**$0**	**$30**	**$(30)**	**$150**	**$150**	**$0**
Connie	$75	$40	$35	$0	$30	$(30)	$75	$70	$5
Nanna	$75	$80	$(5)	$0	$0	$0	$75	$80	$(5)
Total Equity	**$150**	**$120**	**$60**	**$0**	**$30**	**$(30)**	**$150**	**$150**	**$0**

Example 4: No Simulated Gain or Loss and Tax Gain

Assume the same facts as Example 3. The results are shown in Tables 10-13.

At the beginning of year 2, the partnership sells the oil and gas property for $50 and determines that its simulated basis and remaining adjusted tax basis are $50 and $20, respectively.[61] For section 704(b) purposes, the partnership must allocate the $50 amount realized in the following order:

1. First, the partnership must allocate an amount equal to the remaining simulated basis in proportion to the allocation of simulated basis. In this case, $25 of the amount realized would be allocated to each partner.
2. Second, the partnership must allocate any amount realized in excess of the remaining simulated basis in accordance with the partnership agreement. In this case, there is no excess.

For tax purposes, section 704(c) principles are considered in determining the amount realized on the disposition of the oil and gas property. Unlike property other than oil and gas property, it may be understandably counterintuitive that the amounts realized allocable to each partner — as determined for tax purposes — may be different than for section 704(b) purposes. Generally, the mechanics of section 704(c) rules allocate any remaining disparities between the section 704(b) and tax basis to the contributing partner, which simultaneously has the effect of mitigating any disparities between section 704(b) and tax amounts for any noncontributory partners.[62] To achieve that parity in the context of oil and gas property given that the gain or loss is determined separately for each partner, a noncontributing partner should be allocated a share of the amount realized equal to the sum of (i) the noncontributing partner's remaining share of adjusted tax basis in the property, plus (ii) an amount equal to the noncontributing partner's share of simulated gain (but not loss). Any remaining amount realized should be allocated to the contributing partner or partners.

[61] The partnership determines its remaining aggregate tax basis based on specific assumptions as described in reg. section 1.613A-3(e)(iii)(c). Alternatively, the partnership may insist that its partners supply the adjusted tax basis data to make that determination.

[62] If the partnership has oil and gas property with several section 704(c) layers (*e.g.*, because of subsequent revaluations), the analysis may not be so clear, as a partner may wear the hat of the contributing and noncontributing partner regarding some section 704(c) layers. In that case, a more mathematically oriented method may be helpful to address the section 704(b)/tax disparity. The discussion of these approaches is outside the scope of this article.

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Table 11. Realized Section 704(b) Simulated Gain — Sales Price of $50

	Total	Connie	Nanna
(i) To the extent of simulated basis	$50	$25	$25
(ii) In accordance with partnership agreement	$0	$0	$0
Amount Realized ((i) + (ii))	$50	$25	$25
Less Simulated Basis	$(50)	$(25)	$(25)
Realized Simulated Gain	$0	$0	$0

Table 12. Realized Tax Gain — Sales Price of $50

	Total	Connie	Nanna
(i) To the extent of Nanna's adjusted tax basis	$20	$0	$20
(ii) To the extent of Nanna's simulated gain, if any	$0	$0	$0
(iii) Remainder to contributing partners	$30	$30	$0
Amount Realized ((i) + (ii) + (iii))	$50	$30	$20
Less Tax Basis	$(20)	$0	$(20)
Realized Tax Gain	$30	$30	$0

Table 13. Section 704(b)/Tax Disparity Roll-Forward — Sales Price of $50

	Beginning	CY Change	Ending
Connie	$35	$(30)	$5*
Nanna	$(5)	$0	$(5)*
O&G Prop.	$30	$(30)	$0

*The $5 of remaining disparity is a result of the ceiling rule distortion in year 1. This distortion creates an inside/outside basis difference for each partner. This ceiling rule limitation will reverse when the partners dispose of their partnership interest — although the character may be different (that is, capital versus ordinary).

When the partnership suffers a simulated loss for section 704(b) purposes, but a tax gain, the effect of the section 704(c) ceiling rule will come into play in a more traditional sense.

Example 5: Simulated Loss and Tax Gain

If the partnership sells the oil and gas property for $40, it has $10 of section 704(b) simulated loss and $20 of tax gain. The results are shown in tables 14 through 17.

Table 14. Partnership Balance Sheet — Sales Price of $40

	Opening Balance Sheet			Year 2 Sale			Ending Balance Sheet		
	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T
O&G Prop.	$50	$20	$30	$(50)	$(20)	$(30)	$0	$0	$0
Cash	$100	$100	$0	$40	$40	$0	$140	$140	$0
Total Assets	**$150**	**$20**	**$30**	**$(10)**	**$20**	**$(30)**	**$140**	**$140**	**$0**
Connie	$75	$40	$35	$(5)	$20	$(25)	$70	$60	$10
Nanna	$75	$80	$(5)	$(5)	$0	$(5)	$70	$80	$(10)
Total Equity	**$150**	**$120**	**$60**	**$(10)**	**$20**	**$(30)**	**$140**	**$140**	**$0**

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Table 15. Realized Section 704(b) Simulated Loss — Sales Price of $40

	Total	Connie	Nanna
(i) To the extent of simulated basis	$40	$20	$20
(ii) In accordance with partnership agreement	$0	$0	$0
Amount Realized ((i) + (ii))	$40	$20	$20
Less Simulated Basis	$(50)	$(25)	$(25)
Realized Simulated Loss	$(10)	$(5)	$(5)

Table 16. Realized Tax Gain — Sales Price of $40

	Total	Connie	Nanna
(i) To the extent of adjusted tax basis	$20	$0	$20
(ii) To the extent of simulated gain, if any	$0	$0	$0
(iii) Remainder to contributing partners	$20	$20	$0
Amount Realized ((i) + (ii) + (iii))	$40	$20	$20
Less Tax Basis	$(20)	$0	$(20)
Realized Gain	$20	$20	$0

Table 17. Section 704(b)/Tax Disparity Roll-Forward — Sales Price of $40

	Beginning	CY Change	Ending
Connie	$35	$(25)	$10*
Nanna	$(5)	$(5)	$(10)*
O&G Prop.	$30	$(30)	$0

*The $10 of remaining disparity is a result of the ceiling rule distortion in year 1 and year 2. In year 2 Nanna does not have a tax loss corresponding to her section 704(b) simulated loss. This distortion creates an inside/outside basis difference for each partner. The ceiling rule limitation will reverse when the partners dispose of their partnership interest — although the character may be different (that is, capital versus ordinary).

Finally, if the partnership suffers both a section 704(b) loss and a tax loss, the amount realized would first be allocated to the noncontributing partner up to the noncontributing partner's simulated adjusted basis in the property.

Example 6: Simulated Loss and Tax Loss

If the partnership sells the oil and gas property for $10, it has $40 of section 704(b) simulated loss and $10 of tax loss. The results are shown in tables 18 through 21.

Table 18. Partnership Balance Sheet — Sales Price of $10

	Opening Balance Sheet			Year 2 Sale			Ending Balance Sheet		
	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T	Section 704(b)	Tax	B/T
O&G Prop.	$50	$20	$30	$(50)	$(20)	$(30)	$0	$0	$0
Cash	$100	$100	$0	$10	$10	$0	$110	$110	$0
Total Assets	$150	$120	$30	$(40)	$(10)	$(30)	$110	$110	$0
Connie	$75	$40	$35	$(20)	$(10)	$(10)	$55	$30	$25
Nanna	$75	$80	$(5)	$(20)	$0	$(20)	$55	$80	$(25)
Total Equity	$150	$120	$30	$(40)	$(10)	$(30)	$110	$110	$0

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Table 19. Realized Section 704(b) Simulated Loss — Sales Price of $10

	Total	Connie	Nanna
(i) To the extent of simulated basis	$10	$5	$5
(ii) In accordance with partnership agreement	$0	$0	$0
Amount Realized ((i) + (ii))	$10	$5	$5
Less Simulated Basis	$(50)	$(25)	$(25)
Realized Simulated Loss	$(40)	$(20)	$(20)

Table 20. Realized Tax Loss — Sales Price of $10

	Total	Connie	Nanna
(i) To the extent of Nanna's adjusted tax basis	$10	$0	$10
(ii) To the extent of Nanna's simulated gain, if any	$0	$0	$0
(iii) Remainder to contributing partner	$10	$0	$0
Amount Realized ((i) + (ii))	$10	$0	$10
Less Tax Basis	$(20)	$0	$(20)
Realized Gain	$(10)	$0	$(10)

Table 21. Section 704(b)/Tax Disparity Roll-Forward — Sales Price of $10

	Beginning	CY Change	Ending
Connie	$35	$(20)	$15*
Nanna	$(5)	$(10)	$(15)*
O&G Prop.	$30	$(30)	$0

*The $15 of remaining disparity is a result of the ceiling rule distortion in year 1 and year 2. In year 2 Nanna has a tax loss that is $10 less than her section 704(b) simulated loss. This distortion creates an inside/outside basis difference for each partner. The ceiling rule limitation will reverse when the partners dispose of their partnership interest — although the character may be different (that is, capital versus ordinary).

As illustrated above, by separately determining the allocation of amounts realized for section 704(b) and tax purposes, the historic oil and gas partnership property rules can be made to work with section 704(c) to prevent the improper shifting of tax gains or losses.

Conclusion

It often feels like the partnership oil and gas rules are disconnected from the rest of subchapter K and subject to their own unique logic. The limited guidance available leaves many questions unanswered as to how the two areas work together. However, we hope that the foregoing helps demonstrate that, while unique, the oil and gas rules can fit neatly within the framework of section 704(b) and (c). Regarding the sale of partnership oil and gas property, viewing section 704(c) as applying to the allocation of the amount realized on the sale achieves the purpose of section 704(c) and an economic outcome that is consistent with the deal struck by the partners.

Additional Takeaways

Treating the partners as directly holding the basis in partnership oil and gas properties creates numerous recordkeeping headaches for taxpayers, and the issues discussed here involve several of their own. In considering how to apply the section 704(c) rules to the sale of partnership oil and gas property, practitioners should keep the following items in mind:

- It likely is necessary for the partnership to keep track of each partner's share of section 704(c) gain or loss in each partnership oil and gas property, even while the rules appear to treat the property as if it is held outside the partnership.
- This will become particularly important — and significantly more difficult — when the partnership revalues its oil and gas properties under section 704(b).
- To correctly determine how to apply section 704(c) to the sale of partnership oil and gas property, it is likely necessary to know what the noncontributing partners' adjusted tax basis in the property is. While many partnerships calculate tax depletion

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for their partners, it is not a universal practice.

- Noncontributing partners may wish to provide their basis information to the partnership to avoid the issue.
- Partnerships may wish to consider requiring information sharing in drafting their partnership agreements.[63] ■

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