Revaluations ("Book-Ups") and Reverse 704(c)

A partnership may encounter situations where the partners' ownership interests differ from their relative positions as represented by their capital accounts. This can happen if there has been disproportionate sharing of cash and income, something commonly found in renewable energy partnership-flip deals. It can also happen when a new or existing partner provides additional capital to the partnership at a point where the sum of the partners' capital accounts does not reflect the fair market value of the partnership assets. In such scenarios, a partnership may be able to use a revaluation to rebalance the partners' capital accounts.

A revaluation (commonly referred to as a "book-up") is a process outlined by the IRS and occasionally used by partnerships to adjust their capital accounts. Typically, a revaluation adjusts each partner's capital account so that it represents the partner's share of ownership in the partnership's underlying assets and therefore corresponds to the partner's claim on those assets in the case of a liquidation.

A 'trigger event' is required by the IRS for a revaluation to occur. The IRS expects this event to be significant and not motivated by tax reasons. An example of a trigger event is an additional capital investment by an existing partner or a buy-in by a new partner. Although the IRS does not mandate a revaluation to keep the capital accounts balanced, many partnerships choose to do one so that the partners' capital accounts represent their respective shares of the partnership should it liquidate.

A revaluation only affects the capital accounts of the partnership. The partners recognize the gain on their investments for book purposes only. For these reasons, a revaluation does not affect the tax basis of the partnership, nor does it change the amount of total allocated taxable income from the partnership.

A revaluation will, however, affect the taxable income of each partner. By "booking up" the partner's capital account and recognizing gain for book purposes only, a revaluation creates a disparity between the capital account and the tax basis for that partner. This disparity, and the allocations used to resolve it, are directly analogous to 704(c) for contributed property.

Using the principles of 704(c), the partnership depreciates the book-up in the capital account according to its current asset mix, and then allocates an offsetting amount of built-in gain between partners in their tax bases. This process brings the capital accounts and the partners' tax bases back in line over time because the allocation of gain is usually recognized by the partner(s) who received the book-up in their capital account(s) but did not immediately recognize their gain as taxable income.

People refer to these adjustments as "reverse 704(c)" because the contributing partner in a revaluation does not typically recognize a book-up or the associated built-in gain. By contrast, in the more commonly encountered "forward 704(c)" for contributed property, the contributing partner is responsible for the built-in gain or loss.

***ABC** provides convenient tools to add revaluations to partnership files. PSHIP/CAPITAL, PSHIP/BASIS, and PSHIP/TAX reports show the effect of the revaluation on each partner.*

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