# Rolling Over and Section 704(c); What's the Big Deal? — Part 1: The Basics

**10.11.23**

When entering into a partnership agreement where one partner is contributing cash and another partner is contributing appreciated property, inevitably, a tax advisor is going to ask, which Section 704(c) allocation method does the partnership want to use? For the business folks, this may lead to some head scratching and the ultimate question of why would I care? For a private equity firm entering into a partnership agreement with rollover sellers, the Section 704(c) allocation method may affect the firm's allocable share of income and deductions. For the rollover sellers, they want to ensure that they aren't going to get hit with an unexpected tax bill, so understanding the Section 704(c) allocation methods is essential.

**Section 704**

When forming a partnership, the parties need to address how allocations of income, gain, loss, and deductions will be made. This will not be left just to the partners. The Internal Revenue Code and the underlying Treasury regulations will have a say. The general concept under Section 704(b) is that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) will be determined in accordance with the partner's interest in the partnership. The regulations under Section 704(b) expand on this concept by providing that allocations will be respected if they have substantial economic effect (SEE). One of the requirements for meeting SEE is for the partnership to maintain capital accounts and liquidate in accordance with positive capital account balances. Allocations that do not have SEE will be determined based upon the partner's interest in the partnership.

In order to maintain a partner's capital account under the Section 704(b) regulations, various requirements must be met. For example, the balance of a capital account must be increased by the fair market value of property that the partner contributes and the allocations of income and gain to that partner, and decreased by the fair market value of the property distributed to the partner and allocations of deductions and losses to that partner. These allocations are generally referred to as "book" allocations.

Section 704(c) and the underlying regulations provide that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined by taking account of the variation between the adjusted tax basis and fair market value of the property. In other words, if a partner contributes property to a partnership where the fair market value of that property is different from the partner's tax basis in that property, the partnership allocations made to that partner must consider that difference — the pre-contribution gain or loss. These allocations are generally referred to as "tax" allocations.

**Applying Section 704(c)**

 

The application of Section 704(c) can be shown in a simple example. Let's assume we have a private equity firm (PE) looking to buy a portfolio company and it wants to partner with the current owners. The PE has agreed to purchase the target corporation's (target) business and this will be the first acquisition in a new platform. The target is treated as a S corporation for federal income tax purposes. The current owners (owners) generally have the institutional knowledge of the target, and rolling over a portion of their ownership into the PE's structure ensures that the persons who originally made the target a success have a continued interest in the business. The rolling-over owners also benefit from the future upside that all the parties expect will occur from the PE's purchase, especially if there are future add-on deals.

The PE and the owners agree that the value of the target's business is $300 million, and this value is attributable to two assets, asset A and asset B. Asset A is valued at $60 million and asset B at $240 million, and the target has a $33 million tax basis in asset A and a $30 million tax basis in asset B. The PE buys asset B for $240 million and has a $240 million tax basis in asset B. The target recognizes $210 million of gain on the sale and the PE has a $240 million tax basis in asset B. The PE then contributes asset B to a new limited liability company (operating partnership) in exchange for 80% of the equity, while the target contributes asset A for the remaining 20% of the equity. The parties agree to split all income, gains, losses, and deductions 80/20.

The operating partnership takes a carryover tax basis in the contributed property: for asset A, operating partnership's tax basis equals $33 million, and for asset B, operating partnership's tax basis equals $240 million. If the operating partnership sells asset A the day after formation for $60 million, there is no economic gain and no book allocations of income because the operating partnership sold asset A for a price equal to its fair market value at the time of contribution. There is, however, taxable gain of $30 million and that gain must be allocated to the partners. Without Section 704(c), allocations of taxable gain would follow book allocations, and the $27 million taxable gain would be allocated 80/20, resulting in a shift of $21.6 million (*i.e.*, $27 million taxable gain multiplied by PE's 80% ownership interest) of pre-contribution gain from the target to the PE. Section 704(c), however, requires that the operating partnership allocate the full $30 million of pre-contribution taxable gain to the target, and prevent the shifting of tax items among the partners. The tax allocations under Section 704(c) therefore can be different from book allocations under Section 704(b).

Real life, though, is never as simple as the above example. When Section 704(c) applies to multiple properties that are depreciable/amortizable, additional complications can arise. In our above example, when the PE and the target form an operating partnership, each ends up with an indirect interest in both asset A and asset B. That means that the PE will share in 80% of the depreciation deductions attributable to asset A and asset B and the target will share in 20%. If both assets could be depreciable evenly over 10 years, the PE may be thinking it should have tax depreciation deductions each year of $24 million, representing 80% of the annual depreciation on the $300 million value of the assets. That's at least how the book allocations would end up at the end of the year.

Depreciation, though, is calculated on an asset-by-asset basis and Section 704(c) also applies on an asset-by asset basis. Asset A in our example has a tax basis of $33 million, and therefore produces some taxable depreciation, but not as much as book depreciation. The operating partnership now needs to establish some method in order to consider the difference between the book depreciation deductions and the tax depreciation deductions. The regulations under Section 704(c) provide a general rule requiring that the allocations made pursuant to Section 704(c) must be made using a reasonable method that is consistent with the purpose of Section 704(c). The regulations provide three reasonable methods: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial method.

In Part 2, we will examine the application and limitations of the traditional method. In Part 3, we will review the traditional method with curative allocations, and finally in Part 4 we will review the remedial method.

For additional information, please contact any of the attorneys listed in this advisory.

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## Related Practices and Industries

Tax

Private Equity

# Rolling Over and Section 704(c); What's the Big Deal? — Part 2: The Traditional Method

**10.18.23**

In Part 1 of our discussion on Section 704(c) (Part 1) we described the basic idea of how the inherent built-in tax gain or loss on a piece of property contributed to a partnership is allocated to the contributing partner. As noted in Part 1, Section 704(c) and the underlying regulations provide that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the variation between the adjusted tax basis and fair market value of the property (the built-in gain or built-in loss). The regulations under Section 704(c) provide that the allocations made pursuant to Section 704(c) must be made using a reasonable method that is consistent with the purpose of Section 704(c), and further provide examples of three reasonable methods: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial method. Below we discuss the application of the traditional method.

To begin our discussion, let's stay consistent and use the example we started with in Part 1: The target contributes asset A to the operating partnership and the private equity firm (PE) purchases asset B from the target corporation (target) and then contributes it to the limited liability company (operating partnership). The target has a tax basis in asset A equal to $33 million and asset A's fair market value is $60 million and therefore there is a built-in gain of $27 million. The PE purchases asset B for $240 million and therefore the PE has a tax basis in asset B equal to $240 million, which also equals its fair market value. The operating partnership has a tax basis in asset A equal to $33 million but a book basis in it equal to $60 million. Meanwhile the operating partnership's book and tax basis in asset B equals $240 million. The PE and the target agree to split all allocations and distributions 80/20. Their initial capital accounts are reflected below based upon the contributed property's tax basis and fair market value.

| Target (20%) | | PE (80%) | |
|---|---|---|---|
| Tax | Book | Tax | Book |
| $33 million | $60 million | $240 million | $240 million |

| | Adjusted Tax Basis | Fair Market Value |
|---|---|---|
| Asset A | $33 million | $60 million |

| | | |
|---|---|---|
| Asset B | $240 million | $240 million |

Let’s assume that both asset A and asset B have 10 years of useful life left and will be depreciated using the straight-line method over that time period. The operating partnership will have both book allocations (allocations made pursuant to Section 704(b)) and tax allocations (allocations made pursuant to Section 704(c)). The tax allocations need to be made in such a manner so that the tax consequences of the built-in gain of asset A are not inappropriately shifted to the PE. The operating partnership chooses the traditional method under Treasury Regulations Section 1.704-3(b) to comply with Section 704(c).

Under the traditional method, if the operating partnership sells asset A, it must make appropriate allocations to the PE and the target to avoid shifting the tax consequences. So, in a sale of asset A, any taxable built-in gain will be allocated to the target. If asset A is depreciated, then the depreciation deductions need to take into account the built-in gain. Therefore, to the extent possible, the tax allocations to the PE of depreciation with respect to asset A generally must equal book allocations made to the PE with respect to asset A. Under the traditional method, however, the allocation of income, gain, loss, or deduction for a taxable year with respect to a property cannot be in excess of the total partnership income, gain, loss, or deduction with respect to that property for the taxable year. This is known as the “ceiling rule.”

**Ceiling Rule**

How does the ceiling ruling apply, and what are the implications? At a high level, the ceiling rule can result in the noncontributing partner (the PE in this case, the partner that did not contribute the built-in gain property) not receiving the full tax allocations it is expecting. Let’s assume that at the end of year 1, the operating partnership has depreciated both asset A and asset B, and has no other income or expenses. With respect to asset A, the operating partnership has book depreciation for the year of $6 million (1/10 of $60 million) and tax depreciation of $3.3 million (1/10 of $33 million). Meanwhile the operating partnership incurs both book and tax depreciation for the year of $24 million (1/10 of $240 million) with respect to asset B. For book purposes, the PE is allocated 80% of the operating partnership’s book depreciation expenses, or $24 million (80% times ($6 million asset A book depreciation plus $24 million asset B book depreciation)). For tax purposes, though, it can only be allocated $22.5 million (100% of the $3.3 million asset A tax depreciation + (80% of the $24 million asset B tax depreciation, $19.2 million)) of depreciation expenses.

The PE receives its full share of tax deductions with respect to asset B, $19.2 million (80% of $24 million). For asset A, however, the PE’s share of book allocations of depreciation equaled $4.8 million, but in Year 1 there is only $3.3 million of tax depreciation with respect to asset A. Under the ceiling rule, the operating partnership cannot allocate any more depreciation deductions to the PE with respect to asset A than the operating partnership incurs with respect to asset A for Year 1. The PE ends up with less tax depreciation than it would have otherwise expected to receive if tax deductions were based on fair market value.

For book purposes, the target is allocated 20% of the operating partnership’s book depreciation expenses, or $6 million (20% times ($6 million asset A book depreciation plus $24 million asset B book depreciation)). For tax purposes, the target is allocated $4.8 million ($0 of remaining asset A tax depreciation plus $4.8 million (20% of the $24 million asset B tax depreciation)) of depreciation expenses.

The PE’s and the target’s capital accounts at the end of Year 1 are below.

| | | |
|---|---|---|
| | | |

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $33 million | $60 million | $240 million | $240 million |
| Depreciation | ($4.8 million) | ($6 million) | ($22.5 million) | ($24 million) |
| Ending Balance | $28.2 million | $54 million | $217.5 million | $216 million |

Assuming the fair market value of the properties does not change, their adjusted tax basis and fair market values at the end of Year 1 are represented below.

| | Adjusted Tax Basis | Book Basis | Fair Market Value |
|---|---|---|---|
| Asset A | $29.7 million | $54 million | $60 million |
| Asset B | $216 million | $216 million | $240 million |

Because of the ceiling rule, the PE has been allocated $1.5 million less of tax depreciation in Year 1 than book depreciation (*i.e.*, the excess of the $4.8 million book depreciation over $3.3 million tax depreciation) with respect to asset A, causing its tax and book capital accounts to misalign. What happens if at the end of Year 1 the operating partnership sells asset A for its fair market value?

**Sale of Asset A**

At a sale price of $60 million, the operating partnership will have an economic/book gain of $6 million ($60 million proceeds less $54 million book basis) while it will have a tax gain of $30.3 million ($60 million sale price minus $29.7 million book basis). As an initial matter, the book gain would be allocated 80/20 minus $4.8 million to the PE ($6 million times 80%) and $1.2 million to the target ($6 million times 20%). The operating partnership will then allocate the $30.3 million tax gain to eliminate the book/tax disparities. The target is allocated $27 million of taxable gain attributable to the built-in gain of asset A (*i.e.*, the $27 million of taxable gain attributable to asset A at the time of contribution) and the PE is allocated the remaining $3.3 million of taxable gain. Their capital accounts after the sale are reflected below.

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $28.2 million | $54 million | $217.5 million | $216 million |
| Gain | $27 million | $1.2 million | $3.3 million | $4.8 million |
| Ending Balance | $55.2 million | $55.2 million | $220.8 million | $220.8 million |

At the end of the day, the tax allocations have rebalanced the capital accounts making book and tax equal.

But what happens if asset A at the time of sale is instead worth $50 million so that there is an economic loss, but a tax gain? In this scenario, there is an economic/book loss of $4 million ($50 million proceeds less $54 million book basis) and a tax gain of $20.3 million ($50 million proceeds less $29.7 million tax basis). The book loss of $4 million would be allocated 80/20 so the PE is allocated $3.2 million of book loss and the target is allocated $.8 million of book loss. The entire $20.3 million of tax gain is allocated to the target because tax gain is allocable to the target in an amount up to the $27 million of built-in taxable gain attributable to asset A at the time of contribution. Since there is no other gain attributable to asset A, no other gain with respect to the sale can be allocated to the target. The PE and the target capital accounts after the sale are reflected below.

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $28.2 million | $54 million | $217.5 million | $216 million |
| Gain (Loss) | $20.3 million | ($.8 million) | $0 | ($3.2 million) |
| Ending Balance | $48.5 million | $53.2 million | $217.5 million | $212.8 million |

**Liquidation of the Operating Partnership**

In the above scenario where asset A is sold for $50 million, the disparity between book and tax is not rectified upon the sale of asset A. This disparity generally represents a timing difference where, upon liquidation of the operating partnership or sale of the partnership interest in the operating partnership, the target will recognize additional gain and the PE additional loss.

How does this work? When the target and the PE formed the operating partnership, each received a tax basis in their respective partnership interest equal to the tax basis of the assets contributed. That tax basis then is increased by allocations of income, gain, and additional capital contributions, and decreased by allocations of deductions, losses, and distributions. So the PE starts with a tax basis in its partnership interests of $240 million. which is then decreased by its allocation of tax depreciation of $22.5 million for a tax basis of $217.5 million.

If the operating partnership sells asset B for an amount equal to its basis in asset B, resulting in no gain or loss, and then liquidates and the PE receives the amount in its book capital account ($212.8 million), the PE will incur a tax loss of $4.7 million with respect to its interest in the operating partnership ($212.8 million proceeds less $217.5 million tax basis). For the target, its tax basis in its partnership interest is $48.5 million and if it received the amount in its book capital account ($53.2 million), it would incur a taxable gain of $4.7 million with respect to its partnership interest. The same result occurs if the partnership interests are sold for an amount equal to the operating partnership's basis in asset B.

The disparity between book and tax generally results in a timing difference that can be resolved upon liquidation or sale of the partnership interest. For the partners, the question becomes who should bear the cost of that timing difference. Using the traditional method causes the noncontributing partner to bear the cost when the ceiling rule applies.

**Unreasonable Method**

As noted above, the allocation method chosen for Section 704(c) purposes must be reasonable. Could the traditional method be unreasonable? Assume the same facts as above but that the target has a $5 million tax basis in asset A and the value remains $60 million. Assume further that asset A has a 10-year depreciation life but only one year of depreciation left at the time of contribution to the operating partnership. Asset A is fully depreciated for both book and tax purposes after Year 1 of the operating partnership. In Year 2, the operating partnership sells asset A for $60 million. At the time of sale, there is no book/tax disparity with respect to asset A (both book and tax basis equal $0) so Section 704(c) no longer applies. The $60 million tax gain will then be allocated 80/20 between the PE and the target, shifting $42 million of the pre-contribution gain in the equipment from target to PE (the PE's $48 million share of the operating partnership's $60 million gain, less the $6 million tax depreciation deduction previously allocated to the PE during Year 1).

The regulations provide that a method is not necessarily unreasonable because another allocation method would result in a higher aggregate tax liability. What if, though, the PE had carryover losses from another source that expire in the near future, and the allocation of gain could be offset by these losses? See Treasury Regulations Section 1.704-3(b)(2), Example 2 for an unreasonable use of the traditional method.

**Conclusion**

Using the traditional method can create some distortions of income, gain, loss, and deductions when the ceiling rule applies. The distortions usually result in a timing difference, but sometimes can also result in recharacterization issues. When a buyer is deciding on partnering with former owners through a partnership and the former owners are rolling over property, it is important for both parties to understand the implications of choosing the traditional method if the ceiling rule applies.

In Part 3 we will examine the application of the traditional method with curative allocations.

For additional information, please contact any of the attorneys listed in this advisory.

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## Related Practices and Industries

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# Rolling Over and Section 704(c); What's the Big Deal? — Part 3: The Traditional Method With Curative Allocations

**10.25.23**

Continuing with our series on the implications of the application of Section 704(c), the below discussion addresses the use of the traditional method with curative allocations. In Part 1 [insert link] we gave a broad overview of Section 704(c) and its application to property that is contributed to a partnership, where the contributor's tax basis in the property differs from the fair market value of the property (the built-in gain or built-in loss). Section 704(c) and the underlying regulations provide that if property is contributed to a partnership by a partner, the partner's distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the built-in gain or built-in loss. The regulations under Section 704(c) provide that the allocations made pursuant to Section 704(c) (allocations of "tax" items) must be made using a reasonable method that is consistent with the purpose of Section 704(c), and further provide examples of three reasonable methods: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial method. Below, we discuss the application of the traditional method with curative allocations.

As noted in Part 2, complications arise under the traditional method where the contributed property does not generate enough tax "items" to equal the "book" items allocated to the noncontributing partner. The ceiling rule under the traditional method prevents the allocation of income, gain, loss, or deduction for a taxable year with respect to a property that is in excess of the total partnership income, gain, loss, or deduction with respect to that property for the taxable year.

In order to correct distortions created by the ceiling rule, the Treasury regulations provide that a partnership that uses the traditional method can make reasonable curative allocations to reduce or eliminate the disparities between book and tax items of noncontributing partners. A curative allocation would be an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's corresponding book item.

The curative allocations can be limited to a particular tax item, such as depreciation, and the partnership must apply the curative allocations consistently with respect to each item of the property from year to year. In addition, the curative allocations must be reasonable. Curative allocations that exceed the amount necessary to offset the effect of the ceiling rule for the current taxable year, or prior years for disposition of the property, will not be considered reasonable, and must be made over reasonable period of time, such as the economic life of the asset. Furthermore, the Treasury regulations provide that the 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. So, for example, if the tax item limited by the ceiling rule is a loss from a sale of property, a curative allocation of gain must be expected to have substantially the same effect to that partner as an allocation of gain from the sale of the property.

Continuing with our example with the target owning asset A and asset B, the private equity firm (PE) buying asset B, the target corporation (target) contributing asset A to the operating partnership, and the PE contributing asset B to the operating partnership, let's change the facts slightly. The PE purchases asset B for $220 million and contributes asset B and $20 million in cash to the operating partnership. The operating partnership uses the $20 million to purchase inventory.

At the beginning of Year 1, the capital accounts of the target and the PE are as follows:

| Target (20%) | | PE (80%) | |
|---|---|---|---|
| Tax | Book | Tax | Book |
| $33 million | $60 million | $240 million | $240 million |

The operating partnership has the following tax basis in its assets:

| | Adjusted Tax Basis | Fair Market Value |
|---|---|---|
| Asset A | $33 million | $60 million |
| Asset B | $220 million | $220 million |
| Inventory | $20 million | $20 million |

The operating partnership will allocate all net income and losses 80/20 between the PE and the target. Both asset A and B have 10 years of useful life left and will be depreciated using the straight-line method over that time period. Let's assume at the end of Year 1, the operating partnership has depreciated both asset A and asset B, sold the inventory for $30 million (recognizing $10 million of income), and has no other income or expenses. The PE and the target determine that the inventory income will have substantially the same effect on their tax liabilities as income from asset A.

With respect to asset A, the operating partnership has book depreciation of $6 million (1/10 of $60 million) and tax depreciation of $3.3 million (1/10 of $33 million). Meanwhile the operating partnership incurs both book and tax depreciation of $22 million (1/10 of $220 million) with respect to asset B. For book purposes, the PE is allocated 80% of the operating partnership's depreciation expenses, or $22.4 million (80% times ($6 million asset A book depreciation plus $22 million asset B book depreciation)). For tax purposes, though, it can only be allocated $20.9 million ($3.3 million asset A tax depreciation plus (80% of $22 million asset B tax depreciation)) of depreciation expenses.

Using the traditional method, the capital accounts would look like the below.

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | | | | |

| | | | | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $33 million | $60 million | $240 million | $240 million |
| Depreciation Asset A | | ($1.2 million) | ($3.3 million) | ($4.8 million) |
| Depreciation Asset B | ($4.4 million) | ($4.4 million) | ($17.6 million) | ($17.6 million) |
| Sales Income | $2 million | $2 million | $8 million | $8 million |
| Ending Balance | $30.6 million | $56.4 million | $227.1 million | $225.6 million |

The PE has a book/tax disparity of $1.5M million as a result of the ceiling rule, measured by the excess of the asset A $4.8 million book depreciation over the asset A $3.3 million tax depreciation. Using curative allocations, the operating partnership can allocate $1.5 million of taxable income from the PE to the target eliminating the PE's book/tax disparity. The capital account balances below show the use of curative allocations.

| | Target | | PE | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $33 million | $60 million | $240 million | $240 million |
| Depreciation Asset A | | ($1.2 million) | ($3.3 million) | ($4.8 million) |
| Depreciation Asset B | ($4.4 million) | ($4.4 million) | ($17.6 million) | ($17.6 million) |
| Initial Sales Income Allocation | $2 million | $2 million | $8 million | $8 million |
| Curative Allocation of Sales Income | $1.5 million | $0 | ($1.5 million) | $0 |
| Ending Balance | $32.1 million | $56.4 million | $225.6 million | $225.6 million |

Alternatively, assume that the target and the PE agreed that curative allocations would be limited solely to depreciation. Tax depreciation with respect to asset B could be used as a curative allocation with respect to asset A.

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |

| | | | | |
|---|---|---|---|---|
| Beginning Balance | $33 million | $60 million | $240 million | $240 million |
| Depreciation Asset A | | ($1.2 million) | ($3.3 million) | ($4.8 million) |
| Initial Depreciation Asset B | ($4.4 million) | ($4.4 million) | ($17.6 million) | ($17.6 million) |
| Curative Allocation of Depreciation Asset B | $1.5 million | $0 | ($1.5 million) | $0 |
| Sales Income | $2 million | $2 million | $8 million | $8 million |
| Ending Balance | $32.1 million | $56.4 million | $225.6 million | $225.6 million |

Under either scenario described above, the target will recognize additional taxable income for Year 1 because of either curative allocations to it of income or curative allocations away from it of depreciation expense.

What if, though, asset B was a nondepreciable asset, and there was no gain or loss with respect to the inventory? The traditional method with curative allocations would not resolve the PE's book/tax disparity because there would be no tax items that it could use to make curative allocations. As discussed in Part 4, remedial allocations could solve the problem.

For additional information, please contact any of the attorneys listed in this advisory.

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## Related Practices and Industries

Tax

Private Equity

 

# Rolling Over and Section 704(c); What's the Big Deal? — Part 4: The Remedial Method

**11.01.23**

In our continuing series on Section 704(c) of the Internal Revenue Code (the Code) we discuss the application of the remedial method to correct for distortions caused by the ceiling rule. As previously discussed, when the tax basis of property contributed to a partnership differs from its fair market value, Section 704(c) requires that the allocation of partnership items of income, gain, loss, and deduction take into account such difference, and the underlying Treasury Regulations provide three methods for taking these differences into account: the traditional method, the traditional method with curative allocations, and the remedial method. When adopting the remedial method, the partnership creates notional remedial items and allocates those items to the partners. So, unlike the traditional method with curative allocations discussed in Part 3, the remedial method will create notional allocation items as opposed to reallocating existing items.

The first step in establishing the remedial items is to determine the book items that the partnership must allocate. As discussed below, the Treasury Regulations provide specific rules for determining book items under the remedial method. After determining the book items, the partnership allocates the corresponding tax items using the traditional method. If the ceiling rule discussed in Part 2 causes the book allocations made to the noncontributing partner to differ from the tax allocations made to that partner, then the partnership will create notional remedial items of income, gain, loss, or deduction equal to the difference and allocate such items to the noncontributing partner. At the same time, the partnership creates offsetting remedial items that it allocates to the contributing partner.

The determination of book items under the remedial method is different than the other methods. Book basis consists of two items:

- First, the portion of the partnership's book basis in the contributed property equals the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered.
- Second, the remainder of the book basis is recovered using whatever recovery period and depreciation method the partnership would use for newly acquired property.

This effectively creates two recovery methods for book purposes and requires special tracking.

The remedial allocations of income, gain, loss, or deduction will have the same tax attributes as the items limited by the ceiling rule, and the tax attributes of the offsetting remedial allocation made to the contributing partner will be made with a reference to the items limited by the ceiling rule. It should be noted that the remedial items do not affect the partnership's calculation of its taxable income and do not affect the partnership's tax basis in its property. For the partners, the remedial items do not affect their book capital accounts, but have the same tax effect as the items that were limited and do affect the partners' tax basis in their partnership interests.

Let's stay with our original example from Part 2 with the target corporation (target) owning asset A and asset B, the private equity firm (PE) buying asset B for $240 million, and then the target contributing asset A worth $60 million and a tax basis of $33 million to the operating partnership, and the PE contributing asset B to the operating partnership.

At the beginning of Year 1, the capital accounts of the target and the PE are as follows:

| Target (20%) | | PE (80%) | |
|---|---|---|---|
| Tax | Book | Tax | Book |
| $33 million | $60 million | $240 million | $240 million |

The operating partnership has the following tax basis in its assets:

| | Adjusted Tax Basis | Fair Market Value |
|---|---|---|
| Asset A | $33 million | $60 million |
| Asset B | $240 million | $240 million |

The operating partnership will allocate all net income and losses 80/20 between the PE and the target. Let's assume asset B has a 10-year recovery period, with 10 years remaining, and will be depreciated using the straight-line method over that time period. Asset A also has a 10-year recovery period, but only three years left. Other than depreciation expense, the operating partnership's income will equal its expenses for the next 10 years.

**Years 1 Through 3**

For each of Years 1 through 3, the operating partnership has book depreciation of $13.7 million attributable to asset A, which by reason of the remedial method, consists of two component parts: (i) $11 million ($33 million tax basis divided by three-year remaining recovery period) plus (ii) $2.7 million ($27 million, which is the excess of $60 million book value over $33 million tax basis, divided by a new 10-year recovery period). For asset B, the operating partnership has book and tax depreciation per year of $24 million ($240 million basis divided by 10-year recovery period).

The target is allocated 20% of book depreciation, or $7.54 million (20% of each of $13.7 million for asset A and $24 million for asset B) and the PE is allocated 80% of book depreciation, or $30.16 million ($10.96 million for asset A (80% times $13.7 million) and (ii) $19.2 million for asset B (80% times $24 million). The PE is allocated $30.16 million of tax depreciation, equal to its share of book depreciation, and the target is allocated the remaining tax depreciation of $4.84 million ($.04 million for asset A ($11 million -$10.96 million allocated to the PE) + $4.8 million for asset B ($24 million - $19.2 million allocated to the PE)). Since the ceiling rule does not cause PE to receive less tax depreciation than book depreciation, no remedial allocations are necessary.

 

The allocations to the target and the PE at the end of three years result in capital accounts as follows:

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $33 million | $60 million | $240 million | $240 million |
| Depreciation Asset A | ($.12 million) | ($8.22 million) | ($32.88 million) | ($32.88 million) |
| Depreciation Asset B | ($14.4 million) | ($14.4 million) | ($57.6 million) | ($57.6 million) |
| Ending Balance | $18.48 million | $37.38 million | $149.52 million | $149.52 million |

**Years 4 Through 10**

For each of the subsequent Years 4 through 10, the operating partnership has $2.7 million of book depreciation with respect to asset A ($27 million (the excess of $60 million initial book value over $33 million tax basis) divided by 10-year recovery period), but no tax depreciation. The book depreciation of $2.7 million is allocated 80% to the PE, $2.16 million, and 20% to the target, $.54 million. Because of the application of the ceiling rule in Year 4, the PE will be allocated $2.16 million of book depreciation with respect to asset A, but no tax depreciation because the entire $33 million tax basis attributable to asset A was depreciated and allocated during Years 1 to 3. At the end of Year 4, the target's and the PE's capital accounts, without the application of the remedial method, would be as follows:

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $18.48 million | $37.38 million | $149.52 million | $149.52 million |
| Depreciation Asset A | | ($.54 million) | | ($2.16 million) |
| Depreciation Asset B | ($4.8 million) | ($4.8 million) | ($19.2 million) | ($19.2 million) |
| Ending Balance | $13.68 million | $32.04 million | $130.32 million | $128.16 million |

Because the ceiling rule would cause a disparity of $2.16 million between the PE's book and tax depreciation, the operating partnership must make remedial allocations of $2.16 million of tax depreciation to the PE under the remedial method for Years 4 through 10. In order to offset the remedial tax depreciation allocations, the operating partnership must also make a remedial allocation to the target of $2.16 million of taxable income that would be of the type produced by asset A. Applying the remedial method, at the end of Year 4, the capital accounts are:

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance | $18.48 million | $37.38 million | $149.52 million | $149.52 million |
| Depreciation Asset A | | ($.54 million) | | ($2.16 million) |
| Depreciation Asset B | ($4.8 million) | ($4.8 million) | ($19.2 million) | ($19.2 million) |
| Remedial | $2.16 million | | ($2.16 million) | |
| Ending Balance | $15.84 million | $32.04 million | $128.16 million | $128.16 million |

At the end of Year 10 the capital accounts are:

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Balance End of Year 4 | $15.84 million | $32.04 million | $128.16 million | $128.16 million |
| Depreciation Asset A | | ($3.24 million) | | ($12.96 million) |
| Depreciation Asset B | ($28.8 million) | ($28.8 million) | ($115.2 million) | ($115.2 million) |
| Remedial | $12.96 million | | ($12.96 million) | |
| Ending Balance | $0 | $0 | $0 | $0 |

**Sale of Asset A**

Let's assume that the operating partnership sells asset A at the beginning of Year 5 for $10 million. Recall that with respect to asset A, during each of Years 1 to 3, the operating partnership has book depreciation of $13.7 million, and during Year 4, $2.7 million of book depreciation. The operating partnership has tax depreciation of $11 million for each of Years 1 to 3 for asset A and $0 of tax depreciation for Year 4. The operating partnership's book and tax basis in asset A at the end of Year 4 is as follows:

| | Tax | Book |
|---|---|---|
| Initial Basis | $33 million | $60 million |
| Depreciation Year 1-4 | ($33 million) | ($43.8 million) |
| Basis End of Year 4 | $0 | $16.2 million |

At a $10 million sales price, the operating partnership will recognize a $10 million taxable gain and $6.2 million book loss. For Year 5, capital accounts would be as follows:

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance Year 5 | $15.84 million | $32.04 million | $128.16 million | $128.16 million |
| Gain (Loss) Sale | $10 million | ($1.24 million) | | ($4.96 million) |
| Depreciation Asset B | ($4.8 million) | ($4.8 million) | ($19.2 million) | ($19.2 million) |
| Ending Balance | $21.04 million | $26 million | $108.96 million | $104 million |

Because the ceiling rule would cause a disparity of $4.96 million between the PE's book and tax loss, the operating partnership must make a remedial allocation to the PE of $4.96 million of loss of the same character and an offsetting remedial allocation of gain to the target of $4.96 million gain. The capital accounts would be as follows:

| | Target (20%) | | PE (80%) | |
|---|---|---|---|---|
| | Tax | Book | Tax | Book |
| Beginning Balance Year 5 | $15.84 million | $32.04 million | $128.16 million | $128.16 million |
| Gain (Loss) Sale | $10 million | ($1.24 million) | | ($4.96 million) |

| | | | | |
|---|---|---|---|---|
| Depreciation Asset B | ($4.8 million) | ($4.8 million) | ($19.2 million) | ($19.2 million) |
| Remedial | $4.96 million | | ($4.96 million) | |
| Ending Balance | $26 million | $26 million | $104 million | $104 million |

After the sale, the assets of the operating partnership consist of the $10 million cash proceeds from the sale and asset B with a basis of $120 million.

**Real World Application**

So, what is the likelihood that a private equity buyer will find a target company that contains two assets and the parties will form a partnership as described above? Extremely unlikely. It is, however, likely that a private equity buyer will find a target corporation that is classified as a S corporation for federal income tax purposes, and will want the owners to rollover a certain portion of their equity interests.

A common plan would be for the shareholders of a target S corporation to form a new corporation (Newco), contribute stock of target to Newco, file a qualified subchapter S subsidiary election with respect to the target, and then convert the target to a limited liability company (LLC). Since the target LLC is wholly owned by Newco, it would be treated as a disregarded entity for federal income tax purposes. If the proper steps are followed, such a conversion would not result in a taxable transaction to the shareholders. After the conversion, Newco would sell a portion of the equity of target LLC to the private equity buyer.

For federal income tax purposes, the private equity buyer is treated as purchasing a pro rata portion of each asset owned by the target LLC. The purchase is a taxable sale, with Newco recognizing gain or loss on the sale and the private equity buyer receiving a tax basis in its portion of the assets deemed purchased equal to the purchase price, with each such asset having a new holding period. The private equity buyer and Newco are then treated as contributing their respective portion of the assets to a new partnership. The target LLC, for federal income tax purposes, is now a partnership and, assuming the portion of the assets deemed owned and contributed by Newco have a tax basis different from their fair market value, Newco is treated as contributing Section 704(c) property.

This is where the parties need to determine whether any of the properties that Newco is deemed to contribute will be subject to the ceiling rule. If so, will curative allocations be available to resolve any book/tax disparities? If the buyer’s cash flow analysis is based upon receiving certain tax deductions that could be limited by the ceiling rule, then the buyer will have a significant incentive to choose either the traditional method with curative allocations or the remedial method. For Newco, it would want to ensure that if, because of a choice of Section 704(c) allocation method, it incurs additional taxable income, that it receives tax distributions to cover its corresponding tax liabilities.

Another complicating factor to consider is whether any of the properties treated as contributed to the partnership by Newco was a nonamortizable intangible in Newco’s hands, such as self-created goodwill. The portion of such self-created goodwill treated as contributed by Newco will not be amortizable by the partnership unless the partnership adopts the remedial method, in which case, remedial allocations of amortization attributable to the goodwill can be made. Where a large portion of the value of the target is attributable to such an intangible, and where there is a large rollover component of the transaction, the election of the remedial method could have significant tax impact on the private equity buyer as the noncontributing partner.

**Conclusion**

As discussed in Parts 1 through 4 of this series, contributing property to a partnership where the fair market value of the property differs from the contributing partner's tax basis in that property can have significant tax consequences to both the contributing and noncontributing partners. The Code and the underlying Treasury Regulations allow the partnership to choose a specific method to deal with the book/tax discrepancies caused by such difference. The choice of method may place the noncontributing and contributing partners at odds with each other since the choice of method may cause one partner to recognize more taxable income then it otherwise would have if a different method was chosen. Properly drafting the partnership agreement to consider Code Section 704(c) allocations and discussing the issues with your tax advisors can go a long way toward ensuring that the partners receive the economic deal that they intend.

For additional information, please contact any of the attorneys listed in this advisory.

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