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

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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.

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