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

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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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