Articles + Publications | October 25, 2023

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

**WRITTEN BY**

Thomas Gray | Joel M. Post

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 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

©2026 Troutman Pepper Locke

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 |

©2026 Troutman Pepper Locke

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.

**RELATED INDUSTRIES + PRACTICES**

- Private Equity

©2026 Troutman Pepper Locke

- Tax