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

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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 than 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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