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Navigating the Turbulent Waters of Section 704(c): The Ceiling Rule

by Phillip W. DeSalvo and Corey Dalton

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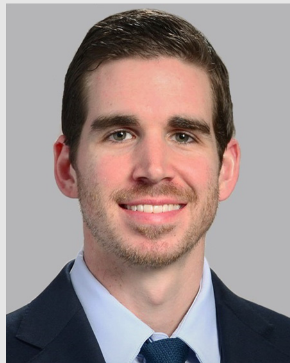
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In this article, DeSalvo and Dalton examine the core principles of section 704(c) and how the ceiling rule may result in unanticipated consequences for taxpayers. They also provide a numerical illustration of the application of the traditional method and the effect of the ceiling rule.

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I. Introduction

Life is really simple, but we insist on making it complicated.

We can't be certain, but we have it on good authority that Confucius was referring to section 704(c) some 2,500 years ago. But why? The tracking of built-in gain (or loss) sounds simple enough, doesn't it? A partner contributes property to a partnership with built-in gain, and when that property is sold, any pre-contribution gain is allocated solely to her. Easy!

Well, what initially sounds straightforward quickly becomes a gauntlet of calculation mechanics and wizardry that can make even the most seasoned tax professional's head spin. Some of these quirks can lead to peculiar and unanticipated tax consequences, one of which this article will further explore — the ceiling rule.[1]

To set up the scope and intended use of this article, imagine the following scenario. Let's say you're tasked to estimate your client's tax basis step-up under section 743(b) as part of its due diligence on a target company. If you work in partnership tax, you've likely heard that a popular shortcut is to assume that the buyer's step-up is equal to the seller's gain on sale, so you get to work with that in mind. As you finish your calculation, admiring how you completely nailed your deliverable color scheme and font choice, a colleague looks over to tell you that the buyer's step-up isn't always equal to the seller's gain. This helpful coworker tells you that the differences could be because of the effect of the ceiling rule. You calmly nod in agreement with unwavering confidence, but quietly wonder to yourself, "What on Earth does that mean?"

This article seeks to answer that question by walking through the purpose of section 704(c), the traditional method prescribed in the regulations, and the ceiling rule. It also provides some

[1] *See* reg. section 1.704-3(b)(1), which provides that "the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)."

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practical examples of how the effect of the ceiling rule reveals itself, including (1) the reporting of 2020 tax basis capital accounts, (2) section 743(b) adjustments, and (3) accounting for income taxes under Accounting Standards Codification (ASC) 740, "Income Taxes."

II. Built-In Gain or Loss Under Section 704(c)

Let's grease the wheels with a refresher on some partnership tax basics. The fundamental idea behind partnership taxation is to facilitate a flexible business arrangement between parties with no entity-level tax. That is, income generated at the partnership level is allocated (or, stated differently, passes through) to its partners, who then pay their share of tax on the income allocated to them. Sounds easy enough, but as we progress, we'll see that Confucius was right — we insist on making it complicated.

The heart of the income allocation rules is found under section 704(b) and intends to support this flexibility by matching the economic business arrangement among partners with the income tax consequences. The rules are robust and largely succeed in achieving this goal; however, the flexibility engrained in the basic principles of partnership tax can lead to abuse. One such area is the shifting of a partner's pre-contribution built-in gain (or loss) to another partner, which section 704(c) was enacted to limit.

Under section 704(c), a partnership must make tax allocations concerning property with a built-in gain (or loss) using a reasonable method that is consistent with the purpose of that section. There are three generally accepted reasonable methods identified in the regulations to account for section 704(c) tax allocations[2]: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial method.

Under the traditional method, there is a so-called ceiling rule that requires the total taxable income, gain, loss, or deduction allocated to the partners for a tax year concerning a property to not exceed the total partnership taxable income, gain, loss, or deduction concerning that property for the tax year. In other words, while the goal of section 704(c) is to provide noncontributing partners with their fair share of tax items (that is, match their share of the economic section 704(b) allocations), if there are not sufficient tax items available, there may be a ceiling on what can be allocated to the noncontributors.[3]

With this background in mind, now is a good time to take a quick detour and introduce the concepts of section 704(c) gain and capital, which will be used in the examples that follow. These two items work together to demonstrate how the ceiling rule affects the various partnership tax maintenance items:

> **Section 704(c) gain:** This is each partner's built-in gain for an item of partnership property as defined in the regulations.[4]
>
> **Section 704(c) capital:** This is equal to the disparity between a partner's section 704(b) economic entitlement account and tax basis capital account.

Note that section 704(c) capital is not a concept specifically defined in the code or regulations but is a useful tool that return preparers can use when reconciling the partnership's tax accounting records.

The remainder of this article addresses the traditional method and the ceiling rule; it does not analyze the traditional method with curative allocations or the remedial method. Also, the

[2] Note that the regulations provide that other methods may also be reasonable. The regs also contain an antiabuse provision in reg. section 1.704-3(a)(10) that provides that an allocation method is not reasonable if that method is used with a view to shifting tax consequences of built-in gain or loss among partners, and that shifting results in a substantial reduction in the present value of the partners' aggregate tax liability.

[3] One could argue that the ceiling rule definition is ambiguous since the ceiling rule limitation also applies to contributors because their tax deductions are limited by the total amount of deductions available to the partnership. However, we choose to use the generally accepted definition of the ceiling rule to refer specifically to the instances when noncontributors have a deficit in their tax deduction allocations.

[4] For the purposes of this article, the section 704(c) gain example contains a single item of partnership property with fair market value exceeding tax basis. In practice, this balance must be tracked on a property-by-property basis for each partner but can be aggregated when tracking each partner's total section 704(c) gain and capital balances. Also, in practice there may be various properties, some with built-in gain and others with built-in loss (tax basis exceeding FMV); however, for purposes of this article, the example does not address built-in loss property.

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Example 1, Exhibit 1: Formation

Gain	Cash			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$120	$80	$400	$320	$80

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$120	$80	$400	$320	$80

rules of section 704(c) apply to both forward and reverse layers[5] — we will focus only on forward layers, but the application of these rules under reverse layers operates similarly. Finally, we do not address the contribution of built-in loss property and the correlative rules under section 704(c)(1)(C).

III. The Traditional Method

Once a taxpayer recognizes that it has a section 704(c) gain, and assuming the traditional method is selected to account for that property, the taxpayer must face the daunting task of establishing and maintaining it. The most effective manner of demonstrating how the traditional method operates is through the use of examples. We will follow our good friends, Jesse and Adam, as they embark on opening a high-end musical instrument business. As we take this journey, we first look at the regulations, which generally set forth the operation of the traditional method as follows:

- First, determine the amount of tax items for an asset for the year (that is, gain, loss, depreciation, or amortization).
- Second, determine section 704(b) items for the asset.
- Third, allocate those section 704(b) items to the partners based on their economic arrangement.
- Last, allocate correlated tax items to the noncontributors up to their section 704(b) amount. If any tax items remain, allocate the remaining to the contributor.

Example 1: Jesse and Adam form the Westfield partnership with a 50/50 ownership split (both immediate liquidation rights and profit- and loss-sharing ratio) on January 1 of year 1. Jesse contributes $200 cash, and Adam contributes a guitar with a fair market value of $200 and a tax basis of $120. Assume the guitar has a remaining useful life of 10 years and is depreciated using the straight-line method.

Immediately after formation, Jesse's and Adam's section 704(c) gain and capital profiles are as follows. Jesse, as a contributor of cash, is considered a noncontributor for purposes of our forward section 704(c) layer and has the following section 704(c) profile for his partnership interest:

- Section 704(c) gain: $0
- Section 704(c) capital: $0

Adam, as a contributor of property that has an FMV exceeding its tax basis, is considered a contributor for purposes of the forward section 704(c) layer on the guitar, and he has the following section 704(c) profile:

- Section 704(c) gain: $80
- Section 704(c) capital: $80

Once we have established our partner and property profiles, next we must calculate the year 1 activity. For purposes of our example, we'll assume that Westfield's activity consists solely of the depreciation of the guitar:

- Tax depreciation for the guitar is $12 ($120 of remaining tax basis/10 years).
- Section 704(b) depreciation for the guitar is $20 ($12 annual tax depreciation/$120 total

[5] A forward section 704(c) layer arises as a result of the contribution of built-in gain or built-in loss property to a partnership, while a reverse section 704(c) layer may be created as a result of a revaluation event as prescribed in the regulations. *See* reg. section 1.704-1(b)(2)(iv)(f).

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Example 1, Exhibit 2: End of Year 1

Gain	Cash			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$120	$80	$400	$320	$80
Depreciation			—	($20)	($12)	($8)	($20)	($12)	($8)
Ending gain value	$200	$200	—	$180	$108	$72	$380	$308	$72

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$120	$80	$400	$320	$80
Year 1 activity	($10)	($10)	—	($10)	($2)	($8)	($20)	($12)	($8)
Ending gain value	$190	$190	—	$190	$118	$72	$380	$308	$72
704(c) gain vs. capital			—			—			—

remaining tax basis * $200 of remaining section 704(b) basis).

- Each partner is entitled to $10 of section 704(b) depreciation (50 percent ownership interest * $20 of total section 704(b) depreciation).
- Jesse is the noncontributor for the forward layer on the guitar and is therefore allocated $10 of tax depreciation, which is equal to his anticipated section 704(b) depreciation on the asset. The remaining $2 of tax depreciation is allocated to Adam as the contributor.

After accounting for year 1 activity, Jesse's and Adam's section 704(c) gain and capital values are as follows:

- Jesse:
  - Section 704(c) gain: $0
  - Section 704(c) capital: $0
- Adam:
  - Section 704(c) gain: $72
  - Section 704(c) capital: $72

In Example 1, Jesse is allocated his full share of tax deductions (that is, deductions equal to his section 704(b) deductions of $10), whereas Adam is allocated less than his expected share of tax depreciation.

Example 2: Same facts as Example 1, except the tax basis of Adam's contributed guitar is $80.

Immediately after formation, Jesse's and Adam's section 704(c) gain and capital profiles are as follows:

- Jesse:
  - Section 704(c) gain: $0
  - Section 704(c) capital: $0
- Adam:
  - Section 704(c) gain: $120
  - Section 704(c) capital: $120

Example 2, Exhibit 1: Formation

Gain	Cash			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$80	$120	$400	$280	$120

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$80	$120	$400	$280	$120

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Example 2, Exhibit 2: End of Year 1

Gain	Cash			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$80	$120	$400	$280	$120
Depreciation			—	($20)	($8)	($12)	($20)	($8)	($12)
Ending gain value	$200	$200	—	$180	$72	$108	$380	$272	$108

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$80	$120	$400	$280	$120
Year 1 activity	($10)	($8)	($2)	($10)	—	($10)	($20)	($8)	($12)
Ending gain value	$190	$192	($2)	$190	$80	$110	$380	$272	$108
704(c) gain vs. capital			**$2**			**($2)**			—

The year 1 activity in Example 2 is illustrated as follows:

- Tax depreciation for the guitar is $8 ($80 of remaining tax basis/10 years).
- Section 704(b) depreciation for the guitar is $20 ($8 annual tax depreciation/$80 total remaining tax basis * $200 remaining of section 704(b) basis).
- Each partner is entitled to $10 of section 704(b) depreciation (50 percent ownership interest * $20 of total section 704(b) depreciation).
- As the noncontributing partner, Jesse has priority on the cost recovery and is allocated $8 of tax depreciation. There is no additional tax depreciation to be allocated to either Jesse or Adam.

After accounting for year 1 activity, Jesse's and Adam's section 704(c) gain and capital profiles are as follows:

- Jesse:
  - Section 704(c) gain: $0
  - Section 704(c) capital: ($2)
- Adam:
  - Section 704(c) gain: $108
  - Section 704(c) capital: $110

In Example 2, Jesse, as the noncontributor, is allocated less tax depreciation ($8) than his section 704(b) depreciation ($10). The ceiling rule limitation has now created a disparity between Jesse's section 704(b) and tax basis capital accounts of $2. Adam, as the contributor of the section 704(c) gain, is left with zero available tax depreciation deductions.

IV. The Ceiling Rule: Effect

In partnership tax, typically when one partner receives a tax-related benefit, the other partner (or partners) must wear a corresponding tax detriment. Metaphorically speaking, partnerships are like the yin and the yang: All things must balance.

The effect of the ceiling rule is typically observed through the detrimental effect it has regarding a noncontributor (if any) through lost cost recovery deductions. However, while less intuitive, the ceiling rule can also benefit the contributor partner from a timing and character perspective through fewer forgone tax deductions than his built-in gain release (that is, the annual section 704(b) cost recovery in excess of tax cost recovery on a specific section 704(c) gain). In other words, under the traditional method in which a ceiling rule exists, the contributing partner's share of built-in gain inside the partnership may be burning off while the contributing partner is not burdened with losing out on tax deductions or picking up any gain that would otherwise be

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Example 2, Exhibit 3: Sale of Asset at End of Year 1

Gain	Cash			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$80	$120	$400	$280	$120
Depreciation			—	($20)	($8)	($12)	($20)	($8)	($12)
Year 1 gain value	$200	$200	—	$180	$72	$108	$380	$272	$108
Sale	$180	$180	—	($180)	($72)	($108)	—	$108	($108)
Ending gain value	$380	$380	—	—	—	—	$380	$380	—

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$200	—	$200	$80	$120	$400	$280	$120
Year 1 activity	($10)	($8)	($2)	($10)	—	($10)	($20)	($8)	($12)
Year 1 capital account	$190	$192	($2)	$190	$80	$110	$380	$272	$108
Sale	—	—	—	—	$108	($108)	—	$108	($108)
Ending capital account	$190	$192	($2)	$190	$188	($2)	$380	$380	—
704(c) gain vs. capital			**$2**			**($2)**			—

recognized under either the curative or remedial method.[6]

If you look back at Example 1, Adam does not get allocated his full share of tax deductions as the contributor since there is a tax cost recovery deficit of $8. This deficit is exactly equal to the annual section 704(b) cost recovery ($20) in excess of tax cost recovery ($12) on his section 704(c) gain for the year. Therefore, there is no tax detriment to Jesse since he has been allocated tax deductions equal to his economic entitlement.

In Example 2, however, not only does Adam have a deficit in his tax allocations, but so does Jesse — he is ceiling-rule-limited by $2 (that is, he expects his entitlement of $10 of both section 704(b) and tax depreciation deductions, but he is limited to only the $8 of tax depreciation available in the year). Therefore, while Adam's $12 of the built-in gain in the guitar is released for the year, he loses out on only $10 of tax deductions. The $2 difference is a benefit to Adam and is exactly equal to the ceiling rule's detrimental effect on Jesse's tax allocations.

Examples 1 and 2 illustrate that when there is no ceiling rule limitation, which is the case in Example 1, no disparity is created between either partner's section 704(c) gain and capital balances. Conversely, when there is a ceiling rule limitation, as there is in Example 2, an equal and opposite disparity in each partner's section 704(c) gain and capital balances has been created.

You may be asking what this disparity means to our partners. Effectively, ordinary income has been shifted through the allocation of deductions from the contributor to the noncontributor over time. In Example 2, the $2 detriment to Jesse from the ceiling rule limitation (the difference between his section 704(c) gain and capital balances) is tax basis that won't ever be recovered unless he sells his partnership interest or the partnership liquidates. To illustrate, if the guitar in Example 2 was sold after year 1 for its section 704(b) value, the partnership's section 704(c) gain and capital profiles would be as shown in Example 3, Exhibit 1.

At the time of sale, Adam has $110 of remaining built-in gain in his section 704(c) capital. He recognizes $108 of that gain when the guitar is sold, leaving the $2 disparity between his section 704(c) capital and asset balances. If the partnership later liquidates, Adam will get $190 of

[6] We note that the contributor may have also previously benefited from the tax deductions during the holding period before contribution, so the total lost tax deductions over the life of the asset may not be as significant as they seem.

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Example 3, Exhibit 1: Formation

Gain	Microphone			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$60	—	$200	$80	$120	$400	$140	$260

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$60	—	$200	$80	$120	$400	$140	$260

cash (equal to his section 704(b) capital account), triggering an additional $2 of gain to him as the cash exceeds his tax basis of $188. A portion of Adam's $108 gain may be characterized as ordinary under section 1245, and his $2 of additional gain on liquidation will be treated as capital under sections 731 and 741.

Jesse, on the other hand, will not recognize any gain when the guitar is sold. He will also get $190 of cash upon liquidation and will recognize a $2 loss as his tax basis is $192. This loss on liquidation will be treated as capital for Jesse.

When we look at this holistically, Adam has benefited from both a timing and character perspective by (1) deferring $2 of income recognition until the partnership liquidates and (2) shifting ordinary income to Jesse in exchange for capital gain on liquidation. Conversely, Jesse had to forgo ordinary income deductions over time and then recognized a capital loss at the end — a bad answer for Jesse from both a timing and character perspective.

V. Ceiling Rule: Multiple Contributing Partners

The prior examples are relatively straightforward because we had one partner treated as a contributor and one partner treated as a noncontributor. Next, let's dial up the complexity and work through a more nuanced set of assumptions.

Example 3: Assume the same facts as Example 2, except that Jesse contributes a microphone with an FMV of $200 and a tax basis of $60 instead of cash. The microphone has a remaining useful life of five years and is depreciated using the straight-line method.

Section 704(c) is generally applied on a property-by-property basis; therefore, both Jesse and Adam are contributors regarding their own property and noncontributors regarding the other partner's contributed property. As you will see, this fact pattern may result in a net ceiling rule effect — a net detriment for one partner, and a net benefit to the other partner.

Immediately after formation, Jesse's and Adam's section 704(c) gain and capital profiles are as follows:

- Jesse:
  - Section 704(c) gain: $140
  - Section 704(c) capital: $140
- Adam:
  - Section 704(c) gain: $120
  - Section 704(c) capital: $120

The year 1 activity in Example 3 is illustrated below:

- Jesse's section 704(c) property — the microphone:
  - Tax depreciation for the microphone is $12 ($60 of remaining tax basis/five years).
  - Section 704(b) depreciation for the microphone is $40 ($12 annual tax depreciation/$60 total remaining tax basis * $200 of remaining section 704(b) basis).
  - Each partner is entitled to $20 of section 704(b) depreciation (50 percent ownership interest * $40 of total section 704(b) depreciation).
  - Adam is allocated $12 of tax depreciation. There is no additional tax depreciation to be allocated to either Jesse or Adam.
- Adam's section 704(c) property — the guitar:
  - Tax depreciation for the guitar is $8 ($80 of remaining tax basis/10 years).

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Example 3, Exhibit 2: End of Year 1

Gain	Microphone			Guitar			Total Assets		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$60	$140	$200	$80	$120	$400	$140	$260
Depreciation	($40)	($12)	($28)	($20)	($8)	($12)	($60)	($20)	($40)
Ending gain value	$160	$48	$112	$180	$108	$72	$340	$120	$220

Capital	Jesse			Adam			Total Capital		
	704(b)	Tax	704(c)	704(b)	Tax	704(c)	704(b)	Tax	704(c)
Formation	$200	$260	$140	$200	$80	$120	$400	$140	$260
Year 1 activity	($30)	($8)	($22)	($30)	($12)	($18)	($60)	($20)	($40)
Ending gain value	$170	$52	$118	$170	$68	$102	$340	$120	$220
704(c) gain vs. capital			($6)			($6)			—

- Section 704(b) depreciation for the guitar is $20 ($8 annual tax depreciation/$80 total remaining tax basis * $200 of remaining section 704(b) basis).
- Each partner is entitled to $10 of section 704(b) depreciation (50 percent ownership interest * $20 of total section 704(b) depreciation).
- Jesse is allocated $8 of tax depreciation. There is no additional tax depreciation to be allocated to either Adam or Jesse.

In total, Jesse has been allocated $30 and $8 of section 704(b) and tax depreciation, respectively, for a section 704(c) capital effect of $22. Jesse's section 704(c) gain built-in gain release was $28.

Adam has been allocated $30 and $12 of section 704(b) and tax depreciation, respectively, for a section 704(c) capital effect of $18. Adam's section 704(c) gain built-in gain release was $12.

After accounting for year 1, Jesse's and Adam's section 704(c) gain and capital profiles are as follows:

- Jesse:
  - Section 704(c) gain: $112
  - Section 704(c) capital: $118
- Adam:
  - Section 704(c) gain: $108
  - Section 704(c) capital: $102

In Example 3, Jesse has benefited (and Adam has suffered) from a net ceiling rule effect of $6. This can be seen by comparing Jesse's section 704(c) gain of $112 on his contributed property (the remaining built-in gain on the microphone he contributed to the partnership) with his section 704(c) capital of $118 at the end of the year. Jesse's lower remaining section 704(c) gain on contributed property, when compared with his section 704(c) capital profile, means that in total, Jesse's forgone tax deductions compared with his section 704(b) deductions ($22) are less than the built-in gain release of his section 704(c) gain ($28).

VI. The Ceiling Rule: In Practice

In practice, the ceiling rule isn't required to be reported directly on a partner's Schedule K-1 or the partnership's Form 1065, "U.S. Return of Partnership Income," although the effect of the ceiling rule does reveal itself in the allocation of partnership tax items. So other than impressing your friends with ceiling rule anecdotes at the next barbecue, how does knowledge of the ceiling rule affect tax professionals on a day-to-day basis?

While not obvious to the untrained eye, the effect of the ceiling rule is relatively common in partnership tax, and we set forth a few real-world examples in which you might see the effect of the ceiling rule pop. This list is not all-inclusive, so be warned — if you experience the Baader-Meinhof phenomenon by seeing the effect of the ceiling

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rule everywhere on a daily basis, the authors of this article are not to be held accountable.

A. Section 743(b) Adjustments

Remember our tax basis step-up calculation with the impeccable formatting? You knew we'd be back. As we mentioned earlier, it's often assumed that a buyer's step-up in tax basis under section 743(b) is equal to a seller's gain recognized in a taxable transaction. While there are other notable exceptions (like the treatment of transaction costs), the effect of the ceiling rule is a potential instance in which a buyer's tax basis step-up will not be equal to a seller's recognized gain.

First things first — why does section 743(b) exist? Principally, the purpose of section 743(b) is to protect a buyer from tax gain inherent in the purchased partnership interest. The rules facilitate this protection through a step-up in tax basis of the transferee's share in partnership property, known as a section 743(b) adjustment.

The regulations contain a hypothetical liquidation construct in which the partnership is deemed to dispose of all its assets for FMV in a fully taxable transaction.[7] Any gain calculated under this hypothetical liquidation is used to compute the transferee's previously taxed capital, which is akin to the tax basis capital account that he purchased.[8] There is a notable exception in which a transferee's previously taxed capital does not equal the tax basis capital account. That's right, folks — you guessed it: the effect of the section 704(c) ceiling rule.

It's important to note the difference between how section 743(b) adjustments and tax gains to sellers are calculated — the hypothetical liquidation construct of section 743(b) adjustments takes a section 704(c) gain view (that is, it looks to the built-in gain profile of the partnership's property and how that gain would be allocated to a transferee partner), as opposed to the calculation of gain on sale by a seller, which looks to the transferor partner's section 704(c) capital profile.

[7] *See* reg. section 1.743-1(d)(2).

[8] *See* reg. section 1.743-1(d)(1).

To illustrate how the ceiling rule can affect section 743(b) adjustments, let's assume that our dear pals Jesse and Adam ran into some irreconcilable differences and decide to part ways — finally, at last, it's the end of heartache. At the beginning of year 2, Jesse quits the business and sells his interests to Howard for $200.

Under the facts in Example 1, Howard's section 743(b) adjustment will be $10, equal to Jesse's remaining section 704(c) gain of $0 plus appreciation of $10 ($200 purchase price less $190 of section 704(b) capital). Jesse's gain on sale will also be $10, which is equal to his remaining section 704(c) capital profile of $0 plus the $10 of appreciation. Lo and behold, Example 1 (no ceiling rule effect) is a situation in which the buyer's section 743(b) adjustment is equal to the seller's gain — a fact pattern worthy of celebration.

Now let's look at Example 3. Howard's section 743(b) adjustment will be $142, equal to Jesse's remaining section 704(c) gain of $112 plus appreciation of $30 ($200 purchase price less $170 of section 704(b) capital). Jesse's gain on sale, however, will be $148, which is equal to his remaining section 704(c) capital profile of $118 plus the $30 of appreciation. The difference between the section 743(b) adjustment and gain on sale is the $6 effect of the ceiling rule.

Further note that because the section 743(b) calculation takes into account section 704(c) principles, which partner the transferee purchases his interest from may change the section 743(b) adjustment because Howard is stepping into the shoes of the seller's section 704(c) gain profile. For instance, if Adam had been the one to sell his interest to Howard instead of Jesse in Example 3, Howard would get a $138 section 743(b) adjustment. The results of the section 743(b) adjustment calculations under examples 1 and 3 can be seen below.

As we can see from Exhibit 3, a transferee's section 743(b) tax basis step-up can vary depending on which transferor partner is selling, and the result may be surprising and pronounced based on section 704(c) profiles, tax basis, and the ceiling rule. Keep this in mind the next time you're removing gridlines and locking that tax basis step-up calculation file for client delivery.

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Examples 1 and 3, Exhibit 3: Section 743(b) Adjustment

	Example 1		*Example 3*		
Transferee's basis in the partnership interest	**Jesse**	**Adam**	**Jesse**	**Adam**	
Cash paid by transferee	$200	$200	$140	$260	
Plus: Share of partnership liabilities	—	—	—	—	
Total outside basis	$200	$200	$200	$200	(A)
Transferee's share of adjusted basis in partnership property	**Jesse**	**Adam**	**Jesse**	**Adam**	
Cash received in hypothetical liquidation	$200	$200	$200	$200	
Less: Allocable tax gain	($10)	($82)	($142)	($138)	
Previously taxed capital	$190	$118	$58	$62	
Plus: Share of partnership liabilities	—	—	—	—	
Total inside basis	$190	$118	$58	$62	(B)
Section 743(b) basis adjustment	$10	$82	$142	$138	(A) - (B)
Seller's gain	$10	$82	$148	$132	
Difference	—	—	($6)	$6	

B. Accounting for Income Taxes Under ASC 740

In addition to section 743(b) adjustments already discussed, the ceiling rule may have an effect on accounting for income taxes under ASC 740. The ceiling rule can result in outside tax basis that will not be recoverable by a noncontributor until its partnership interest is sold or the partnership is liquidated, often referred to as a residual outside basis difference. The recognition of a deferred tax asset, the character of any deferred tax amount, and the realizability of any deferred tax asset for a residual outside basis difference may depend upon the partner's expected manner of recovery of its investment in the partnership, whether it has an overall taxable or deductible temporary difference for the investment and its accounting policies.

We expect more entities to have residual outside basis differences to evaluate as umbrella partnership C corporation (UP-C) structures continue to be a popular initial public offering vehicle,[9] in which the accounting for income taxes associated with the investment in the partnership can be complex and the entity is subject to public company reporting requirements. Advisers assisting with UP-C operating structures at non-audit clients should expect that entities and their auditors may request information and detailed workpapers that support outside tax basis differences, including any supporting detail for the effect of the ceiling rule. If those detailed workpapers are not initially prepared and painstakingly maintained, it may prove to be a real challenge to pull together and provide the support upon request.

C. Reporting of Tax Basis Capital Accounts

Over the past several years, the IRS had been inching closer to the requirement of tax basis capital account reporting for all partners in a partnership, which finally came to fruition for tax years ending on or after December 31, 2020.[10]

[9] Phillip W. DeSalvo, "The Staying Power of the UP-C: It's Not Just a Flash in the Pan," *Tax Notes*, Aug. 8, 2016, p. 865; DeSalvo, "The Evolution of the UP-C," *Tax Notes*, Oct. 22, 2018, p. 439.

[10] Notice 2020-43, 2020-27 IRB 1, explicitly provided that the new rules applied for tax years ending on or after December 31, 2020. The draft 2020 Form 1065 instructions refer only to "tax year 2020," but we believe the clear intent is for the dates used in the notice to apply to the dates in instructions.

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In the Form 1065 instructions for 2020, the IRS implemented a tax basis method for maintaining tax basis capital accounts, which is essentially a chronological transactional approach. If the partnership had not used the tax basis method in the prior year, beginning capital for the 2020 tax year may be calculated under the following four permissible ways: (1) tax basis method, (2) modified outside basis method, (3) modified previously taxed capital method, and (4) section 704(b) method.

Under the section 704(b) method, beginning 2020 tax basis capital is calculated by subtracting a partner's remaining built-in gain (or loss) under section 704(c) (what we refer to as the partner's section 704(c) gain) from its section 704(b) capital account. This calculation works well if there is no section 704(c) present in the partnership; however, the ceiling rule effect can lead to discrepancies.

In Example 3, Jesse's section 704(b) capital account at the end of the first year is $170. His remaining section 704(c) gain is $112, so his tax basis capital account, as calculated using the section 704(b) method, is $58. However, using a pure roll-forward approach (that is, the tax basis method), we know that Jesse's actual tax basis capital account at the end of the year is $52, which is measured by his opening tax capital account of $60 less the year 1 tax loss of $8. This $6 difference between the two methods of calculating Jesse's tax basis capital account is the effect of the ceiling rule discussed earlier.

It's worth noting that one of the other approaches blessed by the instructions — the modified previously taxed capital method — may also be affected by the ceiling rule. This method uses a hypothetical liquidation calculation to determine tax basis capital and is nearly identical to the calculation used in section 743(b) adjustments.

VII. Conclusion

The ceiling rule is probably not the most challenging tax oddity you'll run across in your career, but it's certainly up there. The examples we've examined are relatively straightforward compared with clients in the real world, but change the facts as you see fit to visualize how difficult it could be to comply with the section 704(c) rules and the effect of the ceiling rule — decades of business activity, thousands of assets, a dozen section 704(c) layers, hundreds of partners, poorly formatted prior-year workpapers using Comic Sans, and so on.

Whether you're preparing a partnership tax return, performing a pre-IPO scrub of historical books and records, or conducting buy-side tax due diligence, familiarity with the ceiling rule and its effect will lead to a better and more accurate work product. We encourage you to consider the by-partner tracking of section 704(c) gain and capital balances that we introduced in this article and hope it proves to be a useful tool in your tax practitioner arsenal.[11] ■

[11] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

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