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Unwinding the Ceiling Rule

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UNWINDING THE CEILING RULE

*Leigh Osofsky**

This article closely examines the unwinding of the ceiling rule. Congress and partnership tax experts historically have assumed perfect unwinding of the ceiling rule on liquidation or sale of a partnership interest. However, this assumption glosses over a significantly more complicated reality. This article closely examines the history of section 704(c) and the interaction between the ceiling rule and the rules regarding sales and liquidations of partnership interests to reveal the extent to which the assumption does not hold. By debunking long-held assumptions about the perfect unwinding of the ceiling rule, this article displays that there is no reasonable justification to maintain the ceiling rule, or the accompanying complexity and distortion that the ceiling rule imposes on the partnership tax system.

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I. INTRODUCTION

The so-called “ceiling rule,” which applies under the traditional method for making section 704(c) allocations, can misallocate income, gain, loss, and deduction to both a partner contributing property and to noncontributing partners. Notwithstanding these predictable misallocations, the Treasury Department still permits application of the ceiling rule under section 704(c).

Historically, Congress and partnership tax experts assumed perfect unwinding of the ceiling rule on liquidation or sale of a partnership interest — an assumption that still operates to some extent today. This assumption glosses over a significantly more complicated reality. This article closely examines the history of section 704(c) and the interaction between the ceiling rule and the rules regarding sales and liquidations of partnership interests. Doing so reveals that when and to what extent the perfect unwinding assumption holds depends, perhaps to a surprising degree, on (1) a variety of relatively arbitrary facts regarding the assets held by the partnership on liquidation or sale, and (2) the unintended interactions of inordinately complicated partnership tax rules. In reaching this conclusion, this article displays that the ceiling rule, which has always been part of the section 704(c) regime, is even worse than commonly thought.

It is important to fully appreciate the extent to which the ceiling rule can perpetuate mistaxation long after the liquidation or sale of a partner’s interest in the partnership. As this article will explain, the ceiling rule results in enormous complexity and creates unjustifiable planning opportunities that accrue to the well informed. The ceiling rule thereby creates a mess of the fundamentally important section 704(c) partnership tax rules governing allocations with respect to contributed property. Despite the mess it makes of the section 704(c) regime, the ceiling rule has

endured in part because of the oversimplified assumptions regarding its unwinding and the resulting perceptions of its limited impact. By debunking these long-held assumptions, this article displays there is no reasonable justification to continue to retain the ceiling rule.

II. SECTION 704(C), THE CEILING RULE, AND THE ALTERNATIVES

A. *The Need for Section 704(c)*

Section 704(c) resolves a potential tension that could flow from two basic tenets of partnership tax. First, as a general matter, contributions of property to partnerships are not recognition events.¹ Second, economic gains, losses, or deductions to partners should be matched by tax gains, losses, or deductions.² Since book capital accounts generally keep track of economic consequences, this tenet can be referred to with the phrase, “tax must follow book.”³ The problem is that while partners should not recognize gain or loss for tax purposes on contribution of built-in gain or loss property, for book purposes the contributing partner gets credit for the fair market value of the contribution (net any liabilities that the partnership assumes or takes subject to).⁴ As a result, the partner is going to take into account the gain or loss for book (and economic) purposes, but not for tax purposes. Section 704(c) is the mechanism that ensures that the tax consequences of the contribution ultimately follow the book consequences.

Specifically, imagine the following scenario (Example 1). *A* and *B* form a partnership. *A* contributes property (Property A) in exchange for a one-half interest in all partnership profits, losses, and capital. Property A has a basis in *A*’s hands of \$50 and a fair market value of \$100. *B* contributes cash of \$100 in exchange for a 50% interest in all partnership profits, losses, and capital. For book purposes, *A* and *B* will each get \$100 in their capital accounts.⁵ As a result, *A* gets credit for the \$50 of built-in gain in Property A for book purposes. *A*, however, does not recognize the

¹ I.R.C. § 721(a). Exceptions apply. For instance, contribution of property to a partnership, followed by distributions of the property can result in disguised sale treatment and gain recognition. I.R.C. § 707(a)(2)(B). Additionally, potential end-runs around section 704(c) in the form of distributions of contributed property to noncontributing partners and distributions of other property to contributing partners can yield recognition events under sections 704(c)(1)(B) and 737.

² I.R.C. § 704(b).

³ LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K* 90 (4th ed. 2011) [hereinafter *LOGIC*]; Gregory J. Marich et al., *The Remedial Allocation Method: A Viable Cure for the Ceiling Rule*, 65 TAX NOTES 1267, 1269 (1994) [hereinafter *A Viable Cure*].

⁴ Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2013).

⁵ *Id.*

\$50 of built-in gain for tax purposes. As a result, the partnership balance sheet after the contribution is as follows:⁶

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book	Tax	Book	OB	
Cash	100	100	<i>A</i>	50	100	50
Property A	50	100	<i>B</i>	100	100	100
Total	150	200	Total	150	200	150

When Property A is ultimately sold, the first \$50 of tax gain should be allocated to *A*. If the partnership sells Property A for \$150, each partner experiences a \$25 gain for book purposes.⁷ Yet there is a \$100 gain for tax purposes, resulting from the \$150 amount realized minus the \$50 basis that the partnership holds in the property.⁸ *B* should recognize an amount of tax gain that corresponds with the amount of book gain that *B* experienced, or \$25. *A*, on the other hand, should recognize the original \$50 of tax gain that was deferred on contribution of Property A to the partnership, as well as the additional \$25 gain that *A* experienced after the contribution of Property A to the partnership.

Section 704(c)(1)(A) dictates that, “income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.”⁹ As a result, *A* recognizes \$75 of gain for tax purposes and *B* recognizes \$25 of gain for tax purposes, even though they each increase their book capital accounts by \$25.¹⁰ Section 704(c) thereby ensures that tax consequences do follow book consequences with respect to contributed property, albeit in a delayed fashion.¹¹ The partnership balance sheet after the sale appears as follows:

⁶ Where helpful, partnership balance sheets are inserted to serve as a guide for the reader. Since there are no liabilities in the examples, the balance sheets do not list liabilities. Rather, they keep track of the tax basis and book value of the partnership’s assets on the left-hand side, and the tax and book capital accounts of the partners on the right-hand side. Outside basis is also added as a column on the right-hand side, in order to assist in determining the tax result to partners on liquidation or sale of a partner’s interest in the partnership.

⁷ Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2013).

⁸ I.R.C. §§ 723, 1001.

⁹ I.R.C. § 704(c)(1)(A).

¹⁰ See Treas. Reg. § 1.704-3(b)(2), ex. (1)(iii) (2013).

¹¹ LOGIC, *supra* note 3, at 91; *A Viable Cure*, *supra* note 3, at 1269.

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	250	250	A	125	125 125
			B	125	125 125
Total	250	250	Total	250	250 250

Section 704(c) applies to the contribution of depreciable property as well. In these cases, section 704(c) also attempts to ensure that tax follows book in a delayed fashion. The reconciliation of tax and book does not have to await the sale or disposition of the property. Rather, it can occur over the life of the property, through allocations of depreciation, which take into account the variation between the basis of the property and the fair market value at the time of contribution.

Imagine, for instance, the following scenario (Example 2). The same facts apply as in Example 1, except that Property A is depreciable property, which the partnership depreciates over a ten-year period, using the straight-line method. The partnership would be able to depreciate \$5 per year for tax purposes. If the partnership chooses the traditional method to make section 704(c) allocations, then the partnership would be able to depreciate \$10 per year for book purposes, which will be allocated equally among the partners in accordance with their economic agreement.¹² In terms of allocating the tax depreciation under section 704(c), the partnership will first allocate tax depreciation to the noncontributor, *B*, to match *B*'s book depreciation to the extent possible.¹³ In this case, all \$5 of tax depreciation per year is allocated to *B*.¹⁴ *A* now takes into account the built-in gain through reduced tax depreciation deductions over the life of the property.

B. Section 704(c) Allocation Methods

1. The Traditional Method

There are a number of ways to implement section 704(c). The Treasury Regulations governing section 704(c) bless three different allocation methods as "generally reasonable": the traditional method, the traditional method with curative allocations, and the remedial allocation method.¹⁵

¹² Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) (2013).

¹³ Treas. Reg. § 1.704-3(b)(1) (2013).

¹⁴ See Treas. Reg. § 1.704-3(b)(2), ex. (1)(ii) (2013).

¹⁵ Treas. Reg. § 1.704-3(a)(1) (2013).

The traditional method is subject to the ceiling rule. Crucially, the ceiling rule dictates, “[T]he 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.”¹⁶ In other words, only the income, gain, loss, or deduction that exists at the partnership level can be allocated among the partners.

In certain situations, however, there may not be sufficient partnership tax income, gain, loss, or deduction to take into account both the precontribution gain or loss in the property and the events subsequent to the contribution. In such situations, the ceiling rule will result in misallocation of tax income, gain, loss, or deduction for both the contributing partner and the noncontributing partners.

Imagine now the following example (Example 3). The facts posed in Example 1 apply, except that the partnership ultimately sold Property A for \$50, rather than \$150. Since Property A was on the partnership books at a value of \$100, there was a \$50 decline in the book value of the property, which should be allocated equally between the partners, in accordance with their economic agreement.¹⁷

Examining each partner’s individual situation is instructive regarding the tax allocations that would be necessary for tax to follow book in a delayed fashion. Prior to contribution of the property, *A* experienced a gain of \$50. Upon contribution, *A* had a one-half interest in Property A, which had a book value of \$100. After contribution, *A* experienced a decline in value of the property of \$25. On a net basis, *A* experienced a \$25 gain in book value of the property. *B* experienced only the decline in value after the contribution of the property to the partnership, or a \$25 decline in book value.

If the partnership were viewed as an aggregate of the partners, *A* should recognize a \$25 gain for tax purposes on sale of Property A, and *B* should recognize a \$25 loss for tax purposes. Indeed, this result would be necessary in order to satisfy the general purpose of section 704(c). There is no tax gain at the partnership level however, because the property is being sold for the basis that the partnership holds in the property.¹⁸ Because the ceiling rule mandates that only the tax income, gain, loss, or deduction that exists at the partnership level can be allocated among the partners, the partnership may allocate no gain to *A* and no loss to *B*.¹⁹ As a result, *A* ends

¹⁶ Treas. Reg. § 1.704-3(b)(1) (2013).

¹⁷ Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2013).

¹⁸ I.R.C. §§ 723, 1001.

¹⁹ See Treas. Reg. § 1.704-3(b)(2), ex. (1)(iii) (2013).

up with too little tax gain and *B* ends up with too little tax loss. The partnership balance sheet after sale of Property A reflects these results and appears as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	150	150	<i>A</i>	50	75 50
			<i>B</i>	100	75 100
Total	150	150	Total	150	150 150

Similar problems can occur in the context of the application of the ceiling rule to depreciable property. The following scenario provides a demonstration (Example 4). The same facts from Example 2 apply, except that the basis of Property A on contribution was \$20. As a result, after contribution, the partnership balance sheet is as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	100	100	<i>A</i>	20	100 20
Property A	20	100	<i>B</i>	100	100 100
Total	120	200	Total	120	200 120

The annual book depreciation would remain \$10 and would still be allocated equally between the partners.²⁰ There would now be only \$2 of annual tax depreciation at the partnership level, because the partnership holds Property A with a basis of \$20. Annual tax depreciation would still be allocated to the noncontributor, *B*, to the extent possible to match annual book depreciation allocated to *B*.²¹ In this case only \$2 of tax depreciation would be available at the partnership level to allocate to *B*, whereas *B* would be allocated \$5 of depreciation a year for book purposes. As a result, *B* would be allocated too little tax depreciation, relative to the amount of book depreciation, while *A* would not have to take into account the full extent of built-in gain over the life of Property A.²² Both Example 3 and

²⁰ Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) (2013).

²¹ Treas. Reg. § 1.704-3(b)(1) (2013).

²² The built-in gain on contribution of the property was \$80. Over the life of Property A, partner *A* would be allocated \$50 of book depreciation and no tax depreciation. As a result, *A* would take into account \$50 of the \$80 of built-in gain over the life of the property. However, the remaining \$30 of built-in gain would not be taken into account by *A* over the life of the property. This \$30 of built-in gain that *A* does not take into account offsets exactly

Example 4 illustrate the more general point: when the ceiling rule applies under the traditional method, it *must* result in misallocations of income, gain, loss, and deduction to both the contributor and noncontributors.

2. The Alternative Methods

Two alternative methods blessed by Treasury Regulations can alleviate the misallocations produced by the ceiling rule, to varying degrees. The first alternative method is the traditional method with curative allocations, which permits a partnership to “make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners.”²³ Curative allocations are “allocation[s] of income, gain, loss, or deduction for tax purposes that diffe[r] from the partnership’s allocation of the corresponding book item.”²⁴ Curative allocations must be reasonable, in that they must not exceed “the amount necessary to offset the effect of the ceiling rule;” they must occur over a reasonable period of time; and they “must be expected to have substantially the same effect on each partner’s tax liability as the tax item limited by the ceiling rule.”²⁵

In Example 3, for instance, if the partnership had a tax gain from the sale of another property, and such gain would be expected to have substantially the same effect as gain from the sale of Property A, up to \$25 of tax gain that would otherwise be allocated to *B* can be reallocated to *A*.²⁶ To the extent that a full \$25 of tax gain that otherwise would have been allocated to *B* is reallocated to *A*, the curative allocation will correct the mistaxation from the ceiling rule.

In the context of Example 4, if the partnership has other depreciation deductions, the partnership may allocate depreciation for tax purposes away from *A* and to *B* to offset the effects of the ceiling rule.²⁷ Alternatively, if the partnership has income that would have substantially the same effect as income from Property A, the partnership can allocate such income away from *B* and toward *A* to the extent necessary to offset the effects of the ceiling rule.²⁸

the \$30 of depreciation that *B* will take for book purposes, but which will not be matched by allocations of tax depreciation to *B*.

²³ Treas. Reg. § 1.704-3(c)(1) (2013).

²⁴ Treas. Reg. § 1.704-3(c)(1) (2013).

²⁵ Treas. Reg. § 1.704-3(c)(3) (2013).

²⁶ See Treas. Reg. § 1.704-3(c)(4), ex. 1 (2013).

²⁷ See Treas. Reg. § 1.704-3(c)(4), ex. 2 (2013).

²⁸ See Treas. Reg. § 1.704-3(c)(4), ex. 1 (2013).

While the traditional method with curative allocations can “cure” ceiling rule distortions, it depends on the existence of some other item of partnership income, gain, loss, or deduction. The traditional method with curative allocations cannot cure the misallocations of the ceiling rule absent this other item at the partnership level.

The second alternative method that can cure ceiling rule misallocations is the remedial allocation method, which does not depend on the existence of items of actual partnership income, gain, loss, or deduction. Rather, the remedial method allows the partnership to create remedial items (with identical tax attributes as the tax item that is limited by the ceiling rule) of income, gain, loss, or deduction to allocate to noncontributors, as necessary to offset ceiling rule distortions.²⁹ The partnership must then create an offsetting, identical remedial item to allocate to the contributing partner.³⁰

Imagine, for instance, the facts of Example 3, and that the partnership has no other income. Under the remedial method, the partnership may allocate \$25 of tax loss (of a type identical to the loss that would have occurred had Property A been sold for a loss) to *B*. The partnership would allocate an offsetting \$25 of tax gain (of an identical type) to *A*.³¹ In Example 4, the remedial allocation method would be slightly more complicated. The remedial allocation method changes the schedule that would otherwise apply for book depreciation. The remedial allocations of depreciation deductions thus occur over a longer period of time.³² Nonetheless, the end result is that remedial allocations of tax depreciation can be allocated to *B*, offset by remedial allocations of income to *A*, albeit over a longer period of time than would have occurred under the traditional method with curative allocations.³³ In sum, the ceiling rule can produce misallocations of income, gain, loss, and deduction, which can be cured in some cases by the traditional method with curative allocations and in all cases by the remedial method.³⁴

²⁹ Treas. Reg. § 1.704-3(d) (2013).

³⁰ *Id.*

³¹ See Treas. Reg. § 1.704-3(d)(7), ex. 2 (2013).

³² Treas. Reg. § 1.704-3(d)(2) (2013).

³³ See Treas. Reg. § 1.704-3(d)(7), ex. 1 (2013).

³⁴ Some partnership tax experts have suggested that the remedial allocation method might present some limited opportunities for abuse. See, e.g., GEORGE K. YIN & KAREN C. BURKE, *PARTNERSHIP TAXATION* 164 (2d ed. 2013) (suggesting that initial misvaluations may allow for some mischief in the context of the remedial allocation method); *A Viable Cure*, *supra* note 3, at 20 (discussing the potential for abuse relative to other methods in the context of depreciable property, but ultimately concluding that it is not really abusive). Others have suggested that the remedial allocation method offers little, if any, opportunity for abuse. See, e.g., Laura Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93, 125 (1996) (“Because of its nod to economic reality in computing book items, the remedial allocation

III. EVOLUTION IN THINKING REGARDING SECTION 704(C)

It has been well understood since the initial creation of section 704(c) that failure to account fully for precontribution gains and losses (as occurs in cases in which the ceiling rule applies) can result in misallocations of income, gain, loss, and deduction.³⁵ There has been a more gradual evolution in understanding regarding the impact of such misallocations. This part explores that evolution. Doing so reveals that the ceiling rule has remained part of the section 704(c) regime for decades in part because of the mistaken and oversimplified assumptions regarding the unwinding of the ceiling rule.

A. 1954: Original Misconceptions

The misallocations that can occur as a result of the ceiling rule were inherent, and even more extreme, in the initial creation of section 704(c) in 1954. In 1954, the law was confused regarding partnership tax generally, and allocations with respect to contributed property, specifically.³⁶ Section

method leaves little, if any, opportunity for creating shifts of income.”). Some partnership tax experts have suggested that a fourth option, a deferred sales method (which was not ultimately incorporated into the section 704(c) scheme) might be better than the remedial allocation method. *See, e.g.,* Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009) [hereinafter *Saving Subchapter K*]. This article does not seek to choose between the two principal alternatives to the traditional method, which are the remedial method and the deferred sales approach. Rather, the article seeks to show that there is no reasonable justification for retaining the traditional method with the ceiling rule. As such, this article, for instance, does not discuss the potential need for anti-churning rules under the remedial method. Full consideration of which of the two alternatives is best is left for another day (and has received interesting examination by others in other work).

³⁵ *See infra* notes 42-48 (discussing early understandings of the misallocations accompanied by beliefs that dampened concern about the misallocations).

³⁶ For a good description of the early state of confusion and the need to settle it, see Cunningham, *Use and Abuse of Section 704(c)*, *supra* note 34, at 101-02. For useful contemporary descriptions of the confused state of partnership tax in the 1950s, see J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partner — American Law Institute Draft*, 9 TAX L. REV. 109, 112 (1954) [hereinafter *1954 ALI Draft*] (describing that “the present Code does little to govern the treatment of this widespread form of business association” and that “[s]uch large areas as the treatment of contributed property . . . are left largely untouched”); *see also* *Forty Topics Pertaining to the General Revision of the Internal Revenue Code*, 83d Cong. 1369 (1953) (statement of Mark H. Johnson, Representative of American Bar Association) (describing the existing “sea of doubt” regarding partnership taxation). As indicated by the American Law Institute, the question of allocations with respect to contributed property was especially troublesome. AMERICAN LAW INSTITUTE, INCOME TAX PROJECT (Preliminary Draft No. 71 1951), at 195

704(c) was put in place at the time in order to provide clarity regarding allocations with respect to contributed property. The version of section 704(c) put in place in 1954 did not *require* partnerships to take into account precontribution gains and losses in making allocations with respect to contributed property at all. Instead, section 704(c)(1) at the time provided:

General Rule. In determining a partner's distributive share of items described in section 702(a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.³⁷

By giving partnerships the option of ignoring entirely precontribution gains and losses, section 704(c)(1) created an extreme form of the misallocations that flow from the ceiling rule. Take the facts of Example 1, for instance. Under section 704(c)(1), when Property A was sold for \$150, the partnership could split both the book and tax gain equally between *A* and *B*. Doing so would fail to take into account precontribution gains and losses entirely, and would result in misallocations of income, gain, loss, and deduction as between contributing and noncontributing partners.

In contrast, the 1954 version of section 704(c)(2) allowed partnerships the *option* of taking into account precontribution gains and losses when making allocations with respect to contributed property.³⁸ Specifically, section 704(c)(2) provided:

Effect of partnership agreement. If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.³⁹

("Probably no other problem has seemed as difficult of resolution as that of the proper treatment of depreciation and gains and losses in respect of contributed property.").

³⁷ I.R.C. § 704(c)(1) (1954).

³⁸ The House version of section 704(c) only contained the general rule that ultimately became incorporated in section 704(c)(1). The Senate amendment added the optional section 704(c)(2) provision. H.R. REP. NO. 83-2543, at 58 (1954), *reprinted in* 1954 U.S.C.C.A.N. 5280, 5319.

³⁹ I.R.C. § 704(c)(2) (1954).

This optional section 704(c)(2) left open the question of what allocation method should be used “to take account of the variation between the basis of the property to the partnership and its fair market value at the time of its contribution.”⁴⁰ The legislative history of section 704(c)(2) suggested that the traditional method, with the ceiling rule, should apply under section 704(c)(2).⁴¹ As a result, even under section 704(c)(2), application of the ceiling rule could result in misallocations of income, gain, loss, and deduction as a result of failure to fully take into account precontribution gains and losses.

The drafters of the 1954 version of section 704(c) and partnership tax experts at the time were aware that ignoring precontribution gains and losses would result in misallocations of income, gain, loss, and deduction. Their concern was dampened by a number of beliefs they held about the misallocations. First, the drafters of section 704(c) and partnership tax experts at the time believed that such misallocations affected only the partners, and did not impact government revenue. The Senate Report states quite plainly that “this is not a matter involving revenue considerations to the Government.”⁴² A 1954 American Law Institute draft (1954 ALI Draft) produced by esteemed tax experts (including the likes of Stanley Surrey) also suggested that distribution of tax burdens among partners was really an issue for the partners, not of particular importance to the Treasury Department.⁴³ The 1954 ALI Draft described a situation in which one partner contributed cash of \$100 and the other partner contributed property with a basis of \$20 and a fair market value of \$100. The 1954 ALI Draft examined the potential overtaxation to the cash contributor and undertaxation to the property contributor, but suggested that the property contributor could compensate the cash contributor for the tax savings transferred to the property contributor. Notably, the 1954 ALI Draft did not consider the potential loss of revenue to the government.⁴⁴

The drafters of the 1954 version of section 704(c) and partnership tax experts at the time also assumed that the misallocations generally would be perfectly unwound upon liquidation or sale of a partner’s interest in the partnership. For instance, a 1954 Senate report on the topic acknowledged that failure to take into account precontribution gains and losses “may result in possible detriment (or gain) to noncontributing partners,” but explained

⁴⁰ *Id.*

⁴¹ S. REP. NO. 83-1622, at 381–82 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5022–23 (providing an example in which the depreciation for the noncontributor was limited by the amount of basis the partnership held in the contributed property).

⁴² *Id.* at 93, *reprinted in* 1954 U.S.C.C.A.N. 4621, 4725–26.

⁴³ 1954 ALI Draft, *supra* note 36, at 112, 132–33.

⁴⁴ *Id.* at 125.

that “there will, in general, be a corresponding loss (or gain) to such partners upon sale or disposition of their interest in the partnership.”⁴⁵ In the example used in the Senate Report, the liquidation or sale actually would not offset the prior misallocation perfectly, as a result of a permanent conversion in character of income on unwinding. The Senate Report did not pick up on or discuss the issue, instead relying on the general assumption of a loss (or gain) on sale or disposition of a partner’s interest, which would offset the prior detriment (or gain).⁴⁶ The 1954 ALI Draft similarly indicated that “at the point of liquidation or sale the tax advantages and disadvantages [of the misallocations] are corrected” because the high-basis cash contributor would reduce his or her gain on liquidation or sale and that the reverse would occur for the low-basis property contributor.⁴⁷ While the 1954 ALI Draft indicated that the unwinding may occur far in the future and that there may be limitations on the use of capital losses, it nonetheless assumed that the unwindings would occur on liquidation or sale, and that gain and loss on unwinding would otherwise offset the prior misallocations.⁴⁸

B. 1984: Partial Evolution of Section 704(c)

By 1984, Congress had corrected one of its prior misconceptions by realizing that misallocations of income, gain, loss, and deduction could cost the government revenue because of potential shifting of tax liability to lower tax bracket partners (inter-partner shifting). Accordingly, Congress partially revised section 704(c) in 1984. Congress eliminated prior section 704(c)(1) and required partnerships to take into account variation between basis and fair market value on contribution.

⁴⁵ S. REP. NO. 83-1622, at 380 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5022.

⁴⁶ The Senate Report set forth an example in which the partners split depreciation from a contributed property, resulting in less depreciation to the noncontributor than would have occurred had the noncontributor been treated as purchasing a half interest in the depreciable property for cash. After recognition of capital gain on sale of the property and liquidation, the noncontributor recognizes a capital loss on liquidation. Part of the capital loss compensates for the reduced depreciation that the noncontributor was allocated. Hence, the reduced ordinary depreciation deductions are ultimately remedied, but in the form of a capital loss. The report does not pick up on or discuss the potential conversion issue. Rather, it rests on the general statement that “there will, in general, be a corresponding loss (or gain) to such partners upon sale or disposition of their interest in the partnership.” *Id.* A similar example and similar issues exist in the report’s discussion of section 704(c)(2). *Id.* at 381–83 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5023–24. The House Report similarly relies on this example and similarly does not address the conversion. H.R. REP. NO. 83-1337, at 224 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4363–64.

⁴⁷ 1954 ALI Draft, *supra* note 36, at 126.

⁴⁸ *Id.* at 126–27.

Congress did not revisit or revise its prior assumption of perfect unwinding however. As a result, Congress did not focus on the extensive delays and character shifts that could occur on unwinding. Congress also did not fully revise section 704(c) to eliminate the misallocations entirely. Congress left open the possibility for continuing misallocations by not eliminating the ceiling rule. This intermediate change in the law (with reduced, but not eliminated misallocations) seems to reflect the intermediate understanding that Congress had reached about the misallocations by 1984.

To understand Congress's realization about inter-partner shifting, take the facts from Example 1. After contribution, the partnership balance sheet was:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	100	100	<i>A</i>	50	100	50
Property A	50	100	<i>B</i>	100	100	100
Total	150	200	Total	150	200	150

If the old section 704(c)(1) applied, all gain on sale of Property A would be split equally between *A* and *B*, for both book and tax purposes. When Property A is sold, there is \$50 of gain for book purposes, split equally between them, or \$25 each. There is \$100 of gain for tax purposes, which would be split equally between them, or \$50 each. As a result, the partnership balance sheet after sale would be:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	250	250	<i>A</i>	100	125	100
			<i>B</i>	150	125	150
Total	250	250	Total	250	250	250

In this situation, *A* actually experienced a total of \$75 of economic gain over the life of Property A, \$50 of which occurred prior to contribution of Property A to the partnership, and \$25 of which occurred after the contribution. *B* actually experienced a total of \$25 of economic gain over the life of Property A, all of which occurred after the contribution of Property A to the partnership. As a result, by failing to take into account precontribution gain in Property A, section 704(c)(1) would include \$25 too little gain for *A* for tax purposes and include \$25 too much gain for *B* for tax purposes. The drafters of section 704(c) and partnership tax experts in

1954 had viewed such misallocations as irrelevant for government revenue because the misallocation of too little gain to *A* is matched exactly by the misallocation of too much gain to *B*.

That simplistic view falls apart when taking into account differing tax rates and the time value of money of deferring tax liability. In the extreme, imagine that *A* is in the 35% tax bracket and *B* is tax-exempt. In such a case, *A*'s tax liability is reduced by \$8.75 ($\$25 \times 35\%$) as a result of the misallocation of tax gain to *B*, even though *B*'s tax liability does not increase as a result of the misallocation. Even to the extent that the undertaxation of *A* and overtaxation of *B* would be unwound on liquidation or sale of their partnership interests, the correction would occur after the original misallocation.

Time value of money principles dictate that deferring tax liability generally benefits taxpayers and hurts the government, because the taxpayers, and not the government, have the use of the money in the interim and can earn a return. As a result, by deferring tax liability, taxpayers would end up with money left over after investing the tax savings upfront and paying tax liability later.⁴⁹ In the context of section 704(c), the partners could reduce the joint, expected cost of their tax liability by shifting greater gain (or lower loss) to lower tax bracket partners upfront, in exchange for unwinding at a later point in time.

The legislative history in 1984 makes clear that Congress by this time had realized the costs from inter-partner shifting. In examining section 704(c), the Senate Report, House Report, and Joint Committee Report explicitly focused on the potential for partners to shift tax consequences between partners of different tax brackets. They explained that "a partner to whom gain could have been shifted in the absence of the Act's provisions could be tax-exempt, could have a lower marginal rate than the contributing partner, or could have expiring net operating loss carryovers."⁵⁰ That realization was central to the elimination of former section 704(c)(1) in 1984.⁵¹

On the other hand, the original assumption regarding perfect unwinding proved more durable. In discussing the possible shifting of losses that could result from misallocations under section 704(c), the Senate and Joint

⁴⁹ For a good description of this standard view, see Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 FLA. L. REV. 203, 222–24 (2009).

⁵⁰ S. REP. NO. 98-169, at 214 (1984); STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 212 (Comm. Print 1984); H.R. REP. NO. 98-432, at 1209 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 875–76.

⁵¹ H.R. REP. NO. 98-432, at 1209 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 875–76.

Committee Reports explained that "the pre-contribution loss would be effectively reallocated to the contributing partner" when the interests in the partnership were liquidated or sold.⁵² The legislative history did not otherwise address or challenge this standard assumption.

A 1984 ALI project regarding Subchapter K incorporated a slightly more advanced understanding. The 1984 ALI project started out with a standard example that assumed perfect unwinding (Basic Example): Partner *A* contributes Blackacre, which had a basis of 0 and a fair market value of \$1,000. Partner *B* contributes \$1,000 cash. After contribution, the partnership balance sheet is as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	1000	1000	<i>A</i>	0	1000 0
Blackacre	0	1000	<i>B</i>	1000	1000 1000
Total	1000	2000	Total	1000	2000 1000

Blackacre is later sold by the partnership for \$1,000. Thereafter, the partnership is liquidated and each of *A* and *B* receive \$1,000 cash. In this case, under old section 704(c)(1), \$500 of *A*'s built-in gain would be shifted to *B* on the sale of Blackacre. As a result, *B* would end up with \$500 too much gain (which is presumably capital gain) and *A* would end up with \$500 too little gain (which is presumably capital gain). The partnership balance sheet at this time would appear as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	2000	2000	<i>A</i>	500	1000 500
			<i>B</i>	1500	1000 1500
Total	2000	2000	Total	2000	2000 2000

On liquidation, *B* would recognize a \$500 capital loss, which would offset the earlier capital gain, and *A* would recognize \$500 capital gain, which would offset the capital gain previously shifted to *B*.⁵³ While the Basic Example displays the longstanding assumption of perfect unwinding,

⁵² S. Rep. No. 98-169, at 214 (1984); STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 212 (Comm. Print 1984).

⁵³ AMERICAN LEGAL INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER K, at 127 (1984).

the 1984 ALI project also briefly mentioned situations in which perfect unwinding may not occur. A footnote stated that if property, rather than cash, were distributed on liquidation, the unwinding would be delayed because the partners would not recognize the offsetting gain and loss on liquidation.⁵⁴ The 1984 ALI project also mentioned that if depreciation were misallocated, an ultimate capital gain or loss on unwinding would not perfectly offset the prior misallocations, because the offsetting capital gain and loss would be of a different character.⁵⁵ Nonetheless, unlike with inter-partner shifting, a changing understanding regarding the perfect unwinding assumption did not take center stage in the rethinking of section 704(c) in 1984. Despite some recognition of problems with the perfect unwinding assumption by the 1984 ALI project, in making changes to section 704(c) in 1984 Congress did not appear to focus on the possibilities of: (1) unwinding not occurring on liquidation, and / or (2) character shifts occurring at the time that the ceiling rule misallocation was ultimately unwound (“extended delays and character shifts”).

In some ways mirroring its intermediate evolution in thought regarding the section 704(c) allocations, Congress eliminated prior section 704(c)(1), thereby reducing the incidence of, but not eliminating, possible misallocation. As a result, partners could no longer ignore entirely the built-in gain and loss on contribution. Instead, Congress implemented as the new rule the current provision, which states:

Under regulations prescribed by the Secretary—

income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.⁵⁶

Even with the change, Congress did not *eliminate* the possibility of misallocations in 1984 because it did not eliminate the ceiling rule from the new section 704(c) regime. The legislative history of the 1984 changes to section 704(c) seemed to contemplate that the ceiling rule would continue to apply. As discussed previously, the ceiling rule applied under section 704(c)(2) prior to 1984. Both the House Report and the conference report in 1984 stated that the regulations for the new law “generally will provide

⁵⁴ *Id.* at 127 n.1.

⁵⁵ *Id.* at 128.

⁵⁶ I.R.C. § 704(c)(1)(A).

for the same result that is achieved under present law.”⁵⁷ These statements suggested that the ceiling rule would remain in place.⁵⁸ At the least, the 1984 legislative changes left open the possibility that the ceiling rule would continue to apply under the new section 704(c) regime. When the Treasury Department eventually issued regulations regarding the new section 704(c) regime, it retained the traditional method accompanied by the ceiling rule as one of the permissible methods.

Commentators have suggested that the Treasury Department did so because, perhaps in part based on the legislative history fleshed out above, it did not believe it had the authority to overrule the ceiling rule.⁵⁹ In any event, the 1984 changes to section 704(c) ended up being a partial evolution. They reduced the incidence of misallocations, but allowed them to continue as a result of retaining the traditional method with the ceiling rule as a permissible allocation method under section 704(c). This partial evolution in the state of section 704(c) in 1984 reflected and perhaps arose out of the partial evolution in understanding. While Congress had realized the inter-partner shifting costs that the misallocations created, Congress did not appear to reexamine its earlier assumption of perfect unwinding.

C. Post 1984: A Mixed Bag

Partnership tax experts since 1984 have continued to rely, at least to some extent, on the perfect unwinding assumption, despite having examined various situations in which perfect unwinding does not occur. Partnership tax experts sometimes implicitly assume perfect unwinding on sale or liquidation of a partner's interest.⁶⁰ Other times, partnership tax

⁵⁷ H.R. REP. NO. 98-432, at 1209 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 875–76; H.R. REP. NO. 98-861, at 855 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1543.

⁵⁸ There is some argument to be made that Congress was not fully aware that existing law would result in misallocations. After explaining its anticipation that the new regulations “generally will provide for the same result that is achieved under present law when a partnership elects [to apply section 704(c)(2)],” the conference report stated, “Thus, it will not be possible to shift built-in gain or loss from the contributing partner to the other partners.” H.R. REP. NO. 98-861, at 855 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1543. This latter statement is either misleading or wrong. For the reasons illustrated previously, the ceiling rule (which applied under existing section 704(c)(2)) created possible misallocations of gain from the contributing partner to other partners. By both stating that the same results should be reached under the new section 704(c) regime and that such a regime would prevent misallocations, the report potentially reflected some misunderstanding about the role of the ceiling rule in the section 704(c) regime.

⁵⁹ *See, e.g.,* Cunningham, *Use and Abuse of Section 704(c)*, *supra* note 34, at 116–17.

⁶⁰ *See, e.g.,* Monroe, *supra* note 34, at 1402–03 (discussing how delay between misallocations and unwinding on sale or liquidation can be costly for government, but not contemplating extended delays or character shifts).

experts assume pieces of the perfect unwinding story. For instance, they may focus on liquidation as an unwinding opportunity (without mentioning possible extended delays or character shifts),⁶¹ or suggest that the misallocations will be offset only on liquidation or sale of a partner's interest in the partnership.⁶²

Partnership tax experts have also continued to make use of the same type of Basic Example set forth in 1984, and even before that, in 1954, in describing the operation of section 704(c) and the ceiling rule. Post-1984 iterations of the Basic Example involve the formation of a partnership by two partners, through the contribution of property (Property A) by one partner (who we can call *A*) and the contribution of cash by the other partner (who we can call *B*). Property A has built-in capital gain. Sometime after the contributions, the partnership sells Property A and recognizes gain for tax purposes, but a loss for book purposes. As a result, on sale of the property the application of the ceiling rule results in *A* being undertaxed and *B* being overtaxed, relative to book. Sometime after the sale, the partnership liquidates. On liquidation, the partnership distributes to *A* and *B* the original cash contributed by *B* plus the cash now held by the partnership as a result of the sale of Property A. The liquidation results in capital gain to *A* and capital loss to *B*. As a result, the liquidation perfectly offsets the earlier ceiling rule misallocations.⁶³ While sometimes even partnership tax experts who rely on variations of this Basic Example also offer slight complications,⁶⁴ the Basic Example and the assumption of perfect unwinding historically at the heart of it persist.

⁶¹ See, e.g., Howard E. Abrams, *Dealing with the Contribution of Property to a Partnership Part I*, 1 No. 6 BUS. ENTITIES 16, 19-20 (exploring how "book/tax disparities . . . will remain until the partnership is liquidated"). Abrams is technically correct that book/tax disparities will, indeed, be eliminated upon liquidation, because there will be no more book and tax accounts. But to the extent that the liquidation does not result in gain or loss offsetting the prior gain or loss misallocations, the elimination of the book/tax disparities will not offset the prior misallocations. Hence, this is a good example of a technically true statement, which nonetheless seems to rely to some extent on the perfect unwinding assumption, or at least not challenge it directly. As a result, the statement, while true, continues the viability of the perfect unwinding assumption).

⁶² Michael G. Frankel et al., *Final Allocation Regulations Still Permit Planning to Avoid Impact of the Ceiling Rule*, 80 J. TAX'N 271, 276 (1994) (recognizing, though not discussing, potential character shifts and looking to liquidation and sale as the moment of unwinding).

⁶³ See, e.g., Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 547, 561-62 (1986) (making use of such an example).

⁶⁴ For instance, after setting forth the Basic Example, described above, Lokken notes that misallocations of depreciation may be corrected with a capital gain or loss on liquidation. *Id.* at 563-64 n.38. As suggested previously, this set of facts would result in the conversion of character of income.

On one level, relying on aspects of the perfect unwinding assumption and variations of the Basic Example in order to describe the operation of section 704(c) and the ceiling rule is entirely reasonable. Section 704(c) is extremely complex. Describing it at a basic level means omitting many complications. Additionally, in order to focus on any particular aspect of section 704(c), it is often necessary to make simplifying assumptions about other aspects of the provision.⁶⁵ It is also worth emphasizing that when partnership tax experts use the Basic Example, the analysis (assuming the facts given) is entirely correct. The assumption of perfect unwinding and the Basic Example, therefore, can play a valuable role in making description and analysis regarding an extraordinarily complicated provision tractable. Nonetheless, on another level, the continuing reliance on aspects of the perfect unwinding assumption and variations on the Basic Example can begin to obscure a more complex reality.⁶⁶

⁶⁵ Cf. John D. Steines, Jr., *Partnership Allocations of Built-In Gain or Loss*, 45 TAX L. REV. 615, 647 (1990) (“The inherent complexity of analyzing built-in items demands unrealistically simple illustrations, such as the basic hypothetical where C contributes appreciated property and D contributes cash.”).

⁶⁶ The Basic Example is actually so oversimplified that it is questionable whether the so-called partnership often described in the Basic Example would qualify as a partnership at all. In section 761(a), a partnership is defined as “any business, financial operation, or venture.” The code section elaborates that the Secretary may exclude an organization from partnership tax treatment “if it is availed of . . . for investment purposes only and not for the active conduct of a business.” I.R.C. § 761(a)(1). A long line of cases attempts to flesh out this definition. The touchstone for a partnership under this line of cases has been, “whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.” *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). More recently, the so-called “check-the-box regulations,” which govern choice of entity classifications, have added that in order to be able to qualify as a partnership for tax purposes, an organization must first qualify as a “separate entity for federal tax purposes.” To qualify as a “separate entity for federal tax purposes,” the participants must “carry on a trade, business, financial operation, or venture and divide the profits therefrom.” Treas. Reg. § 301.7701-1(a)(2) (2013). The regulations elaborate that “mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.” *Id.* The so-called “partnership” in the Basic Example does not seem to “carry on” a business and may or may not constitute the conduct of an enterprise. On liquidation, the only cash that the partnership distributes is the original cash contributed by *B* and the cash obtained through sale of Property A. This suggests that the partnership’s sole function appears to be a sale of Property A, followed by liquidation. The simplification at the heart of the Basic Example thereby threatens to render the “partnership” in the Basic Example not even a partnership at all for tax purposes. In a way, then, the simplification that the Basic Example relies upon to help make the analysis tractable is so great that it becomes questionable how useful the Basic Example really is for real world partnerships.

To be sure, partnership tax experts since 1984 have also, to varying degrees, recognized that the ceiling rule misallocations might not be unwound on liquidation or sale of a partnership interest. For instance, partnership tax experts have suggested that the offsetting gain or loss on liquidation may not be of the same character as the original misallocation.⁶⁷ These discussions have often focused on situations in which the original misallocation is ordinary, and the ultimate reversal is capital.⁶⁸ Some partnership tax experts have provided more detailed examinations. For instance, R. Donald Turlington explored, to some extent, how the unwindings will not necessarily occur on liquidation, and the possible conversion of too much capital gain into eventual ordinary loss.⁶⁹ All of these discussions by partnership tax experts have been important. The common assumption of perfect unwinding nevertheless has continued alongside these discussions. And there is more to the story than what has been examined thus far.

IV. UNWINDING THE CEILING RULE MISALLOCATIONS

This part sets forth in detail the situations in which the perfect unwinding assumption may not apply. The many possibilities reveal that whether or not the ceiling rule misallocations are unwound on liquidation or sale of a partnership interest depends on: (1) a variety of relatively arbitrary

⁶⁷ See, e.g., STEPHEN A. LIND ET AL., *FUNDAMENTALS OF PARTNERSHIP TAXATION* 164 (5th ed. 1998) (“B’s loss on liquidation or sale of his partnership interest would be a capital loss while the gain on the sale of the depreciable property might be ordinary as a result of depreciation recapture.”); RICHARD M. LIPTON ET AL., *PARTNERSHIP TAXATION* 115, 117–18 (2008) (explaining that “the character of the gain and loss recognized on liquidation could be different than that associated with the land and the liquidation may occur years after disposition of the land”); Gregory Marich & William McKee, *Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 *TAX L. REV.* 627, 640–41 (1986) [hereinafter *Shortcomings of Existing Regulations*] (“When the partnership is liquidated or the partners sell their partnership interests, shifts of built-in gain attributable to ceiling rule limitations of depreciation or depletion may finally be corrected, but at the cost of potentially significant timing and character distortions.”); ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, *PARTNERSHIP TAXATION* 10-135 (7th ed. 2013) (discussing how “the disposition of the partnership interest could result in capital gain or loss, whereas a sale of, or depreciation, or amortization of, the contributed property could have resulted in ordinary income or deduction”).

⁶⁸ See WILLIS & POSTLEWAITE, *PARTNERSHIP TAXATION*, *supra* note 67; see also YIN & BURKE, *supra* note 34, at 166 (“[T]he reversal may be imperfect once income character is taken into account. The initial income shift may be of ordinary income or loss, whereas the reversed amount of gain or loss is almost always capital in nature.”).

⁶⁹ See, e.g., Donald Turlington, *Section 704(c) and Partnership Book-Tax Disparities, The Ceiling Rule and the Art of Tax Avoidance*, 46 *INST. ON FED. TAX’N* § 26-21 (1988).

facts regarding the assets held by the partnership on either liquidation or sale, and (2) the unintended interactions of inordinately complicated partnership tax rules. The result is a somewhat haphazard system of taxation.

A. Liquidations

As an initial matter, it is worth emphasizing that unwinding on liquidation is actually the statutory exception, rather than the rule. Section 731(a)(1) dictates that on distribution to a partner, gain shall not be recognized, except to the extent that any money distributed exceeds the partner's outside basis in the partnership, immediately prior to the distribution.⁷⁰ Section 731(a)(2) dictates that a partner shall not recognize loss on receipt of a distribution, except if no property other than money or unrealized receivables or inventory is distributed.⁷¹ In such a case, the partner may recognize loss to the extent that the partner's outside basis in the partnership prior to the distribution exceeds the sum of the money distributed and the basis of the unrealized receivables and inventory.⁷² Ceiling rule misallocations to a partner can be unwound on liquidation of that partner only to the extent that gain or loss is recognized on liquidation of that partner. As a result, only in the limited circumstances in which the statute permits gain or loss to be recognized on liquidation will the ceiling rule misallocations be unwound on liquidation.

For instance, take Example 3, as set forth above. After the partnership sold Property A, it had \$150: \$50 from the sale of Property A, and \$100 from partner B's original contribution. There had also been a ceiling rule misallocation, whereby partner A had recognized \$25 too little gain for tax purposes, and partner B had recognized \$25 too little loss for tax purposes. After the sale of Property A, the partnership balance sheet appeared as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	150	150	A	50	75 50
			B	100	75 100
Total	150	150	Total	150	150 150

⁷⁰ I.R.C. § 731(a)(1).

⁷¹ I.R.C. § 731(a)(2).

⁷² *Id.*

Of course, given this set of facts, if the partnership immediately liquidated and distributed the cash (which would occur in the Basic Example often used to describe section 704(c)), the misallocations would be offset. This would occur because, immediately prior to liquidation, *A* has an outside basis of \$50 and *B* has an outside basis of \$100.⁷³ When they each receive \$75 on liquidation of the partnership, *A* would recognize a \$25 gain and *B* would recognize a \$25 loss, which would offset the prior misallocation. The respective gain and loss would be capital,⁷⁴ ensuring perfect unwinding if Property A is a capital asset.

In the case of any number of alternative sets of facts, the misallocation would not actually be unwound on liquidation. Beginning with partner *B*, imagine that the partnership had used cash to purchase another capital asset (Property B). If the partnership distributed Property B to partner *B*, partner *B* would not recognize gain or loss on liquidation. Rather, *B* would take a basis in Property B equal to *B*'s outside basis in the partnership immediately prior to the distribution.⁷⁵ As a result, the misallocation occurring from the ceiling rule would not be unwound on liquidation. Instead, it would be preserved in Property B and the misallocation may not be unwound until sale of Property B, potentially resulting in an extensive delay in unwinding.

If the partnership distributes either inventory or unrealized receivables, any number of outcomes might occur, and only by happenstance would the misallocation be offset by the correct amount of loss on liquidation. Imagine, for instance, that the partnership used the \$150 it had after sale of Property A to purchase a number of items of inventory.⁷⁶ If the partnership distributes to *B* inventory with a basis equal to or greater than *B*'s outside basis of \$100, *B* will take a basis of \$100 in such inventory.⁷⁷ As a result, just as with the distribution of a capital asset, *B* will not recognize a loss on liquidation. Instead, the loss will be preserved in the inventory, potentially resulting in an extensive delay in unwinding.

Perhaps more interestingly, if the partnership distributes to *B* inventory with a basis less than \$75, *B* would actually recognize more loss on liquidation than necessary to offset the ceiling rule misallocation, and this greater loss may not correspond with a real economic loss. For instance, imagine that the value of *B*'s partnership interest has not changed since the

⁷³ I.R.C. § 722.

⁷⁴ I.R.C. § 731(a).

⁷⁵ I.R.C. § 732(b).

⁷⁶ All of the cash is being turned into inventory to eliminate complexities presented by section 751(b).

⁷⁷ I.R.C. § 732(b), (c).

sale of Property A. As a result, *B* is still entitled to a distribution worth \$75 from an economic perspective. The partnership purchased a number of different items of inventory after the sale of Property A, including both inventory that appreciated in value and inventory that depreciated in value. The partnership distributes inventory that appreciated in value to *B* on liquidation. The inventory has a basis of \$10 and a value of \$75. In this situation, *B* will recognize a loss of \$90 on distribution of the inventory on liquidation.⁷⁸ Partner *B* will recognize such a loss because *B* cannot inflate the basis of the inventory on liquidation.⁷⁹

After the liquidation, *B* will hold the inventory worth \$75 with a basis of \$10. On eventual sale of the inventory (assuming the inventory retains its value of \$75), *B* would recognize a gain of \$65. The \$65 gain minus the \$90 loss would net out to the \$25 loss necessary to offset the original ceiling rule misallocation. The ultimate, correct result, however, would not occur until eventual sale of the inventory, again resulting in a potential, extensive delay. In this particular instance, the liquidation would actually result in an inflated loss, relative to the correct loss necessary to offset the ceiling rule misallocation.⁸⁰

If, instead, the partnership distributed to *B* inventory with a basis of more than \$75 but less than \$100, *B* would recognize a loss on liquidation, but not the full \$25 loss necessary to offset the prior ceiling rule misallocation.⁸¹ The remainder of the \$25 loss would be preserved in the inventory and deferred until eventual sale of the inventory. The only way *B* would recognize the exact \$25 loss necessary to offset the ceiling rule misallocation on liquidation would be if *B* were to receive inventory (or a combination of inventory, unrealized receivables, and cash) with basis of exactly \$75. While certainly possible, this outcome is just one possibility among many.

A very similar set of possibilities exists with respect to the liquidation of partner *A*, although there is arguably an even smaller chance of unwinding on liquidation for *A* because the possibility of gain recognition on liquidation is even smaller than the possibility of loss recognition. If the partnership acquires and then distributes a capital asset to partner *A*, the outcome is the mirror image of what would happen as a result of a property distribution to partner *B*. Partner *A* would take a basis in the capital asset

⁷⁸ I.R.C. § 731(a)(2).

⁷⁹ *Id.*

⁸⁰ The cost of the accelerated loss in this case, offset by later gain, would be that the loss would be capital and would be offset by ordinary income on sale. I.R.C. § 731(a). Character conversion issues are discussed in the text to follow. For now, it is worthwhile to focus on when unwinding would actually occur on liquidation.

⁸¹ I.R.C. § 731(a)(2).

equal to *A*'s outside basis immediately prior to liquidation,⁸² and the ceiling rule misallocation would be perpetuated until eventual sale of the capital asset.

Unlike with partner *B*, a distribution of inventory or unrealized receivables would never offset the prior ceiling rule misallocation to partner *A*, because a distribution of inventory and unrealized receivables cannot result in gain recognition.⁸³ Indeed, the distribution of inventory or unrealized receivables with a basis less than *A*'s outside basis immediately prior to the distribution may result in loss to *A*.⁸⁴ The prior ceiling rule misallocation would persist.

Furthermore, the additional loss recognized on liquidation, which may not reflect an economic loss, may also have to be offset at a later point in time. For instance, imagine that *A*'s partnership interest remains worth \$75 at the time of liquidation. The partnership distributes appreciated inventory to *A*, which has a basis of \$10 and a fair market value of \$75. Partner *A* would actually recognize a loss of \$40 on the liquidation, which would not reflect an economic loss.⁸⁵ Rather, it would reflect the relatively arbitrary fact that inventory with a basis of \$10 was being distributed on liquidation to a partner who happened to have an outside basis of \$50 at the time. In this circumstance, the ceiling rule misallocation would go uncorrected at liquidation. The allocation of noneconomic tax loss to *A* would exacerbate the ceiling rule misallocation, at least on a temporary basis.⁸⁶

The only set of facts that would result in unwinding of the ceiling rule misallocation on liquidation of partner *A* would be a distribution of money in excess of *A*'s outside basis on liquidation.⁸⁷ Even if money is distributed to *A*, the combination of a distribution of money and other property (including inventory or unrealized receivables) would perpetuate at least part of the misallocation until later sale or disposition of the other property.⁸⁸ In short, to an even greater extent than with partner *B*, the actual unwinding of the ceiling rule misallocation on liquidation of partner

⁸² I.R.C. § 732(b).

⁸³ I.R.C. § 731(a)(1).

⁸⁴ I.R.C. § 731(a)(2).

⁸⁵ *Id.*

⁸⁶ Here, as before with partner *B*, the cost of the additional loss would be that the loss would be capital, whereas the future gain would presumably be ordinary.

⁸⁷ I.R.C. § 731(a)(1). Relief from debt would also be considered a distribution of money for these purposes. I.R.C. § 752(b).

⁸⁸ This would occur because, to the extent that other property was distributed, such property would reduce the money distribution. Only a distribution in cash of the full fair market value of partner *A*'s partnership interest (*i.e.*, \$75) would produce the gain recognition of \$25, as a result of receiving money in excess of outside basis.

A remains just one possibility. A number of other possibilities exist, in which the ceiling rule misallocation would not be unwound on liquidation of partner *A*.

Moreover, putting aside the potential for extensive delays, possibilities abound for character shifts on unwinding of the misallocations, either at the time of the liquidation or sometime after the liquidation. As an initial matter, there are many straightforward situations that would predictably create a character mismatch between the original misallocation and the correcting allocation of income or loss. In perhaps the most straightforward case, the character of the original misallocation may be ordinary, whereas the ultimate correction may be capital.⁸⁹ Take the facts of Example 4. The partnership balance sheet after contribution in Example 4 was as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	100	100	<i>A</i>	20	100	20
Property A	20	100	<i>B</i>	100	100	100
Total	120	200	Total	120	200	120

In this example, the noncontributor, partner *B*, would be allocated \$5 a year of depreciation for book purposes, but only \$2 a year of depreciation for tax purposes. As a result, over the life of the property, *B* would take \$30 too little depreciation for tax purposes, relative to the book result. Partner *A* would correspondingly fail to take into account \$30 of the built-in gain in Property A over the life of the property. If the partnership eventually liquidated the partners with only cash, the liquidation would produce capital loss for partner *B* and capital gain for partner *A*.⁹⁰ The foregone tax depreciation deductions, however, would have been ordinary deductions to *B*.⁹¹ Any foregone depreciation deductions to *A* (and possible recapture on the property if the property were sold) would also be ordinary in nature.⁹² As a result, *B* recognized too little ordinary deductions over the life of the property, and *A* recognized too little ordinary income. To the extent that a cash liquidation occurs, the ordinary misallocations would be offset by capital gain or loss.

⁸⁹ As noted previously, this situation is the one that has received the most attention thus far by partnership tax experts.

⁹⁰ I.R.C. § 731(a).

⁹¹ I.R.C. § 167.

⁹² I.R.C. §§ 167, 1245.

Of course, various other possible outcomes exist after the ceiling rule misallocation in Example 4, and only in some of these other possibilities would a character shift occur. For instance, if the partnership acquires all ordinary income property⁹³ and distributes such property on liquidation, the gain or loss ultimately recognized by the partners on sale of the property would be ordinary. In such a case, the character shift would not occur. If, instead, the partnership were to acquire all property that would produce a capital gain or loss, then a distribution of such property to the partners on liquidation would eventually yield a character conversion. To make matters even more complicated, property that is ordinary income property to the partnership may be capital gain or loss property to the partners, and vice versa.⁹⁴ For instance, even if the partnership acquires property that is inventory in the partnership's hands, if the partner is not a dealer in such property, the property may produce capital gain or loss in the partner's hands. As a result, even if the partnership acquires property that is inventory in the partnership's hands, if the partnership distributes the property to a partner on liquidation and the partner waits more than five years to sell the property, the partner may recognize capital gain or loss on the sale.⁹⁵ In such a case, if the earlier misallocation was a misallocation of depreciation, a conversion of character would again occur.

As one might by now imagine, a wide array of possibilities also exists with respect to Example 3, in which a sale of property created the misallocation. In Example 3, if Property A were ordinary income property, then the misallocation resulting from the ceiling rule would be ordinary. Later distribution of cash or a capital asset would result in an offset that would be capital.

The flip set of circumstances is also possible. Property A in Example 3 may be a capital asset. After the sale of Property A, the partnership may purchase all assets that produce ordinary income.⁹⁶ Distribution of such assets on liquidation would mean that the ultimate (albeit, extensively delayed) unwinding would be ordinary in nature, thereby creating a shift from capital gain (loss) to ordinary loss (gain). In this context as well, property that is inventory in the partnership's hands may not be inventory in

⁹³ The assumption of acquisition of all ordinary income property again is made to eliminate potential complexities from section 751(b).

⁹⁴ See I.R.C. § 1221(a)(1) (excluding from the definition of capital asset "stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business").

⁹⁵ I.R.C. § 735(a)(1).

⁹⁶ This assumption is again being made so as to eliminate potential complexities from section 751(b).

the hands of the partner.⁹⁷ As a result, even if the original misallocation was ordinary in nature and the partnership distributes property that is inventory in the partnership's hands, if it is not inventory in the distributee partner's hands and the distributee partner waits more than five years to sell the property, there will again be a shift of character.⁹⁸

The extent to which the ceiling rule misallocation actually gets unwound without a permanent shift in character of income therefore depends on an almost overwhelming number of facts, including: (1) what assets the partnership holds on liquidation, (2) what the partnership distributes to which partners, (3) what the tax profiles of such partners are (i.e., whether the partners are dealers or not with respect to various properties, questions that do not have anything to do with the partnership itself), and, potentially, (4) how long the partner holds any distributed asset prior to selling it (which affects whether or not the character of the gain or loss on sale will be dictated by the character that would have resulted at the partnership level).⁹⁹

B. Sales of Partnership Interests

Unlike liquidations, sales of partnership interests will always unwind prior ceiling rule misallocations. The rules regarding sales of partnership interests nonetheless can result in conversion of the character of the allocated income and loss. Moreover, as a result of the combination of the ceiling rule and the rules regarding sales of partnership interests, the sale of a partnership interest itself can result in a ceiling rule misallocation. Character conversion can accompany those misallocations as well. The application of the ceiling rule on sale of a partnership interest can also create surprising errors in taxation for the new, purchasing partner.

As an initial matter, while sales of partnership interests always unwind prior ceiling rule misallocations, the unwindings can yield permanent character conversions. Imagine, for instance, that *W*, *X*, *Y*, and *Z* form a partnership. Partner *W* contributes inventory, an ordinary income asset with a basis of \$50 and a fair market value of \$100 at the time of contribution. Partner *X*, partner *Y*, and partner *Z* each contributes cash of \$100. Each of the partners has a 25% interest in profits, losses, and capital of the partnership. The partnership balance sheet after the contributions is as follows:

⁹⁷ I.R.C. § 1221(a)(1).

⁹⁸ I.R.C. § 735(a)(1).

⁹⁹ As intimated previously, gain or loss on the sale of inventory only retains its character as ordinary income if sold or exchanged within five years of the distribution. I.R.C. § 735(a)(1).

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	300	300	<i>W</i>	50	100	50
Inventory	50	100	<i>X</i>	100	100	100
			<i>Y</i>	100	100	100
			<i>Z</i>	100	100	100
Total	350	400	Total	350	400	350

The partnership then sells its inventory for \$80. If the partnership applies the traditional method for making section 704(c) allocations, the ceiling rule will apply on sale. *W*, *X*, *Y*, and *Z* will each be allocated a \$5 loss for book purposes.¹⁰⁰ Partner *W*, however, will be allocated a \$30 gain for tax purposes.¹⁰¹ This will understate by \$15 the gain *W* has actually experienced over the life of Inventory from an economic perspective. *X*, *Y*, and *Z* will not be allocated any tax loss. As a result, each will be allocated \$5 too little tax loss, relative to the loss they experienced from an economic perspective. Since the relevant property is ordinary income property, *W*, the contributing partner, has been allocated too little ordinary gain and the noncontributing partners have been allocated too little ordinary loss. The partnership balance sheet after the sale is as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	380	380	<i>W</i>	80	95	80
			<i>X</i>	100	95	100
			<i>Y</i>	100	95	100
			<i>Z</i>	100	95	100
Total	380	380	Total	380	380	380

Now imagine that the partnership uses the \$80 cash from the sale of its inventory to purchase a capital asset, Property C, and that Property C retains its value of \$80 until the time that *W* sells her partnership interest. The partnership balance sheet appears as follows at the time that *W* sells her partnership interest.

¹⁰⁰ See Treas. Reg. § 1.704-3(b)(2), ex. (1)(iii) (2013).

¹⁰¹ *Id.*

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	300	300	<i>W</i>	80	95 80
Property C	80	80	<i>X</i>	100	95 100
			<i>Y</i>	100	95 100
			<i>Z</i>	100	95 100
Total	380	380	Total	380	380 380

Partner *W* sells her partnership interest to *N* for \$95, reflecting *W*'s one-fourth interest in the \$300 cash and Property C. The rules governing sales of partnership interests dictate that the selling partner, *W*, must determine what, if any, of her amount received on sale of her partnership interest is attributable to inventory or unrealized receivables (both of which produce ordinary income).¹⁰² To the extent that any of *W*'s amount received is attributable to inventory or unrealized receivables, the money or fair market value received is considered received in exchange for ordinary income property.¹⁰³ The remainder of the amount received is considered received in exchange for a capital asset.¹⁰⁴

In this case, the partnership holds no inventory or unrealized receivables at the time of the sale of *W*'s interest to *N*, so there would be no amounts received attributable to such items. The entire gain or loss on sale of *W*'s partnership interest to *N* would be capital. As a result, the earlier misallocation of too little ordinary gain to *W* would be converted to capital gain. The mirror image of this result would apply if any of the noncontributors were the selling partner. The earlier misallocations of too little ordinary loss to the noncontributors would be converted into capital loss on the sale of any of their partnership interests.

Even if the partnership held inventory or unrealized receivables at the time of the sale of any of the partners' interests to *N*, the character conversion would still occur. In order to determine the amount of any gain or loss that is characterized as ordinary on the sale of a partner's interest, one must imagine a hypothetical sale of all inventory and unrealized receivables (section 751(a) property) immediately prior to the selling partner's transfer of her partnership interest.¹⁰⁵ Any gain or loss allocable to the selling partner from such sale is ordinary gain or loss to the selling

¹⁰² See I.R.C. § 751(a), (c), (d).

¹⁰³ Treas. Reg. § 1.751-1(a)(1) (2013).

¹⁰⁴ *Id.*

¹⁰⁵ Treas. Reg. § 1.751-1(a)(2) (2004).

partner.¹⁰⁶ It is not enough, then, for the partnership to hold section 751(a) property on sale of a partner's interest in order for ordinary income or loss to result. Rather, there must be gain or loss built into such property at the time of sale. To the extent that any ordinary income or loss is built into any ordinary income property purchased by the partnership, the resulting ordinary income or loss would reflect the separate gain or loss in such ordinary income property.

Taking into account such gain or loss would not correct the prior ceiling rule misallocation. Instead, by taking the hypothetical sale approach and viewing any remaining gain or loss as capital, the rules governing sales of partnership interests systematically convert ordinary income and loss ceiling rule misallocations into capital gain or loss on sales of partnership interests. There is no obvious reason for such conversion. Rather, it results from the disconnect between the rules governing character determination for the sale of the property subject to the ceiling rule (which focus on the specific property being sold)¹⁰⁷ and the rules governing sales of partnership interests (which only require ordinary income or loss to the extent of gain or loss built into section 751(a) properties held by the partnership at the time of sale of partnership interest).¹⁰⁸

Perhaps more surprisingly, as a result of the interaction between the ceiling rule and the rules regarding sales of partnership interests, the sale of a partnership interest itself can create both a ceiling rule misallocation and a simultaneous character shift. Imagine, for instance, the following fact pattern. On January 1, 2010, *W*, *X*, *Y*, and *Z* form a partnership. On partnership formation, each partner makes the following contributions to the partnership: *W* contributes Greenacre, a capital asset; *X* contributes inventory; and *Y* and *Z* each contributes \$900 cash. At the time of contribution, Greenacre has a basis in *W*'s hands of \$900 and a fair market value of \$900 and the inventory has a basis in *X*'s hands of \$500 and a fair market value of \$900. Each of the partners has a one-fourth interest in profits, losses, and capital of the partnership. After the contributions, the partnership balance sheet appears as follows:

¹⁰⁶ *Id.*

¹⁰⁷ See I.R.C. § 702(b) (determining "the character of any item of income, gain, loss, deduction, or credit . . . as if such item were realized directly from the source from which realized by the partnership").

¹⁰⁸ Treas. Reg. § 1.751-1(a)(1) (2004).

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	1800	1800	<i>W</i>	900	900	900
Greenacre	900	900	<i>X</i>	500	900	500
Inventory	500	900	<i>Y</i>	900	900	900
			<i>Z</i>	900	900	900
Total	3200	3600	Total	3200	3600	3200

A year after partnership formation, at a time at which no material tax events have occurred in the partnership, *X* sells *X*'s interest in the partnership to *N* for \$1225. At the time of the sale, Greenacre has a fair market value of \$2400 and the inventory has a fair market value of \$700. Assume that the partnership applies the traditional method for making section 704(c) allocations. The partnership balance sheet appears as follows at this time:

ASSETS				CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB) AND FMV) ¹⁰⁹				
	Basis	Book	FMV		Tax	Book	OB	FMV
Cash	1800	1800	1800	<i>W</i>	900	900	900	1225
Greenacre	900	900	2400	<i>X</i>	500	900	500	1225
Inventory	500	900	700	<i>Y</i>	900	900	900	1225
				<i>Z</i>	900	900	900	1225
Total	3200	3600	4900	Total	3200	3600	3200	4900

In analyzing the outcome of the facts posed above, it is first important to recognize that *X* contributed built-in gain to the partnership whereas *W*, *Y*, and *Z* did not. As a result, partner *X* should take the built-in gain into account under section 704(c). *W*, *Y*, and *Z* should not have to take into account any variation between basis and fair market value prior to partnership formation.

Combining any built-in gain or loss contributed prior to the partnership with each partner's share of appreciation or depreciation after the formation of the partnership reveals what has happened to each partner from an economic perspective. From an economic perspective, *X* has experienced a net increase in the value of the inventory of \$350. Prior to the contribution of the inventory, *X* experienced an increase in value of the inventory of \$400. After the contribution of inventory, its value declined by \$200, and

¹⁰⁹ In analyzing the consequences of the sale in this case, it is essential to take into account fair market value. As a result, a fair market value column has been added to the asset and capital accounts sides of the balance sheet.

one-fourth of that decline, or \$50, is attributable to *X*'s interest. There has also been a \$1500 increase in the value of Greenacre since the formation of the partnership, and one-fourth of that increase, or \$375, is attributable to *X*'s interest as well.

W, *Y*, and *Z* each experiences a \$50 decrease in the value of the inventory after formation of the partnership ($\$200 \times 25\%$) and a \$375 increase in value in Greenacre ($\$1500 \times 25\%$). From an economic perspective, then, *X* has experienced a \$350 increase in the value of the inventory — a section 751(a), or ordinary income property — and a \$375 increase in value in Greenacre, a capital asset. Each of the other partners has experienced a \$50 decline in the value of the inventory — a section 751(a), or ordinary income property — and a \$375 increase in value in Greenacre, a capital asset. In order for the tax consequences to match the economics,¹¹⁰ *X* should recognize \$350 of ordinary income and \$375 of capital gain on sale of her partnership interest. If, instead, it was one of the noncontributors selling her partnership interest to *N*, the noncontributor should recognize a \$50 ordinary loss and \$375 of capital gain.

As a result of the combination of the ceiling rule and the rules governing sales of partnership interests, the correct economic results discussed above do not occur. When *X* sells her partnership interest to *N*, *X* first calculates overall gain or loss (as measured by amount realized minus outside basis). This amount is \$725 ($\1225 less $\$500$).¹¹¹ Partner *X* then must take into account as ordinary income any amounts required under section 751(a), which include *X*'s share of ordinary income from a hypothetical sale of the inventory.¹¹² Importantly, as a result of application of the ceiling rule, such amount is limited to \$200 for *X*.¹¹³ This occurs

¹¹⁰ Readers might notice that at this point the discussion focuses on tax following economic realities, as opposed to “book.” The reason is because sales of partnership interests are not a point in time at which revaluations of partnership property are permitted. *Cf.* Treas. Reg. § 1.704-1(b)(2)(iv)(f). As a result, strictly speaking, the appreciation and depreciation in value of the property that occur after formation of the partnership have not yet been reflected in the books of the partnership. Nonetheless, the economic analysis described in the text holds. As a result, it is accurate to discuss what would have to happen in order for tax to follow the economics, which is ultimately the most important analysis. In other situations, book is just standing in for economics.

¹¹¹ Treas. Reg. § 1.751-1(a)(2) (2013).

¹¹² *Id.*

¹¹³ The operative language to determine the amount of gain or loss from the sale of section 751(a) property is:

The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under § 1.704-3(d)) that would have been

because the value of Inventory has decreased to \$700 since contribution to the partnership. As a result, only \$200 of the original \$400 of built-in gain exists at the partnership level, and only \$200 of ordinary income can be taken into account by *X* under section 751(a). The remainder of *X*'s gain on sale of her partnership interest, or \$525, must be capital gain.¹¹⁴ As a result of the combination of the ceiling rule and the rules governing sales of partnership interests, *X*'s \$350 of ordinary income and \$375 capital gain from an economic perspective has been turned into \$200 of ordinary income and \$525 capital gain. The result is a conversion of \$150 ordinary income to capital gain.

A ceiling rule misallocation and character shift would also occur in the above example if it were any of the noncontributors who sold the partnership interest to *N*. Imagine, for instance, that *N* purchased the partnership interest from *Z* for \$1,225. Overall, *Z* would have a \$325 gain

allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership.

Treas. Reg. § 1.751-1(a)(2) (2013) (emphasis added). The language in italics suggests the possibility of remedial allocations. Remedial allocations would remedy the ceiling rule limitation. However, the language appears to permit, but not require, remedial allocations, thereby leaving the possibility of elective ceiling rule misallocations in place. The Treasury Department's historical view that it did not have authority to override the ceiling rule, *see* Cunningham, *Use and Abuse of Section 704(c)*, *supra* note 34, at 116–17, would seem to support the view that the Treasury Department has permitted, but not mandated, remedial allocations in the context of sales of partnership interests. Moreover, the Treasury Department preamble for the 1999 issuance of the current section 751(a) regulation (which regulation is set forth above) supports the notion that partnerships can choose, but are not required to apply remedial allocations for the hypothetical sales that will occur in the context of sales of partnership interests. The preamble discusses sales of partnership interests and explains that the partnership's choice of section 704(c) methods will dictate the recovery period for the purchasing partner's section 743(b) adjustment attributable to built-in gain. T.D. 8847, 1999-2 C.B. 701, 69,904. The preamble further states, "The IRS and the Treasury Department believe that under the current regulations under section 704(c), a partnership may use the remedial method under § 1.704-3, even where it is not readily apparent at the time the property is contributed that the ceiling rule will be applicable." *Id.* As such, the preamble clearly seems to contemplate the partnership's ability to choose a method under section 704(c) in the context of sales of partnership interests. The language "including any remedial allocations" seems designed to clarify that the remedial method *may* be applied on the hypothetical sale, at the partnership's option. In the preamble to the proposed regulations, the Treasury Department indicated as much, explaining that "the proposed regulations . . . coordinate sections 743 and 704(c) *when partnerships elect the remedial allocation method under* § 1.704-3(d)." 63 Fed. Reg. 4408-01, 1998-1 C.B. 944, 4409-10 (emphasis added).

¹¹⁴ Treas. Reg. § 1.751-1(a)(2) (2013).

on the sale of her partnership interests (\$1225 sale price less Z's \$900 outside basis).¹¹⁵ As discussed previously, for economic purposes Z has experienced a \$50 decline in the value of the inventory, a section 751(a), or ordinary income property, and a \$375 increase in value in Greenacre, a capital asset. In determining what, if any ordinary income gain or loss partner Z takes into account, the hypothetical sale approach applies.¹¹⁶

If the partnership were to sell all of its property in a fully taxable transaction for cash immediately prior to the transfer of Z's partnership interest, the ceiling rule would apply to the sale of the inventory. Although there has been a loss of \$200 for book purposes, there has been a gain of \$200 for tax purposes. As a result, no tax loss can be allocated to Z on the hypothetical sale of the inventory. Under the rules governing sales of partnership interests, any gain or loss that is not ordinary under section 751(a) will be capital.¹¹⁷ Partner Z, therefore, would recognize a \$325 capital gain on sale of her partnership interest. The combination of the ceiling rule and the rules governing sales of partnership interests has therefore converted a \$50 ordinary loss into a capital loss.

Those results are not intuitive. Only a detailed focus on the interaction between the ceiling rule and the rules governing sales of partnership interests reveals those outcomes. Even so, the results are quite difficult to justify. They can only be explained as the result of unintended interactions between multiple, complex partnership tax rules. In the case of sales of partnership interests in particular, the operation of the ceiling rule seems particularly arbitrary. Normally, the ceiling rule applies when there is an actual sale of partnership property, and therefore an actual partnership gain or loss. Under an entity conception of partnership tax, some might view such partnership gain or loss as limiting the amount of gain or loss that can be allocated to the partners. In the context of sales of partnership interests, however, there is no actual sale of the property subject to the ceiling rule. There is merely a hypothetical sale for the purposes of the rules governing sales of partnership interests. The value of the property subject to the ceiling rule at the time of the sale of the partnership interest therefore plays no role, other than as an arbitrary determination of whether or not the ceiling rule, and resulting character conversion, will apply. If the value of the section 751(a) property were such that the property were not ceiling-rule-limited at the time of the hypothetical sale, the distortions would not result.

¹¹⁵ I.R.C. § 722.

¹¹⁶ Treas. Reg. § 1.751-1(a)(1) (2013).

¹¹⁷ *Id.*

Indeed, the fact that there is no actual sale of the section 751(a) property extends the problematic effects of the ceiling rule. The application of the ceiling rule to the selling partner makes it difficult, if not impossible, to correctly tax the partners in the partnership on the property going forward. To understand this outcome, it is easiest to use the following example, with a very simplified set of facts. *W* and *X* form a partnership. On formation of the partnership, *W* contributes inventory. At the time of contribution, the inventory is worth \$1000 and has a basis of \$500. *X* contributes \$1000 cash. Each of the partners has a one-half interest in profits, losses, and capital of the partnership. The partnership applies the traditional method for making section 704(c) allocations. After the contributions, the partnership balance sheet appears as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))			
	Basis	Book		Tax	Book	OB
Cash	1000	1000	<i>W</i>	500	1000	500
Inventory	500	1000	<i>X</i>	1000	1000	1000
Total	1500	2000	Total	1500	2000	1500

No material tax events occur in the partnership from the time of the formation. At a time when the inventory is worth \$800, *W* sells her partnership interest to *N* for \$900. At this point in time, the partnership balance sheet is as follows:

ASSETS				CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB) AND FMV)				
	Basis	Book	FMV		Tax	Book	OB	FMV
Cash	1000	1000	1000	<i>W</i>	500	1000	500	900
Inventory	500	1000	800	<i>X</i>	1000	1000	1000	900
Total	1500	2000	1800	Total	1500	2000	1500	1800

Partner *W* has a total gain on sale of her partnership interest of \$400.¹¹⁸ From an economic perspective, *W* has experienced an ordinary gain of \$400 (the \$500 increase in the value of the inventory prior to contribution, minus the \$100 decrease in the value of the inventory attributable to *W* after contribution). If the partnership applies the traditional method for making section 704(c) allocations, however, only \$300 of ordinary gain can be allocated to *W*.¹¹⁹ The remaining \$100 of *W*'s gain would be capital,¹²⁰

¹¹⁸ *W* has an amount realized of \$900 and a basis of \$500 under section 722.

¹¹⁹ This is because the inventory would be sold for \$800 in the hypothetical sale.

thereby resulting in a conversion of \$100 of ordinary income into capital gain.

Even more problematic, though, is the distortion to *N* that might occur when the partnership sells the inventory. Imagine that after *N* purchases *W*'s partnership interest, the partnership sells the inventory for \$900. In this case, there is a book loss of \$100 on the sale. This book loss should be allocated equally between *N* and *X*, according to their interests in the partnership. Critically, because there was no actual sale of the inventory at the time of hypothetical sale (at the sale of *W*'s partnership interest), the inventory retains a basis of \$500 to the partnership.¹²¹ The sale of the inventory results in a tax gain of \$400. Such gain cannot be allocated to *X*, who experienced a loss with respect to the inventory. Instead, it must be allocated to *N*, who stands in for *W* with respect to the inventory, which was contributed by *W*.¹²²

Even if a special basis adjustment were made for *N* on purchase of *W*'s partnership interest, the special basis adjustment would reflect only the gain actually allocated on the hypothetical sale.¹²³ Specifically, the special basis adjustment would be \$300.¹²⁴ As a result, *N* would be allocated \$400 of tax

¹²⁰ Treas. Reg. § 1.751-1(a)(2) (2013).

¹²¹ I.R.C. § 723.

¹²² See Treas. Reg. § 1.743-1(j)(3)(ii) (2004) (providing examples of application of section 704(c) after sale of partnership interest).

¹²³ Here, too, there is some potential ambiguity in the regulatory language. The regulations provide that a transferee partner gets a special basis adjustment equal to the excess of the transferee partner's outside basis over the transferee's share of the adjusted basis to the partnership of the partnership's property. Treas. Reg. § 1.743-1(b). The transferee's share of the adjusted basis of partnership property is equal to the transferee's share of previously taxed capital plus share of partnership liabilities. Treas. Reg. § 1.743-1(d)(1). In this case, the transferee's share of previously taxed capital would equal the amount of cash the transferee would receive on liquidation immediately following the hypothetical sale of all partnership assets decreased by "[t]he amount of gain (*including any remedial allocations under § 1.704-3(d)*), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest)." Treas. Reg. § 1.743-1(d)(1)(iii) (2004) (emphasis added). However, as with Treas. Reg. § 1.751-1(a)(2) (2004), the regulations here seem designed to accommodate optional remedial allocations, but not require remedial allocations.

¹²⁴ The special basis adjustment would be calculated as follows:

New partner *N*'s outside basis in the partnership of \$900 — *N*'s share of previously taxed capital of \$600. The \$600 is determined by the \$900 of cash that *N* would receive on liquidation following the hypothetical transaction less the \$300 gain allocated from the hypothetical transaction, if the traditional method for making section 704(c) allocations is applied. Treas. Reg. § 1.743-1(b) (2004). The \$300 gain allocated from the hypothetical transaction would reflect the application of the ceiling rule.

gain on sale of the inventory, which would be reduced by *N*'s \$300 special basis adjustment. The net tax gain for *N* would be \$100.¹²⁵

To some extent, it is appropriate for *N* to experience a tax gain on sale of the inventory. The inventory has increased in value by \$100 since the purchase of *N*'s interest in the partnership. Nonetheless, only \$50 of that increase in value will be allocated (in the form of a reduced book loss) to *N*. As a result, *N* will have \$50 tax gain in excess of economic, or book gain. If a remedial allocation were made at the time of sale of the inventory, this problem would become even worse for *N*. The remedial allocation would provide *X* with a \$50 tax loss to match her \$50 book loss on the sale of the inventory.¹²⁶ Under the remedial method, this would presumably have to be matched with \$50 of tax gain for *N*.¹²⁷ The result would be an inclusion of \$150 of tax gain for *N*, whereas *N* experienced only a \$50 gain with respect to the inventory from an economic perspective. An additional \$100 of built-in gain from the inventory ended up being recognized on the actual sale of the inventory, relative to the amount taken into account by *W* on the hypothetical sale of the inventory at the time of *W*'s sale of partnership interest.

Since the ceiling rule previously limited the amount of built-in gain *W* actually had to take into account, *N* is left responsible for the additional built-in gain. New partner *N*, of course, did not contribute the inventory, but nonetheless is left holding the bag. The bottom line is that when the sale of the partnership interest itself yields ceiling rule distortions, not only are character conversions possible for the contributing and noncontributing partners, but also additional distortions (by way of overtaxation or undertaxation) may apply to the purchasing partner when the ceiling rule limited property is ultimately sold. Far from being perfectly unwound on sale of the partnership interest, the ceiling rule misallocations may only begin to do mischief on sale of a partnership interest.

In sum, the combination of the ceiling rule and the basic rules governing liquidations and sales of partnership interests creates the potential for extensive delays and character conversions. In many situations, unwinding will not occur on liquidation. With both liquidations and sales of partnership interests, permanent character conversions will occur in a wide array of possibilities. Sales of partnership interests may actually create ceiling rule misallocations, the effects of which may be long

¹²⁵ I.R.C. § 743(b).

¹²⁶ See Treas. Reg. § 1.743-1(j)(3)(ii), ex. 3 (2004) (describing application of remedial allocation method for sale of property subsequent to sale of partnership interest).

¹²⁷ See *id.*; Treas. Reg. § 1.704-3(d)(1) (2013) (mandating remedial item for contributor to offset remedial allocation to noncontributor).

lasting and may even be borne in part by a new, purchasing partner. It is difficult to justify situations in which perfect unwinding does not occur, when starting from the premise that any misallocations flowing from the ceiling rule are errors that should ultimately be corrected. Rather, whether and to what extent imperfect unwinding occurs depends on a variety of arbitrary facts regarding the assets the partnership holds at the time of liquidation or sale of a partnership interest and the interaction of such facts with inordinately complicated partnership tax rules. At bottom, a broad-based evaluation reveals that the combination of the ceiling rule and the rules governing liquidations and sales of partnership interests creates a somewhat haphazard, and difficult to justify, system of taxation.

V. A BROAD-BASED EVALUATION OF THE CEILING RULE

The unwinding issues examined here advance the broader case for elimination of the ceiling rule. The perpetuation of the ceiling rule creates an enormously complex tax regime, with unjustifiable planning opportunities that accrue to the well informed. The Treasury Department could potentially, and Congress could certainly, eliminate the ceiling rule. Nevertheless, Congress seems not to have done so in part based on mistaken assumptions that the impact of the ceiling rule is limited, as a result of unwinding on liquidation or sale of a partnership interest. Having thoroughly undermined these assumptions, this article displays that there is no reasonable justification for retaining the ceiling rule.

As an initial matter, the existence of the ceiling rule creates an extremely complex regime, so complex that it is even difficult to describe the rules. The section 704(c) regulations set forth three separate methods of making section 704(c) allocations: the traditional method, the traditional method with curative allocations, and the remedial method. The choice of methods only becomes important to the extent that a ceiling rule limitation would otherwise occur, because only in such situations will the three different methods produce different results.¹²⁸ The section 704(c) regime may therefore best be described as the choice between three different ways to address the ceiling rule problem.

In order to understand the section 704(c) regime and the impact that the choice of a particular method might have, taxpayers must understand and be

¹²⁸ See Treas. Reg. § 1.704-3(c)(1), -3(d)(1) (2013) (explaining that “to correct distortions created by the ceiling rule, a partnership using the traditional method under paragraph (b) of this section may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners,” and that “a partnership may adopt the remedial allocation method described in this paragraph to eliminate distortions caused by the ceiling rule.”).

able to predict when a ceiling rule limitation might occur. Taxpayers contributing depreciable property with tax basis less than the book value attributable to the noncontributing partners should realize that a ceiling rule limitation will likely occur.¹²⁹ On the other hand, whether or not nondepreciable, contributed property will create a ceiling rule limitation will depend on the ultimate sale price of the property, a fact often unknowable at the time of the contribution.¹³⁰ The existence of the ceiling rule therefore in many cases makes section 704(c) a choice between methods if a given set of contingent facts occurs.

To make matters significantly more complicated, Congress at least partially repealed the ceiling rule in 2004 in the case of losses. Congress did so in 2004 by putting in place section 704(c)(1)(C), which provides:

(C) if any property so contributed has a built-in loss—

(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

¹²⁹ To understand this assertion, imagine that *A* contributes depreciable property with a fair market value (and therefore book value) at the time of contribution of \$300. The partnership is an equal one-third partnership, in which each of *A*, *B*, and *C* holds a one-third interest in all partnership income, losses, and capital. Based on these facts, \$100 in book value from the contributed property will be allocated to each of *B* and *C*. They will each be entitled to take depreciation for book purposes of \$100 for the contributed property. See Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) (2013). As a result, the contributed property must have at least \$200 of tax basis in order for *B* and *C* to be able to depreciate for tax purposes an amount equal to their book depreciation. The analysis is more complex if there is a sale prior to full book depreciation.

¹³⁰ See *Shortcomings of Existing Regulations*, *supra* note 67, at 650 (“Unlike ceiling rule limitations of depreciation or depletion, ceiling rule limitations of gain or loss are attributable to post-contribution changes in value.”); Barksdale Hortenstine & Gregory J. Marich, *An Analysis of the Rules Governing Partnership Allocations with Respect to Contributed Properties: The Final Regulations Under Section 704(c)(1999)*, reprinted in THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, Tax 799, 39–40 (Louis S. Freeman ed., 6 vol., 2011) [hereinafter *An Analysis of the Rules*] (discussing the limited potential for abuse of the ceiling rule in the case of sales, as a result of the difficulty in predicting the application of the ceiling rule).

By indicating that built-in losses can only be taken into account by contributing partners, the provision seems to dictate that the ceiling rule will not apply in the case of a contribution of built-in loss property. Imagine the following facts: *A* and *B* form a partnership. Partner *A* contributes Property A in exchange for a one-half interest in all partnership profits, losses, and capital. Property A has a basis in *A*'s hands of \$200 and a fair market value of \$50 – a built-in loss of \$150. *B* contributes cash of \$50 in exchange for a one-half interest in all partnership profits, losses, and capital. After the contributions, the partnership balance sheet is as follows:

ASSETS			CAPITAL ACCOUNTS (AND OUTSIDE BASIS (OB))		
	Basis	Book		Tax	Book OB
Cash	50	50	<i>A</i>	200	50 200
Property A	200	50	<i>B</i>	50	50 50
Total	250	100	Total	250	100 250

Imagine that Property A ultimately is sold by the partnership for \$90. In this case, Property A is being sold for a book gain of \$40, but a tax loss of \$110. For book purposes, \$20 of gain should be allocated to each *A* and *B*, in accordance with their economic agreement.¹³¹ In order for tax to follow book for the noncontributor (or the “other partner,” within the terms of the statutory provision), \$20 of gain would also have to be allocated to *B* for tax purposes. If the ceiling rule applied, there would be no tax gain that could be allocated to *B*, because there is no tax gain available at the partnership level. Failure to allocate tax gain to *B* would allow *B* to avoid tax gain with respect to the \$20 gain experienced by *B* for book purposes. This result would occur because part of *A*'s precontribution built-in loss would be shifted to *B*, thereby reducing the tax gain that would otherwise be allocated to *B*.

By directly stating that “built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner,”¹³² section 704(c)(1)(C)(i) appears to prevent this result, and thereby prevent application of the ceiling rule in the case of built-in loss property. Instead, the text of section 704(c)(1)(C)(i) appears to require *B* to be allocated \$20 gain for tax purposes, to match the \$20 gain allocated to *B* for book purposes. The text of section 704(c)(1)(C)(ii) supports this result. If “the basis of the contributed property in the hands of the partnership [was]

¹³¹ Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2013).

¹³² I.R.C. § 704(c)(1)(C)(i).

treated as being equal to its fair market value at the time of contribution,”¹³³ then the basis of Property A would be treated as \$50. The gain on sale of the property would be \$40, \$20 of which would be allocated to *B*, in accordance with *B*’s one-half interest in the partnership.¹³⁴

The above interpretation of section 704(c)(1)(C) leaves open the question of what should happen to partner *A* on the sale of Property A. Section 704(c)(1)(C) does not appear to dictate a remedial allocation of loss for the contributor. Such a remedial allocation appears only fair, however, and the correct tax result, for a number of reasons. First, if an essentially remedial allocation of \$20 of gain for tax purposes is being allocated to *B*, it seems that an offsetting remedial allocation of \$20 of loss for tax purposes should be allocated to *A*. Otherwise, the partners, as a whole would be recognizing too much gain, by virtue of the \$20 of tax gain allocated to *B*, without any offsetting loss.¹³⁵ Additionally, *A* would have experienced a total of a \$130 loss with respect to Property A (\$150 loss prior to contribution of Property A minus one-half of the \$40 gain after the contribution of Property A). Without a remedial allocation of loss to *A*, *A* would be allocated only a \$110 loss for tax purposes (the \$110 loss recognized at the partnership level on sale of Property A). The allocation of \$20 of remedial loss to *A* would be necessary in order for the tax results to *A* to match the book results. Notwithstanding this reasoning, in the absence of regulations, it is not entirely clear what the tax treatment should be with respect to contributors of built-in loss property.

Moreover, a number of commentators have questioned whether section 704(c)(1)(C) does eliminate the ceiling rule generally in the case of built-in losses (as suggested above), or whether it merely prevents the duplication of built-in losses when there is a liquidation or sale of the contributing partner’s partnership interest prior to realization of the built-in loss at the partnership level.¹³⁶ This view is based on the legislative history of section 704(c)(1)(C), which discusses in particular liquidation or sale of the contributing partner’s partnership interest prior to realization of the built-in loss at the partnership level.¹³⁷

¹³³ I.R.C. § 704(c)(1)(C)(ii).

¹³⁴ Cf. CUNNINGHAM & CUNNINGHAM, *supra* note 3, at 94 (taking this approach and explaining that section 704(c)(1)(C) “would appear to override the regulatory ceiling rule with respect to built-in losses”).

¹³⁵ See *id.* at 96 (also discussing the need to offset the essentially remedial allocation to the noncontributor with an offsetting essentially remedial allocation to the contributor).

¹³⁶ See, e.g., ALAN GUNN & JAMES R. REPETTI, PARTNERSHIP INCOME TAXATION 87–88 (4th ed. 2005); WILLIS & POSTLEWAITE, *supra* note 67 at 10–142.

¹³⁷ See STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONG., at 384–86 (Comm. Print 2005); H.R. REP.

A number of treatises suggest that in enacting section 704(c)(1)(C), Congress only meant to address this narrower set of circumstances. The Willis and Postlewaite treatise indicates, "The legislative history behind the enactment [of 704(c)(1)(C)] appears to suggest that the provision is applicable only to post-sale or post-liquidation transactions."¹³⁸ The Gunn and Repetti treatise similarly relies on legislative history to explain their view that, "We expect that those regulations will limit the application of 704(c)(1)(C) to cases involving transfers of interests by and distributions to partners who have contributed loss property."¹³⁹ Many other commentators have weighed in on the question one way or another.¹⁴⁰

Perhaps the clearest conclusion at present is that the enactment of section 704(c)(1)(C) has created significant uncertainty about how, if at all, the ceiling rule operates in the context of contribution of built-in loss property. Indeed, if the operation of section 704(c)(1)(C) is limited to circumstances in which there is a liquidation or sale of the contributing partner's partnership interest prior to realization of the built-in loss at the partnership level, then whether or not the ceiling rule will operate would seem to depend on a striking number of contingent possibilities. These include: (1) whether the traditional method for making section 704(c) allocations is selected; (2) whether the property is built-in gain or loss property; (3) whether a ceiling rule limitation would apply based on the sale price of property or the tax depreciation available for depreciable assets; and (4) whether, in the case of built-in loss property, there is a liquidation or sale of the contributor's interest prior to ultimate realization of the built-in loss at the partnership level. This set of possibilities confirms that the ceiling rule, which was borne out of an original desire to simplify partnership tax,¹⁴¹ is currently doing anything but.¹⁴²

No 108-755, at 621 (2004) (Conf. Rep.), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1684; H.R. REP. NO. 108-548, at 281-83 (2004).

¹³⁸ WILLIS & POSTLEWAITE, *supra* note 67 at 10-142.

¹³⁹ GUNN & REPETTI, *supra* note 136, at 87-88.

¹⁴⁰ See, e.g., GEORGE MUNDSTOCK, A UNIFIED APPROACH TO SUBCHAPTERS K S 103 (2d ed. 2006); YIN & BURKE, *supra* note 34, at 177; Darryll Jones, *It's the Ceiling Rule, Stupid!*, 107 TAX NOTES 1579 (2005); Lukasz Rachuba, *New Issues With Partnership Built-In Loss Property*, 107 TAX NOTES 1569 (2005).

¹⁴¹ See, e.g., Laura E. Cunningham & Noël B. Cunningham, *Simplifying Subchapter K: The Deferred Sale Method*, 51 SMU L. REV. 1, 7-8 (1997) (explaining that in setting forth the original section 704(c) regime, "Congress (and the A.L.I.) seemed primarily concerned with making the law simple and consistent with the expectations of partners."). As explored earlier in the article, the ceiling rule can be seen as a vestige of the original section 704(c) regime that was put in place, in the form of the original section 704(c)(1).

¹⁴² Andrea Monroe has forcefully made this point with respect to section 704(c)(1)(C). In response to the complexity resulting from section 704(c)(1)(C), Monroe has stated,

Unfortunately, the choice of alternative methods under section 704(c) actually does not eliminate the complexity introduced by the ceiling rule. As Steven Dean, Heather Field, and others have explored, when taxpayers face the possibility of choosing between alternative regimes, planning often ensues as taxpayers assess the alternatives in order to determine which possibility results in the lowest tax liability.¹⁴³ As a result, the fact that alternatives to the traditional method with the ceiling rule exist does not mean that taxpayers are simply going to avoid dealing with the ceiling rule. Rather, it means that, to the extent possible, taxpayers may assess the tax results under all of the possible methods, choosing the one that is likely to result in the lowest tax liability.¹⁴⁴ This dynamic also means that the benefits of choosing between the three methods will tend to accrue to well-informed taxpayers in particular, who will be best suited to manipulate the alternatives to minimize their tax liability. Creating an enormously complex tax regime that will offer well-informed taxpayers in particular the possibility of minimizing tax liability through the consideration of various taxing regimes is difficult to justify.¹⁴⁵

In considering the complexity and planning opportunities created by the ceiling rule, it is worthwhile to revisit and restate explicitly a point from the beginning of this article. When the ceiling rule applies, it uncontroversibly results in misallocations of income, gain, loss, and deduction. The undesirable complexity and disparate planning opportunities introduced by the ceiling rule are therefore being borne to perpetuate mistaxation. This situation calls for serious reconsideration of the ceiling rule. To the extent that long-standing assumptions regarding the unwinding of the ceiling rule have dampened concern about its application, this article eliminates this source of sanguinity, thereby making a final push toward elimination of the ceiling rule.

"Despite the commendable policy shift . . . its practical effect is disastrous." Monroe, *supra* note 34, at 1419.

¹⁴³ Steven A. Dean, *Attractive Complexity: Tax Deregulation, The Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005); Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 27–32 (2010).

¹⁴⁴ See Terence Floyd Cuff, *The Traditional Method Under Section 704(c)(1)(A)*, 34 J. REAL EST. TAX'N 117, 10–145 (2007) ("The only way to determine which method is most favorable for each partner is to prepare a spreadsheet indicating the effect of each method."); see also Monroe, *supra* note 34, at 1420 ("To state the obvious, the simultaneous application of three independent allocation methodologies, each the subject of highly technical regulations, is anything but simple.").

¹⁴⁵ In a prior work I discuss arguments sometimes made in favor of price discrimination with respect to taxation. For this discussion, see Leigh Osofsky, *Who's Naughty and Who's Nice? Screening, Frictions, and Tax Law Design*, 61 BUFF. L. REV. 1057, 1068 n.32 (2013).

The Treasury Department, potentially, and Congress, certainly, could eliminate the ceiling rule and thereby eliminate the mistaxation as well as the accompanying complexity and planning opportunities. Some commentators, however, have suggested that the Treasury Department might not have the authority to overrule the ceiling rule.¹⁴⁶ Other commentators have discussed how the Treasury Department itself at least seemed to think it might not have the authority to overrule the ceiling rule in response to Congress's 1984 redrafting of section 704(c).¹⁴⁷ This belief appears to be based on the legislative history, in which the 1984 house report and the conference report stated that the regulations for the new law "generally will provide for the same result that is achieved under present law."¹⁴⁸ Since the ceiling rule was part of the old section 704(c)(2) regime, this statement could be read to reflect Congress's intention for the ceiling rule to be maintained after 1984.¹⁴⁹

Even if the Treasury Department could have issued regulations eliminating the ceiling rule after Congress's 1984 redrafting, its reissuance of new regulations would require new notice and comment rulemaking under the APA.¹⁵⁰ In any event, whether or not the Treasury Department could eliminate the ceiling rule today, Congress certainly can, as illustrated by Congress's at least partial repeal of the ceiling rule in the case of losses, in the form of section 704(c)(1)(C). For the reasons suggested in this article, Congress, if not the Treasury Department, should take this step and finally unwind the ceiling rule itself.

VI. CONCLUSION

The analysis in this article sets forth a perhaps surprisingly interesting case study in how the intellectual apprehension of complex material can

¹⁴⁶ See, e.g., Hortenstine & Marich, *supra* note 130, at 24:

One must not overlook the fact that repeal of the Ceiling Rule (or even relaxation of such rule through an anti-abuse rule) is not simply the elimination of a regulatory rule of convenience – it is a substantial erosion of Sections 703, 721, 722, and 723. To the extent the dictates of the Ceiling Rule are eliminated or even relaxed, Section 704(c) becomes far more than a mere allocation provision. Only Congress has the discretion to impose such a change to the existing statutory framework . . .

¹⁴⁷ See Cunningham, *Use and Abuse of Section 704(c)*, *supra* note 34, at 116–17.

¹⁴⁸ H.R. REP. NO. 98-432, at 1209 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 875–76; see also H.R. REP. NO. 98-861, at 855 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1543.

¹⁴⁹ But see *supra* note 58 for an alternative possible reading.

¹⁵⁰ 5 U.S.C. § 551(5) (2012) ("rule making" means agency process for formulating, amending, or repealing a rule").

occur in phases. The problems flowing from misallocations with respect to contributed property have existed since the beginning of partnership taxation, but Congress and partnership tax experts have only realized these problems over time. The history of such realizations and lack of realizations exemplifies how sometimes only by really focusing on a long-accepted assumption can we appreciate the extent to which the assumption masks a much more complicated and problematic reality.

This article has focused in particular on the problems hiding just beneath the surface of common assumptions regarding ceiling rule misallocations. Doing so undermines the long-held belief that the ceiling rule misallocations have only limited impact. As revealed in this article, the complex and unintended interactions between the ceiling rule misallocations and the rules governing liquidations and sales of partnership interests yield a variety of haphazard, difficult to justify results, which may last long after liquidation or sale of a partnership interest. The assumption regarding the limited impact of the ceiling rule therefore does not provide a reasonable justification for maintaining what is in fact a wholly unjustifiable provision.