

**COMMENTS CONCERNING REGULATIONS UNDER  
SECTION 705 OF THE INTERNAL REVENUE CODE  
REGARDING BASIS IN A PARTNER'S INTEREST  
PROPOSED DECEMBER 29, 2000 (REG-106702-00)**

The following Comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The Comments were prepared by members of the Committee on Partnership Taxation of the Section of Taxation. Principal responsibility was exercised by Eric Sloan, Glenn Mincey, and Noel Brock. These Comments have also been reviewed by Monte Jackel, a member of our Committee on Government Submissions.

Although the members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the federal income tax principles addressed by these Comments, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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**I.     Executive Summary**

In December 1999, the IRS and Treasury Department issued Rev. Rul. 99-57<sup>1</sup> and Notice 99-57.<sup>2</sup> Rev. Rul. 99-57 addresses the tax consequences to a partnership and its corporate partner from certain dealings in the corporate partner's stock by the partnership. Under the ruling, when a partnership sells stock of a corporate partner and properly allocates the resulting gain (or loss) to the corporate partner under section 704,<sup>3</sup> the corporate partner increases (or decreases) its basis in its partnership interest ("outside basis") for the full amount of the gain (or loss), but, pursuant to section 1032, does not recognize such gain (or loss). Notice 99-57 announced the IRS's and Treasury Department's intention to issue regulations under section 705 to address inappropriate basis adjustments that might arise from transactions relying on Rev. Rul. 99-57. Specifically, Notice 99-57 announced that, under forthcoming regulations, a corporate partner would adjust its outside basis by an amount equal to the gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for

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<sup>1</sup> 1999-2 C.B. 678.

<sup>2</sup> 1999-2 C.B. 693.

<sup>3</sup> Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations issued thereunder.

the year in which the corporate partner acquired the interest, a section 754 election had been in effect with respect to the partnership.

In January 2001, the Treasury Department issued proposed regulations governing the treatment of the sale of a corporate partner's stock by a partnership (or by a lower tier partnership). The proposed regulations generally limit a corporate partner's ability to adjust its outside basis to reflect its distributive share of gain (or loss) recognized on the partnership's sale of stock of that partner if, when the corporate partner acquired its partnership interest, the partnership (or any lower tier partnership owning such stock, in the case of a tiered partnership structure) did not have a section 754 election in effect. Specifically, the proposed regulations provide that the corporate partner may adjust its outside basis under section 705 to reflect the corporate partner's distributive share of such gain (or loss) only to the extent that such gain (or loss) exceeds the amount of the section 743(b) basis adjustment that such partner would have received with respect to such stock had a section 754 election been in effect at the time the corporate partner acquired its partnership interest.

We believe that the proposed regulations reflect sound tax policy in that they preserve the intent of sections 1032 and 705. Moreover, though we believe that the regulations might well be upheld if challenged in court, we recognize that the authority upon which the proposed regulations appear to rely seems to be in some tension with the plain language of section 705 and the recent Supreme Court decision in *Gitlitz*.<sup>4</sup> We believe that regulations providing that the aggregate treatment of partnership taxation applies in the context of section 1032 would be much more supportable on regulatory authority grounds and less subject to attack under a *Gitlitz* type of argument than the current proposed regulations. Therefore, we suggest that, when the regulations are issued in final form, they reaffirm the holding of Rev. Rul. 99-57 (that the aggregate treatment of partnership taxation applies for purposes of section 1032) and explicitly state that such treatment provides the legal authority for the regulations.<sup>5</sup> The regulations should then make clear that they are merely the mechanical means to ensure that appropriate adjustments are made to a corporate partner's outside basis to reflect this treatment. We further suggest that the IRS and Treasury Department consider obtaining specific legislative support for the regulations before issuing them in final form.<sup>6</sup>

In any event, Example 2 of the proposed regulations, involving tiered partnerships, should be modified to prevent avoidance of the proposed regulations via the normal partnership allocation rules of section 704(b). In addition, the proposed regulations should be expanded to include the issues addressed in Rev. Rul. 96-10<sup>7</sup> and Rev. Rul. 96-11.<sup>8</sup>

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<sup>4</sup> *Gitlitz v. Commissioner*, 121 S. Ct. 701 (2001).

<sup>5</sup> It may also be advisable to rely on the intent of section 705 as supplementary support.

<sup>6</sup> This could be accomplished in connection with the proposed legislative reversal of *Gitlitz*. See JOINT COMMITTEE ON TAXATION, *Description of the "Economic Security and Recovery Act of 2001"* (JCX-69-01), Oct. 11, 2001. On October 24, 2001, the House of Representatives passed the Joint Committee's proposal as H.R. 3090.

<sup>7</sup> 1996-1 C.B. 138.

<sup>8</sup> 1996-1 C.B. 140.

## II. Detailed Comments

### A. Background

Under section 1032, corporations do not recognize gain or loss from dealings in their own stock, whether newly issued or treasury. The introduction of a partnership between a corporation and its own stock, however, leaves the application of section 1032 unclear when the partnership deals in the corporate partner's stock. Practitioners have generally agreed that, to carry out the intention of section 1032, the corporate partner's distributive share of the partnership's gain (or loss) from the partnership's dealings in the stock of the corporate partner must not be subject to tax.<sup>9</sup> One method to achieve this result would be to adopt a quasi-section 751 approach to corporate stock. Under such an approach, a portion of a corporate partner's outside basis would be allocated to the corporate partner's proportionate interest in the corporate partner's stock held by the partnership. Separate accounting would be required to account for income, gain, and loss attributable to (and distributions made in respect of) such portion in a manner similar to the section 751(a) approach for allocating sale proceeds of a partnership interest attributable to ordinary income assets of the partnership.<sup>10</sup> This separate accounting would, of course, be quite complex in all but the simplest partnerships. (Imagine, for example, the tax accounting that would be required if a partnership issued multiple classes of interests, or where a corporate partner's outside basis included partnership liabilities.)

An alternative method to carry out the nonrecognition rule of section 1032 where a partnership deals in the stock of its corporate partner is to treat the partnership as an aggregate of its partners for this purpose. Treating a partnership as an aggregate of its partners, however, addresses only the most fundamental issues of gain or loss recognition. Such treatment raises the question of whether basis adjustments should be made under section 705 to reflect gain or loss excluded under section 1032.<sup>11</sup> Section 705 mandates that every partner adjust its outside basis for all items of income and loss, whether taxable or tax-exempt. Failure to limit the adjustment to a corporate partner's outside basis for gains and losses attributable to the partnership's dealings in the corporate partner's stock can give rise to the subsequent recognition of gain or loss upon the sale or exchange of the corporate partner's partnership interest – gain or loss that replicates the gain or loss previously excluded under section 1032.

In December 1999, the IRS issued both a revenue ruling and a notice addressing these issues. The IRS held in Rev. Rul. 99-57 that:

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<sup>9</sup> See, e.g., Michael L. Schler, *Exploring the Boundaries of Section 1032*, 49 TAX LAW. 543, 576-77 (Spring 1996).

<sup>10</sup> *Id.*

<sup>11</sup> Cf. Treas. Reg. § 1.701-2(f), *Example 2* (aggregate treatment of partnership appropriate to carry out the purpose of section 1059; partnership must make appropriate adjustments to the basis of corporate stock where extraordinary dividend was paid).

If a corporate partner contributes its own stock to a partnership in exchange for a partnership interest, and the partnership later exchanges the stock in a taxable transaction, then the partnership will realize gain that will be allocated to the partners under § 704. Under § 1032, however, the corporate partner will not recognize the gain allocated to it with respect to the sale or exchange of the stock. Furthermore, under § 705, the corporate partner increases its basis in its partnership interest by an amount equal to its share of the gain resulting from the partnership's sale or exchange of the stock.

The IRS based its holding on the aggregate treatment of partnerships, explicitly stating that “use of the aggregate theory of partnerships is appropriate in determining the application of [section] 1032 with respect to gain allocated to a corporate partner.”<sup>12</sup>

In Notice 99-57, published in the same issue of the Internal Revenue Bulletin, the IRS and Treasury Department indicated that they intended to promulgate regulations under section 705 to address situations in which gain or loss may be improperly created by adjusting the basis of a partnership interest for partnership income that is not subject to tax, or for partnership losses that are permanently denied, with respect to a corporate partner. The Notice correctly pointed out that subchapter K generally attempts to preserve equality between a partner's outside basis and the partner's share of basis in the assets of the partnership (“inside basis”). The Notice observed that section 743(a) permits a partner's outside basis to diverge from the partner's share of inside basis in order to promote administrative convenience.<sup>13</sup>

Notice 99-57 also noted that failure to make a section 754 election will generally result in a timing benefit or detriment to the partner(s) with divergent inside and outside bases and set forth the following example to demonstrate this point:

[A] person (A) purchases a 50 percent interest in a partnership for \$100x. The partnership owns one asset with a basis of \$100x and a value of \$200x. If the partnership had made a § 754 election, A would have a \$50x special basis adjustment in the property, so that when the partnership disposed of the property for \$200x, A's special basis adjustment would exactly offset A's allocated share of the gain. A's basis in the partnership interest would remain at \$100x after the sale. Accordingly, A would not recognize any gain upon the sale of the partnership interest immediately thereafter.

If the partnership had not made a § 754 election, A would have no special basis adjustment, so that when the partnership disposed of the property for \$200x, A would be allocated \$50x of gain. A's basis in the partnership

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<sup>12</sup> Rev. Rul. 99-57, 1999-2 C.B. 678.

<sup>13</sup> Section 743(a) provides that, if a section 754 election is in effect with respect to a partnership, the basis of partnership property shall be adjusted upon the transfer of an interest in such partnership.

interest would increase to \$150x under § 705(a)(1)(A), so that A would recognize an offsetting \$50x loss (or reduced gain) upon a subsequent sale of the partnership interest. Thus, without the § 754 election, there may be a timing detriment to A, but the correct amount of cumulative income or loss (albeit possibly of a different character) is ultimately reported by A.

The correct amount of cumulative income may not be reported, however, in certain situations in which A is not subject to tax on the gain that results from the failure to make the § 754 election. For instance, in the example discussed immediately above, if A was a corporation and the property held by the partnership was A stock, under § 1032, the gain allocated to A (assuming that no § 754 election had been made) would not be subject to tax. [Citing Rev. Rul. 99-57.] In this situation, it would be inconsistent with the intent of § 705 to increase the basis of A's partnership interest for the non-recognized gain. To do so would create a recognizable loss in a situation where no offsetting gain had previously been recognized.

In January 2001, the IRS and Treasury Department issued the proposed regulations promised by Notice 99-57. The proposed regulations attempt to deal with both the issue of nonrecognition of income (or loss) and the issue of basis adjustments emanating from a partnership's dealing in the stock of a corporate partner. The proposed regulations address the issue of nonrecognition of income (or loss) by implicitly applying the aggregate treatment of partnerships for purposes of the nonrecognition provision of section 1032. The proposed regulations address the issue of section 705 basis adjustments by limiting the amount of the corporate partner's basis adjustment under section 705 resulting from the sale or exchange of the corporate partner's stock by the partnership. Under the proposed regulations, such adjustments are limited to an amount equal to the gain (or loss) the corporate partner would recognize (absent section 1032) if, for the year in which the corporation purchased the partnership interest, a section 754 election had been in effect (*i.e.*, the appreciation or depreciation in value of the corporate stock after the corporate partner acquired its interest).

#### **B. Authority for Position Advanced in Proposed Regulations**

In Notice 99-57, the IRS and Treasury Department set forth the authority for the proposed regulations:

The legislative history describing § 705(a) states that adjusting the basis of a partner's interest is necessary to prevent unintended benefit or detriment to the partners. Thus, a partner should add to the basis of the partner's partnership interest the partner's distributive share of nontaxable income so that the partner does not lose the benefit of that type of tax-exempt income. Otherwise, the partner could eventually incur a capital gain with respect to such amounts.<sup>14</sup>

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<sup>14</sup> Citing H.R. Rep. No. 83-1337, at A225 (1954); S. Rep. No. 83-1622, at 384 (1954).

The Notice cites Rev. Rul. 96-10<sup>15</sup> and Rev. Rul. 96-11<sup>16</sup> as examples of how section 705 has been interpreted to carry out the purpose of this legislative history. The test established in both rulings for whether a transaction results in exempt income within the meaning of section 705(a)(1)(B) is “whether the transaction has a permanent effect on the partnership’s basis in its assets, without a corresponding current or future effect on its taxable income.” At issue in Rev. Rul. 96-10 was whether partners’ outside bases should be decreased under section 705(a)(2) to reflect a loss disallowed to the partnership under section 707(b)(1), and whether partners’ outside bases should be increased under section 705(a)(1) to reflect gain from the sale of partnership property that is not recognized by the partnership due to sections 707(b)(1) and 267(d). The ruling held that reducing partners’ outside bases by their respective shares of the partnership’s disallowed loss preserves the intended detriment of not allowing the recognition of losses from sales or exchanges between partnerships and related persons. The ruling correctly noted that if the partners’ outside bases were not reduced by the amount of the partnership’s disallowed loss, the partners could subsequently recognize this loss (or a reduced gain) upon the disposition of their partnership interests. The ruling also held that increasing the partners’ outside bases by their respective shares of the unrecognized gain on the sale of property would preserve the intended benefit of section 707(b)(1) and section 267(d) and noted that if the partners’ outside bases were not so increased, the partners could subsequently recognize that gain (or a reduced loss) upon a disposition of their partnership interests.

At issue in Rev. Rul. 96-11 was the extent to which partners should reduce their outside bases to reflect a charitable contribution of property by the partnership. The ruling held that partners should reduce their outside bases by their respective shares of the permanent decrease in the partnership’s basis in its assets arising from the contribution. The ruling specifically rejected reducing partners’ outside bases by the fair market value of the contributed property, that is, by the amount of the charitable deduction allowed to the partners, because to do so would cause the partners to recognize gain (or a reduced loss) upon the disposition of their partnership interests.<sup>17</sup>

The situations addressed in Rev. Rul. 96-10 and Rev. Rul. 96-11 differ from the situation posed by the proposed regulations in that the rulings focused on situations in which a transaction permanently affects a partnership’s basis in its assets without affecting the partnership’s taxable income by the same amount.<sup>18</sup> In the situation presented in the proposed regulations, the partnership’s basis in its assets is permanently

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<sup>15</sup> 1996-1 C.B. 138.

<sup>16</sup> 1996-1 C.B. 140.

<sup>17</sup> This gain (or reduced loss) would be attributable to the unrecognized appreciation in the property at the time of its contribution.

<sup>18</sup> For example, assume that partnership XY sells an asset with a basis of \$101 and a fair market value of \$1 to X, its 60 percent partner, for \$1. The partnership’s aggregate basis in its assets is reduced by \$100, but its taxable income is not reduced by the same amount because the \$100 loss is disallowed under section 707(b)(1)(A). It should be noted that, as a technical matter, a charitable deduction does not affect partnership taxable income. *See* section 703(a)(1) (partnership taxable income does not include separately stated items) and section 703(a)(2)(C) (partnership charitable deductions are separately stated). Nevertheless, the same principles apply.

affected, and the partnership's taxable income is equally impacted.<sup>19</sup> This is because, in the rulings, the relevant nonrecognition rules are applied at the partnership level, whereas the nonrecognition rule of section 1032 applies at the corporate partner level. Notwithstanding this technical distinction, the intention and effect of the rulings and the proposed regulations are the same. In the revenue rulings, the IRS sought to preserve the policy of each relevant provision by requiring that the partners' outside bases be adjusted to reflect the nontaxable income or deduction. Similarly, the proposed regulations seek to preserve the policy of section 1032 by ensuring that gain or loss that section 1032 excludes is not accidentally (or intentionally) replicated in a partnership interest.

### **C. Issues with Authority for Proposed Regulations**

As was noted above, we agree with the tax policy advanced by the proposed regulations, and we also believe that the proposed regulations might well be upheld in court if challenged. Nevertheless, as is discussed below, the authority upon which the proposed regulations appear to rely seems questionable for a number of reasons.

#### **1. The Proposed Regulations Seemingly Override the Plain Language of Section 705**

First, it seems clear that the proposed regulations are inconsistent with the plain language of section 705. Section 705 specifically requires that a partner's outside basis be adjusted to reflect the partner's distributive share of taxable income or loss. Because section 1032 does not apply to partnerships, when a partnership disposes of corporate stock in a taxable transaction, the partnership will recognize gain or loss,<sup>20</sup> and section 705 would seem to require that such gain or loss be reflected in the partners' outside bases. Of course, Rev. Rul. 96-11 suffers from the same infirmity. In that ruling, a partnership claimed a charitable deduction in an amount equal to the fair market value of the contributed asset, yet the partners were permitted (or required) to reduce their outside bases not by their distributive shares of such deduction, but by their respective shares of the basis of the contributed asset.<sup>21</sup>

Any authority that causes partnership income or loss that is properly allocated to a partner not to affect such partner's outside basis seems questionable in light of the recent Supreme Court decision in *Gitlitz*.<sup>22</sup> In *Gitlitz*, the Supreme Court held that solvent shareholders of an insolvent subchapter S corporation could increase their adjusted bases in their stock in the corporation for excluded discharge of indebtedness

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<sup>19</sup> For example, assume that partnership XY sells X stock with a basis of \$1 and a fair market value of \$101 to an unrelated person for \$101. The partnership's basis in its assets increases by \$100, as does its taxable income. X, of course, does not recognize its distributive share of such gain under section 1032.

<sup>20</sup> Unless, of course, the amount realized equals the partnership's basis in such stock.

<sup>21</sup> Rev. Rul. 96-10 differs somewhat in that it *created* items of income or loss for purposes of adjusting outside bases under section 705.

<sup>22</sup> *Gitlitz v. Commissioner*, 121 S. Ct. 701 (2001). For an excellent discussion of the *Gitlitz* case and its development, see Richard M. Lipton, *Supreme Court Hands Taxpayers a Victory in Gitlitz, But Will Congress Take it Away?*, 94 J. TAX'N 133 (Mar. 2001), and the author's prior articles cited therein.

income. Such increases allowed the shareholders to deduct corporate losses and deductions, including losses suspended in previous years.

Before the Court addressed the issue of whether discharge of indebtedness income impacted stock basis, the Court had to address the IRS's assertion that discharge of indebtedness income that was excluded by section 108 was not an "item of income" for purposes of the S corporation provisions.<sup>23</sup> If the IRS's assertion were correct, then such income would not impact an S corporation shareholder's basis under section 1367(a)(1). The Court observed that section 61(a)(12) specifically includes discharge of indebtedness income in gross income, and that section 108(a)(1) is merely an exception to this general rule of inclusion. And the Court held that, "[u]nder a plain reading of the statute, . . . excluded discharged debt is indeed an 'item of income,' which passes through to the shareholders and increases their bases in the stock of the S corporation."<sup>24</sup> Thus, the Court rejected the IRS's argument that the section 108(a)(1) exclusion from gross income somehow alters the character of the discharge of indebtedness income so that it is no longer an "item of income."

The Supreme Court's adherence to a plain reading of sections 1366 and 1367 even though such a reading allows S corporation shareholders a "double windfall" has led many in the tax community to believe that the IRS may have similar difficulties in defending the proposed regulations under section 705. The S corporation basis provisions that increase a shareholder's basis by the shareholder's pro rata share of items of income (including tax-exempt income)<sup>25</sup> are strikingly similar to section 705. Indeed, the S corporation provisions were based on subchapter K.<sup>26</sup> Just as the Court held that the income exclusion afforded by section 108 does not transmute an item of tax-exempt income into a non-income item, it is quite possible that a court would hold that the partner-level exclusion afforded by section 1032 does not transmute partnership-level gain into a non-income item. Such a court might well then conclude that, if the partnership properly allocates stock gain to a partner, section 705 requires the partner to increase its basis by the amount of such gain, notwithstanding the application of section 1032 at the partner level. Indeed, it may well be that the taxpayer's arguments against the proposed regulations would be stronger than the taxpayer's arguments in *Gitlitz* for two reasons. First, it is quite clear that, unless a partnership is treated as an aggregate of its partners for purposes of section 1032, a partnership recognizes gain or loss on the sale of corporate stock.<sup>27</sup> Thus, a court would not have to address the issue of whether an excluded income item is still an income item. Second, in *Gitlitz*, the IRS's argument applied to all excluded income. The proposed regulations, on the other hand, select only a portion of the excluded income for disallowance. Governmental "cherry picking" may not be viewed favorably.

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<sup>23</sup> *Gitlitz*, 112 S. Ct. 701, 706.

<sup>24</sup> *Id.*

<sup>25</sup> Sections 1366(a)(1) and 1367(a)(1).

<sup>26</sup> See H.R. Rep. No. 97-826, at 17 (1982); S. Rep. No. 97-640, at 18 (1982).

<sup>27</sup> It should be noted that Rev. Rul. 99-57 sidesteps this issue by stating that a partnership *realizes* gain. The ruling does not address the issue of gain recognition by the partnership.

## 2. **The Proposed Regulations Seemingly Override the Elective Nature of Section 743(b)**

In addition to the fact that the proposed regulations appear to be inconsistent with the plain language of section 705 and *Giltitz*, they also seemingly override the elective nature of section 743(b). As was noted earlier, the proposed regulations state that “it may be inconsistent with the intent of section 705 to increase the basis of the corporation’s partnership interest by the full amount of the gain that is not recognized.” The proposed regulations nevertheless find no inconsistency in deviating from the intention of section 743(b). The basis of partnership property is adjusted under section 743(b) only if a partnership files an election under section 754. The legislative history of section 743(b) clearly indicates that the provision was intended to be optional. As the House Report stated:

In general, the transfer of an interest will not affect the basis of partnership assets. Provision is made, however, whereby the partnership *may* elect to adjust the basis of partnership assets to reflect the increase or decrease in the basis of partnership interest transferred by sale or upon the death of a partner. Such an election, once filed, is irrevocable until the termination of the partnership and will require similar basis adjustments with respect to all future transfers of partnership interest.

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*It is anticipated that many partnerships will prefer not to make an election which entails the adjustment to the basis of partnership assets each time a transfer of an interest in a partnership takes place. The possible tax advantages of such an adjustment may be outweighed by the bookkeeping expense and inconvenience. However, the adjustment may be desirable in cases where there is a substantial increase in the tax basis of the transferred partnership interest.*<sup>28</sup>

Similarly, the Senate noted:

In general, the transfer of an interest will not affect the basis of partnership assets. Provision is made, however, whereby the partnership may elect to adjust the basis of partnership assets to reflect the increase or decrease in the basis of partnership interest transferred by sale or upon the death of a partner.

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It should be clear, however, that partnerships are not required to make such adjustments if they do not desire to do so.<sup>29</sup>

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<sup>28</sup> H.R. Rep. No. 83-1337, at 70 (1954) (emphases added).

<sup>29</sup> S. Rep. No. 83-1622, at 96-97 (1954).

The effect of the proposed regulations is to mandate a section 743(b) adjustment with respect to certain corporate partners, even if no section 754 election has been made. Such a mandate, although arguably not without precedent,<sup>30</sup> is troubling when viewed as the government's arbitrary decision that section 705 is more important than sections 743 and 754.

#### **D. Alternative Authority for the Proposed Regulations**

While we agree with the tax policy the proposed regulations propose to implement, we believe that a better approach would be for the government to state firmly that a partnership is properly treated as an aggregate of its partners for purposes of applying section 1032. We believe that such treatment is quite plainly appropriate and further believe that the Treasury Department would have much stronger authority to promulgate regulations that provide for basis adjustments arising from such treatment, rather than regulations that purport to advance the intent of section 705, while arguably doing violence to the intent of section 743(b).<sup>31</sup>

Partnership taxation has long been complicated by the blending of two different views of partnerships – the aggregate view and the entity view. Under the aggregate view of partnerships, the partnership is viewed as merely a conduit and each partner is treated as owning directly an undivided interest in the partnership's assets. Under the entity view of partnerships, the partnership is viewed as an entity distinct from its partners so that the partner's investment represents an investment in the partnership interest, rather than the partnership assets.

The blending of the aggregate and entity views of partnerships has been a part of partnership taxation since 1954. In enacting subchapter K, the Congressional committees opted to treat a partnership as an entity for some purposes, but as an aggregate for others. Thus, for example, a partnership is generally treated as an entity for purposes of computing income and making elections,<sup>32</sup> but as an aggregate for purposes of contributions to and distributions from a partnership.<sup>33</sup> The committee reports indicate that one view of partnerships should not take precedence over the other. Instead, whether a partnership is treated as an entity separate from its partners or as an aggregate of its

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<sup>30</sup> See Treas. Reg. § 1.1017-1(g)(2)(ii)(C) (requiring a partnership to reduce inside asset basis in certain circumstances even if the partnership does not have a section 754 election in effect).

<sup>31</sup> Significantly, there is considerable regulatory precedent for such an approach. See, e.g., Treas. Reg. § 1.856-3(g) (treating a real estate investment trust that is a partner in a partnership as owning "its proportionate share of each of the assets of the partnership" and to be "entitled to the income of the partnership attributable to such share"); Treas. Reg. § 1.368-1(d)(5), *Example 7* (treating the continuity of business enterprise requirement to be met where all of the assets acquired in a reorganization are contributed through a chain of wholly-owned subsidiary corporations and finally contributed to a partnership in exchange for a 20 percent interest therein where the contributing subsidiary performs active and substantial management functions). See also Treas. Reg. § 1.701-2(e) (the so-called "abuse of entity" regulations).

<sup>32</sup> Sections 703 and 706.

<sup>33</sup> Sections 721 and 731.

partners depends on which characterization is “more appropriate” for the particular Code section under consideration.<sup>34</sup>

The courts follow this dictate. In *Holiday Village Shopping Center v. United States*,<sup>35</sup> the Claims Court described the test as follows: “the proper inquiry is not whether a partnership is an entity or an aggregate for purposes of applying the internal revenue laws generally, but rather which is the more appropriate and more consistent with Congressional intent with respect to the operation of the particular provision of the Internal Revenue Code at issue.”<sup>36</sup> In *Holiday Village Shopping Center*, the court held that a partnership should be treated as an aggregate for purposes of depreciation recapture under sections 1245 and 1250. The court found it “difficult to comprehend why there should be imputed to Congress the intent to adopt an entity theory in the application of [sections] 1245 and 1250, which would allow a taxpayer to insulate itself from recapture [merely by disposing of depreciable assets through a partnership].”<sup>37</sup>

Similarly, we believe adopting the entity theory of partnership taxation in connection with section 1032 would clearly frustrate the intent of the nonrecognition rule of section 1032. Section 1032 provides, in part, that “[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.” Before 1954, corporations could recognize gain or loss from dealings in their own stock, depending on the facts and circumstances.<sup>38</sup> Section 1032 was enacted to prevent this. Unless the mechanic of the proposed regulations is adopted, corporate taxpayers will effectively recognize gain or loss from indirect dealings in their own stock, frustrating clear Congressional intent. And there is no indication that Congress intended subchapter K to thwart section 1032. Significantly, treating a partnership in these transactions as an aggregate, and requiring appropriate basis adjustments, will preserve the nonrecognition rule of section 1032, without doing violence to any policy that can fairly be attributed to Congress.<sup>39</sup>

As should be clear, there is a clear distinction between the stated authority for the proposed regulations and the authority suggested in this Comment. While we believe that the proposed regulations are a reasonable interpretation of section 705, we also believe that a court could view them as incompatible with the plain language of

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<sup>34</sup> H.R. No. 83-2543, at 59 (1954).

<sup>35</sup> 5 Cl. Ct. 566 (1984), *aff'd*, 773 F.2d 276 (Fed. Cir. 1985).

<sup>36</sup> *Id.* at 570. See also *Brown Group v. Commissioner* 104 T.C. 105 (1995), *vacated and remanded on other grounds*, 77 F.3d 217 (8<sup>th</sup> Cir. 1996).

<sup>37</sup> *Id.* at 572. But see *Petroleum Corp. of Texas v. United States*, 939 F.2d 1165 (5<sup>th</sup> Cir. 1991) (the distribution of a partnership interest in a partnership owning recapture property does not give rise to recapture and government had no authority to treat such distribution under aggregate theory as a distribution of assets subject to recapture). Perhaps the most cogent judicial explication of the appropriate test can be found in *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 423 (1997), in which the IRS unsuccessfully argued for application of the aggregate approach to the sale of a partnership interest in a partnership that owned a sports franchise.

<sup>38</sup> S. Rep. No. 83-1622 (1954); H.R. Rep. No. 83-1337 (1954).

<sup>39</sup> It seems clear that the nonrecognition rule provided by Rev. Rul. 99-57 and the proposed regulations properly extends to gain recognized under sections 704(c)(1)(B), 737, or 751(b). It would be helpful, however, for the final regulations to provide guidance with respect to such issues.

section 705, which clearly provides for a basis increase for all income, including tax-exempt income. Moreover, the proposed regulations focus on the intent of section 705, while disregarding the intent of sections 743(b) and 754. We suggest that the appropriate focus is the intent of section 1032, and that the sought-after authority is more properly found in aggregate treatment, bolstered by clear legislative and judicial authority to treat a partnership as an aggregate of its partners.<sup>40</sup> We believe a court would agree that the government was reasonable in treating a partnership as an aggregate of its partners for purposes of section 1032, and would agree that regulations implementing this treatment are valid as a reasonable exercise of the Treasury Department's authority.<sup>41</sup>

## **E. Additional Suggestions Regarding Proposed Regulations**

### **1. Example 2 of the Tiered Partnership Rule**

Leaving for the moment the issue of regulatory authority, one potential for abuse remains unthwarted by the proposed regulations. The second example in the proposed regulations involves the acquisition of an interest in a lower-tier partnership ("LTP") by an upper-tier partnership ("UTP") at a time when one of the partners of UTP is a corporation, the stock of which is held by LTP. The facts of the example are as follows:

A, B, and C form an equal partnership (UTP), with each partner contributing \$100,000. D, E, and F also form an equal partnership (LTP), with each partner contributing \$30,000. LTP purchases stock in corporation B for \$90,000, which appreciates in value to \$900,000. LTP has no liabilities. UTP purchases D's interest in LTP for \$300,000. LTP does not have an election under section 754 in effect for the taxable year of UTP's purchase. LTP later sells the B stock for \$900,000. UTP's share of the gain is \$270,000, and B's share of that gain is \$90,000.

The example then concludes that, under section 1032, B does not recognize its share of the gain. The example goes on to explain why not all section 705 basis adjustments are appropriate:

With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the B stock (including B's share) were to increase the basis of UTP's interest in LTP, UTP's basis in the LTP interest would be \$570,000 (\$300,000 + \$270,000), and the fair market value of such interest would be \$300,000, so that B would be allocated a loss of \$90,000  $((\$570,000 - \$300,000) \times 1/3)$  if UTP sold its interest in LTP immediately after LTP's

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<sup>40</sup> It should be noted that, even if the final regulations do not explicitly rely on aggregate treatment, it is possible that a court could rely on such treatment to uphold the regulations. See *Chevron v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 n. 11 (1984) (a reviewing court "need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction"). Administrative guidance is generally given the weight of authority unless it is arbitrary, capricious, or manifestly contrary to the statute. *Id.* at 844.

<sup>41</sup> *Id.*

disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of UTP's interest in LTP. B would not incur an economic loss in the transaction, and B was not allocated a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of UTP's interest in LTP. Accordingly, increasing UTP's basis in its LTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because E and F were allocated taxable gain on the disposition of the B stock, it would be appropriate to increase E's and F's bases in their respective interests in LTP by the full amount of such gain.)

The example concludes by explaining which basis adjustments should be made:

(iii) The appropriate basis adjustment for UTP's interest in LTP upon the disposition of the B stock by LTP can be determined as the amount of gain that UTP would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that subsequently is allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a \$90,000 positive basis adjustment under section 743(b), allocable to B, in the property of LTP. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be \$810,000. UTP's share of this gain, \$270,000, would be offset, in part, by the \$90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to \$180,000.

(iv) If the basis of UTP's interest in LTP were increased by \$180,000, the total basis of UTP's partnership interest would equal \$480,000. This would conform to the sum of UTP's share of the cash held by LTP ( $1/3 \times \$900,000 = \$300,000$ ) and the taxable gain recognized by A and C on the disposition of the B stock that appropriately may be offset on the disposition of their interests in UTP ( $\$90,000 + \$90,000 = \$180,000$ ). Such a basis adjustment does not inappropriately create the opportunity for the allocation of a loss to B on a subsequent disposition of UTP's interest in LTP and is consistent with the purpose of this section. Accordingly, of the \$270,000 gain allocated to UTP, only \$180,000 will apply to increase the adjusted basis of UTP in LTP under section 705(a)(1). UTP's adjusted basis in its LTP interest following the sale of the B stock is \$480,000.

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of \$190,000

(\$100,000 + \$90,000) and a value of \$100,000, so that B would recognize a loss of \$90,000 if B sold its interest in UTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of \$90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective interests in UTP by the amount of gain recognized by A and C.)

(vi) The appropriate basis adjustment for B's interest in UTP upon the disposition of the B stock by LTP can be determined as the amount of gain that B would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that is subsequently allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a basis adjustment under section 743(b) in the property of LTP of \$90,000. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of UTP's gain from the sale of the B stock (before considering section 743(b)) would be \$810,000. UTP's share of this gain, \$270,000, would be offset, in part, by the \$90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to \$180,000. The \$90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal \$100,000. This would conform to B's share of UTP's basis in the LTP interest  $((\$480,000 - \$180,000 \text{ (i.e., A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election)}) \times 1/3 = \$100,000$ ) as well as B's indirect share of the cash held by LTP  $((1/3 \times 1/3) \times \$900,000 = \$100,000)$ . Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under paragraph (c) of this section, of the \$90,000 gain allocated to B, none will apply to increase the

adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is \$100,000.

Example 2 is not objectionable, except that it fails to consider how the section 704(c) rules may permit taxpayers to achieve results similar to those the proposed regulations attempt to prevent. Consider the following example.<sup>42</sup> (For simplicity, the amounts are drawn from Example 2 of the proposed regulations.)

**Example.** Upon initial formation, the partners would have the following capital accounts and outside bases:

**LTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
D	\$30,000	\$30,000
E	\$30,000	\$30,000
F	\$30,000	\$30,000

**UTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
A	\$100,000	\$100,000
B	\$100,000	\$100,000
C	\$100,000	\$100,000

After formation, LTP purchases stock in B for \$90,000 that appreciates in value to \$900,000. Thereafter, UTP purchases D's interest in LTP for \$300,000. Immediately after UTP purchases D's interest in LTP for \$300,000, LTP's partners have the following capital accounts and outside bases:

**LTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
UTP	\$30,000	\$300,000
E	\$30,000	\$30,000
F	\$30,000	\$30,000

D's section 704(b) book capital account carries over to UTP under Treas. Reg. § 1.704-1(b)(2)(iv)(l). Additionally, UTP's inherited section 704(b) book capital account is not adjusted pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(m). Finally, because LTP does not have a section 754 election in effect for the taxable year of UTP's purchase, UTP has a \$270,000 difference between its outside basis and its share of LTP's inside basis (\$300,000 (UTP's outside basis) minus \$30,000 (UTP's 1/3 share of LTP's inside basis)).

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<sup>42</sup> For additional examples, see Jackel and Goold, *The Code Section 705 Regulations – Fact or Fiction?*, 4 JOURNAL OF PASSTHROUGH ENTITIES 5 (Mar./Apr. 2001).

Next, LTP sells the B stock for \$900,000. This generates both a section 704(b) book gain and a tax gain of \$810,000 (\$900,000 amount realized minus \$90,000 book and tax basis). After this sale, the partners' respective capital accounts and outside bases would be as follows:<sup>43</sup>

**LTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
UTP	\$300,000	\$480,000 <sup>44</sup>

<sup>43</sup> These results should be contrasted with the results that would occur if a section 754 election had been in effect at the time UTP purchased its interest in LTP.

Step 1: UTP purchases D's 1/3 interest in LTP at a time when LTP has a section 754 election in effect.

**LTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
UTP	\$30,000	\$300,000
E	\$30,000	\$30,000
F	\$30,000	\$30,000

Once again, UTP would simply inherit D's section 704(b) book capital account. Now, however, there would be no difference between UTP's outside tax basis and its 1/3 share of LTP's inside tax basis because UTP would have a special basis adjustment of \$270,000 with respect to its share of LTP's assets (namely, the B stock).

Step 2: LTP sells the B stock. After taking into account UTP's section 743(b) adjustment, LTP has only \$540,000 of gain to allocate from the sale of the B stock, computed as follows: \$900,000 amount realized less \$360,000 aggregate inside tax basis (\$30,000 E's share of inside tax basis + \$30,000 F's share of inside tax basis + \$300,000 UTP's share of inside tax basis). The gain would be allocated equally to E and F because UTP's share of the gain or loss is zero (\$300,000 share of amount realized less \$300,000 share of inside tax basis). The capital accounts thereafter would be as follows:

**LTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
UTP	\$300,000	\$300,000
E	\$300,000	\$300,000
F	\$300,000	\$300,000

UTP's outside tax basis is computed as \$300,000 initial outside basis plus \$0 share of gain. E's and F's outside tax bases are computed as \$30,000 initial outside basis plus \$270,000 share of gain.

**UTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
A	\$100,000	\$100,000
B	\$100,000	\$100,000
C	\$100,000	\$100,000

UTP's partners' book and tax capital accounts are not impacted by LTP's sale of the B stock because UTP was allocated no gain on the sale of the B stock by LTP. Additionally, UTP's economic claim on the assets of LTP (\$300,000) exactly equals its outside basis (tax capital) (\$300,000).

<sup>44</sup> Computed as follows: \$300,000 initial outside basis, plus \$270,000 share of gain, less \$90,000 basis reduction under the proposed regulations.

E	\$300,000	\$300,000
F	\$300,000	\$300,000

**UTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
A	\$190,000	\$190,000
B	\$190,000	\$100,000 <sup>45</sup>
C	\$190,000	\$190,000

If UTP sold its LTP interest immediately afterwards, UTP would recognize a \$270,000 book loss, but only a \$180,000 tax loss. If UTP were to allocate the book loss equally to its partners, each partner would then have a \$100,000 capital account.<sup>46</sup> If the tax loss followed the book loss,<sup>47</sup> each partner would be allocated a \$60,000 tax loss, reducing A's and C's outside bases to \$130,000 each, and B's to \$40,000. Although A and C would eventually recognize the \$30,000 built-in loss on the liquidation or sale of their interests, and B would eventually recognize the \$60,000 built-in gain, one can imagine that A and C would seek to recognize their losses more quickly than B would seek to recognize its gain. More fundamentally, such a result seems inconsistent with the intention of the proposed regulations.

The problem with Example 2 of the proposed regulations is the creation of a "book/tax disparity" in UTP.<sup>48</sup> That is, income from the sale of the B stock results in book income of \$270,000 allocable to UTP, giving UTP a section 704(b) book basis of \$570,000, while UTP's tax basis in its LTP interest is increased by only \$180,000, to \$480,000. One way to prevent this potential avoidance would be to extend the rule of the proposed regulations to the capital account maintenance rules of Treas. Reg. § 1.704-1(b)(2)(iv), as is already the case with losses disallowed under section 267 or 707(b).<sup>49</sup> In that event, UTP's book income would be limited to an amount equal to the amount of gain that UTP would have recognized (absent section 1032 with respect to B) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that ultimately is allocated to B were determined as if LTP had made an election under section 754. Thus, UTP would have section 704(b) income equal to its taxable income of \$180,000. B's section 704(b) income would be limited in the same manner, resulting in section 704(b) income of zero.

<sup>45</sup> Computed as follows: \$100,000 initial outside basis, plus \$90,000 share of gain (one-third of \$270,000), less \$90,000 basis reduction under the proposed regulations.

<sup>46</sup> It should be noted that UTP could presumably allocate the loss disproportionately to B, provided the allocation passed muster under section 704. Such an allocation may be troubling, especially if A or C were tax-exempt. But the substantiality rules of Treas. Reg. § 1.704-1(b)(2)(iii) are designed to address such concerns.

<sup>47</sup> Tax generally follows book. See Treas. Reg. §§ 1.704-1(b)(4)(i) and 1.704-3(b)(1).

<sup>48</sup> See Treas. Reg. § 1.704-3(a)(3)(i). This arises because the purchase of the partnership interest by UTP is not a revaluation event under the capital account maintenance rules. Treas. Reg. § 1.704-1(b)(2)(iv)(f).

<sup>49</sup> See Treas. Reg. § 1.704-1(b)(2)(iv)(i)(3).

Under such an approach, when UTP subsequently sells its interest in LTP, UTP's section 704(b) loss of \$180,000 would equal its tax loss. The proposed regulations envision that such loss will be allocated \$90,000 each to A and C to appropriately offset the gain that A and C recognized on the sale of the B stock. It should be noted, however, that such an allocation is not required. If UTP were to allocate the entire loss on the sale of its LTP interest to B, the allocation would arguably be appropriate so long as the substantial economic effect rules of section 704(b) were satisfied.<sup>50</sup>

An alternative would be to treat the difference between the tax basis and section 704(b) book basis of UTP's LTP interest as a section 704(c) amount<sup>51</sup> allocable to B.<sup>52</sup> Under such an approach, when UTP sells its LTP interest, UTP would recognize a book loss of \$270,000, but a tax loss of only \$180,000. The \$90,000 difference would be attributable to B, as if B were the contributor of that UTP interest. Thus, to the extent A and C were allocated book loss, they would be allocated tax loss. If the book loss were allocated equally among A, B, and C, the tax loss would be allocated only to A and C.<sup>53</sup> This would cause the partners' capital accounts and outside bases to be as follows:

**UTP:**

<u>Partner</u>	<u>704(b) Book Capital</u>	<u>Outside Basis</u>
A	\$100,000	\$100,000 <sup>54</sup>
B	\$100,000	\$100,000 <sup>55</sup>
C	\$100,000	\$100,000 <sup>56</sup>

Note that B has no built-in gain or loss in its partnership interest.

**2. Provide a De Minimis Rule for the Proposed Regulations**

The mechanic of the proposed regulations may be unnecessarily burdensome to a partnership in which the ownership of stock of a corporate partner is merely incidental. We therefore suggest that, as a matter of administrative convenience, the final regulations provide an elective *de minimis* exception to the required basis adjustments (and associated nonrecognition rule). Such an exception, which should be available at the partnership level by election of the partnership, could be based upon (i) an absolute dollar value of the stock owned by the partnership, (ii) the percentage of the

<sup>50</sup> See *supra* note 43.

<sup>51</sup> See Treas. Reg. § 1.704-3(a)(3)(i).

<sup>52</sup> Another alternative would be to make UTP's acquisition of the LTP interest a revaluation event at LTP. This alternative, however, may be overly complex.

<sup>53</sup> Once again, however, such an allocation is not required and UTP could presumably allocate the loss disproportionately to B.

<sup>54</sup> Computed as follows: \$190,000 initial book capital account and \$190,000 outside basis, each reduced by \$90,000 book loss and tax loss respectively.

<sup>55</sup> Computed as follows: \$190,000 initial book capital account, reduced by \$90,000 book loss.

<sup>56</sup> Computed as follows: \$190,000 initial book capital account and \$190,000 outside basis, each reduced by \$90,000 book loss and tax loss respectively.

total fair market value of the partnership's assets represented by the stock of corporate partners, or (iii) an absolute dollar value of the amount of unrecognized gain (or loss) of corporate partners recognized during any given taxable year.

### 3. Expand Scope of the Proposed Regulations<sup>57</sup>

We believe that the scope of the proposed regulations should be expanded to include the issues addressed in Rev. Rul. 96-10 and Rev. Rul. 96-11.<sup>58</sup> As we have discussed, those two revenue rulings dealt with matters very closely related to the issue dealt with by the proposed regulations and are even cited in Notice 99-57 as examples of how section 705 has been applied. Just as the proposed regulations intend to preserve the intent of section 1032, the rulings represent the use of section 705 to preserve the intent of other provisions of the Code, *i.e.*, sections 707 and 267 in Rev. Rul. 96-10,<sup>59</sup> and section 170 in Rev. Rul. 96-11.<sup>60</sup> When, in the past, regulations have been revised, care has been taken to incorporate relevant revenue rulings. For example, when the regulations under section 708(b)(1)(B) were revised in 1997, the revised regulations incorporated the holdings of a number of revenue rulings.<sup>61</sup> We believe that similar care should be taken in this case.

### III. Conclusion

The importance of establishing appropriate tax policy in preserving the intent of section 1032 cannot be overstated. Nevertheless, the recent decision in *Giltitz* indicates that there is considerable risk in the government's attempt to issue regulations

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<sup>57</sup> It may also be appropriate to expand the holding of Rev. Rul. 99-57 to sales of partnership interests. We believe, however, that such expansion requires careful consideration and is beyond the scope of this Comment and the proposed regulations.

<sup>58</sup> The final regulations could follow the model of the consolidated return investment adjustment rules. Those rules follow the principles of Rev. Rul. 96-10 and Rev. Rul. 96-11 in connection with basis adjustments arising from tax-exempt income and noncapital, nondeductible expenses. *See* Treas. Reg. §§ 1.1502-32(b)(3)(ii) and (iii).

<sup>59</sup> "Reducing the partners' bases in their partnership interests by their respective shares of the partnership's \$20x loss preserves the intended detriment of not allowing losses from sales or exchanges between partnerships and related persons to be deducted" and "[i]ncreasing the partners' bases in their partnership interests by their respective shares of the unrecognized gain on the sale of Property preserves the intended benefit of §§ 707(b)(1) and 267(d)." Rev. Rul. 96-10.

<sup>60</sup> "Reducing the partners' bases in their partnership interests by their respective shares of the permanent decrease in the partnership's basis in its assets preserves the intended benefit of providing a deduction (in circumstances not under § 170(e)) for the fair market value of appreciated property without recognition of the appreciation. By contrast, reducing the partners' bases in their partnership interests by the fair market value of the contributed property would subsequently cause the partners to recognize gain (or a reduced loss), for example, upon a disposition of their partnership interests, attributable to the unrecognized appreciation in X at the time of this contribution." Rev. Rul. 96-11.

<sup>61</sup> The holdings of Rev. Rul. 87-50 and Rev. Rul. 87-51 (dealing with the effect of terminations under section 708(b)(1)(B) on lower-tier partnerships) and Rev. Rul. 86-73 and Rev. Rul. 88-42 (dealing with the effect of a section 754 election made by the terminating partnership) were incorporated, without substantive change, into the regulations under section 1.708-1. *See* T.D. 8717, 62 Fed. Reg. 25,498 (May 9, 1997).

that contradict a plain reading of the Code. This risk is exacerbated by the fact that the proposed regulations seem contrary to the elective nature of sections 743(b) and 754. Given this risk, we believe the legal authority for the proposed regulations should be grounded in the 1954 Code and its clear dictate that aggregate treatment of partnership taxation may be more appropriate in certain circumstances: the application of section 1032 to transactions conducted by a partnership with respect to the stock of a corporate partner seems quite clearly to be one of those circumstances.

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Should you have any questions or wish to discuss any of our comments or suggestions, please contact Glenn Mincey at 212/492-4271 or Eric Sloan at 212/492-4159.