



Section of Taxation

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April 25 2007

Hon. Mark. W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Notice 2006-14

Dear Commissioner Everson:

Enclosed are comments concerning Notice 2006-14. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

- cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
- Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
- Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
- William P. O'Shea, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
- William P. Bowers, Senior Counsel, Office of Tax Policy, Department of the Treasury
- Christopher T. Kelley, Counsel to the Chief Counsel Staff (Passthroughs & Special Industries), Internal Revenue Service
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**ABA SECTION OF TAXATION
COMMENTS CONCERNING NOTICE 2006-14**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Howard E. Abrams of the Partnerships and LLCs Committee of the Section of Taxation. Substantive contributions were made by Karen Burke, Deborah Harrington, Matthew Lay, Karen Lohnes, and Jeanne Sullivan. The Comments were reviewed by James Wreggelsworth, Committee Chair, and Eric Sloan, Committee Vice-Chair. The Comments were further reviewed by Adam Handler of the Section’s Committee on Government Submissions and by Barbara de Marigny, Supervisory Council Director for the Partnerships and LLCs Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, 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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April 25, 2007

EXECUTIVE SUMMARY

I. General Summary

In Notice 2006-14,¹ the Internal Revenue Service (the “Service”) proposed possible modifications to the regulations promulgated under section 751(b) and requested comments on those proposed modifications, as well as alternative proposals.² We believe the approach suggested in Notice 2006-14 is far superior to the rules found in the existing section 751(b) regulations. We believe, however, that alternatives exist that might better address the concerns underlying section 751(b). Alternatively, refinements to the Service’s proposals may better capture the transactions to which section 751(b) should apply. Such alternatives and refinements are discussed below. We wish to make clear, however, that as between continuing the existing section 751(b) regulations and adopting the proposals set forth in Notice 2006-14, we strongly believe that the proposals in Notice 2006-14 are superior.

Section 751(b) grants the Secretary of the Treasury broad regulatory authority to provide guidance on the operation of section 751(b). However, that authority is constrained by the language of the statute, which seemingly requires that section 751(b) create a mechanism for recharacterizing certain distributions as exchanges between a distributee partner and the distributing partnership. This two-party exchange requirement arguably places a significant limitation on the available options for improving the section 751(b) regulations and for coordinating the application of section 751(b) with changes made to the statute and to the regulations in the more than 50 years since section 751(b) was enacted as part of the Internal Revenue Code of 1954.

Given the constraints of the statute, the complexity of subchapter K, and the endless variety of transactions to which the rules of subchapter K must apply, it is likely that no set of rules under section 751(b) can work perfectly. Trade-offs are inevitable, and we believe the promulgation of rules that address most distributions simply and clearly will succeed where rules that are more complex might fail, even though they may apply to a slightly larger class of transactions.

II. Summary of Recommendations

- A. New regulations should be promulgated under section 751(b) that restrict application of section 751(b) to distributions that rearrange the partners’ shares of the unrealized appreciation in the partnership’s substantially appreciated inventory and unrealized receivables. That is, the regulations should apply only if a distribution reduces a partner’s share of the partnership’s ordinary income.³

¹ 2006-8 I.R.B. 498.

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all references to “regulations” and “Reg.” are to the Treasury regulations promulgated under the Code.

³ Technically, section 751(b) speaks only to those ordinary income assets that are either “unrealized receivables” or “substantially appreciated inventory,” but for ease of exposition we refer to such assets as the ordinary income assets of the partnership. Likewise, any references to a partner’s share of the partnership’s ordinary

Consequently, new regulations should confirm that nonliquidating distributions of cash or capital assets by a partnership that elects to revalue its assets immediately before the distribution as provided in Reg. § 1.704-1(b)(2)(iv)(f)-(g) generally should not give rise to adjustments under section 751(b).

- B. These regulations should provide rules for measuring each partner's share of the partnership's ordinary income both before and after a distribution (before taking into account the application of section 751(b), if at all). These rules should incorporate the rules of sections 704(b) and 704(c), as well as any basis adjustments required by statute or arising from the application of a section 754 election.⁴
- C. These new regulations should achieve the following goals:
1. The rules under section 751(b) should apply to each partner's share of the partnership's ordinary income in the aggregate so that shifts in ordinary income from one asset to another should be irrelevant if the partner's aggregate share of the partnership's ordinary income is unchanged;
 2. If a distribution reduces a partner's share of the partnership's ordinary income, section 751(b) should apply and trigger ordinary income to that partner;
 3. Ordinary income recognized by one partner under section 751(b) should result in appropriate basis adjustments so that the same income will not be recognized a second time by the same partner or by other partners;
 4. Section 751(b) should not accelerate the recognition of capital gain other than when necessary to prevent a distribution from affecting the partners' shares of the partnership's ordinary income;
 5. Section 751(b) should be coordinated with the basis adjustment rules of sections 732(d), 734(b), and 743(b) to ensure that a distribution cannot reduce or rearrange the partnership's allocations of ordinary income; and
 6. In situations in which a distribution reduces the nondistributtee partners' shares of the partnership's ordinary income, all three approaches described below (the "hot asset sale" approach, the "distributtee purchase" approach,

income are intended to describe a partner's share of ordinary income in unrealized receivables and substantially appreciated inventory within the meaning of sections 751(c) and (d).

⁴ Taking account of basis adjustments arising from section 754 elections raises one technical issue: the taxation of distributions is, in general, determined at the time that the distribution is made, while an election under section 754 can be made by the partnership after the close of the partnership's taxable year. Problems resulting from these timing disparities seem more theoretical than actual and are encountered in other parts of subchapter K. Nevertheless, the government may wish to provide that the application of section 751(b) is determined at the close of the partnership's taxable year.

and the “section 704(c)(1)(B) approach”) reach the same result; they differ only on how that result is justified. In the interests of simplicity, we prefer the “section 704(c)(1)(B)” approach, which arrives at the same result without requiring any deemed transactions between the partnership and its partners.

COMMENTS

I. Description of Existing Law Under Section 751(b)

In general, distributions from a partnership to a partner with respect to the partner's interest in the partnership are taxable to the distributee partner under section 731 only to the extent that the distributed cash (or marketable securities) exceeds the distributee's pre-distribution outside basis in the partner's partnership interest and are tax-free to all other partners. However, section 751(b) overrides section 731 for certain current and liquidating partnership distributions that alter a partner's share of the partnership's unrealized receivables and substantially appreciated inventory items (sometimes called "section 751 property" or "hot assets") in exchange for that partner's interest in other partnership property (including money) (collectively, "non-section 751 property" or "cold assets").⁵ The taxing provision of section 751(b), section 751(b)(1), was enacted in 1954 as part of the codification of the Internal Revenue Code of 1954. With minor indirect modifications,⁶ section 751(b) has remained unchanged for more than 50 years. It provides:

“(b) CERTAIN DISTRIBUTIONS TREATED AS SALES OR EXCHANGES.

(1) GENERAL RULE.

To the extent a partner receives in a distribution--

(A) partnership property which is--

(i) unrealized receivables, or

(ii) inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in other partnership property (including money), or

(B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),

such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).”

⁵ Under section 751(b)(2)(A) and (B), section 751(b) does not apply with respect to a distribution of property that the distributee partner contributed to the partnership or to payments to a retiring partner or successor in interest of a deceased partner to the extent such payments are described in section 736(a).

⁶ Section 751(b)(1) incorporates the definition of “substantial appreciation” from section 751(b)(3)(A), and that provision has been modified slightly in a way not relevant to the discussion in these comments. The definition of an “unrealized receivable” has been expanded repeatedly.

As a result of the deemed exchange provided for in section 751(b), if the distribution increases the distributee partner's interest in section 751 property, the excess section 751 property is treated as acquired by the distributee partner in exchange for a portion of that partner's interest in the partnership's non-section 751 property. This deemed exchange may generate taxable income to both the distributee partner and to the partnership, generally capital gain or loss to the distributee partner and ordinary income to the partnership (allocable exclusively to the non-distributee partners).⁷ In addition, it will produce a fair market value cost basis for all exchanged assets (or portion thereof) by reason of the application of sections 1001(a) and 1012 to the deemed exchange. Similarly, if the distribution increases the distributee partner's interest in non-section 751 property, the excess non-section 751 property is treated as acquired by the distributee partner in exchange for a portion of that partner's interest in the partnership's section 751 property. This generally will produce ordinary income to the distributee, who is viewed as disposing of a portion of his interest in section 751 property, and capital gain or loss to the continuing partnership, which is viewed as transferring the excess non-section 751 property to the distributee partner in a taxable exchange.⁸ In either case, the remainder of the property actually distributed to the distributee partner is subject to the general distribution provisions of sections 731, 732, and 733.⁹ Consider the following example.

Example 1. W, X, Y, and Z are equal members of Partnership. X receives a liquidating distribution of \$15,000 in cash when partnership assets consist of cash of \$20,000, a capital asset with an adjusted basis of \$16,000 and a fair market value of \$20,000, and inventory having an adjusted basis of \$8,000 and a fair market value of \$20,000. At the time of the distribution, each partner has an outside basis in its partnership interest and a capital account of \$11,000.

In the absence of section 751(b), this distribution would be taxable to X the extent of \$4,000, all of which would be capital gain.¹⁰ Under existing section 751(b) rules, however, the distribution would be treated as involving multiple steps. First, X would be treated as receiving a distribution of inventory with a value of \$5,000 and a basis of \$2,000. This distribution would be tax-free under section 731(a)(1), X would take a basis in this inventory of \$2,000, and X would reduce her outside basis to \$9,000. X would then be treated as selling this inventory to the partnership for cash of \$5,000, causing X to recognize ordinary income of \$3,000 under sections 1001(a) and 735(a)(2), and the partnership would take a cost basis in this portion of the inventory pursuant to section 1012. Finally, X is treated as receiving a liquidating distribution of \$10,000, triggering capital gain to X of \$1,000 (and a positive basis adjustment to the partnership under section 734(b) if the partnership has an election under section 754 in effect). Thus, X continues to recognize aggregate income of \$4,000, but the application of section 751(b) converts \$3,000 of this income from capital gain into ordinary income. The partnership takes an automatic step-up in basis under section 1012 to the extent of the ordinary income recognized by X and an optional step-up in basis under section 734(b) to the extent of the capital gain recognized by X if an election under section 754 is in effect.

⁷ Reg. § 1.751-1(b)(2)(ii).

⁸ Reg. § 1.751-1(b)(3).

⁹ See Reg. §§ 1.751-1(b)(2), (3).

¹⁰ Section 741.

II. The Legislative History of Section 751(b)

Section 751(b) was enacted as part of the major reforms that became the Internal Revenue Code of 1954. Among the many changes adopted by Congress in enacting the 1954 Code was the codification of rules regarding the tax treatment of partnerships and partners in subchapter K. While many of these rules have been amended, and new provisions have been added to subchapter K, section 751(b) remains virtually unchanged.

Prior to 1954, it was unclear whether the sale or exchange of a partnership interest should be treated as the disposition of an undivided interest in the partnership's assets or of an interest in a separate entity distinct from the assets it holds.¹¹ The general rule of section 741 adopts the entity theory, treating a partnership interest as a single capital asset. That general rule, however, is subject to section 751(a), which requires the selling partner to treat a portion of the gain or loss as ordinary income or loss based upon the selling partner's share of ordinary income or loss in the partnership's assets.¹²

As originally proposed, the rule of current section 751(a) would have applied to sales and exchanges of partnership interests as well as to liquidating distributions of cash and capital assets.¹³ The inapplicability of the proposed section 751 to distributions of hot assets was criticized by the American Bar Association in testimony before the Senate Finance Committee,¹⁴ and, in response, the Senate bill ultimately leading to the Internal Revenue Code of 1954 proposed a revised section 751(a) applicable only to dispositions of partnership interests, along with a new section 751(b) applicable to distributions.

While the Treasury treated section 751(b) as applicable to current distributions as well as to liquidating distributions, the role of section 751(b) in the context of nonliquidating distributions was less certain. At least one early commentator thought that section 751(b) need not apply to most current distributions because in such circumstances the distribution does not cause the distributee to relinquish a share of the partnership's undistributed assets,¹⁵ a very

¹¹ See Dale E Anderson & Melvin A. Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (Second Installment)*, 15 TAX L. REV. 497, 498 (1960).

¹² The exception in section 751 does not swallow the general rule of section 741. A selling partner cannot treat any portion of the gain or loss as section 1231 gain or loss regardless of the assets held by the partnership, and a failure to fragment the seller's gain or loss based upon the assets of the partnership presents difficult issues when sourcing must be determined, when the partnership owns stock of the selling partner, and in other circumstances in which the tax treatment of the partnership's assets raises issues beyond the capital gain/ordinary income distinction. For example, recently proposed regulations under section 1248 have treated a partnership interest as an aggregate in applying section 1248 to foreign partnerships. See Prop. Reg. § 1.1248-1(a)(4), REG-135866-02, 71 FR 31985 (June 2, 2006); see also Reg. § 1.1(h)-1 (capital gain look-through rule on sales of partnership interests).

¹³ See H.R. 8300, 83d Cong., 2d Sess. § 751(a) (1954).

¹⁴ *Hearings on H.R. 8300 Before the Senate Committee on Finance*, 83d Cong., 2d Sess. 475 (1954) (supplemental statement of the American Bar Association); see Anderson & Coffee, *supra* note 11, at 526-28; S. Rep. No. 1635, 83d Cong. 2d Sess. 98-99 (1954).

¹⁵ Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954 (First Installment)*, 10 TAX L. REV. 161, 187-88 (1954).

modern view of the problem now largely accurate given the current rules of section 704(c).¹⁶ This commentator, Paul Little, also found support for such a reading of section 751(b) in the legislative history of section 751(b). Little observed that the legislative history of section 751(b) includes the statement that gain recognized by the partnership by reason of a section 751(b) deemed exchange should be allocated “to the partnership as constituted after the distribution, i.e., to the partners other than the distributee.”¹⁷ As Little observed, the partnership will be composed of “the partners other than the distributee” only if the distribution is in liquidation of the distributee’s interest.¹⁸

The leading commentators at the time (a group including Professor Stanley Surrey of the Harvard Law School and Dean William Warren of the Columbia Law School) devoted little space to section 751(b) in their comprehensive analysis of then-newly enacted subchapter K,¹⁹ and what they did say largely supports the inapplicability of section 751(b) to many current distributions. They wrote:

Assume equal partnership AB owns cash of \$36,000 and inventory having a cost basis of \$4,000 and a fair market value of \$10,000. A and B had both contributed \$10,000 cash to the partnership, but it has undistributed earnings of \$20,000, so that each has a basis for his partnership interest of \$20,000. The partnership currently distributes all of the inventory to A, who has offsetting personal ordinary losses and who would, therefore, not be taxed on any ordinary income if he sold the inventory. As a result of this distribution B has, in effect, transferred to A half his interest in appreciated inventory in return for A’s half interest in the remaining \$10,000 of earnings. Consequently, the normal current distribution rules will not apply. B will be taxed on ordinary income of \$3,000 (\$5,000 - \$2,000) and A’s basis for the inventory will be \$7,000.

Under section 751 the normal current distribution rules will also be inapplicable if a distribution of property or cash is made to a partner in exchange for an interest in the partnership’s inventory and receivables. If, for example, the partnership in the above hypothetical distributed \$10,000 in cash to B *and he agreed to relinquish his interest in the inventory*, the proceeds on the sale of which would be allocated to A, B would recognize a gain of \$3,000 and the partnership’s basis for the inventory would be increased to \$7,000.²⁰

While this example predates the mandatory application of current section 704(c)(1)(A) and its extension to optional revaluations and the creation of reverse 704(c) layers, it gets the analysis exactly right. Section 751(b) should apply to a distribution only if the distribution

¹⁶ See text at note 36 *infra*.

¹⁷ H.R. Conf. Rep. No. 2534, 83d Cong., 2d Sess. 65 (1954) (emphasis added).

¹⁸ See Little, *supra* note 15, at 186 n.106.

¹⁹ J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey, Carolyn K. Tenen & William C. Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1214-15 (1954).

²⁰ *Id.* at 1215 (emphasis added and footnote omitted).

causes a shift in the partners' shares of the partnership's ordinary income. In the context of a current distribution, such a shift generally will occur only when (i) the distribution includes hot assets or (ii) the distributee's share of the partnership's ordinary income is reduced by the distribution (which is possible under current law only if the partnership does not revalue its assets and restate capital accounts immediately before the distribution).

The current regulations under section 751(b) contain examples, each of which constructs an exchange table detailing the distributee's share of the partnership's hot assets immediately before and after the distribution. To the extent the distribution causes a change in the distributee's share of the hot assets, a deemed exchange is constructed that triggers income recognition to the distributee, to the nondistributee partners, or to both. While this exchange table approach is applicable under the examples in the existing regulations to current and liquidating distributions alike, the legislative history of section 751(b) includes such an approach only in the context of a liquidating distribution.²¹ As to the intended application of section 751(b) to nonliquidating distributions, the legislative history is silent.

There is no question that nonliquidating distributions can rearrange the partners' shares of the partnership's ordinary income, and this was understood before enactment of section 751. For example, the ALI proposed a complicated method of addressing such ordinary income swaps in its comprehensive 1954 report on income tax reform. Yet for the ALI, too, the possible problems created by nonliquidating distributions may have been an afterthought, reflected in the fact that all of the examples in its report involve only liquidating distributions.²²

We believe a fair reading of the legislative history can be described as follows: Considerable attention was paid to the possible application of section 751(b) to liquidating distributions, and the current regulations under section 751(b) faithfully reflect the legislative history in that context. Far less attention was given to the possible application of section 751(b) to nonliquidating distributions. But the goal of section 751(b) in all contexts was clear. Section 751(b) was enacted to "inhibit[] tax avoidance by applying special rules to prevent the shifting between partners of potential ordinary gain attributable to substantially appreciated inventory and unrealized receivables owned by the partnership."²³

²¹ S. Rep. No. 1635, 83d Cong., 2d Sess. 404-05 (1954).

²² See 2 American Law Institute, FEDERAL INCOME TAX STATUTE §X761, at 409-11 (1954) (Stanley S. Surrey & William C. Warren, reporters). Section X761 of the proposal is entitled: "Treatment of Disproportionate Distributions in Winding Up of a Partnership or on Retirement of a Partner or the Reduction of His Interest Where Non-capital Assets of the Partnership Have Increased or Decreased Significantly in Value."

²³ Jackson, Johnson, Surrey, Tenen & Warren, *supra* note 19, at 1214.

III. Recognized Problems With Existing Law Under Section 751(b)²⁴

A. The Need for Coordination With Changes in Subchapter K

Section 751(b) has remained almost unchanged since 1954, but many of its companion provisions have undergone significant transformation. In particular, section 704(b) was rewritten in 1976 to test tax allocations against the requirement of “substantial economic effect.” Prior to 1976, a subjective tax avoidance test played the role of the objective rules now governing tax allocations. Further, what is now section 704(c)(1)(A) applied only to those partnerships that chose to be subject to it, and partnership revaluations and reverse 704(c) allocations had not yet joined the tax lexicon.

Section 751(b) was intended to backstop the more general rules of subchapter K to ensure that partnership distributions could not be used to convert or reallocate partnership ordinary income. The tax consequences of partnership distributions now are determined in part by the principles of section 704(c) as applied pursuant to the rules of section 704(b).²⁵ As a result, the effect of a distribution on future tax allocations is reduced considerably. It is appropriate, therefore, for the application of section 751(b) to be modified to account for the changes in its companion provisions.

B. The Focus on Value Rather than Unrealized Appreciation

Under the examples in the existing regulations, section 751(b) applies to any partnership distribution to the extent the distribution increases or decreases the distributee partner’s share of the hot assets of the partnership measured on a *gross value basis*.²⁶ As a result, a distribution can result in the exchange of low-basis assets (with substantial ordinary income potential) for high-basis assets (with little ordinary income potential) without recharacterization under section 751(b). Consider the following:

Example 2. W, X, Y, and Z are equal members of Partnership. The partnership assets consist of cash of \$20,000, a capital asset with an adjusted basis of \$16,000 and a fair market value of \$20,000, inventory with an adjusted basis of \$8,000 and a fair market value of \$20,000, and an unrealized receivable with an adjusted basis of \$0 and a fair market value of \$20,000. X receives a liquidating distribution of half the capital asset (having an adjusted basis of \$8,000 to the partnership) and half the inventory (having an adjusted basis to the partnership of \$4,000). At the time of the distribution, each partner has an outside basis and capital account of \$11,000.

²⁴ See generally Monte A. Jackel & Avery I. Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, 98 TAX NOTES 1557 (March 10, 2003).

²⁵ Reg. § 1.704-1(b)(4)(i).

²⁶ See, e.g., Reg. § 1.751-1(b)(1)(ii).

In the absence of section 751(b), this distribution would be tax-free to all parties, and X would take a basis of \$4,000 in the distributed inventory and \$7,000 in the capital asset. Under the examples in the existing section 751(b) regulations, this result does not change because X's share of the hot assets immediately before the distribution (\$10,000 or one-quarter of the \$20,000 of inventory plus one-quarter of the \$20,000 unrealized receivable) equals X's share of those assets immediately after the distribution (\$10,000 of distributed inventory).

In fact, though, section 751(b) ought to apply to the distribution. Immediately before the distribution, X's share of the partnership's ordinary income equaled \$8,000 (one-quarter of the \$12,000 unrealized appreciation in the inventory and one-quarter of the \$20,000 unrealized appreciation in the unrealized receivable). After the distribution, X's share of that income has declined to \$6,000 (because X now owns inventory with a value of \$10,000 and an adjusted basis of \$4,000). Thus, the distribution caused an exchange of X's share of the zero-basis unrealized receivable for an additional share of the non-zero-basis inventory, allowing X to reduce her share of the partnership's ordinary income. If the goal of section 751(b) is to prevent the shifting among partners of the ordinary income of the partnership, then failing to account for differences in adjusted bases of the partnership's hot assets ensures it can do only a "poor job" of preventing such shifts.²⁷

C. The Need to Determine the Hypothetically-Distributed Assets

When section 751(b) applies to a distribution, the transaction is recharacterized as an initial distribution of some of the assets that are actually left behind by the distributee. These assets are then treated as exchanged (in a taxable transaction described in section 1001(a)) for some of the assets actually distributed to her. For example, reconsider the facts of example 2, above, but assume that X receives a liquidating distribution consisting exclusively of the unrealized receivable.

Example 3. W, X, Y, and Z are equal members of Partnership. The partnership assets consist of cash of \$20,000, a capital asset with an adjusted basis of \$16,000 and a fair market value of \$20,000, inventory with an adjusted basis of \$8,000 and a fair market value of \$20,000, and an unrealized receivable with an adjusted basis of \$0 and a fair market value of \$20,000. X receives a liquidating distribution of the unrealized receivable. At the time of the distribution, each partner has an outside basis and capital account of \$11,000.

Under the existing section 751(b) regulations, this distribution results in an increase of \$10,000 in X's share of the partnership's hot assets. As a result, the existing section 751(b) regulations require the transaction to be recharacterized, and the first step of that recharacterization is a hypothetical distribution of \$10,000 worth of the partnership's cold assets. In this example, the hypothetical distribution consists of cash, a portion of the capital asset, or both.

²⁷ WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, 2 FEDERAL INCOME TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 21.01[2], at 21-4 through 21-5 (3d ed. 1996).

If the hypothetical distribution is treated as consisting of \$10,000 in cash, then it will be tax-free to all parties and will reduce X's outside basis to \$1,000. This cash is then deemed exchanged by X for \$10,000 of the unrealized receivable, causing the partnership to recognize ordinary income of \$10,000 and giving X a cost basis in this portion of the unrealized receivable treated as purchased by X. Finally, X is treated as receiving the remainder of the receivable, giving X a basis in this second portion of the receivable and an immediate capital loss of \$1,000 to account for X's outside basis that disappears as a result of the distribution.²⁸

If, however, the hypothetical distribution is treated as consisting of half the capital asset (having an adjusted basis to the partnership of \$8,000), rather than solely cash, then the results are different. The hypothetical distribution is again tax-free to all parties, with X taking a basis in the distributed half of the capital asset equal to \$8,000 and reducing her outside basis to \$3,000. Then, X is deemed to exchange this portion of the capital asset for half of the unrealized receivable, causing the partnership to recognize ordinary income of \$10,000 as before, and X to recognize a capital gain of \$2,000. The liquidating distribution of the remainder of the unrealized receivable then triggers an immediate capital loss to X of \$3,000.²⁹ The \$2,000 capital gain recognized by X results in an immediate basis increase to the partnership in the capital asset because the partnership takes a cost basis in that portion of the capital asset treated as distributed to X and then reacquired by the partnership in exchange for half of the unrealized receivable.

In the absence of an agreement to the contrary, the hypothetical distribution is apparently deemed to consist of all partnership assets of the appropriate class (hot assets or cold assets) in proportion to relative fair market values.³⁰ However, if (as in Example 3) the hypothetical distribution consists of cold assets, the existing regulations clearly permit the partners to agree which assets are treated as distributed in the hypothetical distribution.³¹ The effect of such an agreement can be to limit the amount of capital gain recognized by the nondistributee partners (or even generate a capital loss for the nondistributee partners).

D. The Ordering Problem

If multiple partners receive distributions in a single transaction, application of section 751(b) to all the distributions is problematic. The distributions can be analyzed serially, but in that case the assumed order of the distributions can affect the tax consequences of the transaction.³² Guidance should be provided by future regulations that address the simultaneous

²⁸ Section 731(a)(2).

²⁹ X's outside basis begins at \$16,000 and is reduced to \$3,000 by the deemed distribution or one-half of the capital asset. X takes the unrealized receivable received in liquidation of her interest with a zero basis under section 732(c)(1)(A), leaving X with a \$3,000 outside basis and capital loss.

³⁰ See Reg. § 1.751-1(g) (Examples 3(c), 3(d)(1), and 5(c)).

³¹ See Reg. § 1.751-1(g), Example 3(c).

³² See MCKEE, NELSON & WHITMIRE, *supra* note 27, ¶ 21.06[2][a], at 21-51. While there may be a way to analyze the distributions as occurring simultaneously, the regulations offer no guidance, and an approach suggested by commentators, in their own words, "does some violence to the language of the statute." *Id.* ¶ 21.06[2][c], at 21-55.

distribution to two or more partners, and analysis of the transaction should not require an artificial assumption that one distribution followed the other.

IV. Notice 2006-14

On February 12, 2006, the IRS published Notice 2006-14, requesting comments on the possible revision of regulations promulgated under section 751(b). Notice 2006-14 proposes to compare each partner's share of the ordinary income in the partnership's assets and the distributed property immediately before and after a distribution, with section 751(b) applying to the extent that the distribution causes a reduction in any partner's share of such income. This approach is called the "hypothetical sale approach" in the Notice because it uses the results from a hypothetical sale of the hot assets as its baseline. Notice 2006-14 suggests that this emphasis on each partner's share of the partnership's ordinary income better comports with the legislative goal underlying section 751(b) to ensure that a distribution cannot convert a partner's share of ordinary income into capital gain and is consistent with the statement in the legislative history of section 751(b) that says the "income rights" of the partners may be treated as "severable" from the partners' interests in partnership capital.³³

The hypothetical sale approach is consistent with the "substantial economic effect" regulations promulgated under section 704(b) because the results of the hypothetical sales are determined only after gain from the hypothetical sales are allocated among the partners consistent with the statutory requirements imposed on tax allocations. In addition, the "hypothetical sale approach" is consistent with section 751(a), an important consideration because the legislative history of section 751 makes clear that the two provisions were intended to work in tandem.³⁴ Further, Notice 2006-14 expressly incorporates section 704(c) principles by taking into account both forward and reverse 704(c) allocations triggered by the hypothetical sales. Because reverse 704(c) book-ups effectively lock the unrealized appreciation and loss of the nondistributed assets into the partners' capital accounts, a nonliquidating distribution of cold assets (including cash) generally should not trigger any consequences under section 751(b).

Notice 2006-14 provides the following example:³⁵

Assume that A, B, and C each contribute \$120 to partnership ABC. ABC purchases land for \$210, which appreciates in value to \$300. At a time when the partnership also has \$90 of zero-basis unrealized receivables and cash of \$150, ABC distributes \$90 to C, reducing C's interest in ABC from 1/3 to 1/5. If, immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to reflect each partner's share of the unrealized appreciation in the partnership's assets, C's entire pre-distribution share of the partnership's unrealized income in the accounts receivable (1/3 of \$90, or \$30) is preserved in C's capital account after the distribution.

³³ S. Rep. No. 1622, 83d Cong., 2d Sess., at 99 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4732.

³⁴ The regulations under section 751(a) were substantially revised in 1999 to incorporate a hypothetical sale approach. Reg. § 1.751-1(a)(2) (as amended by T.D. 8847, 1999-2 C.B. 701).

³⁵ "Example 1" in Notice 2006-14, 2006-8 I.R.B. at 499.

As this example makes clear, the effect of a revaluation of the partnership's assets and a restatement of the partners' capital accounts is to preserve each partner's share of the unrealized appreciation and loss in the undistributed assets regardless of changes made to the partners' sharing of future appreciation and loss. As a result, section 751(b) should not apply to such a distribution.

The converse of this example is that the distribution of hot assets will, in general, trigger the application of section 751(b). Reconsider the facts of the example from Notice 2006-14 above, but assume that the distribution consists of \$90 of unrealized receivables. Now, the distribution reduces A's and B's shares of the partnership's ordinary income to \$0 because all of the hot assets have been distributed to A. Unless section 751(b) applies to the distribution, the partnership's ordinary income will have been shifted to A. While this does not cause a net conversion of ordinary income into capital gain, it allows two of the three partners (B and C) to shift their shares of the partnership's ordinary income to the third partner (A).

Notice 2006-14 suggests that when a distribution implicates section 751(b), a partner whose share of the partnership's ordinary income is reduced by the distribution could be treated as receiving a share of the hot assets in a tax-free distribution followed by a transfer of that property back to the partnership in a taxable sale. This recharacterization, called the "hot asset sale approach," triggers gain recognition to the partner whose share of partnership's ordinary income otherwise would decline and gives a cost basis to the partnership in the portion of the asset deemed reacquired by the partner. This recharacterization largely follows the approach adopted by existing regulations, but without the need to identify any partnership cold assets that are treated as exchanged.

Notice 2006-14 identifies 10 specific areas in which guidance is requested. They are:

A. For purposes of determining each partner's share of partnership assets before and after a distribution that may be subject to section 751(b),

(1) Whether the hypothetical sale approach (combined with the application of section 704(c) principles) for determining each partner's share of partnership assets provides an accurate and appropriate measure for purposes of section 751(b). In particular,

a. Whether special rules would be necessary to address situations in which the distributee partner's interest in unrealized appreciation in hot assets prior to the distribution exceeds the partner's interest in partnership capital after the distribution;

b. Whether the hypothetical sale approach should be modified to take into account changes in allocations that are planned or may occur in the future or changes in the partner's interest in anticipated future appreciation and depreciation in partnership assets;

c. The extent to which regulations adopting the hypothetical sale approach should take into account the distributee partner's basis in the partnership interest and basis

adjustments under sections 734(b) and 743(b), including basis adjustments resulting from the distribution;

d. Whether the partners' shares of partnership liabilities should be considered in determining the partners' shares of partnership assets, and how the rules of section 752 should be coordinated with those of section 751(b).

(2) Whether section 751(b) should be limited to transactions that change the partners' shares of unrealized appreciation in hot assets or should also apply to transactions that change the partners' shares of unrealized depreciation in hot assets.

(3) Whether other approaches to determining a partner's share of partnership hot and cold assets should be considered.

B. For purposes of simplifying the tax consequences of a distribution that is subject to section 751(b), whether the hot asset sale approach is an appropriate method of applying section 751(b) or whether other approaches should be considered. Comments are specifically requested on the following:

(1) Whether the regulations should provide a simple safe harbor that approximates the appropriate taxation of a disproportionate distribution and, if so, the appropriate parameters and availability of such a safe harbor.

(2) Whether the current section 751(b) regulations should be generally retained or retained in connection with a safe harbor, or whether the current section 751(b) regulations should be completely revised to adopt a new paradigm such as the hot asset sale approach.

(3) Whether mandatory or elective capital gain recognition should be included in the hot asset sale approach.

V. Alternatives and Proposals

A. Basic Principle

As recognized in Notice 2006-14, section 751(b) was intended to ensure that a partnership distribution cannot be used to rearrange the partners' interests in the unrealized appreciation in the partnership's hot assets. Commentators have long observed – and Notice 2006-14 has agreed with this observation – that the focus in the examples in the existing regulations should be changed from each partner's share of the *gross asset value* of hot assets to each partner's share of the *unrealized appreciation* in the partnership's hot assets. Accordingly, new regulations should be promulgated – as proposed in Notice 2006-14 – that make clear that the appropriate comparison is between each partner's share of the partnership's ordinary income immediate prior to and immediately after the distribution based on a hypothetical sale of those assets before and after the distribution.

B. Nonliquidating Distributions of Cold Assets

1. In General

The legislative history of section 751(b) is clear that a nonliquidating distribution of cold assets should trigger application of section 751(b) only if the distributee partner gives up some or all of her interest in partnership hot assets in exchange for the distributed property. If the partnership elects to revalue its assets and restate capital accounts immediately prior to the distribution, such an exchange will not occur because of section 704(c) principles invoked by the revaluation.³⁶ Accordingly, new regulations should provide that a nonliquidating distribution of cold assets will not implicate section 751(b) so long as the partnership books-up its assets immediately prior to the distribution.³⁷ This is recognized in Notice 2006-14 and described in its Example 1:

Assume that A, B, and C each contribute \$120 to partnership ABC. ABC purchases land for \$210, which appreciates in value to \$300. At a time when the partnership also has \$90 of zero-basis unrealized receivables and cash of \$150, ABC distributes \$90 to C, reducing C's interest in ABC from 1/3 to 1/5. If, immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to reflect each partner's share of the partnership's ordinary income, C's entire pre-distribution share of the partnership's unrealized income in the accounts receivable (1/3 of \$90, or \$30) is preserved in C's capital account after the distribution. ABC will have the following post-distribution balance sheet (before the application of section 751(b)):

<u>Assets</u>	<u>Basis</u>	<u>Value</u>	<u>Capital</u>	<u>Basis</u>	<u>Value</u>
Cash	\$ 60	\$ 60	A	\$120	\$180
Unrealized Receivables	\$ 0	\$ 90	B	\$120	\$180
Land	<u>\$210</u>	<u>\$300</u>	C	<u>\$ 30</u>	<u>\$ 90</u>
Total	\$270	\$450		\$270	\$450

If section 704(c) principles were applicable for purposes of section 751(b), the distribution to C would not trigger section 751(b), as C's pre-distribution share of the unrealized income in the receivables (\$30) is fully preserved in C's capital account after the distribution. Section 704(c) principles would require the partnership to allocate that share of appreciation to C when it is recognized.

³⁶ Section 704(c) principles are made applicable to partnership revaluations by Reg. § 1.704-1(b)(2)(iv)(g)(1).

³⁷ As discussed below, there are exceptions to this general rule. If a partnership fails to revalue its assets, and does not use special allocations of unrealized appreciation and loss to mimic the effect of a book-up, section 751(b) could be implicated by the distribution of cold assets. In addition, a distribution of high-basis cold assets to a low-basis partner may trigger a basis strip, and if an election under section 754 is in effect that basis strip could reduce ordinary income inherent in partnership property if, for example, the partnership owns capital assets subject to depreciation recapture under section 1245.

The same analysis should apply if the distribution consists of property other than cash so long as the property distributed consists exclusively of cold assets. For example, the analysis would not change if the cash distribution to C were replaced (in part or in whole) by land. Similarly, the analysis should not change if the distribution arises from a shift in partnership liabilities under section 752 because such a distribution generally does not change the partners' shares in the partnership's ordinary income; that is, a deemed distribution under section 752(b) arising from a shift in liabilities should be tested under section 751(b) but should not in general trigger ordinary income recognition under section 751(b) because a liability shift does not change the partners' shares of the partnership's ordinary income.³⁸

2. The Interplay of Section 751(b) With Section 751(a)

Section 751(b) should work in tandem with section 751(a) because they were enacted at the same time to address the same general issue.³⁹ Accordingly, limitations on the recognition of ordinary income under section 751(a) should be reflected in the operating rules of section 751(b). Depending on the facts, however, the distribution of an appreciated cold asset can raise a difficult question concerning the interplay of section 751(b) with section 751(a). Consider the following:

Example 4. Assume that A, B, and C each contribute \$120 to Partnership. The partnership purchases land for \$120, which appreciates in value to \$150. At a time when the partnership assets consist of the land, \$75 of zero-basis unrealized receivables, and cash of \$240, the partnership distributes the land to C. If, immediately before the distribution, the partnership's assets are revalued and the partners' capital accounts are increased to reflect each partner's share of the unrealized appreciation in the partnership's assets, the partnership will have the following post-distribution balance sheet (before the application of section 751(b)):

<u>Assets</u>	<u>Basis</u>	<u>Value</u>	<u>Capital</u>	<u>Basis</u>	<u>Value</u>
Cash	\$240	\$240	A	\$120	\$155
Unrealized Receivables	\$ 0	\$ 75	B	\$120	\$155
			C	\$ 0	\$ 5
Total	\$240	\$315		\$240	\$315

If section 751(b) does not apply to this distribution so that the distribution is tax-free, C takes a carryover basis of \$120 in the distributed land and reduces outside basis to \$0. The unrealized receivables have been booked to current fair market value. Therefore, the \$75 of

³⁸ *But see* Rev. Rul. 84-102, 1984-2 C.B. 119, which reaches the opposite conclusion in the absence of applying section 704(c) considerations. Because a liability shift does not rearrange the partners' interests in the partnership's ordinary income, we recommend that Rev. Rul. 84-102 be revoked.

³⁹ However, section 751(a) captures all ordinary income and loss of a partnership while section 751(b) speaks only to unrealized receivables and "substantially appreciated" inventory. As a result, the sale or exchange of an interest in a partnership owning inventory that is not "substantially appreciated" will produce tax consequences different from those arising from a liquidating distribution made by the same partnership.

taxable gain that will be realized and recognized when the receivables are collected will be allocated equally among the partners, \$25 to each partner.

If, in fact, the partnership collects the receivables and the \$75 of ordinary income is recognized while C remains a partner, each member of the partnership will recognize her proper share of the partnership's ordinary income. But if C sells her partnership interest prior to recognition by the partnership of the \$75 of ordinary income, the analysis arguably becomes more difficult.

Assume C sells her partnership interest for its fair market value of \$5 while the receivables remain outstanding. Because C's outside basis equals \$0 at the time of this sale, C recognizes \$5 of capital gain on the sale except to the extent section 751(a) provides a different result.⁴⁰

Under the literal language of the current regulations promulgated under section 751(a), the sale by C of her partnership interest produces ordinary income to C equal to the ordinary income that C would recognize if the partnership's assets were sold for current fair market value;⁴¹ that is, C recognizes ordinary income of \$25. Because the total gain realized by C on the sale equals only \$5, the current regulations further provide that C recognizes \$20 of capital loss on the sale in addition to the \$25 of ordinary income.⁴²

Some practitioners assert that the statutory language of section 751(a) does not support such a result.⁴³ Section 751(a) provides that the amount of money or property received for a partnership interest, to the extent attributable to the partnership's hot assets, "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." In the view of these practitioners, this language sets a limit to the amount of ordinary income that can be recognized by the partner equal to the actual amount realized on the sale; in Example 4, that limit is \$5. While nothing in the section 751(a) regulations expressly provides for such a limitation on the amount of ordinary income recognized by a selling partner, it is possible that a court could infer such a limitation from the words of the statute.

We believe that new regulations should confirm that no limitation on the recognition of ordinary income exists under section 751(a). If the Treasury believes that such a limitation does exist – that is, if a partner's share of the partnership's ordinary income cannot exceed the value of that partner's interest in the partnership – then:

- Even a nonliquidating distribution of cold assets can reduce the distributee's share of partnership's ordinary income;
- A distribution of cold assets should trigger recognition of ordinary income to the distributee in an amount equal to the excess of the partner's share of the partnership's ordinary income (determined immediately prior to the distribution)

⁴⁰ See section 741.

⁴¹ Reg. § 1.751-1(a)(2).

⁴² *Id.*

⁴³ See Jackel and Stok, *supra* note 24, at 1581.

over the fair market value of the partner's interest in the partnership (determined immediately after the distribution); and

- The mechanics of the application of section 751(b) should be the same as are used in the context of liquidating distributions that reduce a distributee's share of the partnership's ordinary income.

Of course, if the Treasury determines that there is no such limitation of the recognition of ordinary income under section 751(a) – that is, if the literal language of the existing section 751(a) regulations is the correct reading without embellishment – then this issue disappears.

3. Cold Asset Basis Strips and Section 1245 Property

While a nonliquidating distribution of cold assets (including cash) generally should not implicate section 751(b), when the distribution triggers a basis adjustment under section 734(b) and the partnership owns property subject to depreciation recapture under section 1245 or 1250, analysis of the transaction becomes more complex (and the treatment of the transaction under current law becomes less clear). Consider the following example:

Example 5. X and Y form Partnership by contributing \$100 apiece. The partnership uses \$160 of its cash to acquire depreciable equipment, \$10 to acquire a nondepreciable capital asset, and \$30 to acquire unimproved land. After the equipment has been fully depreciated, the partnership distributes the land (still worth \$30) to X in a nonliquidating distribution. At the time of the distribution, the adjusted basis and book value of the equipment is \$0, its fair market value equals \$50, and the fair market value of the nondepreciable capital asset is still \$10. Each partner has an outside basis of \$20. The equipment is subject to depreciation recapture under section 1245.

Assuming that section 751(b) does not apply to this distribution, the distribution is tax-free to X, and X takes a basis of \$20 in the distributed land under section 732(a)(2). If the partnership has an election under section 754 in effect, the step-down in the basis of the land reappears as a step-up in inside basis in the equipment pursuant to section 734(b).⁴⁴ Although that inside basis step-up does not actually reduce the potential section 1245 depreciation recapture associated with the equipment, it may have the effect of reducing the ordinary income that would be recognized by the partnership on a taxable disposition of the equipment.

Before the distribution, the partnership had \$50 of appreciation in its assets, all of which would be ordinary. After the distribution, if section 751(b) does not apply, there still would be \$50 of appreciation in the assets originally held by the partnership. However, \$40 of this appreciation would be ordinary income in the equipment (shared equally between X and Y), and \$10 of this appreciation would be capital gain in the land distributed to X. Significantly, though, it may well be that this is simply not a transaction to which section 751(b) applies because ordinary income may not be shifted between the partners. That is, because of the manner in which “recomputed basis” is determined under section 1245, whether ordinary income is

⁴⁴ Reg. § 1.755-1(c).

reduced, eliminated, or not affected at all as a result of the adjustment depends on whether the partnership disposes of the adjusted asset and, if so, for what amount.

One potential solution to this shifting in character would be to modify the section 755 basis adjustment rules to ensure that a basis adjustment under section 734(b) cannot be allocated to property subject to depreciation recapture to the extent doing so could have the effect of reducing ordinary income that would be recognized by the partnership on a taxable disposition of the property. For example, if the basis adjustment in Example 5 were allocated to the partnership's nondepreciable asset, then the potential recapture in the equipment would not be affected.

If the section 755 basis adjustment rules are not modified, regulations under section 751(b) could require X to recognize \$10 of ordinary income immediately prior to the distribution. The \$10 of ordinary income recognition would produce, immediately prior to the distribution, both a \$10 inside basis adjustment to the equipment and an aggregate \$10 outside basis adjustment to X and Y. As a result of the outside basis adjustment, X will take the distributed land with an adjusted basis of \$30, so the distribution will not trigger an inside basis adjustment under section 734(b). The adjusted basis of the equipment has been increased by \$10 as a result of the transaction, but that increase resulted from the application of section 751(b) rather than section 734(b). In order to prevent ordinary income from shifting between X and Y, this basis adjustment would need to be allocated exclusively to X, either reducing X's share of income upon a sale of the equipment or increasing X's share of future depreciation deductions. Thus, for example, if the equipment were immediately sold for \$50, the resulting ordinary income would be allocated \$25 to Y and \$15 to X. Overall, X and Y each would recognize total ordinary income of \$25.

Another alternative that would ameliorate this problem without accelerating ordinary income to X and Y would be to carry the "two asset" fiction of Reg. § 1.755-1(a)(1) to its logical extension. Reg. § 1.755-1(a)(2) provides that, "[f]or purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property." Under such an extension, a positive basis adjustment would not displace section 1245 recapture, even if the adjustment attached to the depreciable property. As a result, ordinary income could not be reduced or eliminated as a result of a positive section 734(b) adjustment. On the facts of Example 5, the partnership receives a positive section 734(b) adjustment of \$10 that is allocable to capital and section 1231 property. New regulations could provide that the basis adjustment would attach to the asset, but would not decrease the section 1245 recapture. Thus, if the asset were sold for \$50 immediately after the adjustment attached, the partnership would recognize \$50 of ordinary income and a \$10 loss, the character of which would be determined under section 1231. Of course, if the basis increase itself is depreciated over time, further deductions would result, offsetting ordinary income. Nevertheless, because the ordinary income potential in the asset would be preserved in many cases, the case for accelerating ordinary income under section 751(b) would be less compelling.

C. Nonliquidating Distributions of Hot Assets

In Notice 2006-14, a distribution that reduces the nondistributee partners' shares of the partnership's ordinary income is recharacterized as a distribution of hot assets to the nondistributee partners followed by a sale of those assets back to the partnership (called the "hot asset sale" approach). Such a recharacterization ensures that the nondistributee partners recognize their shares of the partnership's ordinary income and increases asset basis to avoid recognition of that same gain a second time by the distributee. But this approach works properly only when the distributee has adequate outside basis to carry over the inside basis of the distributed assets. When such outside basis is lacking, the approach fails to prevent changes in the partners' shares of the partnership's ordinary income. Consider Example 3 from Notice 2006-14:

[Assume A, B and C are each 1/3 partners in partnership PRS which holds one hot asset and one cold asset, each with a basis of \$0 and a fair market value of \$150. A, B, and C each have an adjusted basis in their partnership interest of \$0, and a \$50 share of hot asset appreciation. A is fully redeemed by a distribution of 2/3 of the hot asset (\$100). Immediately before the distribution, the assets of PRS are revalued and the partners' capital accounts are increased to \$100 to reflect each partner's share of the unrealized appreciation in PRS' assets.] Because only \$50 of hot asset appreciation remains in the partnership after the distribution, B's and C's shares of that appreciation have been reduced by \$25 each. Under the hot asset sale approach, PRS would be deemed to distribute the relinquished share of the hot asset (\$50) equally to B and C and each would be treating as selling \$25 worth of the hot asset to the partnership. B and C would each recognize \$25 of ordinary income and would be treated as contributing \$25 to the partnership. The portion of the hot asset deemed sold would take a cost basis, increasing the partnership's basis in the distributed portion of the distributed hot asset to \$50. Because A's basis in its partnership interest is \$0, however, the basis of the distributed hot asset would be reduced under section 732(b) to \$0 in A's hands. If the partnership had a section 754 election in effect, the partnership would increase the basis of the retained hot asset under section 734(b) by \$50. After the distribution, A's share of unrealized income in hot assets would still be \$100, and B and C, who each recognized \$25 of ordinary income, would recognize no additional ordinary income.

As this example demonstrates, if the distributee partner has insufficient outside basis to carry over the partnership's inside basis in the distributed hot assets, the distributee's low basis in the distributed hot assets will cause some ordinary income to be recognized by the distributee when those assets are sold. This ordinary income has, however, already been taxed to the other partners. Further, if the partnership has an election under section 754 in effect at the time of the distribution, a basis adjustment will be given to the partnership for the extra ordinary income ultimately recognized by the distributee, an adjustment that reduces the ordinary income shares of the other partners. This adjustment would precisely unwind the impact of section 751(b) on the distribution.

Notice 2006-14 recognizes the problem identified above and suggests that the distributee be permitted or required to increase outside basis by electing to recognize capital gain.⁴⁵ An election to recognize capital gain was proposed by Professor William Andrews in his well-known article on hot assets⁴⁶ and, if the election is made, achieves what we believe to be the proper outcome. But the election solution is flawed precisely because it is elective. If the distributee eschews the election, the distribution can in fact rearrange the partners' shares of the partnership's ordinary income as demonstrated by Example 3 of the Notice as discussed above.

We believe there are at least three ways to reach the proper result:

- The first is to adopt the approach identified in Notice 2006-14 but, as the request for comments in the Notice describes, make the capital gain recognition mandatory to the distributee whenever the distributee's outside basis is less than the inside basis of the distributed hot assets (the "hot asset sale" approach). This yields the proper outcome to all the partners, and its only weakness is that there is no obvious statutory basis for the capital gain recognition to the distributee in the low-basis case.

- The second is an alternative approach (the "distributee purchase" approach) that more naturally solves the low basis problem. To the extent that a distribution of hot assets reduces the nondistributee partners' shares of the partnership's ordinary income, the transaction could be recharacterized as occurring in three steps:

- (1) *a purchase* by the distributee of some of the distributed hot assets, resulting in ordinary income recognition by the partnership. This ordinary income is allocated among those nondistributee partners whose shares of the partnership's ordinary income would otherwise be reduced;

- (2) *a distribution* of any remaining hot assets actually distributed to the distributee partner, excluding those hot assets deemed purchased in step (1); and

- (3) *a distribution* to the distributee partner of the cash treated as received by the partnership in step (1), along with any cold assets actually distributed to the distributee.⁴⁷

This approach ensures that no ordinary income is reallocated by the distribution and also guarantees that the distributee takes a cost basis in the hot assets deemed purchased. This

⁴⁵ 2006-8 I.R.B. at 501.

⁴⁶ William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991).

⁴⁷ The ordering of these steps cannot be changed without adversely changing the tax consequences in the low basis case: if the cash is not treated as distributed last, then a low basis distributee may take a reduced basis in distributed hot assets rather than carrying-over the partnership's inside basis along with a recognition of capital gain.

approach eliminates the low basis problem described above.⁴⁸ In addition, the final step of this approach – the deemed distribution of cash equal to the fair market value of the hot assets deemed purchased by the distributee (along with the cold assets actually distributed, if any) – can trigger capital gain to the distributee under section 731(a)(1).

Here is the analysis of the facts of Example 3 from Notice 2006-14 using this alternative, distributee purchase, approach:

Example 6. A, B, and C are equal partners in a partnership that holds one hot asset and one cold asset, each with a basis of \$0 and a fair market value of \$150. A, B, and C each have an adjusted basis in the partnership of \$0 and a \$50 share of the partnership's ordinary income. A is fully redeemed by a distribution of 2/3 of the hot asset (\$100). Immediately before the distribution, the partnership's assets are revalued and each partner's capital account is increased to \$100 to reflect each partner's share of the unrealized appreciation in the partnership's assets.

There is only \$50 of ordinary income remaining in the partnership after the distribution. Consequently, B's and C's shares of that income have been reduced from \$50 each to \$25 each. As a result, in step (1), A is treated as purchasing \$50 of the hot asset for cash, triggering ordinary income recognition to B and C. In step (2), the remainder of the hot asset is then treated as distributed to A, giving A an adjusted basis of \$0 in that portion of the asset. Finally, in step (3), cash of \$50 is deemed distributed to A, triggering a capital gain to A in that amount.

What distinguishes this result from that first proposed by Professor Andrews and as discussed in Notice 2006-14 is the automatic basis step-up to A in the distributed hot asset. After the transaction, A owns the hot asset with an adjusted basis of \$50 (arising from that part of the asset deemed purchased) and will recognize ordinary income of only \$50 when the asset is sold. If the partnership has an election under section 754 in effect, the inside basis of the partnership's cold asset will be increased to \$50, ensuring that each partner ultimately reports the correct amount of ordinary income and capital gain. Ordinary income will not be shifted, regardless of whether an election under section 754 is in effect.

Reconsider Example 6 but assume the partnership owns an additional cold asset having an inside basis and a fair market value of \$150, and that each partner has a pre-distribution outside basis of \$50.

Example 7. A, B, and C are equal partners in a partnership that holds one hot asset with an adjusted basis of \$0 and a fair market value of \$150. The partnership also owns two cold assets, #1 and #2. Cold asset #1 has a basis of \$0 and a fair market value of \$150, while cold asset #2 has a basis and a fair market value of \$150. A, B, and C each have an outside basis and capital account of \$50,

⁴⁸ This approach also avoids two aspects of the existing regulations identified as undesirable in Notice 2006-14: (1) a need to identify cold assets of the partnership deemed exchanged for distributed hot assets, and (2) acceleration of capital gain recognition to the nondistributee partners.

along with a \$50 share of the partnership's ordinary income. A is fully redeemed by a distribution of 2/3 of the hot asset (worth \$100) and one-third of cold asset #2 (worth \$50). Immediately before the distribution, the partnership's assets are revalued and each partner's capital account is increased to \$150 to reflect each partner's share of the unrealized appreciation in the partnership's assets.

There is only \$50 of ordinary income remaining in the partnership after the distribution. Consequently, B's and C's shares of that income have been reduced from \$50 each to \$25 each. As a result, in step (1), A is treated as purchasing \$50 of the hot asset for cash, triggering ordinary income recognition to B and C. In step (2), the remainder of the hot asset is then treated as distributed to A, giving A an adjusted basis of \$0 in that portion of the asset. Finally, in step (3), cash of \$50 is deemed distributed to A (reducing A's outside basis to zero) along with the one-third of cold asset #2. There is no capital gain recognition to A, and A takes a basis of \$0 in the distributed cold asset.

- A third approach (the "section 704(c)(1)(B)" approach) would be to forego any recharacterization in its entirety in favor of getting to the right result directly. If a distribution reduces the nondistributee partners' shares of the partnership's ordinary income, then, immediately before the distribution: (1) the nondistributee partners recognize ordinary income to that extent, (2) the bases of the distributed hot assets and the outside bases of the nondistributee partners are increased to reflect the ordinary income recognized by the nondistributee partners, (3) if the inside bases of the hot assets distributed to any partner exceed the outside basis of that distributee partner, that distributee partner recognizes capital gain and increases its outside basis by the amount of gain recognized, and (4) the partnership increases its basis in its undistributed cold assets by the same amount (with the basis adjustment being allocated among undistributed partnership cold assets in accordance with rules analogous to those under Reg. § 1.737-3(c)). This largely mirrors the statutory approach of section 704(c)(1)(B) (coupled with the possible capital gain recognition) and might fairly be described as the partnership selling some of its hot assets to itself. (This approach also could be adapted to address "hot asset basis strips," which are discussed in Section VI.E, below.)

The application of this approach to the facts of Example 6 would be as follows: (1) because the distribution of 2/3 of the hot asset to A reduces B's and C's shares of ordinary income from \$50 each to \$25 each, B and C each recognize \$25 of ordinary income, (2) the inside basis of the distributed portion of the hot asset is increased by \$50, and B's and C's outside bases are increased by \$25 each, and (3) A recognizes \$50 of capital gain and increases its outside basis to reflect that gain recognized, and (4) the partnership increases the adjusted basis of its cold asset by \$50. As a result of the application of this approach, A, immediately after the distribution, holds the inventory with a basis of \$50 and a value of \$100, preserving A's \$50 share of ordinary income. B and C each hold partnership interests worth \$100 with a \$25 basis, reflecting that they each recognized \$25 of ordinary income. The partnership holds ordinary income property with a zero basis and a value \$50 and capital gain property with a basis of \$50 and a value of \$150.

This third approach is the most difficult to square with the language of section 751(b) because it does not create a two-party exchange. However, it is arguably more honest than the other two approaches because it does not construct a two-party exchange to reach an answer already known. Instead, it identifies the right answer directly and demands that it be achieved. All three approaches (the “hot asset sale” approach, the “distributee purchase” approach, and the “section 704(c)(1)(B) approach”) reach the same result; they differ only on how that result is justified.

D. Mechanics of the Pre-Distribution Revaluation

1. In General

When the partnership revalues its assets immediately before a nonliquidating distribution, all unrealized appreciation in undistributed assets is locked into the partners’ capital accounts.⁴⁹ The economic arrangement among the partners dictates how much of the revaluation gain (or loss) must be allocated to each of the partners, but only the totals and not the individual asset book-ups affect the non-tax relationships. We believe that a partnership should be permitted to specially allocate unrealized gain and loss within the class of hot assets to minimize the effect of the distribution on the partners’ shares of the partnership’s ordinary income. Consider the following example in which the distribution consists exclusively of hot assets.

Example 8. X and Y are equal partners in the XY partnership. The partnership owns inventory items with an aggregate adjusted basis and book value of \$80 and fair market value of \$400. Each partner has an outside basis and capital account of \$40. The partnership makes a nonliquidating distribution of one-quarter of the inventory to X; this inventory has a basis to the partnership of \$20 and a fair market value of \$100. The partners agree to revalue the assets and restate capital accounts immediately before the distribution.

Because the partnership has elected to revalue its assets and restate capital accounts immediately before the distribution, the \$320 unrealized appreciation in the inventory items must be allocated among the partners. If all of the unrealized appreciation from the distributed inventory (that is, \$80 of appreciation) is allocated to X, and the \$240 of unrealized appreciation from the undistributed assets is allocated \$80 to X and \$160 to Y, then, immediately after the distribution, the books of the partnership will read (where “CA” stands for “Capital Account” and “OB” stands for “Outside Basis”):

⁴⁹ Technically, only unrealized section 704(b) *book* appreciation is locked into the capital accounts at the book-up. If the unrealized tax appreciation in the partnership’s assets differs from that of the book appreciation, that difference has already been reflected in the partners’ capital accounts.

First Analysis

	X		Y	
	CA	OB	CA	OB
Starting values	\$ 40	\$ 40	\$ 40	\$ 40
Book-up of distributed assets	80	0	0	0
Book-up of undistributed assets	80	0	160	0
Distribution	(100)	(20)	<u>0</u>	<u>0</u>
	\$ 100	\$ 20	\$ 200	\$ 40

	X	Y
Ordinary Income From Retained Assets	\$ 80	\$160
Ordinary Income From Distributed Assets	<u>80</u>	<u>0</u>
Totals	\$160	\$160

Each partner has received a total allocation of \$160 from the book-up of the inventory. For X, half of the book-up is attributable to the distributed assets and half of the book-up is attributable to the retained assets. As for Y, all of the book-up is attributable to the retained assets. As a result, the distribution has had no effect on the partners' shares of the partnership's ordinary income: Y's share remains at \$160, all from undistributed assets, and X's share also remains at \$160, half from undistributed assets and half from the distributed assets. Thus, there is no need for section 751(b) to apply to the distribution.

What permits the distribution to avoid the application of section 751(b) is the mechanics of the book-up. Because the partners had agreed to be equal partners, the \$320 of unrealized book gain had to be divided equally between the partners, \$160 to each partner. Then, by allocating all of the unrealized book gain arising from the distributed assets to the distributee (along with a correspondingly smaller portion of the book gain in the undistributed assets), the effect of the distribution on partner's shares of the partnership's ordinary income is eliminated.

We believe that regulations promulgated under section 751(b) should mandate such allocations (and the section 704(b) regulations should be modified accordingly): *to the extent the distributed asset includes unrealized appreciation or loss, that appreciation or loss should be allocated to the distributee as part of the pre-distribution book-up.* This will have the effect of minimizing the need for the application of section 751(b) to the distribution. If the unrealized appreciation in each asset separately had been allocated equally between the partners, section 751(b) would have been triggered as shown below.

Second Analysis

	X		Y	
	CA	OB	CA	OB
Starting values	\$ 40	\$ 40	\$ 40	\$ 40
Book-up of distributed assets	40	0	40	0
Book-up of undistributed assets	120	0	120	0
Distribution	(100)	(20)	<u>0</u>	<u>0</u>
	\$ 100	\$ 20	\$ 200	\$ 40

	X	Y
Ordinary Income From Retained Assets	\$120	\$120
Ordinary Income From Distributed Assets	<u>80</u>	<u>0</u>
Totals	\$200	\$120

As shown in the table above, if the unrealized appreciation in each asset is allocated equally among the partners on a property-by-property basis, then the distribution to X triggers the application of section 751(b) because the distributed asset carries with it \$40 of the unrealized ordinary income appreciation allocated to Y. We believe that such a result should be avoided by the mechanics of the book-up as shown in the first of the two tables (the table labeled “First Analysis”). All unrealized appreciation in the distributed property will, of necessity, be reported by the distributee because the property is owned, after the distribution, outside of the partnership. If the distributed property has more unrealized appreciation than can be allocated to the distributee consistent with the economic relationship among the partners, however, then, as Example 9 demonstrates, section 751(b) will be triggered by the distribution.

Example 9. A, B, and C each contribute \$120 to Partnership. The partnership purchases inventory for \$210. When the partnership’s assets consist of the inventory worth \$300, \$90 of zero-basis unrealized receivables, and cash of \$150, the partnership distributes the receivables to C and \$90 of the inventory (with an adjusted basis of \$63) to B. Immediately before the distribution, the partnership’s assets are revalued and the partners’ capital accounts are increased to reflect each partner’s share of the unrealized appreciation in the partnership’s assets. The “distributee purchase” approach is used in applying section 751(b).

If the partnership’s assets are booked-up immediately before the distribution in accordance with their equal sharing relationship, then each partner’s share of the ordinary income in the inventory retained by the partnership is \$21, and the ordinary income in the distributed receivables and in the distributed inventory shifts entirely to the distributee partners. Thus, A’s share of the partnership’s ordinary income declines from \$60 to \$21 (all attributable to the retained inventory), for a net reduction of \$39; B’s share declines from \$60 to 48 (\$21 attributable to the retained inventory and \$27 attributable to the distributed inventory),⁵⁰ for a decline of \$12, and C’s share increases from \$60 to \$111 (\$21 attributable to the retained inventory and \$90 attributable to the distributed receivables), an increase of \$51. Accordingly,

⁵⁰ The inventory distributed to B has a value of \$90 and a basis of \$63.

under the distributee purchase model described above, C is treated as purchasing \$51 of the receivables, triggering gain recognition of \$39 to A and \$12 to B. The inventory and the remainder of the receivables are then treated as distributed to B and C, followed by a deemed distribution of \$51 dollars in cash to C. After the distribution, the books of the partnership become:

	A		B		C	
	CA	OB	CA	OB	CA	OB
Contribution	\$ 120	\$ 120	\$ 120	\$ 120	\$ 120	\$ 120
Book-up of inventory	30	0	30	0	30	0
Book-up of receivables	30	0	30	0	30	0
Deemed purchase by C ⁵¹	0	39	0	12	0	0
Distribution to B and C ⁵²	0	0	(90)	(63)	(39)	(0)
Deemed distribution of cash to C ⁵³	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(51)</u>	<u>(51)</u>
Totals	\$ 180	\$ 159	\$ 90	\$ 69	\$ 90	\$ 69

<u>Asset</u>	<u>Book</u>	<u>Tax</u>
Inventory	\$ 210	\$ 147
Cash	<u>150</u>	<u>150</u>
	\$ 360	\$ 297

An analysis of the appreciation in the partnership's hot assets immediately after the distribution is:

	<u>A</u>	<u>B</u>	<u>C</u>
Distributed Inventory	0	27	0
Receivables	0	0	39
Retained Inventory	21	21	21
751(b) Recognized Gain	<u>39</u>	<u>12</u>	<u>0</u>
Totals	\$ 60	\$ 60	\$ 60

The need for section 751(b) could be minimized by allocating unrealized appreciation in each distributed asset to the intended distributee to the extent that doing so is consistent with the economic arrangement of the partners. Suppose, for example, that the pre-distribution unrealized appreciation were allocated as follows:

	<u>A</u>	<u>B</u>	<u>C</u>
Distributed Inventory	0	27	0
Distributed Receivables	15	15	60
Retained Inventory	<u>45</u>	<u>18</u>	<u>0</u>
Totals	\$ 60	\$ 60	\$ 60

⁵¹ C is treated as purchasing \$51 of the receivables from the partnership, triggering ordinary income to the partnership of \$51, allocable \$39 to A and \$12 to B.

⁵² Inventory with value of \$90 and adjusted basis of \$63 is distributed to B, while receivables with value of \$39 and adjusted basis of \$0 are distributed to C.

⁵³ The \$51 in cash that was treated as received by the partnership from C in exchange for \$51 worth of receivables is deemed distributed back to C in the final step. Had C's outside basis been significantly lower, this final step would have triggered capital gain to C.

Now, the distribution of the inventory to B has no effect on the partners' shares of the partnership's ordinary income. This is because the ordinary income the distribution carries out to B was allocable to B before the distribution; thus, the ordinary income allocable to A and C is not reduced. Similarly, the distribution of the receivables to C reduces the shares of A and B in the partnership's ordinary income only by \$15 each. With this set of allocations, A and B should each recognize \$15 of ordinary income as a result of the transaction.⁵⁴ Allocating most of the unrealized appreciation in each distributed asset to its distributee thus reduces the impact of section 751(b) from \$51 to \$30, while ensuring that each partner appropriately recognizes her share of the partnership's ordinary income.

2. Previously Booked Gain or Loss

Reconsider the facts of Example 8, but assume that a third partner joined the partnership prior to the distribution. To keep the example simple, assume that this third partner ("Z") joined the partnership more than two years before the distribution,⁵⁵ contributing nothing to the venture other than the promise of future services in exchange for a profits interest,⁵⁶ and that the inventory was worth \$400 at the time of Z's admission.

Example 10. X and Y are equal partners in Partnership. Partnership owns two inventory items, item #1 with an adjusted basis of \$20 and a fair market value of \$100, and item #2 with an adjusted basis of \$60 and a fair market value of \$300. Each partner has an outside basis and capital account of \$40. Z is admitted in exchange for a contribution of future services in exchange for a one-third interest in future profits. More than two years later, when Partnership's assets have not changed in value, Partnership makes a nonliquidating distribution of inventory item #1 to X. The partners agree to revalue the assets and restate capital accounts immediately prior to the admission of Z and again immediately prior to the distribution to X.⁵⁷

⁵⁴ The aggregate impact of section 751(b) cannot be reduced below \$30 on these facts, but the distribution of the impact of section 751(b) between A and B could be modified by changing their pre-distribution sharing of the unrealized appreciation in the receivables and in the inventory retained by the partnership.

⁵⁵ As a result of the two-year delay, the contribution by Z and the distribution to X would be presumed not to constitute a disguised sale under Prop. Reg. § 1.707-7(d) even if Z contributed "property." See REG-149519-03, 69 Fed. Reg. 68838 (Nov. 26, 2004).

⁵⁶ Such a contribution generally is tax-free. See Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191.

⁵⁷ Because the partnership's assets do not change value after the admission of Z, no asset gain or loss is allocable to Z. Z's admission to the partnership is added to the facts solely to permit the pre-distribution book-up of the partnership's assets. See Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii).

	X		Y		Z	
	CA	OB	CA	OB	CA	OB
Before transactions	\$ 40	\$ 40	\$ 40	\$ 40	\$	\$
Book-up	160	0	160	0		
Admission of Z	0	0	0	0	0	0
Distribution to X	(100)	(20)	0	0	0	0
Totals	\$ 100	\$ 20	\$ 200	\$ 40	\$ 0	\$ 0

Immediately after the distribution to X, the partnership owns inventory item #2 with a book value of \$300 and an adjusted basis of \$60. If that property is eventually sold for \$300, there will be no book gain, but there will be taxable ordinary income of \$240. If \$160 of that ordinary income were allocated to Y and \$80 were allocated to X, then these amounts, when coupled with the built-in tax gain of \$80 in the inventory distributed to X that X will recognize when that inventory is sold, should permit the distribution to X to avoid the reach of section 751(b) because the partners' shares of the partnership's ordinary income have not been altered.

Such a conclusion assumes, however, that all of the gain from inventory item #1 was allocated to the distributee (that is, to X). That book allocation, though, was done immediately before Z was admitted to the partnership (that is, more than two years before the distribution to X). When the book-up was done immediately before Z joined the partnership, the books became:

	X		Y	
	CA	OB	CA	OB
Before transactions	\$ 40	\$ 40	\$ 40	\$ 40
Book-up of item #1	40		40	
Book-up of item #2	120	0	120	0
Totals	\$ 200	\$ 40	\$ 200	\$ 40

This table reflects not only the aggregate \$160 book-up to each partner, but also the division of that amount between the partnership's two assets. Such an allocation is required because the principles of section 704(c) must be applied on a property-by-property basis.⁵⁸ For the subsequent distribution of inventory item #1 to avoid the reach of section 751(b), Y's \$40 share of the book appreciation in inventory item #1 must be exchanged for an equal amount of the book appreciation in inventory item #2. Absent such an exchange, the distribution of inventory item #1 to X will carry out some of Y's share of the partnership's ordinary income and will trigger application of section 751(b). Although such an exchange, or shifting, of built in gain is not permissible under current law, we believe that the regulations should be modified to permit it, because the partners should be no worse off having booked-up the assets when Z joined the partnership than they would be had the book-up been done later (i.e., immediately prior to the distribution to X).

⁵⁸ Reg. § 1.704-3(a)(2). However, the existing regulations permit the aggregation of property under certain, limited circumstances. See Reg. §§ 1.704-3(e)(2) and (3). The principles expressed in the 704(c)(1)(A) regulations are applicable to reverse section 704(c) allocations (that is, to book-ups) pursuant to Reg. §§ 1.704-1(b)(2)(iv)(f)(4) and 1.704-3(a)(6).

We believe that the legitimacy of such an exchange of reverse section 704(c) layers should be tested under the “substantiality” requirement of Regulation § 1.704-1(b)(2)(iii). That is, if, when the inventory items were booked-up, the partners could have allocated all of the gain in inventory item #1 to X and a disproportionate amount of the gain in inventory item #2 to Y, then the partners should be permitted to effectuate that allocation immediately prior to the distribution of inventory item #1 to X.⁵⁹ If such a shifting, or reallocation, were permitted, the distribution to X would not trigger the application of section 751(b). We recognize that this post-allocation shifting of reverse-section 704(c) ordinary income would represent a change in the law and may be viewed by some as inappropriate. No other proposal made in these Comments is dependent on its acceptance. Nonetheless, we believe that this particular proposal should be considered seriously for inclusion in forthcoming regulations under section 751(b).

E. Coordination With Section 734(b): Hot Asset Basis Strips

If high-basis property is distributed to a partner having a low basis in her partnership interest, the distributee partner will take a basis in the distributed property below its adjusted basis in the hands of the partnership immediately before the distribution. If the partnership has an election under section 754 in effect for the taxable year of the distribution, the basis lost from the distributed asset will be reallocated to the common basis of property of the same character owned by the partnership. Such a transaction commonly is called a “basis strip” because basis is removed, or “stripped” from the distributed property and transferred to retained partnership property. If the distributed property is an ordinary income asset, one effect of the basis strip can be a rearrangement of the partners’ shares of the partnership’s ordinary income. Consider the following example.

Example 11. A, B, C, and D are equal partners in Partnership. The partnership owns inventory with an adjusted basis and book value of \$80 and fair market value of \$200, as well as an unrealized receivable with an adjusted basis and book value of \$0 and a fair market value of \$1,000. A, B, C, and D each have a capital account and outside basis of \$20. The partnership distributes the inventory item to D in a nonliquidating distribution and elects to revalue its assets and restate capital accounts immediately before the distribution.

Immediately before the distribution, each partner’s share of the partnership’s ordinary income equals \$280. The distribution to D removes \$120 of that appreciation from the partnership. Because that amount is less than D’s share of the partnership’s ordinary income, there should be no need (absent the basis strip) for section 751(b) to apply to the distribution. If there is no section 754 election in effect for the taxable year of the distribution, then \$280 of the unrealized appreciation in the receivable will be allocable to each of the three nondistributee

⁵⁹ The question arises whether such reallocation of book ordinary income ought to be aggregated with pre-contribution gain (that is, forward-section 704(c) layers). The legislative history of current section 704(c)(1)(A) suggests that such an exchange could be permitted. *See* H.R. Rep. No. 432 (pt. 2), 98th Cong., 2d Sess. 1209 (1984), providing: “It is anticipated that the regulations will permit partnerships to agree to a more rapid elimination of disparity among partners than required for items described in section 704(c) and vice versa, provided there is no tax avoidance potential.” In limited situations, taxpayers are permitted to aggregate forward and reverse section 704(c) amounts. *See, e.g.*, Rev. Proc. 2001-36, 2001-1 C.B. 1326.

partners, and the remaining \$160 of unrealized appreciation will be allocable to D (assuming that all of the unrealized appreciation in the inventory was allocated to D and the unrealized appreciation in the unrealized receivable was disproportionately allocated to A, B, and C in connection with the partnership's revaluation). However, D will take a basis of only \$20 in the distributed inventory item (because of the limitation in section 732(a)(2)), so that D's aggregate share of the partnership's ordinary income will increase from \$280 to \$340.⁶⁰ This increase to D is not a reallocation from the other partners to D (each other partner's share continues to equal \$280), but rather reflects an increase in aggregate ordinary income because of the basis step-down imposed by section 732(b) arising from D's relatively low outside basis as compared with the pre-distribution inside basis of the distributed inventory.

If, however, an election under section 754 is in effect for the year of the distribution, then the asset basis step-down to D (from \$80 to \$20) gives rise to a dollar-for-dollar step up (pursuant to section 734(b)) in the partnership's inside basis in its receivable. This \$60 inside basis increase is made to the common basis of the receivable, rather than made as a special adjustment benefiting D only. Indeed, the regulations on capital account maintenance provide:

[T]he capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to such adjustment for its recomputed adjusted tax basis.⁶¹

If the gain that is "displaced" were a portion of the distributee's gain alone, then coordination of section 751(b) and 734(b) would be relatively straightforward. Reconsider Example 11. Immediately before the distribution, each partner's share of the partnership's ordinary income equals \$280, of which \$250 is from the receivable and \$30 is from the inventory. On the pre-distribution book-up, \$120 of unrealized appreciation in the inventory should be allocable to D and the \$1,000 unrealized appreciation in the receivable should be allocated \$280 to A, \$280 to B, \$280 to C, and \$160 to D. This leaves the nondistributee partners' shares at \$280 each, and increases D's share to \$340 because of the basis step-down in the inventory. Then, if the inside basis adjustment reduces D's share of the appreciation in the receivable from \$160 to \$100, the distribution (when coupled with the section 734(b) basis adjustment) will have had no net effect on any of the partners' shares of the partnership's ordinary income.

It seems relatively clear, however, that the section 734(b) basis adjustment does not work this way under current law. That is, the statute is clear that the adjustment is made to the partnership's common basis, and this implies quite strongly that the basis adjustment "displaces" income otherwise allocable to *all* of the partners. That is, the \$60 basis adjustment reduces each

⁶⁰ Of this \$340, \$160 represents D's share of the undistributed receivable and \$180 represents the built-in gain inherent in the distributed inventory immediately after the distribution.

⁶¹ Reg. § 1.704-1(b)(2)(iv)(m)(4).

partner's share of ordinary income from the receivable by \$15.⁶² As a result, the nondistributtee partners must each recognize \$15 of ordinary income to account for the income reduction that will arise from the common section 734(b) adjustment.⁶³ This ordinary income recognition should result in an outside basis adjustment for each nondistributtee partner (so that each sees an outside basis increase of \$15), but there cannot be a corresponding inside basis adjustment because that basis adjustment has already been made pursuant to section 734(b). To reach the correct result and avoid the ambiguity and potential circularity under existing law, new regulations should provide that the income recognition to the nondistributtee partners must be treated as *resulting from* the inside basis adjustment, rather than *triggering* the inside basis adjustment.

F. Liquidating Distributions

As described above, the drafters of section 751(b) gave more thought to the application of section 751(b) to liquidating distributions than to its application to nonliquidating distributions. Further, while a book-up of partnership assets immediately before a nonliquidating distribution can significantly reduce the need for section 751(b), the same is not true in the context of a liquidating distribution because the distributee leaves the partnership's assets behind regardless of any pre-distribution book-up. Thus, the current rules of section 751(b) should work reasonably well when applied to liquidating distributions *provided* those rules focus on the partners' shares of the partnership's ordinary income, rather than on the partners' shares of gross asset value.

However, improvement remains possible. We recommend that the new regulations dispense with constructing a hypothetical exchange between partnership hot assets and partnership cold assets, an improvement recommended in Notice 2006-14.⁶⁴ The current regulations use such an approach, and identifying the assets deemed exchange causes additional complexity in the application of section 751(b) and can needlessly accelerate the recognition of capital gain to partners for whom the transaction ought to be tax-free. Eliminating the deemed exchange of partnership hot assets for partnership cold assets also should eliminate the "ordering problem" identified above.

A liquidating distribution may increase or decrease the distributee's share of the partnership's ordinary income even if the partnership elects to revalue its assets and restate capital accounts immediately prior to the distribution. If the distribution has the effect of reducing the nondistributtees' shares of the partnership's ordinary income, then the distribution has the same effect as a nonliquidating distribution implicating section 751(b). In such a case, all three approaches identified above (the "hot asset sale" approach identified in Notice 2006-14, the

⁶² See generally Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 TAX LAWYER 343 (2004).

⁶³ Each nondistributtee partner must be allocated exactly \$280 of appreciation for book purposes to ensure that they remain equal partners for book purposes.

⁶⁴ "Under the hot asset sale approach [proposed in Notice 2006-14] there would be no deemed exchange for cold assets, thereby eliminating the need to identify cold assets to be exchanged and to construct a deemed distribution of those assets." 2006-8 I.R.B. at 500.

“distributee purchase approach,” and the “section 704(c)(1)(B)” approach) could be used here as well.

Example 12. A, B, and C are equal partners in a partnership that holds one hot asset and one cold asset, each with a basis of \$0 and a fair market value of \$150. A, B, and C each has an adjusted basis in their partnership interests of \$0 and a \$50 share of the partnership’s ordinary income. A is fully redeemed by a distribution of 2/3 of the hot asset (\$100). Immediately before the distribution, the partnership’s assets are revalued and each partner’s capital account is increased to \$100 to reflect each partner’s share of the unrealized appreciation in the partnership’s assets.⁶⁵

Because there is only \$50 of ordinary income remaining in the partnership after the distribution, B’s and C’s shares of that income have been reduced from \$50 each to \$25 each. Accordingly, A could be treated as purchasing \$50 of the hot asset for cash, triggering gain recognition to B and C. The remainder of the hot asset would then be treated as distributed to A, giving A an adjusted basis of \$0 in that portion of the asset. Finally, cash of \$50 would be deemed distributed to A, triggering a capital gain to A of that amount. Using this approach, A owns the hot asset with an adjusted basis of \$50 (arising from that portion of the asset deemed purchased) and will recognize ordinary income of \$50 when the asset is sold. The same result would be obtained by applying the “hot asset sale” approach of Notice 2006-14 or the “section 704(c)(1)(B)” approach described above.

If the distribution reduces the distributee’s share of the partnership’s ordinary income, the analysis must be different. Consider the following.

Example 13. X, Y, and Z are equal members of Partnership. The partnership owns inventory with an adjusted basis of \$120 and a fair market value of \$180, along with an unrealized receivable having a zero adjusted basis and a fair market value of \$360. Each partner has an outside basis and capital account of \$40. Z receives the inventory in liquidation of her interest in the partnership.

As a result of Z’s exit from the partnership, the two remaining partners will each see an increase in their respective shares of the partnership’s ordinary income from \$140 to \$180. Accordingly, Z should be required to recognize \$80 of gain from the undistributed receivable. The “distributee purchase” approach described above will not work in this context because it generates ordinary income to the nondistributee partners, and here the ordinary income must be recognized by the distributee. Other possibilities include the approach adopted in the existing section 751(b) regulations, the “hot asset” sale approach described in Notice 2006-14, and the “section 704(c)(1)(B)” approach described above, which does not construct a two party exchange.

The existing section 751(b) regulations treat some of the receivable as distributed to X and Y, followed by a deemed exchange of that receivable for a portion of the hot asset actually

⁶⁵ “Example 3” from Notice 2006-14, 2006-8 I.R.B. at 500.

distributed to Z.⁶⁶ The problem with this approach is that it triggers gain recognition not only to the distributee, but also to the nondistributee partners. The policy justification for accelerating income to X and Y is not clear. We believe that an approach should not be used when it accelerates capital gain, unless that acceleration is necessary. In addition, if there are multiple distributees, the approach used to tax one will affect the taxation of the others, resulting in an ordering problem like that identified above.

Under the “hot asset sale” approach described in Notice 2006-14, Z would be treated as receiving \$80 worth of the receivable followed by a sale of that receivable back to the partnership in exchange for cash. Presumably, the cash would then be treated as contributed back to the partnership, and only then would the actual distribution of inventory be treated as occurring. This approach avoids accelerating income to the nondistributee partners, but also requires a relatively circuitous recharacterization. Part of the receivable is treated as leaving the partnership and then returning. Hypothetical cash also is treated as leaving the partnership and then returning. In effect, an exchange is created and then completely unwound. We recommend avoiding an approach that manufactures two round-trips simply to impose taxation on Z.

We believe that a better approach is to treat a portion of the receivable as sold by the partnership to itself; that is, we prefer the “section 704(c)(1)(B)” approach. This arrives at the same result as the “hot asset sale” approach without its circuitous reasoning. However, the statute arguably requires a constructive sale. If it is determined that such a constructive sale is required, then we believe that the “hot asset sale” approach described in Notice 2006-14 is appropriate and achieves the proper result.

G. Failure to Book-Up

We have assumed throughout these comments that every partnership will revalue its assets and restate capital account balances immediately before each distribution. But such a book-up is of course optional: while a partnership is required to revalue any assets actually distributed, the decision to revalue its remaining undistributed assets is optional.⁶⁷ If a partnership elects not to revalue its assets in connection with a partnership distribution, then the distribution may inappropriately shift value from one partner to another. As the current regulations under section 704(b) make clear, the failure of a partnership to book up its assets in connection with a non-pro rata distribution will be closely scrutinized.⁶⁸

Special allocations often can be used to achieve essentially the same results as a book-up. But in the absence of such special allocations or an actual book-up, a distribution may rearrange not only the economic relationship among the partners but also their sharing in the partnership’s hot asset appreciation. This can be true even if the

⁶⁶ See Reg. § 1.751-1(b)(2).

⁶⁷ Compare Reg. § 1.704-1(b)(2)(iv)(f) (“A partnership agreement may...”) with Reg. § 1.704-1(b)(2)(iv)(e)(1) (“The basic capital accounting rules...require”). The first cited regulation deals with revaluations of all partnership assets, whereas the second cited regulation deals with distributed property.

⁶⁸ See Reg. §§ 1.704-1(b)(1)(iii), (iv) and 1.704-1(b)(5), example 14(iv).

distribution consists exclusively of cold assets and no section 734(b) basis adjustment is triggered. We believe that in such circumstances, the Service should apply section 751(b) to those partners whose shares of the partnership's ordinary income declines in a manner consistent with the application of section 751(b) to liquidating distributions.

CONCLUSION

We believe that the regulations under section 751(b) should be modified to ensure that they reflect the many significant developments in subchapter K since 1956 and to minimize the inappropriate acceleration of income and gain to partners as proposed in these Comments.