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May 5, 2009

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on the Application of Section 108(i) to Partnerships and Partners

Dear Commissioner Shulman:

Enclosed are comments on the application of section 108(i) to partnerships and partners. 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,

Stuart M. Lewis
Chair - Elect, Section of Taxation

Enclosure

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**AMERICAN BAR ASSOCIATION SECTION OF TAXATION
COMMENTS ON THE APPLICATION OF SECTION 108(i)
TO PARTNERSHIPS AND PARTNERS**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) 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 Matthew Lay of the Section’s Partnerships and LLCs Committee (the “Committee”). Substantive contributions were made by Martin D. Pollack, David H. Schnabel, Eric Sloan, and Monte A. Jackel of the Committee. The Comments were reviewed by R. Brent Clifton, Chair of the Committee, and Mark S. Wallace of the Section’s Bankruptcy and Workouts Committee. The Comments were further reviewed by Joseph Schimmel of the Section’s Committee on Government Submissions and by William H. Caudill, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these comments, no such member (or the firm or the 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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Date: May 5, 2009

EXECUTIVE SUMMARY

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (“ARRA”)¹ was signed into law. The ARRA added a new section 108(i).² As discussed more fully below, section 108(i) provides for an elective deferral of cancellation of debt income (“CODI”) realized by certain debtors as a result of a “reacquisition” of an “applicable debt instrument” that occurs in 2009 or 2010. The application of section 108(i) to partnerships and partners raises difficult and unresolved issues. This report discusses many of these issues and recommends that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“Service”) publish guidance to:

- Allow partners to “opt-out” of a partnership level election;
- Clarify the application of the “trade or business” requirement to partnerships and partners;
- Address the effects of a partnership’s section 108(i) election on the partners’ capital accounts and the partners’ adjusted bases in their partnership interests;
- Defer deemed distributions under section 752(b) to the extent necessary to ensure that a section 108(i) election does not cause gain under section 731 in any taxable year;
- Clarify that section 751(b) does not apply to debt-for-equity exchanges;
- Provide relief under section 465 to prevent a section 108(i) election from triggering recapture under section 465(e);
- Provide special rules for determining the income tax consequences of transferring all or a portion of a partnership interest;
- Clarify that a partial redemption of a partner’s interest does not accelerate CODI or original issue discount (“OID”) deductions that have been deferred under section 108(i);
- Clarify that the contribution of a partner’s interest to an upper-tier partnership does not accelerate CODI or OID deductions that have been deferred under section 108(i);
- Clarify that a sale or exchange of a partnership interest that results in a technical termination under section 708(b)(1)(B) does not accelerate CODI or OID deductions that have been deferred under section 108(i) with respect to the non-selling partners;

¹ Pub. L. No. 111-5, 123 Stat. 115.

² ARRA § 1231. References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

- Clarify that a partnership's contribution of its trade or business to a lower-tier partnership does not accelerate CODI or OID deductions that have been deferred under section 108(i); and
- Clarify that partnership mergers do not accelerate CODI or OID deductions that have been deferred under section 108(i).

DISCUSSION

I. Introduction

A. Background

The Bankruptcy Tax Act of 1980,³ as modified by the Tax Reform Act of 1986,⁴ established a comprehensive set of rules for the tax treatment of discharge of indebtedness. One set of rules governs debt discharge for solvent debtors and another set governs debt discharge for bankrupt or insolvent debtors. Specifically, section 108(a) provides exceptions to the general rule of section 61(a)(12) that requires CODI to be included in a taxpayer's gross income. Notwithstanding the general rule of section 61(a)(12), under section 108(a) CODI is excluded from gross income if the taxpayer qualifies for an exception. If CODI is excluded from gross income, the taxpayer generally is required to reduce certain "tax attributes" in a prescribed order.⁵

B. Deferral of Cancellation of Debt Income

The ARRA added a new section 108(i), which provides a new exception to the general rule of section 61(a)(12). Section 108(i) generally provides for an elective deferral of CODI realized by certain debtors as a result of a "reacquisition" of an "applicable debt instrument" that occurs in calendar year 2009 or 2010.⁶ Any resulting CODI generally will be deferred and subsequently recognized ratably over five taxable years ("Inclusion Period"). The Inclusion Period begins five taxable years after the taxable year in which the CODI is realized for CODI that is realized in calendar year 2009. For CODI realized in calendar year 2010, the Inclusion Period begins four taxable years after the taxable year of realization.⁷

By definition, section 108(i) applies only if an "applicable debt instrument" is reacquired. For purposes of the provision, an "applicable debt instrument" is any debt instrument issued by (1) a C corporation or (2) any other person "in connection with" the conduct of a trade or business by such person.⁸ A "debt instrument" is broadly defined to include any bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of section 1275(a)(1)).⁹

³ Pub. L. No. 96-589, 94 Stat. 3389.

⁴ Pub. L. No. 99-514, 100 Stat. 2085.

⁵ See I.R.C. § 108(b)(2).

⁶ See H.R. Rep. No. 111-16, at 564 (2009) ("Conference Report").

⁷ I.R.C. § 108(i)(1). Because section 108(i)(1) explicitly references taxable years, for reacquisitions of applicable debt instruments in a particular calendar year, fiscal year taxpayers may have Inclusion Periods that cover different taxable years.

⁸ I.R.C. § 108(i)(3)(A).

⁹ I.R.C. § 108(i)(3)(B).

Thus, a debt instrument issued by a partnership will be considered an applicable debt instrument only if the partnership issued the debt instrument in connection with the conduct of its trade or business.

For purposes of section 108(i), a “reacquisition” is any “acquisition” of an applicable debt instrument by (1) the debtor that issued (or is otherwise the obligor under) the debt instrument, or (2) any person related to the debtor within the meaning of section 108(e)(4).¹⁰ For purposes of the provision, an “acquisition” includes, without limitation, (1) an acquisition of a debt instrument for cash, (2) an exchange of a debt instrument for another debt instrument (including an exchange resulting from a modification of a debt instrument), (3) an exchange of a debt instrument for corporate stock or a partnership interest, (4) a contribution of a debt instrument to capital, and (5) a complete forgiveness of a debt instrument by a holder of the instrument.¹¹

In addition to the deferral of CODI, section 108(i) defers the deduction of OID that results from the reacquisition of an applicable debt instrument. The deferred OID deductions are recognized and taken into account over the same Inclusion Period as the deferred CODI.¹² Deferred CODI and deferred OID deductions are accelerated and taken into account currently upon the “acceleration” events discussed below.¹³

If a taxpayer issues a debt instrument and the proceeds of the issuance are used directly or indirectly to reacquire a debt instrument of the taxpayer, the newly issued debt instrument is treated as if it were issued in satisfaction of the retired debt instrument for purposes of section 108(i).¹⁴ Thus, if the newly issued debt instrument has OID, all or a portion of the OID deductions on the new debt instrument are deferred into the five-taxable-year period in which the CODI is recognized.¹⁵ If only a portion of the proceeds of a new debt instrument are used by a taxpayer to satisfy outstanding debt, then the deferral rule applies to a portion of the OID deductions on the new debt instrument.¹⁶

C. Acceleration of Deferred Items

Significantly, the deferred items are accelerated and taken into account currently upon the occurrence of certain “acceleration” events. All deferred CODI and OID not previously recognized are accelerated and taken into account in the taxable year in which

¹⁰ I.R.C. § 108(i)(4)(A). *See* Conference Report at 564.

¹¹ I.R.C. § 108(i)(4)(B). *See* Conference Report at 564-565.

¹² I.R.C. § 108(i)(2).

¹³ I.R.C. § 108(i)(5)(D).

¹⁴ I.R.C. § 108(i)(2)(B). *See* Conference Report at 565. There does not appear to be a related party rule that would apply to defer the OID deductions if a related party borrowed the funds to reacquire the debt instrument. *See* Monte A. Jackel, Jeffrey W. Maddrey, & Robert J. Crnkovich, *New COD/AHYDO Legislation: Needed Relief Provides Complexity*, 123 TAX NOTES (TA) 197 (April 13, 2009).

¹⁵ *See* Conference Report at 565.

¹⁶ I.R.C. § 108(i)(2)(B). *See* Conference Report at 565.

the issuer dies, liquidates, sells substantially all of the assets of its business, ceases its business, or in which similar circumstances occur.¹⁷ Therefore, the deferral benefit of the election generally is limited to issuers that continue the business or activities to which the CODI relates.

D. Election Procedures

If a taxpayer makes the election provided by section 108(i), the exclusions provided by sections 108(a)(1)(A), (B), (C), and (D) do not apply to the CODI for the year in which the taxpayer makes the election or any subsequent year.¹⁸ Thus, for example, an insolvent taxpayer may elect under section 108(i) to defer CODI, rather than exclude the CODI and reduce tax attributes by a corresponding amount.¹⁹ The election is to be made on an instrument by instrument basis and is irrevocable.²⁰ A taxpayer makes an election with respect to a debt instrument by including with its return for the taxable year in which the reacquisition of the debt instrument occurs a statement that (1) clearly identifies the debt instrument, and (2) includes the amount of deferred income to which the provision applies and such other information as may be prescribed by the Secretary of the Treasury (“Secretary”).²¹

E. Regulatory Authority

Section 108(i)(7) authorizes the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of applying section 108(i), including rules extending the acceleration provisions to other circumstances where appropriate, rules requiring reporting of the election and other information as the Secretary may require on tax returns for subsequent taxable years, and rules for the application of section 108(i) to partnerships, S corporations, and other pass-thru entities, including rules for the allocation of deferred deductions.²²

II. Special Rules for Partnerships

Broadly speaking, section 108(i) contains four special rules concerning the application of section 108(i) to partnerships. The application of these rules is ambiguous and it is uncertain how these rules should be integrated with the principles of Subchapter K of the Code. The ambiguity and uncertainties in applying these rules to partnerships

¹⁷ I.R.C. § 108(i)(5)(D)(i). *See* Conference Report at 565.

¹⁸ I.R.C. § 108(i)(5)(C). In general, sections 108(a)(1)(A), (B), (C), and (D) exclude discharge of indebtedness income if the discharge occurs in a title 11 case, the discharge occurs when the taxpayer is insolvent, the indebtedness discharged is qualified farm indebtedness, or (in the case of a taxpayer other than a C corporation) the indebtedness discharged is qualified real property business indebtedness, respectively.

¹⁹ *See* Conference Report at 566.

²⁰ I.R.C. § 108(i)(5)(B).

²¹ *Id.* *See* Conference Report at 566.

²² *See* Conference Report at 566.

are discussed in detail in the question and answer section of this letter, which follows a general discussion of the rules below.

First, the election to defer CODI is made by the partnership, rather than by the partners (“Partnership Election Rule”).²³

Second, any income or deduction deferred under section 108(i) is allocated among the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of the partners under section 704 if such income were recognized at that time (“Partnership Allocation Rule”).²⁴ Thus, the CODI will be allocated among the partners based on the partners’ shares of partnership income immediately before the discharge, rather than their shares of partnership income when the deferred income is recognized.

Third, any decrease in a partner’s share of partnership liabilities as a result of a partnership’s discharge of indebtedness is not taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731, and any reduction in partnership liabilities that is deferred under this provision is taken into account under section 752 as the deferred gain is recognized (“Deferred Distribution Rule”).²⁵

Finally, the acceleration rule discussed above also applies in the case of the sale, exchange, or redemption of an interest in a partnership by a partner (“Partner Acceleration Rule”).²⁶

III. Analysis and Comments

The following questions and suggested answers illustrate some of the issues surrounding the application of section 108(i) to partnerships and partners and suggest how published guidance might address those issues. The questions and answers are grouped into the following general categories: (A) Partnership-Level Election, (B) Trade or Business Requirement, (C) Partnership Allocation Issues, (D) Deferred Distribution Rule, and (E) Acceleration Events.

²³ I.R.C. § 108(i)(5)(B)(iii). Section 108(i) elections are also made at the entity level in the case of S corporations and other pass-thru entities. *Id.*

²⁴ I.R.C. § 108(i)(6). *See* Conference Report at 566.

²⁵ I.R.C. § 108(i)(6). *See* Conference Report at 566.

²⁶ I.R.C. § 108(i)(5)(D)(ii). The same rule applies to owners of S corporation stock and interests in other pass-thru entities. *Id.*

A. Partnership-Level Election

Q1: Conflicts Among Partners. Should partners be allowed to “opt-out” of a partnership-level election?

A1: Under the Partnership Election Rule, the section 108(i) election is made by the partnership. The main purpose of section 108(i) is to provide relief to taxpayers who are in financial difficulty. In some cases, the Partnership Election Rule will frustrate this purpose because a taxpayer that is a partner in a partnership may defer CODI under section 108(i) only if the taxpayer convinces the partnership to make the election.

For example, assume that a partnership with two partners (A and B) has CODI that is eligible for the section 108(i) election, and that A, but not B, would be eligible to exclude the CODI from income under the bankruptcy or insolvency exceptions under section 108(a). A may prefer not to make the section 108(i) election, whereas B may prefer to make the election. If the partnership does not make the section 108(i) election, B will be deprived of the opportunity to defer the CODI. If the partnership does make the election, A will be deprived of the opportunity to exclude the CODI under section 108(a).

In order to resolve the conflicts of interest that arise when some, but not all, of the partners in a partnership desire to make the election, we recommend that the Treasury and the Service consider allowing partners to opt-out of a partnership-level section 108(i) election, provided the Treasury and the Service agree that such guidance is within their authority under section 108(i)(7). This approach is similar to the approach taken in regulations under section 1045 with regard to elections to defer gain on qualified small business stock.²⁷ If this approach were adopted and if a partnership made the election, the result would be similar to allowing the partners to make the election on their own behalf. The partnership, however, would continue to report the tax consequences of the election to each partner.²⁸

Q2: New Partners. If a partnership that has elected to defer CODI under section 108(i) issues a partnership interest to a new partner that will not be allocated any of the partnership’s CODI when it is recognized, should the new partner’s distributive share of OID deductions be deferred?

A2: It appears that, as a general rule, the new partner’s share of the OID deductions would be deferred.²⁹ The Treasury and the Service, however, may

²⁷ Reg. § 1.1045-1(b)(4).

²⁸ Cf. Reg. § 1.1017-1(g) (effects of partner-level elections under sections 108(b)(5) and 108(c) on partnerships); Rev. Proc. 2009-16, 2009-6 I.R.B. 449 (effect of partner-level elections under section 162(k)(4) on partnerships); Reg. § 1.1363-2(b) (effect of partners’ LIFO recapture on partnerships).

²⁹ I.R.C. § 108(i)(2)(A)(i).

wish to consider issuing guidance that would permit the OID to be deducted as it arises, provided that the partnership agrees to recognize currently an appropriate proportion of its deferred CODI.³⁰

B. Trade or Business Requirement

Q3: Application to Partnerships. How does a partnership determine whether a debt instrument was issued “in connection with the conduct of a trade or business by such person”?

A3: If a partnership has only trade or business assets when a debt instrument is issued, the instrument should be treated as issued “in connection with” a trade or business. If a partnership has some trade or business assets and some non-trade or business assets when a debt instrument is issued by the partnership, it is unclear how to determine if the debt instrument is issued “in connection with” the conduct of the partnership’s trade or business, because section 108(i) does not define the term “in connection with” for purposes of section 108(i).

The term “in connection with” generally has been construed, in other contexts, to mean having a *relation or connection* to the trade or business or other specified statutory activity.³¹ Under this broad language, it does not appear to be necessary

³⁰ In contrast to the situation described above, if a person purchases, from a partner, an interest in a partnership that has in effect a section 108(i) election that is causing OID deductions to be deferred, the analysis of the proper treatment under section 108(i) of the purchaser’s share of OID deductions may be complex. The simplest case is the “straight-up” partnership (“ABC”) that deferred CODI in 2010 and in which C has a 10 percent interest that C sells to D in 2011. Because of the simple nature of the partnership’s allocations, C’s share of the deferred CODI is 10 percent and C’s share of the deferred OID deductions is 10 percent. Because C’s entire share of the CODI will be accelerated on the sale of C’s interest to D, we believe it would be appropriate for guidance to provide that D’s share of the OID deductions will not be subject to deferral. The sale would have no effect on A’s and B’s shares of the subsequent OID deductions (which will remain subject to deferral to the same extent as if C had not sold his interest to D). Although we recognize that crafting such a rule would be substantially more difficult if the transferor’s share of deferred CODI is different from the transferor’s share of the deferred OID deductions, we believe it would be appropriate for guidance to include a rule that permits such a transferee to avoid deferral of that portion of his distributive share of OID deductions that is properly attributable to the transferor’s share of CODI accelerated by reason of the transfer. In addition, we believe it would be appropriate for the rule to permit the non-selling partners (A and B above) to be relieved from deferral in respect of OID deductions allocable to them to the extent those deductions are properly attributable to the seller’s share of deferred CODI accelerated by reason of the transfer. In light of the potential complexity of such a rule, however, it may be appropriate that it be made elective.

³¹ See *Snow v. Commissioner*, 416 U.S. 500 (1974) (experimental expenditures were deductible under section 174 as incurred “in connection with” the taxpayer’s trade or business even though, at the time incurred, the activities did not constitute a trade or business for purposes of section 162); *Huntsman v. Commissioner*, 905 F.2d 1182 (8th Cir. 1990) (a debt incurred three years after the taxpayer purchased his residence was incurred “in connection with” the purchase of the residence as required by section 461(g)(2) when the debt replaced three-year balloon debt incurred at the time the residence was purchased); *Alves v. Commissioner*, 734 F.2d 478, 481-82 (9th Cir. 1984) (stock purchased by an employee was in connection with the performance of services under section 83 even though purchased at full market value and not considered compensation). As stated in TAM 200014007 (Dec. 13, 1999), “When Congress used ‘in connection with’ in section 108(c)(3)(A) it was aware of the Supreme Court’s interpretation of this same

that the proceeds of an applicable debt instrument be traced under the principles of Temporary Regulation section 1.163-8T³² to a trade or business to qualify under section 108(i).

In order to resolve this uncertainty, and to provide bright-line tests that would resolve the issue correctly in most cases, we recommend that the Treasury and the Service issue guidance providing safe harbors for partnerships to apply the term “in connection with” for purposes of section 108(i).

First, we recommend that the Treasury and the Service publish guidance providing a safe harbor under which a debt instrument would be treated as issued “in connection with” the conduct of a partnership’s trade or business to the extent that (i) the proceeds are used in the partnership’s trade or business, (ii) the proceeds are used to acquire a trade or business, or (iii) the instrument is issued to the seller in order to acquire a trade or business (collectively, the “Use of Proceeds Rule”). Any remaining proceeds may or may not be treated as issued in connection with the conduct of the partnership’s trade or business, depending on all of the facts and circumstances.

Second, we recommend that the Treasury and the Service publish guidance providing a safe harbor under which a debt instrument would be treated as issued in connection with the conduct of a partnership’s trade or business if the partnership is owned entirely by C corporations, which are eligible to make a section 108(i) election whether or not they are engaged in a trade or business.³³

Third, we recommend that the Treasury and the Service publish guidance providing a safe harbor under which a debt instrument would be treated as issued in connection with the conduct of a partnership’s trade or business if the partnership’s trade or business assets are subject (directly or indirectly) to the claims of its creditor, and the gross fair market value of the partnership’s trade or business assets is at least 50% of the gross fair market value of all of the partnership’s assets (the “Borrower Rule”). Under the Borrower Rule, if the gross fair market value of the partnership’s trade or business assets is less than 50% of the gross fair market value of all of the partnership’s assets, the instrument might be treated as issued partly in connection with the conduct of a trade or business. The portion of the debt that is treated as issued in connection with the conduct of a trade or business would be the percentage of the gross fair market value of the partnership’s assets that is attributable to the partnership’s trade or business

language in *Snow*. Therefore, it is reasonable to assume that it intended the same broad interpretation be given to the language in section 108(c)(3)(A).”

³² 52 Fed. Reg. 24,996 (Jul. 2, 1987).

³³ If a partnership is owned partly by C corporations, and partly by other taxpayers, then guidance might provide that a debt instrument issued by the partnership is treated as incurred in connection with a trade or business of the partnership to the extent that the partnership is owned by C corporations. We recognize, however, that such a rule could be complex for taxpayers and the Service to apply.

assets. The remaining portion of the debt may or may not be treated as issued in connection with the conduct of the partnership's trade or business, depending on all of the facts and circumstances.

If a partnership issues a debt instrument, only part of which is treated as incurred in connection with the conduct of its trade or business, and the partnership later realizes CODI with respect to the debt instrument and makes a section 108(i) election, we believe that the partnership should be allowed to determine the portion of CODI that is deferred using any reasonable method.³⁴ If the partnership makes a section 108(i) election with respect to the percentage of the CODI that is attributable to the portion of the debt instrument that was incurred in connection with a trade or business of the partnership, and the event giving rise to the CODI also results in OID deductions, then the partnership would be required to defer an identical percentage of those OID deductions.

Q4: Debt Instruments Issued to Acquire Partnership Interests. How does a taxpayer determine whether a debt instrument is issued “in connection with the conduct of a trade or business by such person” if the taxpayer issues a debt instrument to acquire an interest in a partnership that is engaged in a trade or business?

A4: If a taxpayer issues a debt instrument to acquire an interest in a partnership that is engaged in a trade or business (whether by issuing a note to the seller of the interest, using the proceeds of a debt instrument to purchase an interest, or contributing the proceeds to a partnership in exchange for an interest), we do not believe that guidance should require that the taxpayer be directly engaged in the conduct of a trade or business or that the debt be incurred on behalf of the partnership in order for the instrument to qualify as an applicable debt instrument for purposes of section 108(i). Thus, cases and rulings that provide standards for resolving such issues should not be relevant in determining whether a debt instrument that is issued by a taxpayer in order to acquire an interest in a partnership qualifies as an applicable debt instrument.³⁵ Rather, we believe that if

³⁴ For example, assume that a partnership issues a debt instrument that is treated partly as issued in connection with a trade or business of the partnership. If the debt is later modified, it generally would be reasonable for the partnership to treat any resulting CODI as (i) attributable to the portion of the debt that was treated as incurred in connection with a trade or business of the partnership (up to the amount of such portion), (ii) attributable to the portion of the debt that was not treated as incurred in connection with a trade or business of the partnership (up to the amount of such portion), or (iii) partly attributable to each such portion of the debt (provided that the CODI attributable to each portion does not exceed the amount of such portion). *Cf.* Reg. § 1.752-3(b)(1) (providing that a single nonrecourse liability may be allocated among multiple properties under any reasonable method for purposes of allocating a partnership's nonrecourse debt among the partners under Regulation section 1.752-3(a)(2), and that a method is not reasonable for this purpose if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time that the debt is incurred).

³⁵ *See, e.g.,* Rev. Rul. 2008-39, 2008-31 I.R.B. 252 (management fee paid by an upper tier partnership was deductible under section 212, rather than section 162, if the upper-tier partnership was not engaged in a trade or business but owned interests in lower-tier partnerships that were engaged in trades or

the partnership in which an interest is acquired has only trade or business assets, the debt instrument should be treated as issued in connection with a trade or business. If the partnership in which an interest is acquired has some trade or business assets and some non-trade or business assets, we believe that principles similar to those described in A3 should apply in determining whether all or part of the instrument is treated as incurred in connection with a trade or business of the issuer.³⁶

C. Partnership Allocation Issues

Q5: Capital Account Maintenance Rules. How should deferred CODI and OID deductions be reported for purposes of maintaining the partners' capital accounts under Reg. § 1.704-1(b)(2)(iv)?

A5: When a partnership realizes CODI, the liabilities on the partnership's section 704(b) book balance sheet (the "Balance Sheet") will necessarily decline by the amount of the CODI, although the mere realization (without recognition) of the CODI would not ordinarily increase the partner's capital accounts (because partnerships are required to maintain the capital accounts of their partners in accordance with federal income tax principles).³⁷ If the Balance Sheet is to remain in balance and the capital accounts of the partners are to reflect their economic entitlements, a correlative adjustment will be necessary. There are three possibilities:

- (1) Increase the partners' capital accounts by the amount of the deferred CODI (the CODI would be treated in a manner analogous to a section 704(c) item so that it is allocated to the correct partners when recognized and would not increase the capital accounts at that time);³⁸
- (2) Treat the amount of the deferred CODI as a liability for purposes of the Balance Sheet; or

businesses); *Cf. Butler v. Commissioner*, 36 T.C. 1097 (1961), *acq.*, 1962-2 C.B. 4 (because loans made by a limited partner to a partnership were sufficiently related to the business activities of the partnership the limited partner was entitled to a business bad debt deduction).

³⁶ Because these comments are limited to partnership issues, we express no opinion as to whether a similar rule should apply to a taxpayer's acquisition of stock in a C corporation that is engaged in a trade or business. *See generally* Reg. § 1.197-2(b)(9) (providing that a section 197 intangible includes a covenant not to compete entered into in connection with an indirect acquisition of an interest in a trade or business, which includes the acquisition of stock of a C corporation that is directly engaged in a trade or business).

³⁷ *See* Reg. § 1.704-1(b)(2)(iv)(n).

³⁸ Similarly, any OID deductions that are deferred under section 108(i) would decrease the capital accounts of the partners when the deductions are realized. The OID deductions would be allocated to the correct partners (under section 704(c) principles) when the deductions are recognized and would not decrease the capital accounts at that time.

- (3) Treat the amount of the deferred CODI as an increase in capital, for purposes of the Balance Sheet, though not allocated to any partner's individual capital account.³⁹

We view the choice among these alternatives as non-substantive because regardless of which selection is made, ancillary rules may be adopted to ensure that the application of section 704(b) to the partnership's allocations is the same regardless of which of these alternatives is adopted. Moreover, we do not believe that any one of these approaches is clearly required by the existing rules. Accordingly, we believe that the guiding principle in deciding which mechanism should be employed is simplicity.

Although alternative (1) is simple, it might be criticized as deviating from the general principle that capital accounts normally should be maintained in accordance with federal income tax accounting principles. Although alternatives (2) and (3) avoid the possible criticism of deviating from normal income tax accounting principles, implementing these alternatives would be considerably more complex than implementing alternative (1) as alternatives (2) and (3) would require a host of ancillary rules to ensure that:

- (a) Any capital account deficit that would not have resulted if alternative (1) had been applied will not trigger a qualified income offset or gross income allocation (for the same reason that a deficit supported by minimum gain is "protected" under the existing regulations), and
- (b) The liability "created" under alternative (2) is not a "liability" for tax purposes (including for purposes of section 752).

On balance, we believe that because alternative (1) is likely to be the simplest of the approaches and will require the fewest ancillary rules to enable it to operate properly, it is probably the best of the alternatives.

Q6: Allocation of Deferred OID Deductions. Are special rules for the allocation of deferred OID deductions necessary?

A6: As noted above, section 108(i)(7) authorizes the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of applying section 108(i), including rules for the allocation of deferred deductions. We do not believe specific rules are necessary regarding the allocation of deferred deductions. In particular, we do not believe guidance should require the deferred deductions to be allocated to the partners in proportion to their interests at the time of the discharge. A partner's distributive share of the deferred deductions

³⁹ This approach would be analogous to the treatment of a noncompensatory option's share of revaluation gain under the proposed noncompensatory option regulations. *See* Noncompensatory Partnership Options, REG-103580-02, 68 Fed. Reg. 2930 (Jan. 22, 2003) (Prop. Reg. § 1.704-1(b)(5), Ex. (22)(iii)).

should be determined under the partnership agreement, provided that allocations under the partnership agreement have substantial economic effect. If the partnership's allocations lack substantial economic effect, the deductions would need to be allocated in accordance with the partners' interests in the partnership. In addition, we note that if a section 108(i) election is not made with respect to a transaction giving rise to both CODI and OID, current law does not require that the CODI and the OID deductions be allocated among the partners in the same proportions. We do not believe that making a section 108(i) election with respect to the same transaction should create such a requirement.

Q7: Effects on Outside Basis. If a partnership elects to defer CODI under section 108(i), does the deferred CODI increase the partners' outside bases when the CODI is realized?

A7: We believe that the CODI deferred under section 108(i) does not increase the partners' outside bases until the CODI is recognized by the partnership.⁴⁰ Similarly, we believe that any OID deductions that are deferred by the partnership under section 108(i) should not decrease the partners' outside bases until those deductions are recognized by the partnership.

D. Deferred Distribution Rule

Q8: Determination of Deferred Distributions. How and when should the amounts of deemed distributions that are subject to the Deferred Distribution Rule be determined?

A8: Section 108(i)(6) provides as follows:

(6) *Special rule for partnerships.*--In the case of a partnership, any income deferred under this subsection shall be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge shall not be taken into account for purposes of section 752 at the time of the discharge *to the extent it would cause the partner to recognize gain under section 731*. Any decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized. (Emphasis added.)

Neither the statute nor the legislative history specifies which distributions are subject to the Deferred Distribution Rule. Thus, the rule might be interpreted to

⁴⁰ See generally Monte A. Jackel & Jerred G. Blanchard, *Reflections on Liabilities: Extension of New Law to Partnership Formations*, 91 TAX NOTES (TA) 1579 (May 28, 2001) (discussing similar issues).

prevent section 731 gain arising solely from deemed distributions at the moment of the discharge, or more broadly to prevent a triggering of section 731 gain at any time prior to the recognition of all of the deferred CODI.

We recommend that the Deferred Distribution Rule be interpreted in the latter manner because we believe this is most consistent with the objective of the Deferred Distribution Rule, which is to prevent section 731 gain from undermining the intended deferral. In our view, the principles of the Deferred Distribution Rule are similar to the principles of Revenue Ruling 92-97 and Revenue Ruling 94-4.⁴¹ In each case, the government has tried to match the timing of deemed distributions under section 752(b) with income that is associated with those distributions. In the revenue rulings, the deemed distribution is deferred only until the end of the partnership's taxable year, because that is moment in time when the associated income is allocated to the partners and increases their outside bases. If a partnership defers CODI under section 108(i), however, the CODI is deferred for more than one year and, accordingly, we believe it is appropriate to expand the matching principles of the rulings to take into account this statutory reality. Thus, we believe the Deferred Distribution Rule should be applied to prevent a partner from recognizing more section 731 gain in any taxable year than the partner would have recognized if the section 108(i) election had not been made.

Q9: Tiered Partnerships. How does the Deferred Distribution Rule apply to tiered partnerships?

A9: If a partnership ("UTP") owns an interest in another partnership ("LTP"), and LTP defers the recognition of CODI under section 108(i), we believe the deemed distribution from LTP to UTP should be subject to the Deferred Distribution Rule to the extent provided in A8. In addition, we believe deemed distributions by UTP to the partners of UTP should be eligible for the Deferred Distribution Rule to the same extent provided in A8. Thus, if LTP defers the recognition of CODI under section 108(i), we believe UTP and its partners should not recognize greater section 731 gain in any year (including taxable years after the year of the discharge) than they would have recognized but for the section 108(i) election.

⁴¹ In Revenue Ruling 92-97, 1992-2 C.B. 124, the Service concluded that because of the "integral relationship" between the CODI resulting from a cancellation of debt and the section 752(b) distribution of money resulting from the cancellation, Regulation section 1.731-1(a)(1)(ii) treats the distribution of money to each partner from the cancellation of the debt as occurring at the end of the partnership's taxable year as an advance or drawing against that partner's distributive share of CODI. Similarly, in Revenue Ruling 94-4, 1994-1 C.B. 196, the Service concluded that a deemed distribution of money under section 752(b) resulting from other decreases in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under Regulation section 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership taxable year. *See also* Rev. Rul. 2003-56, 2003-1 C.B. 985 (if a partnership engages in a like-kind exchange under section 1031 that spans two taxable years, the partnership nets decreases in liabilities in the first year against increases in liabilities in the following year).

Q10: Decreases in At-Risk Amounts. Should the principles of the Deferred Distribution Rule be applied to a partner’s at-risk amount under section 465?

A10: If, at the close of any taxable year, a taxpayer’s amount at risk in an activity is below zero, the taxpayer generally is required to recognize the amount of the excess in gross income.⁴² The amount required to be included in gross income, however, is limited to the losses allowed in previous years that have not already been recaptured. The recaptured amount is treated as a deduction in the first succeeding taxable year and is allowed in a subsequent year if and to the extent a taxpayer’s at-risk amount is increased.⁴³

Although section 108(i) defers the deemed distribution under section 752(b) to the extent that it would have triggered gain under section 731, there is no similar rule for at-risk basis. Thus, if the discharged debt had been included in a partner’s at-risk amount (either because it was recourse or because it was qualified nonrecourse financing under section 465(b)(6)), and some of that debt is discharged, it appears that there could be recapture under section 465(e) if the amount discharged exceeds the partner’s at-risk amount. We believe this result would frustrate the purpose of section 108(i) and the Deferred Distribution Rule, which is to minimize the current tax consequences of CODI.

We recommend that the Treasury and the Service publish guidance providing that the principles of the Deferred Distribution Rule also apply to a partner’s at-risk amount under section 465. Specifically, we recommend that if partnership debt is discharged and the partnership makes a section 108(i) election with respect to that debt, the reduction in a partner’s at-risk amount arising from that discharge be deferred to the extent necessary to prevent the partners from recognizing more recapture under section 465(e) in any taxable year than the partners would have recognized if the section 108(i) election had not been made.

Q11: Debt-for-Equity Exchanges. Should section 751(b)⁴⁴ apply if a lender contributes its debt to a partnership in exchange for a partnership interest and the exchange causes deemed distributions to the original partners under section 752(b)?

A11: We believe that section 751(b) should not apply if a lender contributes its debt to a partnership in exchange for a partnership interest, and the exchange causes deemed distributions to the original partners under section 752(b).

⁴² I.R.C. § 465(e)(1)(A).

⁴³ I.R.C. § 465(e)(1)(B).

⁴⁴ Under section 731(a), a partner that receives a distribution from a partnership generally does not recognize gain unless the partner receives a distribution of money in excess of its basis in the partnership. Section 751(b), however, provides an exception to the general nonrecognition rule of section 731(a) if the distribution changes the distributee partner’s share of “unrealized receivables” or substantially appreciated “inventory items” as those terms are defined in section 751 and the regulations thereunder.

In Revenue Ruling 84-102,⁴⁵ the Service considered a transaction in which a new partner contributed money in exchange for an interest in a partnership that held section 751 property. After the contribution, part of the partnership's liabilities were allocated to the new partner, causing a deemed distribution to the original partners under section 752(b). The ruling concludes that each of the original partners was required to recognize ordinary income under section 751(b)(1)(B) because their shares of the partnership's section 751 property were reduced.

If a lender contributes its debt to a partnership in exchange for a partnership interest, Revenue Ruling 84-102 suggests that the original partners might be required to recognize ordinary income under section 751(b)(1)(B) because their shares of the partnership's section 751 property arguably could be viewed as reduced.

The relevance of Revenue Ruling 84-102 under current law is unclear for a number of reasons. In particular, Revenue Ruling 84-102 does not reflect changes to section 704(c) and the regulations under section 704(b) that have occurred since the ruling was issued that protect against the shifting of ordinary income among partners.⁴⁶ In addition, in Notice 2006-14,⁴⁷ the Service described the "hypothetical sale approach" to measure a partner's share of ordinary income assets.⁴⁸ We believe that, under current law, the principles of section 751(b) are not implicated if a lender contributes its debt to a partnership in exchange for a partnership interest, and the partnership's property is revalued immediately before the contribution, because upon a future sale of section 751 property, any resulting income or loss would be allocated to the original partners in proportion to their percentage interests prior to the exchange. Accordingly, we recommend that guidance clarify that, in the case of a debt-to-equity exchange, section 751(b) will not apply regardless of whether a section 108(i) election is made with respect to any CODI resulting from the exchange, provided the partnership revalues its property under Regulation section 1.704-1(b)(2)(iv)(f) immediately before the exchange.

⁴⁵ 1984-2 C.B. 119.

⁴⁶ See Deficit Reduction Act of 1984, Division A, Tax Reform Act of 1984, Pub. L. No. 98-369, § 73, 98 Stat. 494, 591, as amended by the Tax Reform Act of 1986, Pub. L. 99-514, § 1805(b), 100 Stat. 2810 (making section 704(c)(1)(A) mandatory for property contributed to a partnership after March 31, 1984); T.D. 8065, 50 Fed. Reg. 53,420 (Dec. 31, 1985).

⁴⁷ 2006-1 C.B. 498.

⁴⁸ Under a hypothetical sale approach, the income or loss realized by a partner from section 751 property upon the sale or exchange of its interest is the amount of income or loss that would have been allocated to the partner from section 751 property (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for fair market value immediately prior to the partner's transfer of the partnership interest.

E. Acceleration Events

Q12: Sale of Interest. What are the consequences of the sale of a partner's entire interest in a partnership?

A12: Although it could be argued under the literal terms of the statute that all of the partnership's deferred CODI would be triggered by the sale,⁴⁹ we believe that only the selling partner's share of deferred CODI should be accelerated on the sale because the tax consequences of the CODI are borne by each partner who is allocated the CODI.

Example. Partnership PRS, in which A, B, and C are equal partners, is engaged in a trade or business in which it has incurred an indebtedness of \$1,000 owing to creditor. In 2009, creditor agrees to reduce the indebtedness to \$800 in a transaction that will result in \$200 of CODI. PRS properly elects to defer its recognition of the CODI under section 108(i). In 2010, C sells its interest in PRS to D in an arms' length transaction for cash. What are the consequences of this sale under section 108(i)?

Under the Partner Acceleration Rule, C's sale of its interest in PRS causes C to recognize its distributive share of PRS's CODI attributable to the reduction of the debt and requires that PRS reduce the amount of its deferred CODI under section 108(i) by the amount so recognized by C. We recommend C's sale of its interest in PRS have no consequences under section 108(i) to A or B.

Q13: Partial Sale of Interest. What are the consequences of the sale of part, but not all, of a partner's interest in a partnership?

A13: If the facts are the same as in the Example in A12 except that C sells only part of its interest in PRS to D, it is unclear what portion, if any, of C's deferred CODI should be recognized in the year of a partial sale of the interest. Arguably, none of the deferred CODI should be recognized because C continues to be a partner in PRS and the partnership could allocate the deferred CODI to C in a future year.

We recommend that the Treasury and the Service publish guidance providing that, in the case of a partial sale of an interest, the portion of CODI that is recognized is determined under the principles of Regulation

⁴⁹ Section 108(i)(5)(D)(i) provides that if an acceleration event occurs, "any item of income or deduction which is deferred under this subsection (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs" Section 108(i)(5)(D)(ii) provides that "the rule of clause (i)" applies in the case of the sale or exchange or redemption of an interest in a partnership. Thus, if there is a sale, exchange, or redemption of a partnership interest, a literal application of sections 108(i)(5)(D)(i) and (ii) would result in the acceleration of all items deferred by the partnership.

section 1.704-3(a)(7).⁵⁰ Thus, if a partner owns an interest in a partnership that has deferred CODI under section 108(i), and later transfers a portion of the partnership interest to another person, a share of deferred CODI (and deferred OID deductions, if any, properly attributable to that CODI) proportionate to the interest transferred must be recognized.⁵¹ We further recommend that because these recognized items are directly attributable to the sale, the partner's basis in the sold portion of the interest (as determined immediately before the sale) should fully reflect the recognized items, and no portion of these items should be allocated to the basis in the retained portion of the interest.⁵²

Q14: Other Transfers. Should transfers of partnership interests that are not sales or exchanges accelerate the transferor's share of deferred CODI?

A14: As discussed above, section 108(i)(5)(D)(ii) treats a sale, exchange, or redemption of a partnership interest as an acceleration event. If a partner transfers a partnership interest to another person for no consideration, a sale or exchange generally results to the extent that a portion of the transferor's share of partnership liabilities shifts to the transferee of the interest.⁵³ In some cases, however, a partner may transfer a partnership interest to another person in a transaction in which the transferor does not have a share of partnership liabilities, or the transferor's share of partnership liabilities does not change as a result of the transfer. As noted above, section 108(i)(7) authorizes the Secretary to prescribe such regulations as may be necessary or appropriate for purposes of applying section 108(i), including rules extending the acceleration provisions to other circumstances where appropriate. We do not believe that a partner should be allowed to avoid deferred CODI by disposing of a

⁵⁰ Regulation section 1.704-3(a)(7) provides that if a partner contributes appreciated property to a partnership and later transfers a portion of its interest, the share of built-in gain proportionate to the interest transferred must be allocated to the transferee partner.

⁵¹ We considered recommending a rule that would treat some partial sales as not resulting in an acceleration of deferred CODI. For example, a partner might not be required to recognize deferred CODI if, after a sale, the selling partner retains at least two-thirds of its original interest. *See generally* Reg. § 1.702-3T(g)(2)(i)(A) (providing a similar rule in another context for partnerships whose taxable year was required to be changed as a result of the Tax Reform Act of 1986). We realize, however, that such a rule would be complex for taxpayers and the Service to administer, and we are concerned that such a rule might cause partnership interests not to be fungible. Therefore, we do not recommend that such a rule be mandatory, although it might be feasible for guidance to allow partnerships to elect to apply such a rule.

⁵² If a partner recognizes CODI as the result of selling a portion of the partner's interest, and a deemed distribution has been deferred with respect to that partner as a result of the Deferred Distribution Rule, then the portion of the partner's deferred distributions properly attributable to the accelerated CODI should be taken into account immediately before the sale.

⁵³ *See, e.g.,* Reg. § 1.1001-2(c), Ex. (4); *Goodman v. United States*, 2000-1 USTC ¶ 50,162 (S.D. Fla. 1999); *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 74-40, 1974-1 C.B. 159; Rev. Rul. 75-194, 1975-2 C.B. 80; Rev. Rul. 77-402, 1977-2 C.B. 222.

partnership interest in a transaction that is not otherwise treated as a sale or exchange, such as a transfer of a partnership interest upon death, or a gift or charitable contribution of a partnership interest.⁵⁴ Therefore, we recommend that the Treasury and the Service publish guidance providing that these transactions will be treated as acceleration events for purposes of section 108(i). As noted in A12 and A13, however, we recommend that only the share of CODI that is proportionate to the transferred interest be accelerated.

Q15: Complete Redemption of Interest. The facts are the same as the example in A12 except that C's entire interest is redeemed by PRS for cash or property. What are the consequences of this redemption under section 108(i)?

A15: We believe the results under section 108(i) should be the same as in A12.

Q16: Partial Redemption of Interest. The facts are the same as the example in A12 except that C receives a distribution of cash or property that reduces C's interest in PRS from one-third to one-sixth. What are the consequences of this distribution under section 108(i)?

A16: As noted above, the Partner Acceleration Rule treats the sale, exchange, or redemption of an interest in a partnership by a partner as an acceleration event. We do not believe a nonliquidating distribution should be treated as a redemption for purposes of this rule. If nonliquidating distributions were treated as acceleration events in some cases, it would be very difficult to determine which distributions should be treated as "redemptions."⁵⁵ In addition, it would be very difficult to determine the appropriate share of the partner's deferred CODI that should be triggered. Furthermore, a rule treating nonliquidating distributions as redemptions is not necessary to ensure that the distributee partner is allocated the appropriate share of deferred CODI, because the Partnership Allocation Rule ensures that the partner's share of the CODI will be allocated to that partner under section 704(c) principles when the CODI is recognized by the partnership.

⁵⁴ It may be appropriate for transfers of partnership interests between spouses or incident to divorce to be excepted from this general rule. Cf. Reg. § 1.1366-2(a)(5)(ii) (effectively allowing losses from an S corporation that have been disallowed under section 1366(d) to be transferred if S corporation stock is transferred to a spouse or former spouse in a transaction described in section 1041).

⁵⁵ Cf. I.R.C. § 302(b) (providing detailed rules for determining when a redemption of corporate stock should be treated as an exchange). See generally T.D. 8902, 65 Fed. Reg. 57,092 (Sept. 25, 2000) (the Treasury and the Service determined that it was not advisable to apply the lookthrough provisions of Regulation section 1.1(h)-1 to redemptions for purposes of taxing the distributee partner's share of collectibles gain or section 1250 gain). Under President Clinton's 2000 budget proposal, nonliquidating distributions would have been treated as partial redemptions, and partners would have been required to use only a portion of their outside basis to determine the tax consequences of such distributions. President William J. Clinton, *Analytical Perspectives: The Budget of the United States Government – Fiscal Year 2000* (February 1, 1999). The proposal was criticized for its complexity and never enacted into law. See Deborah Harrington, Eric Sloan, & Avery Stok, *The FY 2000 Budget Proposals: The Administration Joins the Choir in Seeking Reform of the Partnership Distribution Rules*, 2 JOURNAL OF PASSTHROUGH ENTITIES 4 (July/August 1999).

Q17: Mere Dilution. The facts are the same as the example in A12 except that in 2010, instead of D purchasing C’s interest, C retains its entire interest and E contributes cash to PRS so that E becomes an equal 25% partner with A, B, and C. What are the consequences of this transaction under section 108(i)?

A17: The dilution of A, B and C by reason of PRS’s issuance of a 25% interest to E is not a “sale,” an “exchange,” or a “redemption” of an interest in PRS. Furthermore, a rule treating the dilution of A, B, and C as an acceleration event is not necessary to ensure that these partners are allocated the appropriate share of deferred CODI, because the Partnership Allocation Rule ensures that each partner’s share of the CODI will be allocated to that partner under section 704(c) principles when the CODI is recognized by the partnership. Thus, the dilution of A, B, and C should not be treated as an acceleration event for purposes of section 108(i)(5)(D)(ii). Accordingly, the contribution by E should not cause any portion of PRS’s deferred CODI to be recognized under the Partner Acceleration Rule.⁵⁶

Q18: Section 721 Contribution of Interest. The facts are the same as the example in A12 except that, in 2010, instead of C selling its interest in PRS to D for cash, C contributes its interest in PRS to the EC partnership and receives in consideration a partnership interest in the EC partnership. The transaction is properly treated for federal income tax purposes as a transaction described in section 721. What are the consequences of this transaction under section 108(i)?

A18: We recommend that the Treasury and the Service publish guidance providing that the contribution of C’s interest to EC does not accelerate C’s share of the deferred CODI, that PRS must allocate C’s deferred CODI to EC, and that EC must allocate C’s deferred CODI to C.⁵⁷ Thus, C will recognize its share of PRS’s remaining deferred CODI under section 108(i) as though C had not transferred any portion of its interest in PRS. EC’s outside basis in PRS, and C’s outside basis in EC, will be increased under section 705 as the income is recognized and allocated to C.⁵⁸

⁵⁶ If part of PRS’s liability is allocated to E, then one or more of the existing partners would receive a deemed distribution of money under section 752(b). For the reasons discussed in A11, we believe that section 751(b) should not apply to such distributions. The extent to which a deemed distribution to A, B, or C should be deferred under the Deferred Distribution Rule is addressed in A8.

⁵⁷ Similar principles are found in Regulation section 1.704-3(a)(9), which provides that if a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner’s remaining built-in gain or loss. This result is consistent with alternative (1) regarding the effect of CODI under capital account maintenance rules in A5.

⁵⁸ If C had contributed its interest to a corporation in a transaction described in section 351, it would be more difficult to achieve similar results, because corporations, other than S corporations and members of consolidated groups, generally do not pass income through to their owners, and neither the rules governing S corporations nor those governing consolidated groups contain rules analogous to section 704(c). It might

Q19: Section 708(b)(1)(B)⁵⁹ Termination. The facts are the same as the example in A12 except that instead of C selling C's interest to D, both B and C sell their interests to E, causing PRS to terminate under section 708(b)(1)(B). What are the consequences of these sales under section 108(i)?

A19: We recommend that the Treasury and the Service publish guidance providing that a technical termination under section 708(b)(1)(B) is not treated as an acceleration event under section 108(i) with respect to the non-selling partners.

Under Regulation section 1.708-1(b)(4), PRS is deemed to contribute all of its assets and liabilities to a new partnership ("new PRS") in exchange for an interest in new PRS; and, immediately thereafter, PRS is deemed to distribute interests in new PRS to its partners in liquidation of their interests. We believe these deemed transactions should not be treated as acceleration events for purposes of section 108(i). In particular, PRS should not be treated as ceasing its business, because its business will be continued by new PRS. A should not be treated as selling, exchanging, or redeeming its interest in PRS because A continues to hold an interest in new PRS. Finally, PRS should not be treated as selling or exchanging its interest in new PRS.⁶⁰

be possible for guidance to allow corporations and shareholders to sign and file with the Service an agreement for deferred CODI to be treated in a similar fashion. *See generally* Reg. § 1.367(a)-8. That is, when the partnership recognizes the CODI or an acceleration event occurs, the transferring shareholder would recognize its share of deferred CODI, the transferee corporation's outside basis would be increased, and the shareholder's basis in corporate stock would be increased. Similar principles also could be applied if a partnership or other person contributes its assets to a corporation in a transaction described in section 351, a partnership elects to be classified as a corporation under Regulation section 301.7701-3, a partnership converts to a corporation under local law, or a partnership incorporates using one of the methods described in Revenue Ruling 84-111, 1984-2 C.B. 88. These Comments are, however, limited to partnership transactions, and we make no recommendations on the tax treatment of corporate transactions such as contributions under section 351.

⁵⁹ Section 708(b)(1)(B) provides that a partnership is considered as terminated if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

⁶⁰ Under section 108(i)(5)(D)(i), deferred CODI or OID deductions are accelerated and taken into account in the case of the death of the taxpayer, the liquidation or sale of substantially all of the assets of the taxpayer, the cessation of business by the taxpayer, or similar circumstances. The term "cessation of business" is not defined in the statute, but the meaning of this term may be drawn from analogous authorities. *See, e.g.*, Rev. Proc. 97-27, 1997-1 C.B. 680, § 7.03(3)(a), (d) (providing that in the context of a deferred section 481 change of accounting method adjustment, a cessation of business is deemed to occur if a section 351 or section 721 transfer is made, but not if a section 381(a) transaction occurs). *But see* Rev. Rul. 66-206, 1966-2 C.B. 206 (providing that if a sole proprietor transfers his or her business to a partnership, becomes a partner, and continues to be active in the partnership's business, there is no acceleration of the transferor's section 481 adjustment attributable to the transferred business). We believe that the principles of section 704(c) should apply rather than the approach of Rev. Proc. 97-27. Therefore, we believe that the technical termination of PRS should not be treated as an acceleration event for partner A, even though the termination would be treated as a cessation of business for purposes of section 481.

In summary, the technical termination of PRS should have no consequences under section 108(i) to A. Rather, B and C should be treated in the same manner as C was treated in A12, and new PRS will reduce the amount of its deferred CODI under section 108(i) by the amount of CODI recognized by B and C.

We recommend that the Treasury and the Service also publish guidance providing that new PRS will be treated as having made a section 108(i) election with respect to the CODI formerly realized by PRS. Thus, a new section 108(i) election is not required to continue the deferral of that CODI. Any reporting requirements that would have applied to PRS with respect to periods after the date of the merger should apply to new PRS.

Finally, we recommend that the Treasury and the Service publish guidance providing that the two short taxable years that are created by a technical termination of the partnership under section 708(b)(1)(B) should be treated as a single taxable year for purposes of determining the Inclusion Period in which the partnership recognizes deferred CODI and OID deductions.⁶¹

Q20: Section 708(b)(1)(A)⁶² Termination. The facts are the same as in Q19 except that the interests of B and C are purchased by A, rather than E. A continues the trade or business. What are the consequences of these transactions under section 108(i)?

A20: We recommend that the Treasury and the Service publish guidance providing that the consequences to B and C are the same as in A19. Under Revenue Ruling 99-6,⁶³ the transaction is treated as a termination of PRS under section 708(b)(1)(A). B and C are treated as selling partnership interests, but A is treated as purchasing B's and C's shares of partnership assets from B and C. In addition, A is treated as receiving a deemed distribution of A's share of partnership assets from PRS in exchange for A's interest in PRS. In this transaction, we believe the guidance should provide that for purposes of section 108(i), these deemed transactions do not constitute a "sale," "exchange" or "redemption" of A's interest in PRS nor do they constitute a "liquidation," "cessation of business" or "sale of substantially all the assets" by PRS for purposes of section 108(i). Accordingly, these sales should have no consequences under section 108(i) to A. Because there is no longer a partnership for federal income tax purposes, A should no longer be subject to the termination rules of

⁶¹ See I.R.C. § 1362(e)(6)(A) (short taxable years not taken into account for purposes of determining the number of taxable years to which any item may be carried back or carried forward by a S corporation); see also Reg. § 1.1502-21(b)(3)(iii) (providing that a short year does not count as a separate year to which net operating losses must be carried for transactions to which section 381 applies).

⁶² I.R.C. § 708(b)(1)(A) provides that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

⁶³ 1999-1 C.B. 432 (Situation 1).

section 108(i)(5)(D)(ii) and instead should be subject only to the termination rules of section 108(i)(5)(D)(i).

Q21: Section 721 Contribution of a Trade or Business. The facts are the same as the example in A21 except that C does not sell C’s interest in PRS. Instead, PRS transfers all of its assets (subject to its liabilities) to unrelated partnership XYZ in exchange for an interest in XYZ. The transaction is properly treated for federal income tax purposes as a contribution described in section 721. PRS does not liquidate or otherwise distribute the interest in XYZ to its partners. What are the consequences of this transaction under section 108(i)?

A21: We believe that the contribution of a trade or business to a lower-tier partnership should not be treated as an acceleration event for purposes of section 108(i), because the contributing partnership continues to own an economic interest in the trade or business after the contribution and section 704(c) principles will ensure that the appropriate partners are allocated the CODI when recognized.⁶⁴

If PRS were not a partnership, we believe that the same standard should apply to determine whether contributions of trades or businesses to partnerships should accelerate items deferred under section 108(i).

After the contribution to XYX, PRS must recognize a ratable portion of the balance of its deferred CODI over a five year period starting in 2014. In addition, PRS must recognize CODI upon any sale or complete redemption its interest in XYZ, or upon the occurrence with respect to XYZ of any of the events described in section 108(i)(5)(D)(i). A, B, and C must recognize their respective distributive shares of any CODI recognized by PRS.

⁶⁴ We believe that the contribution of PRS’s trade or business to XYZ should not be treated as an acceleration event, even though the termination would be treated as a cessation of business for purposes of section 481. See note 60, *supra*. We also considered whether rules similar to the continuity of business enterprise (“COBE”) or continuity of interest (“COI”) rules should apply to determine whether the contributing partner should be treated as continuing to be engaged in a trade or business. These rules were designed to address different policy concerns. See Reg. § 1.368-1(d)(1) (the policy underlying the general COBE rule is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form); Reg. § 1.368-1(e)(1)(i) (the purpose of the COI requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available in corporate reorganizations). For purposes of section 108(i)(6), we believe the primary policy concern is to ensure CODI is allocated only among those partners that were partners in the partnership immediately prior to the discharge of the debt. We do not believe that rules similar to the COBE and COI rules are necessary or advisable in the context of section 108(i), because guidance may simply provide, in the alternative, that the contributing partner will be allocated its share of the deferred CODI under section 704(c) principles.

Q22: Partnership Merger. The facts are the same as the example in A12 except that instead of PRS transferring all of its assets (subject to its liabilities) to unrelated partnership XYZ, partnership PRS merges with partnership EFG. What are the consequences of this transaction under section 108(i)?

A22(a): Electing Partnership Does Not Terminate. If PRS is treated as the surviving entity in accordance with the regulations under section 708, the merger is analogous to the transaction analyzed in A17 and, accordingly, we recommend that the Treasury and the Service publish guidance providing that any dilution of A, B and C as a result of the merger is not a “sale,” “exchange,” or “redemption” of an interest in PRS for purposes of the Partner Acceleration Rule. Therefore, the merger should have no effect on A, B, C, or PRS under section 108(i).

A22(b): Electing Partnership Terminates. If EFG, rather than PRS, is treated as the surviving entity, we believe that the merger transaction should also not be treated as an acceleration event, because A, B, and C continue to own an economic interest in the trade or business after the merger and section 704(c) principles will ensure that the appropriate partners are allocated the CODI when recognized. We recommend that the Treasury and the Service publish guidance providing that EFG will be treated as having made a section 108(i) election with respect to the CODI formerly realized by PRS. Thus, a new section 108(i) election is not required to continue the deferral of that CODI. Any reporting requirements that would have applied to PRS with respect to periods after the date of the merger should apply to EFG. We also recommend that the guidance provide that the short taxable year that is created by the merger of PRS into EFG will not be treated as a separate taxable year for purposes of determining the Inclusion Period in which the surviving partnership recognizes deferred CODI and OID deductions. A, B, and C must recognize their respective distributive shares of deferred CODI upon a future sale or redemption of their EFG interests, or upon the occurrence with respect to EFG of any of the events described in section 108(i)(5)(D)(i).

Q23: Changes in the Ownership of Upper-Tier Partnership. Is the sale, exchange or complete redemption of an indirect owner’s interest in an upper-tier partnership an acceleration event if a lower-tier partnership has deferred CODI under section 108(i)?

A23: A sale, exchange or complete redemption of an interest in an upper-tier partnership should be treated as an acceleration event for the lower-tier partnership, provided that in the case of a sale or exchange, the transfer does not qualify for one of the exceptions described above. Similar rules should apply in the case of a sale, exchange, or redemption of stock in an S corporation that owns an interest in a partnership that has deferred CODI under section 108(i).