

**AMERICAN BAR ASSOCIATION**

**SECTION OF TAXATION**

**REPORT TO THE HOUSE OF DELEGATES**

**RECOMMENDATION**

1       **RESOLVED**, That the American Bar Association recommends that Section  
2       751(b) of the Internal Revenue Code of 1986 be amended by removing the  
3       substantial appreciation requirement in order to conform the tax treatment of  
4       transactions under Sections 751(a) and 751(b).

5       **FURTHER RESOLVED**, That all necessary technical and conforming changes  
6       to the Internal Revenue Code of 1986 be made.

## REPORT

### The Problem Prior to Enactment of Section 751

Prior to the adoption of the Internal Revenue Code of 1954 (“1954 Code” or I.R.C. 1954”), the character of gain produced by the sale of a partnership interest was uncertain. It was not clear whether the sale should be viewed as a sale of a single capital asset, i.e. the partnership interest, or the sale of undivided interests in partnership assets. The latter alternative could result in a taxpayer recognizing ordinary income or loss upon the sale of their partnership interest.

The Internal Revenue Service (the “Service”) initially took the position that the sale of a partnership interest was to be treated as the sale of the partner’s undivided interest in the partnership assets. G.C.M. 10092. From a revenue and a policy perspective, the Commissioner found it best to argue for this “fragmentation” approach, since the transaction would be subjected to ordinary income treatment to the extent that the partnership held ordinary income assets. See MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 16.01[1] (3<sup>rd</sup> ed. 1997 Supp. 2000) (hereinafter “MCKEE”). The Service’s concern was that wholesale capital gain treatment on the sale of a partnership interest could lead to a conversion of substantial amounts of ordinary income into capital gain. *Id.*

In 1950, the Service, acquiescing to an increasing amount of contrary case law authority,<sup>1</sup> issued a General Counsel Memorandum stating that the sale of a partnership interest would be treated as the sale of a capital asset. G.C.M. 26379, 1950-1 C.B. 58-59. Specifically, capital gain treatment was to be limited to those circumstances where the substance of the transaction was the sale of a partnership interest (as opposed to a sale of the assets), and did not involve payments made to a retiring partner as part of his distributive share of earnings from past services. *Id.*

The Second Circuit in Williams v. McGowan is largely credited with being the impetus of the tax law’s movement toward fragmentation. 152 F.2d 570 (1945). The Williams case involved two main factual events: (1) the surviving partner purchased a deceased partner’s interest in a hardware business by the surviving partner and (2) the surviving partner sold the entire business to a third party. *Id.* at 571-72. The surviving partner reported an ordinary gain on the purchase of his partner’s interest and

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<sup>1</sup> See Commissioner v. Shapiro, 125 F.2d 988 (2<sup>nd</sup> Cir 1941); Song v. Commissioner, 173 F.2d 471(5<sup>th</sup> Cir. 1949); Commissioner v. Lehman, 334 U.S. 819 (1948); Kessler v. United States, 124 F.2d 152 (3<sup>rd</sup> Cir. 1941); Thornley v. Commissioner, 147 F.2d 416 (3<sup>rd</sup> Cir. 1945); Commissioner v. Estate of Gartling, 170 F.2d 73 (9<sup>th</sup> Cir. 1948); Commissioner v. Smith, 173 F.2d 470 (5<sup>th</sup> Cir. 1949), *certiorari denied*, 388 U.S. 818 (1949); Long v. Commissioner, 173 F.2d 471, *certiorari denied*, 388 U.S. 818 (1949); Shapiro v. United States, 83 F. Supp 375 (D.M.N. 1949).

an ordinary loss on the sale of the entire business. Id. Ordinary loss treatment was based upon the large number of ordinary income producing assets held in the business at the time of sale. Id. at 572-73.

The Service tried to characterize both the gain and the loss as capital in nature. Id. at 571-72. The Court decided to fragment the sale of the going business into its individual assets, and the gain was to be characterized by comparing each asset against the definition of “capital asset” found Section 117(a) of the Internal Revenue Code of 1939 (precursor to Section 1221 of the current Code). Id. at 572-73. The Williams rule of fragmentation represented the minority position among the courts with regard to the sale of an entire business until the United States Supreme Court explicitly sanctioned Williams in Watson v. Commissioner, 345 U.S. 544 (1953).<sup>2</sup>

It must be noted that Williams involved the sale of an “entire business” that was a sole proprietorship, and not the sale of a partnership interest. In 1953, the United States Supreme Court specifically endorsed the approach of Williams in Watson, et al. v. Commissioner, 345 U.S. 544, 551-52 (1953). Watson involved the sale of a individual’s ownership interest in an orange grove. Id. at 545-46. There were some unmaturing crops among the trees in the orange grove. Id. The Supreme Court upheld the Ninth Circuit’s holding that the sale of the taxpayer’s unmaturing portion of their interest in the orange grove as ordinary income. Id. at 551-53. After Watson, the rationale of the Williams case was construed by some as applying in the context of sole proprietorships, partnerships and corporations. See Edwin S. Cohen, et al., *A Proposed Revision of the Federal Income Tax Treatment of Sale of a Business Enterprise—American Law Institute Draft*, 54 COLUM. L. REV. 157 (1954). However, the legislative history to the 1954 Code reveals that Congress was initially unsure of how sales of interests should be treated. H.R. Rep. No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 70, reprinted in 1954 U.S. Code Cong. Admin. News 4096. The Williams and Watson decisions were precursors to the partial fragmentation approach that was finally adopted by Congress in the 1954 Code.

### **History of Section 751 (Prior to 1997)**

Section 751 was enacted as part of the 1954 Code as a prophylactic measure to prevent the conversion of potential ordinary income into capital gain through sales of partnership interests and certain property distributions. S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 98, reprinted in 1954 U.S. Code Cong. Admin. News 4731; 100 Cong. Rec. 3428 (discusses how Section 751 will prevent partners from converting their interests in the partnership’s inventory and uncollected receivables into capital gain); H.R. Rep. No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 70-71, reprinted in 1954 U.S. Code Cong. Admin. News 4096-4098. Section 751 was initially comprised of four subsections: Subsection (a) concerned sales of partnership interests, Subsection (b) concerned distributions in redemption of partnership interests, Subsection (c) defined unrealized receivables and Subsection (d) defined inventory items. I.R.C. 1954 § 751(a)-(d).

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<sup>2</sup> See footnote 1, *supra*; see also G.C.M. 26379, 1950-1 C.B. 58-59.

Section 751(a) continued the general rule that the sale of an interest in a partnership is treated as the sale of a capital asset. However, in order to prevent the conversion of ordinary income to capital gain, if a partner sells all or a part of his interest in a partnership and receives proceeds attributable to his share of (1) the unrealized receivables and fees of the partnership or (2) substantially appreciated inventory, such amounts are to be treated as ordinary income or loss. I.R.C. 1954 § 751(a); S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 98-99, 401-404, reprinted in 1954 U.S. Code Cong. Admin. News 4731-4733, 5043-5047; H.R. Rep. No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 70-71, reprinted in 1954 U.S. Code Cong. Admin. News 4096-4098. The aforementioned items identified as potentially causing ordinary income or loss are commonly referred to as “hot assets,” whereas all other assets are referred to as “cold assets.”

Section 751(b) was enacted as a backstop to Section 751(a). See Dale E. Anderson & Melvin 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, 525-28 (1960). Section 751(b) applies any time a partner receives a distribution that represents a disproportionate share of the value of the partnership’s “hot assets” or “cold assets.” S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 98-99, 401-404, reprinted in 1954 U.S. Code Cong. Admin. News 4731-4732, 5044-5047; H.R. Rep.No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 71, reprinted in 1954 U.S. Code Cong. Admin. News 4097; LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K* (2<sup>nd</sup> ed. 2000) (hereinafter “CUNNINGHAM”). This section treats such a disproportionate distribution as a sale or exchange between the distributee partner and the partnership. Id. However, Section 751(b) does not apply to a distribution of property which the distributee contributed the partnership or Section 736 payments<sup>3</sup> to a retiring partner. I.R.C. 1954 § 751(b)(2)(A) & (B); I.R.C § 751(b)(2)(A) & (B).

Section 751(c) originally defined “unrealized receivables” as including, to the extent not previously included in income, any rights to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered. I.R.C. 1954 § 751(c); S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 98-99, 402, reprinted in 1954 U.S. Code Cong. Admin. News 4731-4732, 5045-5047; H.R. Rep.No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 70-71, reprinted in 1954 U.S. Code Cong. Admin. News 4096-4098. From 1962 until 1986, Congress gradually broadened the definition of unrealized receivables to include such varied items as: Section 1245 recapture; Section 1250 recapture; Section 617(d) mining property recapture; gain treated as ordinary income upon the transfer of a franchise, trademark or tradename under Section 1253; or accumulated domestic international sales company income recapture under Section 995(c). See MCKEE at ¶ 16.03.

Section 751(d) originally defined “substantially appreciated inventory” as inventory whose fair market value exceeds 120% of the basis of such property in the hands of the partnership and 10% of the adjusted basis of all partnership property, other

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<sup>3</sup> It is not clear under the I.R.C. whether an in-kind distribution can be considered a Section 736 payment. See MCKEE at ¶ 22.06.

than money. I.R.C. 1954 § 751(d); H.R. Rep. No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 71, reprinted in 1954 U.S. Code Cong. Admin. News 4097. In 1993, Section 751(d) was amended to remove the 10% exception from the definition of substantially appreciated inventory. Omnibus Budget Reconciliation Act of 1993 (“OBRA 1993”), Pub. L. No. 103-66; Internal Revenue Code of 1986 (“Code” or “I.R.C.”) § 751(d)(1); H.R. Rep. No. 103-111, 103<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 642-643, reprinted in 1993 U.S. Code Cong. Admin. News 873-874. Section 751(d) was also amended in 1993 to provide that assets acquired with a principal purpose of reducing appreciation to less than 120% will be disregarded. OBRA 1993, Pub. L. No. 103-66; I.R.C. § 751(d)(1)(B) (1993); H.R. REP. NO. 103-111, 103<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 643, reprinted in 1993 U.S. Code Cong. Admin. News 874. The 1993 amendments to Section 751(d) are discussed in detail below.

### **Removal of the Appreciation Requirement in Section 751(a)**

The definition of “substantially appreciated inventory” found in the original Section 751(d), contained a two prong test: (1) the fair market value of the inventory must exceed 120% of its basis and (2) the inventory must constitute 10% of the adjusted basis of all partnership property, other than money. I.R.C. 1954 § 751(d). Congress originally intended Section 751 to clarify the tax treatment of transfers of partnership interests as well as prevent the use of such transfers as a device for converting ordinary income into capital gain. S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 98, reprinted in 1954 U.S. Code Cong. Admin. News 4731; H.R. Rep. No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 70, reprinted in 1954 U.S. Code Cong. Admin. News 4096. Nothing in the legislative history explained why Congress required inventory to be substantially appreciated as part of achieving the aforementioned purposes. S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 98-100, 402, reprinted in 1954 U.S. Code Cong. Admin. News 4731-4733, 5043-5047; H.R. Rep.No. 83-1337, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 70-71, reprinted in 1954 U.S. Code Cong. Admin. News 4096-4098. However, it was implicit in the legislative history that the substantial appreciation requirement was thought to help insulate some partnerships from the complexity of Section 751. S. Rep. No. 83-1622, 83<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. 403; reprinted in 1954 U.S. Code Cong. Admin. News 5045.<sup>4</sup> The substantial appreciation requirement was removed entirely from Section 751(a) with the passage of the Taxpayer Relief Act of 1997 (“TRA 1997”). The legislative history associated with the 1997 removal of the substantial appreciation requirement from Section 751(a) indicates that Congress, at that time, considered part of the purpose of the substantial appreciation requirement to be a device to insulate some partnerships from the complexities of Section 751. S. Rep. No. 105-33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 192-193; H.R. Rep. No. 105-148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 506-507, reprinted in 1997 U.S. Code Cong. Admin. News 900-901.

Both of the original tests for substantial appreciation were open to manipulation and tax planning techniques. See AMERICAN LAW INSTITUTE, FEDERAL

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<sup>4</sup> S. Rep. No. 83-1622 specifically notes that its committee bill “liberalizes” the substantial appreciation test so that the value of inventory items must exceed 10 percent of the fair market value of such partnership’s property rather than the House Committee’s proposed 10 percent of the adjusted basis of all partnership property other than money. The Senate version prevailed.

INCOME TAX PROJECT: SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS, p. 26 (1984). In order to avoid being caught by the 10% test, a partnership simply had to purchase more assets in order to reduce the percentage that substantially appreciated inventory constituted of the whole of the partnership's assets. *Id.* In order to avoid being caught by the 120% test, a partnership could sell off part of its appreciated inventory or acquire additional inventory with little or no appreciation. *Id.* Although the substantial appreciation requirement may have been easily circumvented, one commentator noted that it was not always easy to for a partnership to value its inventory for purposes of determining the existence of substantial appreciation. William D. Andrews, *Colloquium on Partnership Taxation: Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 43 (1991).

In addition to these issues, the substantial appreciation requirement only insulates a partnership from Section 751 if the partnership does not have unrealized receivables. Given the broad scope of unrealized receivables under Section 751(c), the substantial appreciation requirement did not really accomplish the simplification goal that it was crafted to serve. *See* MCKEE at ¶ 16.04[2].

The 10% prong of the substantial appreciation test was removed from the statute in 1993. OBRA 1993, Pub. L. No. 103-66. However, the 120% prong of the test remained. *Id.* The legislative history is clear that Congress removed the 10% exception because it could very easily be manipulated to convert capital gain into ordinary income. H.R. Rep. No. 103-111, 103<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 642-643, reprinted in 1993 U.S. Code Cong. Admin. News 873-874. A vague facts and circumstances test was inserted into Section 751(b) in order to stop manipulation of the 120% test. H.R. Rep. No. 103-111, 103<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 643, reprinted in 1993 U.S. Code Cong. Admin. News 874; I.R.C. § 751(b)(3)(B). Under this facts and circumstances inquiry, the value of any inventory acquired in order to avoid the 120% test will not be counted in the substantial appreciation calculation. *Id.* There is nothing in the legislative history indicating why the 120% test was not eliminated. Also lacking from the legislative history is any commentary as to whether Congress felt the 120% was less subject to manipulation and abuse. One could draw the inference from the absence of any such discussion that Congress felt (1) that the 120% test was subject to less abuse and (2) that some parties could legitimately (i.e., without manipulation) avoid the complexities of Section 751 through the 120% test.

Congress eventually determined that the substantial appreciation requirement did not spare many taxpayers from the complexities of Section 751 and contributed to conversion of ordinary income attributable to inventory for partnerships with profit margins of less than 20%. *See* S. Rep. No. 105-33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 192-193; MCKEE at ¶ 16.04[2]. The "substantial appreciation" requirement was finally removed from Section 751(a) as part of the TRA 1997. TRA 1997, Pub. L. No. 105-34; I.R.C. § 751(a). The legislative history reveals that the substantial appreciation requirement was removed primarily for two reasons: (1) to conform the treatment of unrealized receivables and inventory items under Section 751 and (2) to stop the conversion of ordinary income into capital gain. S. Rep. No. 105-33, 105<sup>th</sup> Cong., 1<sup>st</sup>

Sess. 192-193; H.R. Rep. No. 105-148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 301, reprinted in 1997 U.S. Code Cong. Admin. News 694. All inventory items are now considered to be “hot assets” which cause a taxpayer to recognize an ordinary gain or loss upon the sale of all or a part of his partnership interests.

### **Does the Appreciation Requirement in Section 751(b) Serve a Continued Purpose**

As discussed in the previous section, the substantial appreciation requirement never really achieved its purpose of insulating some taxpayers from the complexities of Section 751. In addition, it was perceived by Congress as contributing to an unacceptable level of game playing directed towards the conversion of ordinary income to capital gains.

Section 751(a) now treats unrealized receivables and inventory consistently. The legislative history of the 1997 removal of the substantial appreciation requirement from Section 751(a) is silent on why this reform was not also extended to Section 751(b). S. Rep. No. 105-33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 192-193; H.R. Rep. No. 105-148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 301, reprinted in 1997 U.S. Code Cong. Admin. News 694. Despite the failure by Congress to conform Section 751(b) to Section 751(a), there is no apparent justification for a substantial appreciation requirement in Section 751(b).

Section 751(a) results in a tax realization event only as to the selling partner. One of the key differences between Section 751(a) and Section 751(b) is that Section 751(b) may impose a tax realization event for partners other than those receiving distributions. Section 751(b) and its accompanying regulations require that any disproportionate distribution results in a deemed exchange between the partner and the partnership in order that the partner is treated for tax purposes as receiving his pro rata share of “hot” and “cold assets”. I.R.C. § 751(b); Treas. Reg. § 1.751-1(b). The deemed exchange portion of a Section 751(b) transaction causes the partnership to recognize gain or loss, which is then allocated among all the partners. This complex fiction helps ensure that partners cannot shift the character of income among the partners. See CUNNINGHAM, at 183. However, there is nothing specific to distributions or the mechanics of Section 751(b) that would require that the substantial appreciation requirement be maintained.

### **Elimination of the Appreciation Requirement in Section 751(b) Simplifies Tax Administration And Provides Consistency Among the Same And Similar Transactions<sup>5</sup>**

The retention of the substantial appreciation requirement in Section 751(b) does not serve any identifiable tax policy goals while, at the same time, has the effect of increasing administrative complexity. First, it causes unrealized receivables and

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<sup>5</sup> The examples in this section and the accompanying charts are inspired by the examples of Section 751(a) and Section 751(b) transactions found in MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (3<sup>rd</sup> ed. 1997 Supp. 2000) and LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K (2<sup>ND</sup> ed. 2000).

inventory to be treated differently. Second, it causes identical transactions governed by Section 751(b) to be treated differently. With the removal of the substantial appreciation requirement from Section 751(a) in 1997 and its retention in Section 751(b) has caused some substantially similar transactions to be treated differently under those two sections when they should not.

Some persons believe that this proposal is complicating in that it broadens the application of Section 751(b) to cases in which inventory items have not substantially appreciated. The following specific situation was identified: When rental real property (appreciated by less than 20%) held for less than 12 months is distributed in redemption of a partner's interest and the partnership's other assets consist solely of capital and Section 1231 assets. Rental real estate held for less than one year is not Section 1231 property or a capital asset and is treated as inventory under Section 751(d)(2). I.R.C. § 1231(b)(1); I.R.C. § 1221(a)(2). Accordingly, a distribution of rental real estate held for less than one year in a partnership whose only other assets are Section 1231 assets and capital assets cannot trigger Section 751(b) if the real estate is not substantially appreciated. The tax treatment of such a distribution of inventory not triggering Section 751(b) is found in Example 2 on p.11. If the substantial appreciation requirement is removed from Section 751(b), the same distribution would generate ordinary income to the partnership limited to the distributee partner's share of appreciation in the inventory and generate capital or Section 1231 gain for the redeeming partner on the other partnership assets involved in the exchange.

It is likely a rare situation where a partnership holding rental real estate does not also possess "hot assets" (Section 751(c) and Section 751(d)). Accordingly, it is doubtful that the retention of the substantial appreciation requirement will spare many distributions of nonsubstantially appreciated real estate held for less than one year from the provisions of Section 751(b). In the limited situations where the removal of the substantial appreciation requirement would cause the above described distribution of rental real estate to trigger Section 751, the recognition of capital or Section 1231 gain on other partnership property assets could usually be avoided by delaying the distribution until the 12 month holding period has been met. The simplification benefit of this proposal should not be denied because of this situation.

### **1. Complexity Arising Within 751(b)**

The first complexity arising within Section 751(b) is its inconsistent treatment of unrealized receivables and inventory items. Unrealized receivables and inventory items are both items which produce ordinary income upon sale. Accordingly, both should be considered "hot assets" for purposes of Section 751. A Section 751(b) disproportionate distribution of "cold assets" in a partnership whose only hot asset is unrealized receivables will trigger an immediate ordinary gain to the distributee partner. I.R.C. § 751(b). However, if the same distribution is made in a partnership whose only hot asset is nonsubstantially appreciated inventory, no gain will be recognized. I.R.C. § 731(a). Requiring inventory to be substantially appreciated creates an inequality in treatment between two ordinary income assets. The treatment of unrealized receivables and inventory items under Section 751(a), dealing with sales of partnership interests, was

harmonized in 1997. Eliminating the substantial appreciation requirement from Section 751(b) will provide similar harmonization to distributions in redemption of a partner's interest.

The second complexity arising within Section 751(b) is that Section 751(b) treats identical or substantially similar transactions involving inventory differently. To illustrate this problem with transactions involving the treatment of inventory under Section 751(b), consider the following two examples.

***Example 1: Substantial Appreciation***

Assume an equal partnership formed by A, B and C where each partner has an outside basis and capital account balance of \$100,000. ABC's balance sheet is as follows:

	<u>Assets</u>			<u>Liabilities &amp; Capital</u>	
	<u>Book</u>	<u>FMV</u>		<u>Book</u>	<u>FMV</u>
Inventory	\$200,000	\$300,000			
Land	\$100,000	\$150,000			
	\$300,000	\$450,000			
				<u>Capital Accounts</u>	
				<u>Book</u>	<u>FMV</u>
			A	\$100,000	\$150,000
			B	\$100,000	\$150,000
			C	\$100,000	\$150,000
				\$300,000	\$450,000

Suppose that ABC distributes the land to C in complete liquidation of his interest in the partnership. C owns an undivided 1/3 interest in all the partnership's assets. ABC's inventory has appreciated 20% and is a "hot" asset. Without Section 751(b), Section 731(a) would allow C to take the distribution of the land without a gain or loss. The land would have a substituted basis of \$100,000 pursuant to Section 732(b). C would forever avoid recognizing any ordinary income with respect to his partnership interest.

Section 751(b) provides that a distribution resulting in a change in the value of a distributee's interest in "hot" or "cold" assets will be treated as an exchange. The statute is silent as to how the exchange occurs. The regulations govern the exchange mechanism and the resulting tax treatment. See Treas. Reg. § 1.751-1(b). The regulations treat all disproportionate distributions as three distinct transactions: (1) a deemed distribution of the type of asset in which, and in the amount by which, the taxpayer's interest has decreased, (2) a sale by the taxpayer to the partnership of the property received in the deemed distribution to the partnership for an equal amount of the type of asset of which a disproportionate amount was initially received and (3) the portion of the asset(s) that the partner was entitled to under a pro rata distribution is treated under the normal distribution rules. Id.

Partnership Exchange Table

	1	+	2	-	3 =		4
	C's post distrib. interest in Ps assets		C's actual distribution		A's pre-distrib interest in Ps assets		A's change in interest
“Hot Assets”							
Inventory	0		0		\$100,000 =		(\$100,000)
“Cold Assets”							
Capital Asset	0		\$150,000		\$50,000 =		\$100,000

C's interest in “hot assets” has decreased by \$100,000, while his interest in “cold assets” has increased by \$100,000. This disproportionate distribution triggers the three transactions discussed above:

- (1) *deemed distribution:* C is deemed to receive \$100,000 of inventory as a current distribution;

tax consequences: Under Section 731(a), C has no gain or loss on the deemed distribution of \$100,000 of inventory. Under Section 732(b), C takes a transferred basis in the inventory of \$66,667 (\$100,000 fmv inventory distributed/\$300,000 total fmv x predistribution basis of \$200,000). C's outside basis in his partnership interest is reduced from \$100,000 to \$33,333 under the provisions of Section 733(2).

Under Section 731(b), ABC recognizes no gain or loss on the deemed distribution to C. ABC's basis in the remaining inventory is \$133,333 (\$200,000 - \$66,667).

- (2) *Section 751(b) Exchange:* C is deemed to transfer the deemed distributed inventory to ABC in exchange for \$100,000 worth of the land;

tax consequences: C has an ordinary gain of \$33,333 on the transfer of the deemed distributed property to the partnership [ $\$100,000AR - \frac{1}{3}(\$200,000)AB$ ]. Section 735(a) dictates the character of the gain. C takes a Section 1012 cost basis of \$100,000 in this portion of the land.

ABC receives \$100,000 worth of inventory which it exchanges for \$100,000 of the land. ABC had a basis of \$66,667 [ $\$100,000 / \$150,000$  total value x \$100,000 basis] in the land. Thus, ABC recognizes a \$33,333 capital gain that will be shared by A and B. ABC partnership takes a Section 1012 cost basis of \$100,000 in the inventory. ABC's basis in the inventory is \$233,333 (\$100,000 basis in exchanged portion of inventory asset and \$133,333 basis in the remaining portion).

- (3) *Non-751(b) Distribution:* C is deemed to receive a liquidating distribution of the remaining \$50,000 worth of the land.

tax consequences: Under Section 731(a), C has no gain or loss and takes a basis in the non-751(b) portion of the land equal to his outside basis \$33,333. The total basis of the capital asset in C's hands is \$133,333 (\$100,000 751(b) portion + \$33,333 non-751(b) portion).

There are no tax consequences to ABC. If a Section 754 election were in place, a Section 734(b) adjustment to the partnership assets would not be needed because C's basis in the portion of the capital asset that was distributed was equal to ABC's basis in that portion of the capital asset (\$33,333).

***Example 2: No Substantial Appreciation***

Assume the same facts regarding the partners and financial structure of the partnership as in Example 1. C's 1/3 interest will again be redeemed for \$100,000.

	<u>Assets</u>		<u>Liabilities &amp; Capital</u>	
	<u>Book</u>	<u>FMV</u>	<u>Book</u>	<u>FMV</u>
Inventory	\$210,000	\$250,000		
Land	<u>\$90,000</u>	<u>\$200,000</u>		
	\$300,000	\$450,000		
			<u>Capital Accounts</u>	
			<u>Book</u>	<u>FMV</u>
			A	\$100,000    \$150,000
			B	\$100,000    \$150,000
			C	<u>\$100,000</u> <u>\$150,000</u>
				\$300,000    \$450,000

ABC's inventory has appreciated only 19% (40/210) and is thus not a "hot" asset. Thus C does not receive "hot assets" in exchange for "cold assets" or vice versa. All of ABC's assets are "cold assets". Section 751(b) will not apply to this disproportionate distribution.

tax consequences: Section 731(a) allows C to take the distribution of the land without a gain or loss. The land would have a substituted basis of \$100,000 pursuant to Section 732(b). C would forever avoid recognizing any ordinary income with respect to his partnership interest.

ABC would not recognize any gain pursuant to the distribution to C. ABC's basis in the land was \$90,000, but C took a \$100,000 substituted basis in the land. If a Section 754 election is in place, a \$10,000 Section 734(b) adjustment will be made to decrease the basis of the remaining partnership property (inventory).

It is clear that the substantial appreciation requirement causes similar or identical transactions involving distributions of inventory to be treated differently. By eliminating the substantial appreciation requirement, only one set of rules will apply to disproportionate distributions involving inventory. Thus, this complexity and inconsistency regarding the treatment of inventory by Section 751(b) is eliminated.

## **2. Complexity Arising Out of the Difference Between 751(a) and 751(b)**

As mentioned in the introduction to this section, the removal of the substantial appreciation requirement in 751(a) in 1997 and its retention in Section 751(b) has caused a new level of complexity and inconsistency to arise among substantially similar transactions treated under Section 751.

The American Law Institute's 1982 study of Subchapter K noted that a full fragmentation approach would eliminate the difference in tax treatment of: (1) a sale by the partnership followed by a distribution to the partners of the sale proceeds; (2) a distribution of assets to a partner followed by a sale by the partner; and (3) a sale by a partner of his partnership interest to a third party. AMERICAN LAW INSTITUTE at 26. Under an aggregate theory model of partnership taxation, these three transactions should have identical tax consequences.

Subchapter K is not based on a pure aggregate or pure entity theory, but a mix of both. Section 751 is a prime example of the tension that exists between the entity and aggregate theory in the provisions of Subchapter K. However, the merits of the entity theory versus the aggregate theory are not the subject of this proposal. The full fragmentation approach of the American Law Institute is likewise not the subject of this proposal. If the substantial appreciation requirement is removed from Section 751(b), the above transactions would not always be treated the same. However, conforming Section 751(b) to Section 751(a) would produce a substantially greater degree of consistency in the tax consequences of the above transactions. Consistency in treatment in this area will serve tax simplification objectives.

To illustrate one of the problems arising from the lack of conformity between the way inventory is treated in Section 751(a) and Section 751(b), consider the following example:

### ***Example 3: Sale Versus Redemption***

Assume the same basic facts regarding the partners and financial structure of the partnership as in Example 2. However, C will sell his 1/3 interest for \$150,000 rather than have the partnership redeem his interest for a distribution of partnership property.

	<u>Assets</u>		<u>Liabilities &amp; Capital</u>
	<u>Book</u>	<u>FMV</u>	
Inventory	\$210,000	\$250,000	
Land	<u>\$90,000</u>	<u>\$200,000</u>	
	\$300,000	\$450,000	

	<u>Capital Accounts</u>	
	<u>Book</u>	<u>FMV</u>
A	\$100,000	\$150,000
B	\$100,000	\$150,000
C	<u>\$100,000</u>	<u>\$150,000</u>
	\$300,000	\$450,000

Sales of partnership interests are generally taxed under Section 741, which provides for capital gain treatment on the sale. I.R.C. § 741(a). However, capital gain treatment on the sale of a partnership interest is subject to the provisions of Section 751(a). Section 751(a) functions much like Section 751(b) by recharacterizing the sale proceeds that are allocable to certain noncapital assets as ordinary income.

Section 751(a) provides that ordinary income treatment will be given to the portion of the purchase price attributable to: (1) unrealized receivables and (2) inventory. Note that inventory is not required to be substantially appreciated before it is considered a “hot” asset. The gain attributable to these categories of assets is recharacterized according to a mechanism in the regulations. Although the result is often the same, calculations under Section 751(a) are less complicated than those under Section 751(b).

The regulations provide for a simple three step approach for calculating the amount of capital and ordinary gain or loss on the sale of an interest: (1) determine the total gain or loss from the sale; (2) calculate the gain or loss attributable to the “hot assets” as if all the assets of the partnership were sold immediately prior to the sale of the partner’s interest; and (3) subtract the amount of gain from the “hot assets” from the total gain or loss on sale. Treas. Reg. § 1.751-1(a).<sup>6</sup> The second step tells us the amount of the ordinary gain and the third step tells us the amount of the capital gain.

<u>Asset</u>	<u>Basis</u>	<u>Fair Mkt Value</u>	<u>Gain/Loss</u>	<u>C’s share</u>
Inventory	\$210,000	\$250,000	\$40,000	\$13,333
Land	\$90,000	\$200,000	\$110,000	\$36,667

- (1) *Determine the total gain from sale:* C’s total amount realized from the sale of his interest is \$150,000. C’s outside basis in his

<sup>6</sup> The current regulations do not reflect the statutory change to Section 751(a). Thus, the regulations refer throughout to Section 751 property, for purposes of sales and redemptions, as being inventory items and substantially appreciated inventory.

partnership interest is \$100,000. Thus, the total gain from the sale is \$50,000 (\$150,000AR - \$100,000AB).

- (2) *Calculate the gain/loss attributable to hot assets:* If all of the partnership assets were sold immediately prior to the sale of C's interest, C's share of the gain on the hot asset(s) (inventory) would be \$13,333. Therefore, C has \$13,333 of ordinary gain under Section 751(a).
- (3) *Subtract the hot asset gain from the total gain:* The total gain from the sale of C's interest is \$50,000. The Section 751(a) ordinary gain is \$13,333. Thus, C will recognize \$36,667 of capital gain under Section 741(a).

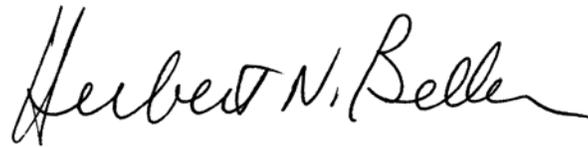
The basic rule for sales of an interest, Section 741(a), and the basic rule for distributions, Section 731(a), are quite different. In theory, there should not be any overall tax difference between a partner selling his interest and a partner redeeming his interest for property and then selling the property. Sales generally produce immediate capital gain, and distributions generally produce no gain. Through adjustments to the distributed property's basis under Section 732(b), any gain or loss in the interest at the time of distribution will be recognized on a later sale of the distributed property. Thus, the basic rules governing the tax treatment of sale versus redemption of interests create a timing difference as to when gain or loss is recognized. In addition, the character of the gain may or may not be preserved, as explained below.

A taxpayer can take a disproportionate distribution of non-substantially appreciated inventory and receive the distribution tax free under Section 731(a). This type of distribution is illustrated in Example 2. In Example 2, if partner C sells the inventory within 5 years, C will recognize ordinary income upon the sale. I.R.C. § 735(a)(2). While the treatment of the gain in Example 2 and Example 3 is consistent in this instance (ordinary income), the timing of the recognition is not. In Example 2, the ordinary income from the distribution of inventory is delayed until it is sold within the 5 year period. However, in Example 3, the ordinary income gain will be recognized immediately upon the sale of the partnership interest. If C can wait 5 years to sell following the distribution in Example 2, C can achieve capital gain treatment on the sale of the distributed inventory. I.R.C. § 735(a)(2). In this instance, C has achieved not only a timing advantage but has successfully converted ordinary income into capital gain.

Both Example 2 and Example 3 resulted in C cashing out his investment in partnership ABC. The timing and character of the gain or loss created in Example 2 and Example 3 should be the same. C should not be rewarded or penalized for the form of transaction he chooses, when the substance of what he is accomplishing is the same. Making all inventory a hot asset would eliminate any timing or tax consequence difference between Example 2 and Example 3.

A contrast of Example 1 and Example 3 reveals a glimpse of what it would be like for the substantial appreciation requirement to be removed from Section 751(b). In Example 1, due to the substantial appreciation of the inventory, C is forced to recognize his share of the hot asset gain under Section 751(b). The gain is the same amount of ordinary gain that C would have to recognize had C sold his interest (as in Example 3). Accordingly, the removal of the substantial appreciation requirement in Section 751(b) will not only force C to recognize an immediate ordinary gain in all disproportionate distributions, but it will also allow C to recognize an immediate ordinary loss. Example 1 and Example 3 are equivalent in the timing and the character of gain recognized. That is, the tax results of the Section 751(b) redemption in Example 1 are equivalent to the sale of an interest under Section 751(a). Uniform definition of “hot assets” under Section 751(a) and Section 751(b) will cause the timing and character of gain or loss produced from sales and redemptions of interests to be more uniform. Uniformity of rules and tax consequences for similar transactions constitutes simplification.

Respectfully submitted,

A handwritten signature in black ink that reads "Herbert N. Beller". The signature is written in a cursive style with a long, sweeping tail on the final letter.

Herbert N. Beller  
Chair, Section of Taxation

February, 2003

## **EXECUTIVE SUMMARY**

### **1. Summary of the Recommendation.**

To conform Section 751(a) and Section 751(b) so as to eliminate the substantial appreciation threshold for Section 751(b) and harmonize the treatment of transactions under Sections 751(a) and 751(b).

### **2. Summary of the Issue Which the Recommendation Addresses.**

In 1993, the substantial appreciation requirement was removed from Section 751(a). This requirement was removed to stop the conversion of ordinary income into capital gain and to treat unrealized receivables and inventory, both ordinary income assets, consistently under Section 751. The substantial appreciation requirement was not removed from Section 751(b). No reason was given in the legislative history relating to the removal of the substantial appreciation requirement from Section 751(a) as to why the requirement was maintained in Section 751(b). Removing the substantial appreciation requirement from 751(a) and keeping it in Section 751(b) perpetuated the inconsistent treatment of unrealized receivables and inventory items and caused transactions that are the same or similar in substance to have different tax consequences.

### **3. Please Explain How the Proposed Policy Position Will Address the issue.**

By eliminating the substantial appreciation requirement, unrealized receivables and inventory will both be considered “hot assets” causing ordinary gain for purposes of Section 751(b) disproportionate distributions. Furthermore, the elimination of the substantial appreciation requirement causes transactions that are the same or similar in substance to be accorded the same tax treatment under both Section 751(a) and Section 751(b).

### **4. Summary of any Minority Views or Oppositions Which Have Been Identified.**

Some persons believe that this proposal is complicating in that it broadens the application of Section 751(b) to cases in which inventory items have not substantially appreciated. The following specific situation was identified by the dissent: When rental real property (appreciated by less than 20%) held for less than 12 months is distributed in redemption of a partner’s interest and the partnership’s other assets consist solely of capital and Section 1231 assets. It is true that this particular situation triggers Section 751(b) where it otherwise would not be triggered, and produces ordinary income to the partnership and Section 1231 gain to the distribute partner. However, those cases in which no other “hot assets”(Section 751(c) and Section 751(d)) other than inventory are likely rare. Furthermore, the simplification benefit of this proposal should not be denied because of this one particular situation.

## GENERAL INFORMATION FORM

Submitting Entity: Section of Taxation

Submitted by: Herbert N. Beller

1. Summary of Recommendation

To conform Section 751(a) and Section 751(b) so as to eliminate the substantial appreciation threshold for Section 751(b) and harmonize the treatment of transactions under Sections 751(a) and 751(b).

2. Approval by Submitting Entity

The Recommendation was approved by the Council of the Section of Taxation on Monday, November 18, 2002. This Recommendation is submitted contingent on Section approval at its Midyear Meeting on January 25, 2003.

3. Has this or a similar recommendation been submitted to the House or Board previously?

No.

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

None.

5. What urgency exists which requires action at this meeting of the House?

Continued application of the substantial appreciation requirement in Section 751(b) causes needless complexity in an already overly complex Internal Revenue Code. Not only will the removal of the substantial appreciation requirement simplify the application of the Internal Revenue Code, but it will help eliminate tax planning to improperly convert ordinary income into capital gain as did the removal of this requirement from Section 751(a).

6. Status of Legislation

None.

7. Cost to the Association

None.

8. Disclosure of Interest

No member of the originating Committee or the Council of the Section of Taxation is known to have a material interest in the resolution by virtue of a specific employment or engagement to obtain the results of the resolution.

9. Referrals

All sections and divisions.

10. Contact Persons

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11. Contact persons (who will present to the House)

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12. Contact person regarding amendments to this recommendation

No amendments have been received, but if any are submitted, the persons listed in paragraph 11 are the contact persons.