

Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004

AMERICAN BAR ASSOCIATION SECTION OF TAXATION*

Abstract

The American Bar Association Section of Taxation (the “Section”) has released comments with respect to the proposed regulations issued by the Treasury and the Service pursuant to changes made by the American Jobs Creation Act of 2004 with respect to Subchapter K. The proposed regulations provide guidance with respect to contributions of built-in loss property to partnerships, substantial basis reduction events, modifying the basis allocation rules to prevent certain unintended consequences in the current rules with regard to substitute basis transactions, and allocations resulting from revaluations of partnership property. While the Section’s comments regarding the proposed regulation package were generally favorable, the Section made a number of comments regarding the government’s approach to specific provisions. Of note, concerns were raised with respect to how section 704(c)(1)(C) is intended to apply to partnership mergers and divisions, how the mandatory basis adjustment rules ought to operate in the context of tiered partnerships, and how section 704(c) reverse layers of gain and loss should be treated by partnerships.

Specifically, as discussed in the Section’s comments, the Section does not believe the proposed regulations do an adequate job of tracking section 704(c)(1)(C) built-in loss layers in partnership mergers and divisions. The result of any failed tracking of section 704(c)(1)(C) loss layer could result in section 704(c)(1)(C) preventing a loss allocation unnecessarily. The Section believes that any final regulations should delineate how section 704(c)(1)(C) ought to apply to partnership mergers and divisions. Further, the Section believes that the final regulations should allow tracking of section 704(c)(1)(C) layers in partnership mergers and divisions, to the extent possible.

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Regarding the mandatory basis reduction rules of sections 734 and 743, the proposed regulations provide that an event at an upper-tier partnership that triggers a mandatory basis reduction rule will force any lower-tier partnership to also revalue its assets regardless of whether the lower-tier partnership is in a loss position. The Section commented that the mandatory basis adjustments should not be required to be pushed into lower-tier partnerships unless the lower-tier partnerships would have also been subject to the mandatory basis adjustment rules had the event happened at the lower-tier partnership level.

Additionally, the proposed regulations provide that a “layering” approach must be used with respect to reverse section 704(c) layers, that is, an approach that treats each partner as having a separate layer for each asset upon each revaluation event. The Section believes that a “netting” approach (*i.e.*, an approach that collapses layers with respect to a partner’s share of partnership assets), which is arguably blessed by current regulations, should also be allowed. One of the Section’s main concerns with requiring a layering approach is the increased taxpayer compliance costs associated with tracking each layer for every partner.

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I. Executive Summary

A. Background

The Department of the Treasury (Treasury) and the Service issued proposed regulations (Proposed Regulations) providing guidance on certain provisions of the American Jobs Creation Act of 2004 (AJCA), conforming the existing regulations under sections 704(c)(1)(B) and 737¹ to statutory changes made by the Taxpayer Relief Act of 1997, modifying the existing basis allocation rules under sections 743(b) and 755 for substituted basis transactions, and providing additional guidance regarding allocations resulting from revaluations of partnership property.²

In the preamble to the Proposed Regulations, Treasury and the Service requested comments regarding specific issues. We appreciate the opportunity to provide comments both in response to these specific requests from Treasury and the Service and on other aspects of the Proposed Regulations.

¹References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated.

²Prop. Reg. § 144468-05, 79 Fed. Reg. 3042 (2014), revised by 79 Fed. Reg. 21,163 (2014).

B. Contributions of Built-in Loss Property

b.1. We recommend that Proposed Regulation section 1.704-3(f) specifically adopt the rule of Proposed Regulation section 1.704-3(a)(6)(iii). If the government intends to require a Last-in First-out (LIFO) ordering rule in this situation, as is implied in an example in the Proposed Regulations, we recommend that the text of the final regulation be clarified to expressly so state.

b.2. Proposed Regulation section 1.704-3(f)(3)(iii)(A) provides special rules under which a section 704(c)(1)(C) basis adjustment is not eliminated if the pertinent section 704(c)(1)(C) partner transfers its partnership interest in a “nonrecognition transaction.” Neither the Proposed Regulations nor their preamble defines the term “nonrecognition transaction.” We believe that additional clarity could be achieved if the Proposed Regulations were modified to provide that the term “nonrecognition transaction” has the meaning set forth in section 7701(a)(45).

b.3. We recommend that the use of a section 704(c)(1)(C) basis adjustment to cure a ceiling rule limitation with respect to other property contributed by the section 704(c)(1)(C) partner be considered a reasonable method for purposes of section 704(c).

b.4. We recommend that Regulation section 1.704-3(a)(8) be amended to provide that when a partnership transfers section 704(c) property and other property to a corporation under section 351, the partnership should take a basis in a separate block of stock that preserves the aggregate built-in gain or loss that would be allocated to the relevant section 704(c) partner had the partnership disposed of the contributed property immediately before the transfer.

b.5. We recommend modifying the final regulations to allow the aggregation rules in Regulation section 1.704-3(e)(2) to be used in connection with the determination of a section 704(c)(1)(C) basis adjustment.

b.6. We recommend that the final regulations provide guidance illustrating that “attributable to” under Proposed Regulation section 1.704-3(f)(3)(iii)(B) means an amount of built-in loss that would have been allocated to a distributee-partner if an upper tier partnership had sold its built-in loss asset in an arm’s length transaction immediately prior to the distribution that occurs in a partnership merger or division (“**Tracing Approach**”).

b.7. We recommend that the final regulations provide that, with respect to section 704(c)(1)(C) partners in a merged partnership, section 704(c)(1)(C) will continue to apply by reference to the resulting partnership in the same manner as section 704(c)(1)(C) applied with respect to the merged partnership prior to the merger.

b.8. We recommend that the final regulations provide a *de minimis* exception regarding the application of section 704(c)(1)(C) to partnership mergers and divisions similar to those in the 2007 proposed regulations relating to the anti-mixing bowl rules and assets-over partnership mergers.

b.9. We recommend that, in determining a distributee-partner’s basis in a distributed lower-tier partnership interest, the final regulations provide

guidance that would allow the term “equitably apportioned” under Regulation section 1.61-6(a) to be defined as taking into account the partner’s share of gains or losses in the distributed lower-tier partnership’s interest (“**Tracking Approach**”).

b.10. We recommend that the final regulations provide an elective rule that, in the context of the distribution transaction in a division, would permit the reallocation of any section 704(c)(1)(C) basis adjustment created in connection with the contribution of assets to the lower-tier partnership in the same way as if the assets were being distributed directly to the partners in the divided partnership.

b.11. If the immediately prior suggestion is not adopted, we recommend that the final regulations provide a rule confirming that in a situation where the “conforming reductions” rule in Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2) overlaps with the Deemed Section 754 Election rule, the “conforming adjustment” would be made first, and the Deemed Section 754 Election rule would be applied after the application of the “conforming reduction.” We believe that the final regulations should also provide an example illustrating the application of the “conforming reduction” rule in the context of a partnership division.

b.12. We agree with the rule of the Proposed Regulations that the noncontributing partner should not take section 704(c)(1)(C) basis adjustments into account under section 732. If a noncontributing partner took section 704(c)(1)(C) basis adjustments into account in applying section 732(f), losses might be inappropriately eliminated and additional gain might be inappropriately created. Accordingly, we recommend that the rule set forth in Proposed Regulations section 1.704-3(f)(3)(v)(B), that is, that a section 704(c)(1)(C) basis adjustment is not taken into account in applying section 732(f) upon a distribution of stock to a partner other than a contributing partner, be retained.

b.13. We recommend that existing Regulation section 1.743-1(g)(2)(ii) be amended, and that the Proposed Regulations be revised to allow taxpayers to reallocate sections 704(c)(1)(C) and 743(b) basis adjustments to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustments arose under the principles of Regulation section 1.755-1(b)(5)(iii).

b.14. We recommend that a section 704(c)(1)(C) basis adjustment attributable to section 704(c)(1)(C) property hypothetically distributed to a non-section 704(c)(1)(C) partner under the existing section 751(b) regulations that is hypothetically reacquired by the distributing partnership in an exchange transaction with the distributee-partner should remain embedded with the section 704(c)(1)(C) property hypothetically distributed and reacquired by the distributing partnership under the current section 751(b) regulations.

b.15. We recommend that the Proposed Regulations or the Proposed Section 751(b) Regulations be clarified with respect to the interaction of sections 704(c)(1)(C) and 751(b) with respect to the Hypothetical Exchange

Approach described in those Proposed Section 751(b) Regulations is adopted in final regulations for section 751(b).

C. Mandatory Basis Adjustment Provisions

c.1. We agree with the Proposed Regulations' clarification as to the timing for a partnership's determination of whether it has a substantial built-in loss being immediately after a transfer.

c.2. Subject to our comments herein as to certain subsidiary partnerships in a tiered partnership structure, we agree that the appropriate consequence of a partnership having a substantial built-in loss immediately after an interest transfer is to treat the partnership as having a section 754 election in effect only with respect to such transfer.

c.3. We agree that the determination of a substantial built-in loss for a partnership should be made without regard to any section 743(b) and 704(c)(1)(C) adjustments other than those of any relevant transferee-partner.

c.4. We agree with the Proposed Regulations' gross up approach for purposes of determining an upper-tier partnership's fair market value in a lower-tier partnership, but we recommend that an example be provided to clarify the manner in which contingent liabilities of the lower-tier partnership are taken into account in determining the gross up amount.

c.5. Although we agree with the stated purpose of the Proposed Regulations' section 743 substantial built-in loss anti-abuse rule, due to the multiple purposes that exist with the implementation of most commercial transactions, we recommend that any such section 743 anti-abuse rule be applicable only in a situation in which "the" principal purpose (as opposed to "a" principal purpose) of a transaction, or series of transactions, is to circumvent or avoid the purposes of the substantial built-in loss rules. We also recommend that final regulations provide specific examples of such principal purpose transactions, as well as clarification as to whether the results of the application of such an anti-abuse rule would be limited to the application of the section 743 substantial built-in loss rules.

c.6. We recommend that final regulations clarify whether an anti-abuse rule similar to that proposed for purposes of the section 743(b) substantial built-in loss rule would be applicable with respect to a section 734(b) substantial basis reduction and, if so, the situations in which such a rule would be applicable.

c.7. Proposed Regulation section 1.743-1(n)(7)(ii) provides that an upper-tier partnership is not considered engaged in a trade or business, and thus as not disqualified from being an electing investment partnership ("EIP"), if the upper-tier partnership owns an interest in a lower-tier partnership and, at all times, the adjusted basis of the upper-tier partnership's interest in the lower-tier partnership is less than 25% of the total capital that is required to be contributed to the upper-tier partnership (the 25% Requirement). We recommend that debt allocations under section 752 by a lower-tier partnership to an upper-tier partnership be disregarded when determining whether the

adjusted basis of an upper-tier partnership's interest in a lower-tier partnership is less than 25% of the total capital that is required to be contributed to the upper-tier partnership by the partners of the upper-tier. This recommended rule should apply without regard to where in the tiered structure a borrowing partnership is located.

c.8. We recommend that Proposed Regulation section 1.743-1(n)(8) be modified to include, as an exception to the Substantive Restriction Rule of Proposed Regulation section 1.743-1(n)(6)(viii), an investor's holding an interest in an electing partnership that constitutes a prohibited transaction under ERISA.

c.9. We recommend that a partnership that has properly elected to be an EIP be permitted to cure a transitory failure to satisfy the terms set forth in section 743(e) and Proposed Regulation section 1.743-1(n). We also believe that any such transitory failure should be disregarded following the electing partnership's return to compliance if no interests in the electing partnership were transferred during the period that the electing partnership was out of compliance with the EIP rules.

c.10. We request that final regulations provide additional guidance regarding interest transfers in an EIP at a time that the EIP is not in compliance with section 743(e) and Proposed Regulation section 1.743-1(n). We recommend that the guidance require the noncompliant EIP to adjust the basis of its property as otherwise required by sections 743(b) and 743(d) with respect to each of its partners that acquired an interest in such partnership during the period that the EIP is out of compliance with sections 743(e) and finalized Proposed Regulation section 1.743-1(n).

c.11. We recommend that an EIP be permitted to disregard its transitory noncompliance with section 743(e) and Proposed Regulation section 1.743-1(n) and to compute and allocate its taxable income and loss as if it had been continuously in compliance with these provisions provided it cures its noncompliance by the time for filing its return for the year in which its noncompliance arose, including extensions.

c.12. We recommend that final regulations provide, as a general rule, that a re-electing EIP (that is, an EIP that revoked its election with the consent of the Treasury but that subsequently re-elects to become an EIP) would be required to maintain and apply any basis adjustments under sections 743(b) and 743(d) that arose following its revocation of its EIP election and before its re-election of EIP status.

c.13. We recommend that final regulations clarify that a re-electing EIP can treat itself as having continuously been in compliance with an EIP election if either: (1) there were no transfers with respect to which a basis adjustment under section 743(b) or 743(d) would have been required during the period between the partnership's revocation and its re-election of EIP status or (2) the partnership properly re-elected EIP status with its timely filed return, including extensions, for the year in which the Treasury's consent for its revocation became effective.

c.14. We believe that requiring a lower-tier partnership to adjust the inside basis of its partnership assets when such partnership does not have a section 754 election in effect will be highly burdensome for many partnerships and that requiring a lower-tier partnership to make adjustments when it does not have a substantial built-in loss is beyond the intent of section 743(d) and is contrary to Revenue Ruling 87-115. Moreover, we believe that the proposal might create a fungibility concern for many publicly traded partnerships, which generally have to ensure that each partnership interest within a class of interests is fungible with any other interest in such class. If adopted, the proposal might require certain publicly traded partnerships to alter their current structures in a manner that would create administrative burdens as noted herein without promoting the purposes of the enactment of the mandatory basis adjustment rules.

c.15. We believe that it is beyond the plain meaning and purpose of section 743(d)(1) to require a lower-tier partnership to make an adjustment to the basis of its assets when it does not have a substantial built-in loss and has not had an actual interest transfer while a section 754 election is in effect.

c.16. If the final regulations require basis adjustments of properties held by a lower-tier partnership as a result of an event at an upper-tier partnership, we recommend that final regulations include guidance requiring the upper-tier partnership to provide the computational information that would be available only at the upper-tier partnership level but is needed at the lower-tier partnership level in order for such lower-tier partnership to make its required adjustments.

D. *The Section 755 Basis Allocation Rules*

d.1. Existing section 755(c)(1) implies that a basis adjustment might be prohibited from being made to the basis of certain equity interests in a non-corporate person. Because we believe that section 755(c) was intended to prevent basis reductions only to stock, we recommend that Treasury and the Service pursue a legislative technical correction to adjust section 755(c)(1) to state that no allocation may be made to a corporation's stock directly or indirectly owned by a partnership in which such corporation is a partner or to a corporation's stock that is directly or indirectly owned by such partnership and that is related—within the meaning of section 267(b)(1)—to a corporation that is a partner in such partnership.

d.2. Proposed Regulation section 1.755-1(e)'s disjunctive approach might be read to prevent an upper-tier partnership from making a negative basis adjustment to a lower-tier partnership interest in a situation in which the upper-tier partnership and the lower-tier partnership are related within the meaning of section 707(b)(1). Because we do not believe this is consistent with the purpose of section 755(c), to the extent that the above recommendation is not accepted and the existing section 755(c)(1) language is retained, we believe that the Proposed Regulations should confirm that the provision is

only intended to prohibit basis reductions in stock of a corporate partner or a corporation that is related to such partner.

d.3. We recommend that the Proposed Regulations clarify that where a negative basis adjustment is allocable to “other partnership property” under Proposed Regulation section 1.755-1(e)(1)(B), the rules set forth in Regulation section 1.755-1(c) apply such that a negative adjustment must be allocated to partnership property of a character similar to that of the distributed property to which the negative adjustment arose.

d.4. We recommend that the Proposed Regulations clarify that the gain recognized under Proposed Regulation section 1.755-1(e)(2) should be allocated to the partners in the partnership in accordance with the general rules of section 704(b).

d.5. We request that the final regulations provide examples as to the interaction of sections 337(d), 755(c), and 732(f).

d.6. We agree with the changes proposed that would provide that if there is an increase in the basis to be allocated to partnership assets under Regulation section 1.755-1(b)(5), the increase must be allocated to capital gain property and ordinary income property in proportion to, and to the extent of, gross gain or gross income that would be allocated to the transferee from a hypothetical sale of all property in each class, while a decrease must be allocated between capital gain and ordinary income property in proportion to, and to the extent of, the gross loss that would be allocated to the transferee from a similar hypothetical sale of all property in each class.

d.7. We recommend that the finalized Proposed Regulations include an example of the proposed modification to Regulation section 1.755-1(b)(5)(iii)(C) and clarify that, to the extent a transferee’s negative basis adjustment is made, the applicable partnership is responsible for tracking any excess adjustment under Regulation section 1.743-1(k).

E. Succeeding to a Transferor’s Basis Adjustment – Proposed Regulation Section 1.743-1(f)(2) Substituted Basis Transactions

e.1. The flush language of section 743(b) states that a basis adjustment under section 743 is an adjustment to the basis of partnership property with respect to the transferee partner only. Regulation section 1.743-1(j)(1) confirms that. The effect of Proposed Regulation section 1.743-1(f)(2) will often be that a transferee partner steps into the shoes of the section 743 basis adjustment of a transferor. We believe this result is inconsistent with both the statutory language and the existing section 743 regulations.

e.2. We believe that the Proposed Regulations prevent a basis shift only in situations where two factors are present: (1) the transferee’s basis in its interest is equal to the transferor’s basis in its interest and (2) the transferor’s outside basis in its interest is equal to the sum of the transferor’s share of the inside basis of partnership assets and the transferor’s section 743 adjustment. There are several common situations in which one or both of these factors will not apply and a substituted basis transaction will often result in a basis shift. As a result,

instances remain in which a partner might effectively elect out of the basis adjustment rules of Regulation section 1.755-1(b)(2) through (4) and into the substituted basis adjustment rules of Regulation section 1.755-1(b)(5).

e.3. The Proposed Regulations indicate that a positive basis adjustment for a transferee-partner is recovered as if it were newly placed in service property. This restart of the depreciable life appears inconsistent with the underlying theory of the Proposed Regulations in that the Proposed Regulations effectively treat a transferor's section 743(b) basis adjustment as common inside basis for both the transferor and the transferee. If final regulations retain the rule set forth in Proposed Regulation section 1.743-1(f)(2), we believe the substantive language of the Proposed Regulations should be amended to make it clear that the transferee does not succeed to the remaining depreciable life associated with the basis adjustment.

e.4. The application of Proposed Regulation section 1.743-1(f)(2) should be clarified with respect to tiered partnerships. Specifically, the Proposed Regulations should clarify as to whether an interest in a lower-tier partnership is also treated as having been transferred in a substituted basis transaction when an interest in the upper-tier partnership is transferred in a substituted basis transaction.

e.5. In light of the questions raised herein regarding the authority for Proposed Regulation section 1.743-1(f)(2) and the continued ability to avoid the electivity that Proposed Regulation section 1.743-1(f)(2) appears to target, we recommend that Treasury and the Service consider withdrawing Proposed Regulation section 1.743-1(f)(2). If Proposed Regulation section 1.743-1(f)(2) is finalized, we recommend that Proposed Regulation section 1.743-1(f)(2) be modified so as to address the comments herein.

F. *Section 704(c): Layering Versus Netting*

f.1. We recommend that a partnership be permitted to use the netting approach where the parties agree to do so and the adoption of netting does not violate Regulation section 1.704-3(a)(10).

f.2. If the immediately prior recommendation is not adopted, we recommend that a partnership be permitted to use the netting approach where the gross value of the partnership's assets is less than \$20 million, adjusted for inflation, as of the date of any revaluation event.

f.3. We recommend that final regulations provide a grandfather rule that allows an existing partnership to continue using the netting approach if it has adopted a netting approach prior to the adoption of final regulations.

f.4. We request that final regulations provide guidance on how to determine when a method is a "reasonable method" in addressing the existence of multiple layers for a single asset.

f.5. We recommend that final regulations provide that the disparity offset method, described below, is a permissible and reasonable section 704(c) method to account for revaluation layers.

II. Discussion

A. Section 704(c)(1)(C)

The following discusses specific comments and recommendations regarding the Proposed Regulation under section 704(c)(1)(C), addressing allocations in respect of built-in loss property contributed to a partnership.

1. *Ordering of Layers Under Proposed Regulation Section 1.704-3(f)(3)*

Proposed Regulation section 1.704-3(f) contains three sets of rules for transfers of built-in loss property to a partnership. Proposed Regulation section 1.704-3(f)(1) lays out the principal rule for contributions of built-in loss property to a partnership in a transaction described in section 721. Proposed Regulation section 1.704-3(f)(3) expands upon that rule in the event the contributing section 704(c)(1)(C) partner transfers its partnership interest to an upper-tier partnership—see Proposed Regulation section 1.704-3(f)(3)(iii)(B)—or the transferee partnership contributes the section 704(c)(1)(C) property to a lower-tier partnership—see Proposed Regulation section 1.704-3(f)(3)(iv)(B)(1). A special rule applies to the latter in cases in which the value of the contributed property has further declined in value. Under Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2)(b), a new section 704(c)(1)(C) layer, separate from the layer arising from the initial contribution, is created and allocated among the partners of the contributing partnership.

An example illustrating the layering rule in the context of a subsequent disposition of the section 704(c)(1)(C) property applies a LIFO ordering rule with respect to the layers. In Proposed Regulation section 1.704-3(f)(3)(iv)(B)(3), example 3, partner A contributes property with value of \$5,000 and a basis of \$11,000 to partnership UTP. At a later date, when the value of the property has declined to \$2,000, UTP contributes the property to partnership LTP, which then sells the property for that amount. The example creates an implicit ordering rule, concluding that, “[f]irst, UTP applies the \$3,000 section 704(c)(1)(C) adjustment attributable to the [contribution of the built-in loss property to LTP]. Next, UTP applies the \$6,000 section 704(c)(1)(C) basis adjustment attributable to [the original contributing partner’s] contribution of property to UTP”³

The text of the Proposed Regulations neither contains a specific ordering rule nor addresses situations in which the property is transferred in a partially tax-free transaction. For example, if the property in example 3 were transferred in a like-kind exchange transaction where, for example, \$3,000 of boot was received, under a LIFO-ordering rule, the second section 704(c)(1)(C) gain would be triggered, but the original layer would be preserved. This implicit ordering rule is inconsistent with Proposed Regulation section 1.704-3(a)(6)(iii). Under that regulation, which addresses multiple layers of forward and reverse section 704(c) items in a single partnership, a partnership

³Prop. Reg. § 1.704-3(f)(3)(iv)(B)(3), Ex. (3(iii)), 79 Fed. Reg. 3042 (2014).

may use “any reasonable method to allocate items of income, gain, loss, and deduction associated with an item of property among the property’s forward and reverse section 704(c) layers.” The implicit ordering rule is also at odds with the flexibility afforded the partnership in PLR 200829023 (July 18, 2008).⁴ We see no reason for a more restrictive rule where the layers are created from subsequent contributions to one or more lower-tier partnerships than where layers are created within a single partnership.

We recommend that Proposed Regulation section 1.704-3(f) specifically adopt the rule of Proposed Regulation section 1.704-3(a)(6)(iii). If Treasury and the Service intend to require a LIFO ordering rule in this situation, we recommend that the text of the final regulation be clarified to expressly so state.

2. Definition of “Nonrecognition Transaction” Under the Proposed Section 704(c)(1)(C) Regulations

Proposed Regulation section 1.704-3(f)(3)(iii)(A) provides special rules under which a section 704(c)(1)(C) basis adjustment is not eliminated if the pertinent section 704(c)(1)(C) partner transfers its partnership interest in a “nonrecognition transaction.” Neither the Proposed Regulations nor their preamble defines the term “nonrecognition transaction.” We believe that additional clarity could be achieved if the Proposed Regulations were modified to provide that the term “nonrecognition transaction” has the meaning set forth in section 7701(a)(45).

3. Using Section 704(c)(1)(C) Basis Adjustments to Cure a Ceiling Rule Limitation with Respect to Other Property Contributed by the Section 704(c)(1)(C) Partner Should Be Considered a Reasonable Method for Purposes of Section 704(c)

Regulation section 1.704-3(a)(1) provides that allocations made under section 704(c) must be made using a reasonable method that is consistent with the purpose of section 704(c). That purpose is “to prevent the shifting of tax consequences among partners with respect to [built-in] gain or loss.”⁵ Regulation section 1.704-3 describes three methods that are generally reasonable: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial allocation method.⁶ Each of these section

⁴Private letter rulings (“PLRs”) are not binding authority and apply only to the taxpayer who received the PLR. See I.R.C. § 6110(k)(3).

⁵Reg. § 1.704-3(a)(1).

⁶Each method, however, is subject to a general anti-abuse rule under Regulation section 1.704-3(a)(10). Regulation section 1.704-3(a)(10) provides that “[a]n allocation method (or combination of methods) is not reasonable if the contribution of property (or [the revaluation event]) and the corresponding allocation of tax items with respect to the [section 704(c)] property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.”

704(c) methods essentially attempts to allocate to each noncontributing partner an amount of tax items with respect to a section 704(c) property that is equal to the amount of book (that is, section 704(b)) items with respect to the property that is allocated to the noncontributing partner.⁷ However, Regulation section 1.704-3 also prohibits the use of particular methods in certain instances. For example, in the absence of specific published guidance, an allocation method is not reasonable if it increases—or decreases—the basis of contributed property to reflect built-in gain (or loss) or causes the partnership to create tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts.⁸

The existing section 704(c) regulations create a general limitation on achieving parity between the book and tax items allocated to noncontributors. The regulations refer to this limitation as the “ceiling rule.” The ceiling rule provides that “the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year.”⁹ An example of a situation in which the ceiling rule would have been relevant is if a noncontributor’s distributive share of book depreciation from a section 704(c) property was \$5, but that property had an adjusted tax basis of zero. In this example, the ceiling rule would have limited the allocation of tax items to the noncontributor to zero and, as a result, caused a discrepancy between the book and tax items allocated to the noncontributor, that is, \$5 of book depreciation and no tax depreciation.

“To correct distortions caused by the ceiling rule, a partnership using the traditional method [with curative allocations] may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners.”¹⁰ “A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership’s allocation of the corresponding book item.”¹¹ “The purpose of curative allocations is to equalize the overall allocations of economic and tax items to noncontributing partners.”¹²

⁷Section 704(c) generally applies on a property-by-property basis. Reg. § 1.704-3(a)(2). In certain instances, however, a partnership may aggregate contributed property for purposes of section 704(c). See Reg. § 1.704-3(e)(2), -(3).

⁸Reg. § 1.704-3(a)(1).

⁹Reg. § 1.704-3(b)(1).

¹⁰Reg. § 1.704-3(c).

¹¹*Id.*

¹²Prop. Reg. § 704(c), 57 Fed. Reg. 61,345 (1992). Because curative allocations involve only tax items, they will differ from economic allocations of the same item. “For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is allocated to the contributing partner.” Reg. § 1.704-3(c)(1).

The issue here concerns whether the general purpose of section 704(c), preventing the shifting of built-in gains and losses, could be advanced by using a section 704(c)(1)(C) basis adjustment to cure the ceiling rule limitation with respect to other property contributed by the section 704(c)(1)(C) partner. As illustrated by the examples below, in order to avoid inside-outside basis disparities, the use of a section 704(c)(1)(C) basis adjustment to cure a ceiling rule limitation with respect to other property contributed by the section 704(c)(1)(C) partner should be considered a reasonable method for purposes of section 704(c).

Example 1: C and NC form Partnership. NC contributes cash of \$100 while C contributes two properties: the first property, P1, has a fair market value of \$100 and a tax basis of zero, and the second property, P2, has a fair market value of zero¹³ and a tax basis of \$100. Assume that both P1 and P2 have one year left of their depreciable lives and C's section 704(c)(1)(C) basis adjustment of \$100 (attributable to P2) is not used to cure the ceiling rule limitation with respect to P1. At the end of year one, C and NC are each allocated \$50 of book depreciation, reducing each of their section 704(b) capital accounts to \$50. NC is allocated zero of tax depreciation because, with respect to NC, both P1 and P2 have a zero tax basis. With respect to C, there is \$100 of tax depreciation attributable to P2 that is allocated entirely to C under section 704(c)(1)(C), reducing C's outside basis to zero. Thus, at the end of year one, NC has a section 704(b) capital account of \$50 and an outside basis of \$100—a built-in-loss interest in Partnership—while C has a section 704(b) capital account of \$50 and an outside basis of zero—a built-in-gain interest in Partnership. Because C was unable to cure the ceiling limitation on P1 with items from P2, C's section 704(c) gain in P1 is effectively shifted to NC.

Example 2: Same facts as Example 1, except C's section 704(c)(1)(C) basis adjustment in P2 is used to cure the ceiling rule limitation with respect to P1. Consequently, NC is allocated \$50 of tax depreciation (from the tax depreciation of P2 related to the section 704(c)(1)(C) basis adjustment) to match its allocation of \$50 of book depreciation, reducing NC's outside basis in Partnership to \$50. The remaining \$50 of the tax depreciation of P2 related to the section 704(c)(1)(C) basis adjustment is allocated to C, reducing C's outside basis in Partnership to \$50. By using C's section 704(c)(1)(C) basis adjustment to cure the ceiling rule limitation with respect to P1, there is no shift of section 704(c) items between C and NC.

Taking into account the section 704(c)(1)(C) basis adjustment to cure a ceiling rule limitation could be interpreted as inconsistent with the language of the statute, which provides that the section 704(c)(1)(C) basis adjustment be “taken into account only in determining the amount of items allocated to the contributing partner.” The statute, however, goes on to provide “except as

¹³An asset with a value of zero might not be considered property for purposes of section 721. However, this example uses zero in order to simplify the illustration.

provided in regulations, determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.”¹⁴ Because the statute grants regulatory authority to alter the general rule, and because taking into account the section 704(c)(1)(C) basis adjustment reaches the appropriate results, we believe such an approach should be considered a reasonable method under the Proposed Regulations and recommend that final regulations make it clear that a section 704(c)(1)(C) basis adjustment can be taken into account to cure a ceiling rule limitation.

A similar issue exists with respect to whether section 704(c)(1)(C) basis should be available to cure a ceiling rule distortion created as a result of a subsequent upward revaluation of a section 704(c)(1)(C) asset. This issue is addressed in the layering versus netting discussion section of these Comments.

4. *Coordination of Section 704(c)(1)(C) with Regulation Section 1.704-3(a)(8)*

Consideration should be given to amending Regulation section 1.704-3(a)(8) to provide that when a partnership transfers section 704(c) property and other property to a corporation under section 351, the partnership should take a basis in a separate block of stock that preserves the aggregate built-in gain or loss that would be allocated to the relevant section 704(c) partner had the partnership disposed of the contributed property immediately before the transfer.¹⁵

Regulation section 1.704-3(a)(8) currently provides, in part, that when a partnership transfers section 704(c) property together with other property to a corporation in a section 351 transaction, the basis of stock received is determined by treating each item of section 704(c) property as if it had been the only property transferred to the corporation by the partnership (Separate Block Rule). Although not entirely clear, and as illustrated in Example 1 *supra*, we believe the Separate Block Rule was originally added in Regulation section 1.704-3(a)(8) to prevent partners from accomplishing through a partnership, what they could not do outside of a partnership.¹⁶

Example 3: A contributes an asset, P3, with a fair market value of \$100 and a tax basis of zero and B contributes a different asset, P4, with a fair market value of \$50 and a tax basis of \$75 to Partnership. Partnership takes a basis of zero in P3 and a basis of \$50 in P4 under section 704(c)(1)(C). A takes a substituted basis of zero in its interest in Partnership, while B takes a \$75 basis in its interest in the Partnership, and has a section 704(c)(1)(C)

¹⁴I.R.C. § 704(c)(1)(C)(ii).

¹⁵The Service has issued private letter rulings where Regulation section 1.704-3(a)(8) was applicable but none of which dealt with contribution of properties by a partnership to a corporation. See P.L.R. 2008-24-005 (June 13, 2008) and P.L.R. 2008-29-023 (July 18, 2008).

¹⁶Neither the preamble to the Proposed Regulations nor the final regulations adopting Regulation section 1.704-3(a)(8) provide clear explanations on why the provision was included. See Prop. Reg § 1.704-3, 57 Fed. Reg. 61,345 (1992); T.D. 8500, 1994-1 C.B. 183.

basis adjustment of \$25 in P4.¹⁷ Partnership then contributes P3 and P4 to Corporation. Under the Separate Block Rule, Partnership is treated as contributing P3 and P4 as if each of the assets is the only property transferred to the Corporation. Consequently, for the contribution of P3, Corporation takes a carryover basis of zero in the asset and Partnership takes a substituted basis of zero in the stock of Corporation. However, section 362(e) applies to the contribution of P4 to Corporation. If an election under section 362(e)(2)(C) is not made to reduce Partnership's basis in the stock of Corporation, the basis of P4 in Corporation's hands is reduced from \$75 to \$50 and Partnership takes a substituted basis of \$50 in the stock of Corporation, and B has a \$25 section 704(c)(1)(C) basis adjustment in the stock received by Partnership.¹⁸

Example 4: Same facts as Example 3, except A and B first contribute P3 and P4 to Corporation in exchange for stock of Corporation. Corporation takes a carryover basis of zero in P3 while A takes a substituted basis of zero in the stock of Corporation. Section 362(e) applies to the contribution of P4 to Corporation, and if an election under section 362(e)(2)(C) is not made to reduce B's basis in Corporation stock, the basis of P4 in Corporation's hands is reduced from \$75 (that is, the \$25 built-in loss) to \$50 and B takes a substituted basis of \$75 in the stock of Corporation. Each of A and B then contributes the stock of Corporation to Partnership and takes a substituted basis of \$0 and \$75, respectively, in its interest in Partnership.

As illustrated *supra*, in two economically similar situations, consistent results are produced when applying the Separate Block Rule such that, in both scenarios, section 362(e) is applied to the contribution of P4 to Corporation.¹⁹ Although the Separate Block Rule works appropriately in the simple fact pattern where a single section 704(c) asset is contributed, as illustrated in Example 5 *infra*, the Separate Block Rule produces inconsistent results where

¹⁷The section 704(c)(1)(C) basis adjustment is considered unique to B and does not affect the basis of partnership property or the partnership's computation of any item under section 703.

¹⁸Proposed Regulation section 1.704-3(f)(3)(iv)(C)(1) provides that a corporation's adjusted basis in property transferred to the corporation by a partnership in a transaction described in section 351 is determined under section 362 (*including for purposes of applying section 362(e)*) by taking into account any section 704(c)(1)(C) basis adjustment for the property. Emphasis added. Presumably this provision is the reason that the example in Proposed Regulation section 1.704-3(f)(3)(iv)(C)(4) indicates that partnership PRS takes a basis of \$10,000 in built-in loss property contributed by partner B, but then implies that such property's basis is \$18,000 in the partnership's hands upon the partnership's contribution of such property to Y Corp. It would be helpful for the example to clarify this point.

¹⁹In Examples 3 and 4, A and B are partners in Partnership with A having an interest with a fair market value of \$100 and a tax basis of zero, and B having an interest with a fair market value of \$50 and a tax basis of \$75. Partnership has two blocks of stock, of which one has a fair market value of \$100 and a tax basis of zero, and one with a fair market value of \$50 and a tax basis of \$50, and with B having a section 704(c)(1)(C) basis adjustment in the stock of \$25 in Example 3. Corporation has one property with a fair market value of \$100 and a tax basis of zero, and one with a fair market value of \$50 and a tax basis of \$50.

multiple assets are contributed. The following example illustrates a situation where A contributes both P3 and P4.

Example 5: A contributes P3 with a fair market value of \$100 and a tax basis of zero and P4 with a fair market value of \$50 and a tax basis of \$75 to Partnership. Partnership takes carryover bases of zero and \$50 in P3 and P4, respectively, while A takes a substituted basis of \$75 in its interest in Partnership and has a section 704(c)(1)(C) basis adjustment of \$25 in P4.²⁰ Partnership then contributes P3 and P4 to Corporation. Under the Separate Block Rule, rather than aggregating P3 and P4 in determining the basis of stock received, Partnership is treated as contributing P3 and P4 as if each of the assets is the only property transferred to Corporation. For the contribution of P3, Corporation takes a carryover basis of zero in the asset and Partnership takes a substituted basis of zero in the stock of Corporation. Section 362(e) applies to the contribution of P4 to Corporation, and if an election under section 362(e)(2)(C) is not made to reduce Partnership's basis in Corporation stock, the basis of P4 in Corporation's hand is reduced from \$75—taking the \$25 section 704(c)(1)(C) basis adjustment into account—to \$50 and Partnership takes a substituted basis of \$50 in the stock of Corporation and A has a \$25 section 704(c)(1)(C) basis adjustment in the stock received by Partnership.²¹

Example 6: Same facts as Example 5, except A first contributes P3 and P4 to Corporation in exchange for stock of Corporation. Section 362(e) does not apply here because the assets contributed by A are aggregated for purposes of applying Section 362(e), and A is treated as contributing assets with a net built-in gain—fair market value of \$150 and tax basis of \$75. Corporation takes carryover bases of zero and \$75 in P3 and P4, respectively, while A takes a substituted basis of \$75 in the stock of Corporation. A then contributes the stock in Corporation to Partnership in exchange for an interest in Partnership. Partnership takes a carryover basis of \$75 in the Corporation stock received, while A receives a substituted basis of \$75 in A's Partnership interest.

As illustrated by Examples 5 and 6 *supra*, in two economically similar situations, where built-in gain and built-in loss assets are contributed by one party, and are subsequently transferred, inconsistent results are produced when applying the Separate Block Rule such that section 362(e) is only applied to the contribution of P4 to Corporation in Example 5, where the assets are first contributed to Partnership and are subsequently transferred to Corporation. If, however, Partnership were treated as contributing both P3 and P4 to Corporation with an aggregate fair market value of \$150 and basis of \$75—net built-in gain of \$75—in determining its basis in the stock of Corporation under Regulation section 1.704-3(a)(8), section 362(e) will not apply to Partnership's contribution of P3 and P4 to Corporation. Under

²⁰The section 704(c)(1)(C) adjustment is considered unique to A and does not affect the basis of partnership property or the partnership's computation of any item under section 703.

²¹See *supra* note 18.

this approach, Partnership takes a substituted basis of \$75 in the stock of Corporation, which preserves the net built-in gain of \$75 that would be allocated to A immediately before Partnership transferred the assets to Corporation, and Corporation continues to have a \$75 basis in P4. This result is economically similar to the results produced by Example 6, where the assets are first contributed to Corporation and are subsequently transferred to Partnership.

In order to create similar tax results for economically similar transactions, we recommend that Regulation section 1.704-3(a)(8) be amended to provide that when a partnership transfers section 704(c) property, together with other property, to a corporation under section 351, the partnership should take a basis in a separate block of stock that preserves the aggregate built-in gain or loss that would be allocated to the section 704(c) partner had the partnership disposed of the contributed property immediately before the transfer.²²

5. Coordination of Special Aggregation Rules Under Regulation Section 1.704-3(e)(2) with Section 704(c)(1)(C)

Section 704(c) allocations generally apply on a property-by-property basis.²³ In specific instances, however, Regulation section 1.704-3(e)(2) provides that certain types of property may be aggregated for purposes of making section 704(c) allocations. In order to ease the complexities that may arise in practice in accounting for section 704(c)(1)(C) basis adjustments, the aggregation of certain types of section 704(c)(1)(C) property should be allowed. Regulation section 1.704-3(e)(2) as well as the Proposed Regulations related to section 704(c)(1)(C) are silent with regard to the application of the aggregation rules in the determination of a section 704(c)(1)(C) basis adjustment. Therefore, we recommend modifying the final regulations to allow the aggregation rules in Regulation section 1.704-3(e)(2) to be used in connection with the determination of a section 704(c)(1)(C) basis adjustment.

6. The Need to Coordinate Section 704(c)(1)(C) Basis Adjustments with the Rules Governing Partnership Mergers and Divisions

The Proposed Regulations provide no specific guidance relating to the application of section 704(c)(1)(C) in the context of partnership mergers and divisions. The Proposed Regulations do generally provide for the carryover of the section 704(c)(1)(C) basis adjustments in the context of contributions under section 721 and transfers of partnership interests in nonrecognition transactions. At first blush, these rules would provide for the flexibility to engage in assets-over partnership mergers and divisions without triggering adverse

²²We note that although the examples herein focus on section 704(c)(1)(C), the issue exists under the current regulations regarding section 704(c) more generally. That is, if the partnership contributes two pieces of section 704(c) built-in gain property contributed to the partnership by the same partner, Regulation section 1.704-3(a)(8) would apply to treat the partnership as receiving two separate blocks of shares.

²³Reg. § 1.704-3(a)(2).

results under section 704(c)(1)(C). Upon closer inspection, however, there are many uncertainties in the guidance as it relates to these transactions.²⁴

a. *Assets-Over Partnership Mergers.* Three distinct scenarios must be considered in determining the application of section 704(c)(1)(C) for assets-over partnership mergers. Those situations include instances where: (1) no pre-existing section 704(c)(1)(C) basis adjustment exists, but one is created in connection with the merger, (2) property with a section 704(c)(1)(C) basis adjustment is contributed by the merged partnership to the resulting partnership in connection with a merger, and (3) property with a section 704(c)(1)(C) basis adjustment is contributed and an additional section 704(c)(1)(C) basis adjustment is created in connection with the contribution in a merger.

a.1. *No Pre-Existing Section 704(c)(1)(C) Assets.* In an assets-over merger, the merged partnership will contribute assets to the resulting partnership in exchange for resulting partnership interests and then will distribute the resulting partnership interests in complete liquidation. If the merged partnership in an assets-over merger holds built-in loss property, that property will become section 704(c)(1)(C) property in the hands of the resulting partnership. For a split second, the merged partnership will be the section 704(c)(1)(C) partner, but it then will immediately distribute the resulting partnership interests.

Proposed Regulation section 1.704-3(f)(3)(iii)(B) provides that, in connection with the transfer of a section 704(c)(1)(C) partner's interest in a nonrecognition transaction, "the transferee of all or a portion of the section 704(c)(1)(C) partner's partnership interest succeeds to the transferor's section 704(c)(1)(C) basis adjustments in an amount attributable to the interest transferred and the transferee will be treated as the section 704(c)(1)(C) partner with respect to the transferred interest." The Proposed Regulation section goes on to provide that, regardless of whether the partnership has a section 754 election in effect or a substantial built-in loss with respect to its assets,

²⁴Many of the comments and recommendations below implicate matters that explain how section 704(c) is applied generally, beyond the more limited ambit of matters arising under section 704(c)(1)(C). For example, both the "Tracking Approach" and "Tracing Approach" described below are analytic tools under section 704(c) that could be properly applicable under section 704(c) more broadly, and not merely to section 704(c)(1)(C). We recommend that the Service and Treasury consider these matters more broadly under section 704(c), rather than restricting its consideration of them to section 704(c)(1)(C).

Additionally, we recommend that the Service and Treasury consider the interaction of the proposed changes to the Regulations under section 751(b) regarding the determination of whether section 751(b) applies to a distribution with the issues noted in this section of the Comments regarding distributions in a partnership merger and division situation. In particular, given that the proposed changes to the Regulations under section 751(b) adopt a pre-distribution versus post-distribution unrealized gain-loss approach in determining whether section 751(b) applies to a distribution (an approach that applies section 704(c) principles in determining each partner's share of section 751 property using a revaluation of partnership property), the Service and Treasury should consider the application of Proposed Regulation section 1.704-3(a)(7) and Proposed Regulation section 1.704-3(f)(3)(iii) to partnership distributions, such as the partnership division and merger transactions discussed herein.

the amount of any section 704(c)(1)(C) basis adjustment relating to section 704(c)(1)(C) property to which the transferee succeeds will be decreased by the amount of the negative section 743(b) basis adjustment that would be allocated to the section 704(c)(1)(C) property if the partnership has a section 754 election in effect with respect to the transfer (Deemed Section 754 Election Rule).

While these rules should prevent the distribution of resulting partnership interests in connection with an assets-over partnership merger from eliminating the section 704(c)(1)(C) basis adjustment that was created in connection with the contribution of built-in loss assets, the Proposed Regulations do not provide guidance as to the portion of the built-in loss in the contributed assets that each distributee-partner should succeed to other than to say it is the amount “attributable to” the transferred interest. When multiple interests in the same partnership are being transferred as part of a single transaction, as in a partnership merger, the amount of the section 704(c)(1)(C) basis adjustment that is attributable to each transferred partnership interest may be unclear.

In the context of an assets-over merger where all partners in the merged partnership participate, a logical rule would provide that the partners in the merged partnership would succeed to the built-in loss in an amount that would have been allocated to such partners if the merged partnership had sold the built-in loss asset in an arm’s length transaction immediately prior to the merger. Examples contained in proposed regulations issued in 2007 relating to the application of section 704(c) in partnership mergers illustrated such a method in determining how the partners in the merged partnerships would share the section 704(c) gain or loss created in a partnership merger.²⁵ Guidance providing for this result under section 704(c)(1)(C) in the form of a specific rule or illustrative examples would be helpful.²⁶

The issue is a bit more complicated if certain partners are redeemed with cash in connection with the merger in a transaction that is treated as a complete liquidation of their interests. In such a situation, certain partners who would have economically shared in the built-in loss will not continue to participate in the resulting partnership.²⁷ Nonetheless, Proposed Regulation section 1.704-3(f)(3)(iii)(B) appears to specifically permit a shifting in the

²⁵ Prop. Reg. § 1.704-4(c)(4)(ii)(F), Exs. (1)-(3), 72 Fed. Reg. 46,932 (2007).

²⁶ Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2)(b), discussed in Part a.2., provides that where pre-existing section 704(c)(1)(C) property is contributed to a lower-tier partnership, and the value of the property has fallen further since the original contribution, the “additional section 704(c)(1)(C) basis adjustment will be allocated among the partners of the upper-tier partnership in a manner that reflects their relative shares of that loss.” This rule operates on a basis that is similar to Proposed Regulation section 1.704-3(f)(3)(iii)(B). That is, presumably each partner’s share of loss is determined by reference to what its share of loss would have been had the property remained in the upper-tier partnership. *See also supra* note 24, regarding the application of such a rule more broadly than just under section 704(c)(1)(C).

²⁷ *See supra* note 24.

section 704(c)(1)(C) basis adjustment among parties as part of a nonrecognition transfer. The Deemed Section 754 Election Rule apparently is intended to prevent improper shifts in basis and built-in loss. In this situation, it would seem appropriate to apply the rule described in the immediately preceding paragraph (that is, allocate the section 704(c)(1)(C) basis adjustment in the resulting partnership assets based upon how losses would have been allocated by the merged partnership) but treating the redeemed partners who will not participate in the resulting partnership as if they were not members of the merged partnership. The Deemed Section 754 Election Rule may then apply to reduce the continuing partners' shares of the section 704(c)(1)(C) basis adjustment.

a.2. *Pre-Existing Section 704(c)(1)(C) Assets.* The issues are more complicated in situations where the merged partnership holds pre-existing section 704(c)(1)(C) assets prior to the merger. Here, the application of section 704(c)(1)(C) must be considered in connection with both the contribution of assets by the merged partnership to the resulting partnership and the distribution of the resulting partnership interests in liquidation of the merged partnership.

The most basic situation would involve the contribution of section 704(c)(1)(C) assets that continue to have a built-in loss exactly equal to the section 704(c)(1)(C) basis adjustment. With respect to the contribution of section 704(c)(1)(C) assets in a transaction qualifying under section 721 (the first step in an assets-over merger), Proposed Regulation section 1.704-3(f)(3)(iv)(B)(1) provides that the interest in the lower-tier partnership (the resulting partnership) received by the upper-tier partnership (the merged partnership) will be treated as the section 704(c)(1)(C) property with the same section 704(c)(1)(C) basis adjustment as the contributed property. The lower-tier partnership (the resulting partnership) would succeed to the upper-tier partnership's (the merged partnership's) section 704(c)(1)(C) basis adjustment.²⁸ The section 704(c)(1)(C) basis adjustment in the lower-tier partnership (the resulting partnership) interest and in the assets contributed to the lower-tier partnership (the resulting partnership) would "be segregated and allocated solely to the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made."²⁹

After the first step in the merger, there are two different section 704(c)(1)(C) basis adjustments relating to the pre-existing section 704(c)(1)(C) assets: (1) a section 704(c)(1)(C) basis adjustment in the resulting partnership interest and (2) a section 704(c)(1)(C) basis adjustment in the resulting partnership's assets. Currently, the Proposed Regulations would deal with these two different basis adjustments in the context of a distribution of the resulting partnership interests—the second and final step in an assets-over merger—through two different rules.

²⁸ Prop. Reg. § 1.704-3(f)(3)(iv)(B)(1), 79 Fed. Reg. 3042 (2014).

²⁹ *Id.*

The first rule applies to a distribution of section 704(c)(1)(C) property to a section 704(c)(1)(C) partner. With respect to the section 704(c)(1)(C) basis adjustment in the resulting partnership interest, Proposed Regulation section 1.704-3(f)(3)(v)(C) provides that, if a section 704(c)(1)(C) partner receives a distribution in liquidation of its partnership interest, “the adjusted basis to the partnership of the distributed property immediately before the distribution includes the section 704(c)(1)(C) partner’s section 704(c)(1)(C) basis adjustment for the property in which the section 704(c)(1)(C) partner relinquished an interest.”³⁰ Accordingly, the section 704(c)(1)(C) partner would continue with its full basis in the distributed resulting partnership interest.

The second rule applies to a transfer of a partnership interest by a section 704(c)(1)(C) partner in a nonrecognition transaction. With respect to the section 704(c)(1)(C) basis adjustment in the resulting partnership’s assets, the Proposed Regulation discussed above relating to transfers of partnership interests provides that the transferee partner in a nonrecognition transaction will succeed to the transferor’s section 704(c)(1)(C) basis adjustment.

It is logical that the section 704(c)(1)(C) basis adjustment that is traced to a section 704(c)(1)(C) partner under the tiered-partnership rule (the first rule described above) would continue to be traced to that partner following the distribution. The applicable Proposed Regulation section (the second rule described above), however, is drafted by reference to the section 704(c)(1)(C) basis adjustment in the hands of the transferor which, in the context of a partnership merger, is the merged partnership. In that regard, the Proposed Regulation relating to transfers of partnership interests—the second rule—provides no link to the tracing rule in the section 721 and tiered-partnership rule—the first rule. The lack of coordination between the two rules creates uncertainty as to the treatment of a section 704(c)(1)(C) adjustment in partnership merger transactions.

An analogous issue arises in the context of partnership mergers and the anti-mixing bowl rules. In that context, Regulation sections 1.704-4(c)(4), 1.737-2(b)(1), and 1.737-2(b)(3) provide that gain or loss will not be recognized under the anti-mixing bowl rules and sections 704(c) and 737 will continue to apply following the merger in the same manner as before the assets-over merger. Rather than trying to adjust the various separate rules in the Proposed Regulations to accommodate the implications of an assets-over partnership merger in the deemed contribution and distribution transactions, we suggest that it would be preferable to adopt the approach used in the anti-mixing bowl regulation. That is, we recommend that the final regulations simply provide that, with respect to section 704(c)(1)(C) partners in the merged partnership, section 704(c)(1)(C) will continue to apply by reference to the resulting partnership in the same manner as section 704(c)(1)(C)

³⁰ By virtue of the exception for partnership mergers under Regulation sections 1.704-4(c)(4) and 1.737-2(b)(1) and (3), the anti-mixing bowl rules need not be considered in such a transaction.

applied with respect to the merged partnership prior to the merger. Given the obvious need to coordinate results under the anti-mixing bowl rules and section 704(c)(1)(C), such a rule seems particularly advisable.

a.3. *Pre-Existing Section 704(c)(1)(C) Assets with Additional Section 704(c)(1)(C) Built-in Loss.* It seems that the two proposed rules discussed above could operate properly in tandem to deal with situations involving both pre-existing section 704(c)(1)(C) assets and additional section 704(c)(1)(C) built-in loss created in the contribution. That is, the pre-existing section 704(c)(1)(C) basis adjustment would simply carryover to the resulting partnership and be allocated to the section 704(c)(1)(C) partner in the same manner as was the case with respect to the merged partnership. Then, for purposes of analyzing the transaction, the section 704(c)(1)(C) basis adjustment would not be treated as basis of the partnership.³¹ Excluding such basis, the transaction would be analyzed like any assets-over merger transaction, and a new section 704(c)(1)(C) basis adjustment would be created and allocated as described above.

a.4. *Identical Ownership or De Minimis Change in Ownership.* Like the anti-mixing bowl rules, the application of section 704(c)(1)(C) with respect to built-in loss assets of a partnership can produce adverse taxpayer results and requires an understanding and application of a complex set of rules. Proposed regulations issued in 2007 relating to the anti-mixing bowl rules and assets-over partnership mergers contained exceptions so that sections 704(c)(1)(B) and 737 would not apply with respect to a new section 704(c) layer created in a partnership merger if the merged and resulting partnerships were owned by the same partners in the same proportions or the difference in ownership was *de minimis*.³² Where the indirect ownership of the relevant assets remain essentially the same after a partnership merger, the loss shifting concerns that justify the application of section 704(c)(1)(C) are not present. A similar *de minimis* exception regarding the application of section 704(c)(1)(C) to partnership mergers would be justified. Accordingly, we recommend that the final regulations provide a *de minimis* exception regarding the application of section 704(c)(1)(C) to partnership mergers and divisions similar to those in the 2007 proposed regulations relating to the anti-mixing bowl rules and assets-over partnership mergers.

b. *Assets-Over Partnership Divisions.* Many of the same issues discussed above also can arise in the context of assets-over partnership divisions. In addition, partnership divisions raise difficult issues under section 704(c) more generally due to the fungibility of partnership interests in the hands of the dividing partnership and the arguable inability to track a partner's status with respect to section 704(c) assets contributed to a resulting partnership to the partnership interest that is distributed to the section 704(c) partner.

³¹ Prop. Reg. § 1.704-3(f)(3)(iv)(B)(1), 79 Fed. Reg. 3042 (2014).

³² Prop. Reg. § 1.704-4(c)(4)(ii)(E), Prop. Reg. § 1.737-2(b)(1)(ii)(E), 72 Fed. Reg. 46,932 (2007).

Because of the exception from the anti-mixing bowl rules for partnership mergers, it was not necessary to consider overlap situations where (1) the anti-mixing bowl rules might trigger current recognition of a loss and (2) the rules under section 704(c)(1)(C) might provide for a partner's continuing share of built-in loss in partnership assets. Unlike partnership mergers, no realistic exception from application of the anti-mixing bowl rules exists in the context of partnership divisions,³³ and, hence, it is necessary to consider the application of the anti-mixing bowl rules in determining the portion of the section 704(c)(1)(C) basis adjustment that may be preserved.

b.1. *New Section 704(c)(1)(C) Basis Adjustment Created in an Assets-Over Division.* For pro rata divisions, a significant issue for clarification is identical to the issue that arises in the context of partnership mergers. That is, it is necessary to determine the share of the section 704(c)(1)(C) basis adjustment created in the contribution transaction that will be allocated to the partners in the resulting partnership following the distribution of such interests. As with partnership mergers, the share of the section 704(c)(1)(C) basis adjustment allocated to these partners should equal the share of the built-in loss that would be allocated to these partners if the built-in loss assets were sold immediately prior to the division.

Note, however, that an additional issue, which does not arise in the context of a merger, can arise in the context of a pro rata assets-over partnership division due to the fact that the distribution of the resulting partnership interest in such a division is often not a liquidating distribution. The issue relates to the determination of each recipient partner's basis in its partnership interest.³⁴ The following example highlights the issue that can arise:

Example 7: A and B each contribute \$1,000 to a partnership (PRS1). PRS1 buys two assets, P5 and P6. A and B initially are equal partners with respect to partnership capital, but they agree to divide profits and losses with respect to P5 1/3-2/3 and P6 2/3-1/3. Each asset originally was acquired for \$1,000 and now is valued at \$700. It is agreed that PRS1 will divide, so that P5 and P6 will be held in separate partnerships. PRS1 will contribute P5 to a new partnership (PRS2), and interests in PRS2 will be distributed to A and B consistent with the economic entitlements with respect to P5. That is, A will receive an interest in PRS2 that is valued at \$400 (that is, \$500 - \$100 (\$300 BIL³⁵ x 1/3)) and B will receive an interest that is valued at \$300 (that is, \$500 - \$200 (\$300 BIL x 2/3)).

Based upon these facts, A should have a \$100 section 704(c)(1)(C) basis adjustment with respect to P5, and B should have a \$200 section 704(c)(1)(C) basis adjustment with respect to P5. These amounts correspond to the share

³³Exceptions are provided in Regulation sections 1.704-4(c)(4) and 1.737-2(b)(2).

³⁴Because the distribution of the resulting partnership interests in a partnership merger is made in liquidation of the partner's interest in the merged partnership, the adjusted basis of the distributed resulting partnership interest always would be determined under section 732(b) by reference to the partner's adjusted basis in its merged partnership interest.

³⁵Built-in loss.

of the built-in loss in P5 that would have been allocated to each of A and B if PRS1 had sold P5 immediately prior to the division, and this amount is consistent with the manner in which A and B will economically share in the loss as partners in PRS2.

Consistent with this analysis, A and B each should take an adjusted basis in the PRS2 interests received equal to \$500, as this would correspond to each partner's share of basis inside the partnership. Note, however, that existing authority does not necessarily provide for this result. Specifically, Rev. Rul. 84-53 indicates that, when a portion of a partnership interest is sold—and the partnership has no liabilities—the adjusted basis of the portion of the partnership interest transferred should be determined by reference to the proportionate fair market value of the interest transferred as compared to the fair market value of the total interest held by the transferor.³⁶

Following the approach described in Revenue Ruling 84-53, the adjusted basis of the interest transferred to A would equal \$571 ($\$1,000 \times 400/700$), and the basis of the interest transferred to B would equal \$429 ($\$1,000 \times 300/700$). Note, however, that following this approach would create an inside-outside basis disparity for A and B.

Revenue Ruling 84-53 cites Regulation section 1.61-6(a), which provides for the equitable apportionment of basis when partial interests in an asset are transferred. Absent extenuating circumstances, most authority follows the approach in Rev. Rul. 84-53 and allocates basis between interests in property based on the relative fair market value of the respective property interests. However, the disproportionate sharing in the built-in loss in the partnership asset (which economically should conform to the built-in loss sharing in the partnership interests) would justify a different approach. Under this alternative approach, the partners' shares of the built-in loss should be considered in determining each party's adjusted basis in its partnership interest. In effect, a partner should be able to "trace" its share of section 704(c)(1)(C) basis adjustment in partnership assets to its partnership interest. This approach in determining the adjusted basis of a partnership interest is called the "**Tracking Approach.**" We believe that the inclusion of a rule or example in the final regulations confirming application of the Tracking Approach in this circumstance would be helpful.

With respect to non-pro rata divisions, the analysis is arguably more difficult. In a transaction where a partner's economic share of built-in loss assets is reduced in connection with a partnership division, a shift in a partner's share in the newly-created section 704(c)(1)(C) basis adjustment related to the property may occur. Given the policy promoted by section 704(c)(1)(C) to prevent the shifting of built-in loss tax attributes among partners, a non-pro rata division can create concerns.

The Proposed Regulations provide that the transferee of a partnership interest in a nonrecognition transaction will succeed to the transferor's section

³⁶Rev. Rul. 84-53, 1984-1 C.B. 159.

704(c)(1)(C) basis adjustment “in an amount attributable to the interest transferred and the transferee will be treated as the section 704(c)(1)(C) partner with respect to the transferred interest.”³⁷ This rule tolerates some shifting in the section 704(c)(1)(C) basis adjustment from one party to another. Under this rule, a section 704(c)(1)(C) basis adjustment in partnership property created in a tiered partnership structure in connection with a partnership division would move with the distributed interest in the resulting partnership regardless of whether the distributee-partner is maintaining or increasing its interest in the built-in loss asset.

Under the Proposed Regulations, it appears that the potential shift in the built-in loss in connection with nonrecognition transfers is addressed through the Deemed Section 754 Election Rule.³⁸ Although the Deemed Section 754 Election may provide for a reasonable “rough justice” result in many circumstances, as the following example illustrates, application of the Deemed Section 754 Election Rule in the context of a non-pro rata division can create some fairly inappropriate results.

Example 8: Assume that two partners, C and D, each contribute \$150 to a partnership (PRS3) and will share equally in all profits and losses. PRS3 acquires P7 for \$200 and P8 for \$100. Both assets are section 1231 assets. At a future date, when P7 has fallen in value to \$100 and its tax basis remains at \$200, the partners determine to undertake a non-pro rata division, whereby PRS3 will contribute P7 to a newly-formed partnership (PRS4), the interests in which will be distributed 80% to C and 20% to D. After the distribution, C will have a 20% continuing interest in PRS3 and D will have an 80% continuing interest in PRS3.

Under these facts, PRS4 would receive P7 with an adjusted basis of \$200, \$100 of which would represent a section 704(c)(1)(C) basis adjustment. The 80% PRS4 interest distributed to C would have an adjusted basis of \$160 (that is, 80% x \$200), but, would be limited by C’s outside basis in its PRS3 interest of \$150. C would have a \$0 adjusted basis in its remaining 20% interest in PRS3. D would take a basis in its PRS4 interest equal to \$40 (that is, 20% x \$200) and would have an adjusted basis of \$110 in its remaining 80% interest in PRS3.

Under the Deemed Section 754 Election Rule, the section 704(c)(1)(C) basis adjustment in P7 held by PRS4 would be reduced by \$10, from \$100 to \$90, due to the \$10 difference in C’s basis in its PRS4 interest and its share of the previously tax capital in PRS4.³⁹

³⁷ Prop. Reg. § 1.704-3(f)(3)(iii)(B), 79 Fed. Reg. 3042 (2014).

³⁸ I.R.C. § 754.

³⁹ Presumably, C’s share of previously taxed capital would be calculated as follows: C would receive \$80 if PRS4 liquidated, and this amount would be increased by the \$80 loss that would be allocated to C’s interest in PRS4, for a total previously taxed capital amount of \$160. Note that this calculation assumes that 80% of the section 704(c)(1)(C) basis adjustment would be allocated to C based on its continuing 80% economic share of P7.

Note that the division would have resulted in the following changed circumstances before and after the division. Before the division, C and D each would have a \$50 built-in loss with respect to P7 and with respect to their interests in PRS3. Accordingly, if all assets were sold and PRS3 was to liquidate, C and D each would be allocated a \$50 section 1231 loss and would receive \$100 cash distribution, triggering no further gain or loss.

Following the division, if PRS3 and PRS4 both were to sell their assets and liquidate, the results would be as follows: When PRS3 sells P8, it would recognize \$10 of section 1231 loss (that is, the basis in that asset would have been increased by \$10 under section 734(b) in connection with the distribution of the PRS4 interest to C (the basis of which is reduced from \$160 to \$150 under section 732(b))). This loss would be allocated 20% to C, creating a \$2 deferred loss under section 704(d) and allocated 80% to D (that is, an \$8 loss), taking D's basis from \$110 to \$102.⁴⁰ C would receive \$20 in liquidation of its PRS3 interest, thereby recognizing a capital gain of \$20. D would receive \$80 in liquidation of its PRS3 interest, thereby recognizing a capital loss of \$22.

When PRS4 sells P7, the \$90 section 704(c)(1)(C) basis adjustment would result in the allocation of a \$70 section 1231 loss to C and a \$20 section 1231 loss to D. C would receive a distribution equal to \$80, which, together with the \$70 loss allocation, would reduce its basis in the PRS4 interest to \$0. D would receive a distribution of \$20, which, together with the \$20 loss allocation, would reduce its basis in PRS4 to \$0.

In total, the division would move C from a situation where it is recognizing one \$50 section 1231 loss, to a situation where it is recognizing \$20 of capital gain with respect to its PRS3 interest, and \$70 of section 1231 loss with respect to PRS4 assets.

D similarly would move from a situation where it is recognizing one \$50 section 1231 loss, to a situation where it is recognizing \$8 of section 1231 loss with respect to PRS3 assets, a \$22 capital loss with respect to its PRS3 interest, and a \$20 section 1231 loss with respect to the assets of PRS4.

Obviously, there is a potential character difference that results from the approach taken. Post-division, C recognizes a net \$70 section 1231 loss and \$20 of capital gain, and D recognizes a net \$28 section 1231 loss and \$22 capital loss.

As this example illustrates, the result that follows from application of the Deemed Section 754 Election rule in a non-pro rata assets-over division is somewhat haphazard and creates the potential for abuse. We believe that a better approach in this context would be to follow the general approach taken with respect to distributions of partnership assets with section 704(c)(1)(C) basis adjustments.⁴¹ Under this approach, the section 704(c)(1)(C) basis

⁴⁰This assumes that the benefit of the positive section 734(b) adjustment is shared 20% by C and 80% by D.

⁴¹See Prop. Reg. §§ 1.704-3(f)(3)(v)(B), -3(f)(3)(v)(C), 79 Fed. Reg. 3042 (2014).

adjustment attributable to each partner would be determined in connection with the contribution to the resulting partnership. If, as part of the division, a partner's share of the section 704(c)(1)(C) basis adjustment in resulting partnership assets would shift to another partner, that portion of the basis adjustment would be reallocated to assets of the divided partnership under Regulation section 1.755-1(c).

Note how the results would occur under such an approach as applied to Example 8. Upon the contribution of P7 to PRS4, PRS4 would receive P7 with an adjusted basis of \$200, \$100 of which would represent a section 704(c)(1)(C) basis adjustment. In connection with the contribution to the resulting partnership, \$50 of the section 704(c)(1)(C) basis adjustment would be allocated to each of C and D. The distribution of an 80% interest in PRS4 to C would result in a shift of 60% (that is, 30%/50%) of D's section 704(c)(1)(C) basis adjustment to C, but under the recommended approach, that \$30 section 704(c)(1)(C) basis adjustment—60% multiplied by the \$50 section 704(c)(1)(C) basis adjustment allocable to D—would be reallocated to P8 and isolated for the benefit of D.

Accordingly, P7 would be contributed to PRS4 with an adjusted basis of \$170. C would take a basis in its distributed PRS4 interest equal to \$130—\$80 attributable to basis equal to its economic share of P7 and \$50 attributable to its share of the underlying section 704(c)(1)(C) basis adjustment. D would take a basis in its distributed PRS4 interest equal to \$40—\$20 attributable to basis equal to its economic share of P7 and \$20 equal to its proportionate share of the section 704(c)(1)(C) basis adjustment.⁴²

⁴²As an alternative to moving basis from P7 to assets in which D has a share of loss, we also suggest considering the Tracing Approach for section 704(c) transfer purposes and the Tracking Approach for outside basis determination purposes. Using those approaches could result in inside-outside basis parity for C and D in both PRS3 and PRS4 that also preserves each partner's share of the \$50 loss in P7. Each partner has a \$50 share of the loss in P7 immediately before the division. We believe that the argument in support of the Tracing Approach is that each partner ought to be able to replicate that \$50 loss share in PRS4 (the partnership that ends up with P7) immediately after the division.

Similarly, it makes sense that the division at hand not result in inside-outside basis disparities for the partners. An equitable apportionment of the \$200 of basis that PRS3 has in its PRS4 interest at the moment of the second step of the assets-over division would result in C having a \$130 outside basis in PRS4 after the division is completed. Doing so would leave C with an outside basis in PRS3 of \$20. C would end up with a built-in loss in its PRS4 interest of \$50 (\$130 outside basis over \$80 fair market value) and a \$50 built-in loss in P7 (now held by PRS4). C would have no gain or loss in its PRS3 interest (\$20 O/B over \$20 fair market value), which mirrors the lack of gain or loss in its share of PRS3's asset.

For D, it has a \$20 fair market value in its PRS4 interest, and under the Tracing Approach, a \$50 section 704(c)(1)(C) amount in P7 (now held by PRS4). That suggests that D should take a \$70 outside basis in PRS4 as a result of an equitable apportionment of PRS3's \$200 outside basis in PRS4. That would result in D having an outside basis in PRS4 that is \$50 higher than its \$20 fair market value interest in PRS4. That leaves D with an outside basis of \$80 in PRS3, which matches D's fair market value interest in PRS3. The lack of any gain or loss in D's interest in fair market value mirrors the lack of gain or loss in its share of PRS3's asset.

With respect to PRS3, C would have an adjusted basis in its partnership interest of \$20 and a similar share of inside asset basis. D would have a \$110 basis in its PRS3 partnership interest, and an equivalent share of inside basis in its partnership assets—including its \$30 section 704(c)(1)(C) basis adjustment. C would recognize a \$50 section 1231 loss on disposition of P7 by PRS4 and no gain or loss on the disposition of P8. D would have a \$30 section 1231 loss on the disposition of P8 by PRS3 and a \$20 section 1231 loss on the disposition of P7 by PRS4.

We believe that the recommended approach provides for a preferable result in the context of an assets-over partnership division.⁴³ We note, however, that such an approach is not consistent with the general model that applies for purposes of allocating built-in gain under section 704(c), and it is proper to question whether the rules for gains and losses should be parallel. Specifically, Regulation section 1.704-3(a)(7) generally provides that if a contributing

⁴³We recognize that matters would become more complicated if the divided partnership splits into more than two resulting partnerships. In such circumstances, the proposed regime may not produce entirely rational results if all of the reallocated section 704(c)(1)(C) basis adjustment is designated to assets held by the divided partnership (which, in some circumstances, may hold a very small portion of the pre-division partnership assets). In this scenario, it may make sense to segregate the division into two separate series of transactions. Initially, the divisions which would result in a reduction in the partner's share of section 704(c)(1)(C) assets would be deemed to take place. The excess portion of the section 704(c)(1)(C) basis adjustment then would be reallocated to assets of the divided partnership under the method described above. Immediately thereafter, the divided partnership would again undergo a division, this time distributing interests in the partnerships in which the partner is not reducing its economic share of section 704(c)(1)(C) assets. In this transaction, the relevant section 704(c)(1)(C) basis adjustments would follow the assets transferred in the division.

We note that, in a non-pro rata division involving multiple partnerships, if there are numerous section 704(c)(1)(C) assets created in the various partnerships, and different partners are increasing or decreasing their interests in the different partnerships, the ordering approach proposed in this footnote cannot work since the approach cannot account for multiple partners who are reducing their interests in different section 704(c)(1)(C) assets in different partnerships. We believe that these circumstances would represent a very small subset of partnership divisions that might occur. In these circumstances, it may make sense to account for such situations by imposing the Deemed Section 754 Election Rule approach set forth in the Proposed Regulations where the alternative approach is not workable. If the proposed approach is made elective, as proposed below, it may be appropriate to provide that such an election would not be available in these circumstances.

We note that the scenario posed more generally in this footnote (that is, a division involving section 704(c)(1)(C) property and more than two partnerships) is not that different from the scenario where a partnership distributes, in transactions that do not liquidate any partner's interest, numerous section 704(c)(1)(C) assets to partners other than the section 704(c)(1)(C) partners whose interests trace to the assets distributed to such partners, leaving only a small number of assets in the partnership following the distributions. In that circumstance, the Proposed Regulations would reallocate all of the section 704(c)(1)(C) basis adjustments to the small number of assets that remain in the partnership. This analogy may argue for following the regime described above and simply reallocating all excess section 704(c)(1)(C) basis adjustments to the divided partnership assets. At least inside-outside basis parity could be preserved under this approach.

partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner in the same manner as it would have been allocated to the transferor partner, and if only a portion of the contributing partner's interest is transferred, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner. Given that, in the example above, PRS 3 is the contributing partner, and PRS3 is transferring 80% of its interest to C, if P7 was a built-in gain asset, C would succeed to 80% of the section 704(c) built-in gain associated with P7.

It is noteworthy that Proposed Regulation section 1.704-3(a)(7) does not apply to built-in loss assets. Instead, reference is made to Proposed Regulation section 1.704-3(f) for rules applicable to built-in loss assets. Accordingly, the structure of the Proposed Regulations recognizes that the result for built-in gain and built-in loss assets may be different. Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2)(b) arguably is instructive as well. That section provides that, where pre-existing section 704(c)(1)(C) property is contributed to a lower-tier partnership, and the value of the property has fallen further since the original contribution, the "additional section 704(c)(1)(C) basis adjustment . . . will be allocated among the partners of the upper-tier partnership in a manner that reflects their relative shares of that loss." This regulation appears to "lock in" the newly-created built-in loss associated with the contributed assets to the partners in the upper-tier partnership based on their "relative shares of that loss." It is unclear, however, how broadly this "lock-in" applies for purposes of section 704(c)(1)(C). For example, it would seem to go beyond the authority provided by section 704(c)(1)(C) to permit the elimination of a portion of the newly-created section 704(c)(1)(C) basis adjustment at the lower-tier partnership level if a partner in the upper-tier partner is redeemed.

In a context like a partnership division, however, where the partners continue their interests in the same group of assets, albeit potentially in different proportions, the "lock-in" arguably is supportable as a way to properly allocate the section 704(c)(1)(C) basis adjustment among the distributee-partners. We believe that the proposal above, which evaluates shifts in the section 704(c)(1)(C) basis adjustment by reference to the amount that is "locked in" to the upper-tier partners, can be justified on this basis. While we believe that such a rule generally provides for a more appropriate result, because the result does diverge from the traditional results under section 704(c) and may be complicated to apply in highly complex economic sharing arrangements, it may be appropriate to leave the rules currently applicable under the Proposed Regulations in place and allow use of this alternative regime on an elective basis.

b.2. *Pre-Existing Section 704(c)(1)(C) Basis Adjustment in an Assets-Over Division.* Additional issues can arise in connection with the contribution of property with a pre-existing section 704(c)(1)(C) basis adjustment in an assets-over division that do not arise when there is no pre-existing section 704(c)(1)(C) basis adjustment. If there is no pre-existing section

704(c)(1)(C) basis adjustment with respect to the contributed property, the interest in the resulting partnership will not constitute section 704(c)(1)(C) property—it is only the built-in loss assets that are contributed to the resulting partnership that become section 704(c)(1)(C) property. As a result, no section 704(c)(1)(C) property is distributed in connection with the division, and there is no need to coordinate results under section 704(c)(1)(C) with the results under the anti-mixing bowl rules.

The results are more complicated when one or more pre-existing section 704(c)(1)(C) basis adjustments exist with respect to the contributed assets. Under Proposed Regulation section 1.704-3(f)(3)(iv)(B), when the divided partnership contributes section 704(c)(1)(C) property to a resulting partnership, the portion of the divided partnership's basis in the resulting partnership interest that is attributable to the section 704(c)(1)(C) basis adjustment must be segregated and allocated to the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made. Under the same Proposed Regulation section, the resulting partnership will succeed to the divided partnership's section 704(c)(1)(C) basis adjustment, and that basis adjustment will be allocated to the section 704(c)(1)(C) partner for whom the initial section 704(c)(1)(C) basis adjustment was made.⁴⁴

While the results in connection with the first step in an assets-over division are fairly straightforward, the same cannot be said with respect to the distribution transaction, which is the second and final step in an assets-over division. As with assets-over mergers, the rules must be applied at two levels, given that a section 704(c)(1)(C) basis adjustment will exist with respect to both the resulting partnership interest and the assets of the resulting partnership.

With respect to the section 704(c)(1)(C) basis adjustment related to the resulting partnership assets, the Proposed Regulations address transfers of partnership interests in nonrecognition transactions, which would include the distribution of the resulting partnership interest in an assets-over division. As previously discussed, that rule provides that the transferee will succeed “to

⁴⁴The allocation of the section 704(c)(1)(C) basis adjustment at both levels is consistent with the allocation of the section 704(c) loss layer under the general section 704(c) rules and anti-mixing bowl rules. Specifically, if section 704(c) property is transferred in a nonrecognition transaction, the property received in exchange for the section 704(c) property will be treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. Reg. §§ 1.704-3(a)(8)(i), -4(d)(1); Reg. § 1.737-2(d)(3)(i). Thus, the resulting partnership interest received by the divided partnership should be treated as section 704(c) property with respect to the original section 704(c)(1)(C) partner. In addition, under the section 704(c) tiered partnership regulation, if a partnership (the upper-tier partnership) contributes section 704(c) property to a second partnership (the lower-tier partnership), the upper-tier partnership must allocate its distributive share of the 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. Reg. § 1.704-3(a)(9). As a result, the section 704(c) loss attributable to the property contributed by the divided partnership to the resulting partnership would be allocated to the partner consistent with the section 704(c)(1)(C) basis adjustment.

the transferor's section 704(c)(1)(C) basis adjustment in an amount attributable to the interest transferred and the transferee will be treated as the section 704(c)(1)(C) partner with respect to the transferred interest."⁴⁵

The Proposed Regulations also address distributions of section 704(c)(1)(C) property. In an assets-over division, this would be the resulting partnership interest. These rules are different depending on whether the distribution is (1) a current distribution of section 704(c)(1)(C) property to the section 704(c)(1)(C) partner, (2) a distribution of section 704(c)(1)(C) property to another partner, or (3) a distribution in complete liquidation of a section 704(c)(1)(C) partner's interest.

In the context of a pro rata division where the section 704(c)(1)(C) partner continues as a partner in both the divided and resulting partnerships, Proposed Regulation section 1.704-3(f)(3)(v)(A) clearly would apply. That Proposed Regulation section provides that, if a partnership distributes property to a partner and the partner has a section 704(c)(1)(C) basis adjustment for the property, the section 704(c)(1)(C) basis adjustment will be taken into account under section 732. The question that arises is whether Proposed Regulation section 1.704-3(f)(3)(v)(B) also should apply. That Proposed Regulation section provides that, if a partner receives a distribution of property in which another partner has a section 704(c)(1)(C) basis adjustment, the distributee will not take that basis adjustment into account under section 732. That Proposed Regulation section also provides that, if section 704(c)(1)(B) applies to the distribution, the section 704(c)(1)(C) basis adjustment will be taken into account in determining the amount of the loss. If section 704(c)(1)(B) does not apply, the section 704(c)(1)(C) basis adjustment will be reallocated among the remaining items of partnership property under Regulation section 1.755-1(c).

In the context of a pro rata division, it is unclear whether a portion of the resulting partnership interest to which the section 704(c)(1)(C) basis adjustment attaches is being distributed to other partners. In the context of such a transaction, it is important to recognize the potential interaction of section 704(c)(1)(C) and sections 704(c)(1)(B) and 737. If the entire section 704(c)(1)(C) basis adjustment attaches to the resulting partnership interest distributed to the section 704(c)(1)(C) partner, it would necessarily follow that the resulting partnership interest distributed to the section 704(c)(1)(C) partner also would be treated as successor property to the section 704(c) property previously contributed by the section 704(c)(1)(C) partner.⁴⁶ As a result, the section 704(c)(1)(C) partner would be treated as receiving a distribution of previously contributed property, and neither sections 704(c)(1)(B) nor 737 would be triggered in connection with the distribution.

⁴⁵ Prop. Reg. § 1.704-3(f)(3)(iii)(B)(1), 79 Fed. Reg. 3042 (2014).

⁴⁶ Reg. § 1.704-4(d)(1); Reg. § 1.737-2(d)(3).

One commentator has summarized the options regarding basis allocations and section 704(c) determinations in an assets-over partnership division as follows:

There are at least two approaches that can be taken to apportion basis and Code Sec. 704(c) gain [in an assets-over division]. Under one approach, the divided partnership could allocate basis and Code Sec. 704(c) gain or loss in proportion to the fair market values of the distributed interests (the “Pro Rata Approach”). Under a second approach, the divided partnership could allocate its basis and Code Sec. 704(c) gain in a manner that preserves, to the maximum extent possible, the distributee partners’ pre-division shares of the transferor partnership’s adjusted basis and Code Sec. 704(c) gain in the properties contributed to the transferee partnership (“Tracing Approach”).⁴⁷

This commentator and other commentators make a strong case for use of the Tracing Approach.⁴⁸ Note also that the Tracing Approach is consistent with the approach proposed earlier with respect to the general determination for allocating the adjusted basis of resulting partnership interests that are distributed in connection with a partnership division involving newly-created section 704(c)(1)(C) property.

Prior indications from Treasury and the Service, however, appear to favor a Pro Rata Approach, at least in the context of a division that could implicate the anti-mixing bowl rules. Specifically, the preamble to the proposed regulations relating to partnership mergers and divisions states as follows:

In many instances, the application of Sections 704(c)(1)(B) and 737 will be appropriate when a partnership divides under either the Assets-Over Form or the Assets-Up Form. Consider the following example: A, B, C, and D form a partnership. A contributes appreciated property X (\$0 basis and \$200 value), B contributes property Y (\$200 basis and \$200 value), and C and D each contribute \$200 cash. The partnership subsequently divides into two partnerships using the Assets-Over Form, distributing interests in the recipient partnership in accordance with each partner’s pro rata interest in the prior partnership. Property X remains in the prior partnership, and property Y is contributed to the recipient partnership. Under these facts, section 737 could be avoided if an exception were created for the distribution of the recipient partnership interests. If, subsequent to the division, half of property Y is distributed to A, section 737 would not be triggered

⁴⁷ Matthew Lay, *Allocation of Basis and Code Section 704(c) Gain in Partnership Divisions*, 12 J. PASSTHROUGH ENTITIES 5, 6 (2009).

⁴⁸ See generally Elizabeth Amoni & John G. Schmalz, *Section 704(c): The Disparity Offset Method Provides Answers to Difficult Questions*, 114 J. TAX’N 223 (2011); John G. Schmalz & Elizabeth Amoni, *Applying the Disparity Offset Method to Achieve Tax-Follows-Economics Results*, 115 J. TAX’N 133 (2011). As illustrated below in the layering versus netting discussion, the Disparity Offset Method, described in detail below and in the articles cited above, sets forth a simple mathematical formula for accomplishing this tracking of basis.

because property X (the section 704(c) property) is no longer in the same partnership as property Y.⁴⁹

We understand the concerns of Treasury and the Service relating to the ability to avoid section 737 by isolating the assets with section 704(c) gain from other assets that might be distributed. We question, however, whether this concern justifies the disruption that application of the Pro Rata Approach would create with respect to the adjusted basis calculations and inside-outside basis parity that should be present following a partnership division. That is, as illustrated above, a Tracking Approach is required to preserve inside-outside basis parity in the context of a pro rata assets-over division where no pre-existing section 704(c)(1)(C) basis adjustment is present but one is created in connection with the contribution to the resulting partnership. If a Tracing Approach is to be adopted for those purposes, it would be inconsistent—or at least unduly complicated—to then use a Pro Rata Approach to evaluate the pre-existing section 704(c)(1)(C) layer.⁵⁰

The foundations of the Tracing Approach described above are based on the directive in Regulation section 1.61-6(a) that the basis of assets should be “equitably apportioned” in situations where divided interests are transferred, and the statement in Regulation section 1.704-3(a)(7) that, in situations where a section 704(c) partner transfers less than its entire interest, the share of section 704(c) gain “proportionate to” the interest transferred must be allocated to the transferee partner. These rules, however, obviously indicate some flexibility and can support application of the Tracing Approach in appropriate circumstances.

Under an ideal regime, the Tracing Approach would preserve section 704(c) layers so long as a partner does not alter its proportionate share of an asset as a result of an assets-over partnership division. Accordingly, if the divided partnership contributes property with a section 704(c)(1)(C) basis adjustment to a resulting partnership in exchange for resulting partnership interests and then distributes those interests pro rata to its partners, the section 704(c)(1)(C) basis adjustment in the partnership interest and underlying assets would continue to trace to the section 704(c)(1)(C) partner. Section 704(c)(1)(C) and the anti-mixing bowl rules would continue to apply in the resulting partnership in the same manner as previously was the case in the divided partnership. However, subsequent transactions with respect to the

⁴⁹Prop. Reg. § 111119-99, 65 Fed. Reg. 1572 (2000). In addressing whether an exception for partnership divisions should be created under the anti-mixing bowl rules, the preamble to the final regulations merely stated: “Most commentators agreed that it would not be wise to expand the current exceptions.” T.D. 8925, 2001-1 C.B. 496.

⁵⁰While inside-outside basis parity could be preserved using a Pro Rata Approach with respect to a pre-existing section 704(c)(1)(C) basis adjustment where loss is recognized under section 704(c)(1)(B), the same problems relating to the preservation of inside-outside basis parity would arise if the seven-year period had lapsed so that section 704(c)(1)(B) was no longer applicable.

divided partnership would not be considered in applying these rules in the resulting partnership going forward.⁵¹

Consistent with the Tracing Approach for divisions involving new section 704(c)(1)(C) basis adjustments, a shift in the economic entitlements with respect to an asset that has a section 704(c)(1)(C) basis adjustment would have ramifications. If the anti-mixing bowl rules were applicable (because the original contribution had been made within the prior seven years), a proportionate part of the section 704(c)(1)(C) built-in loss would be recognized and determined by reference to the proportionate reduction in the section 704(c)(1)(C) partner's economic share of the section 704(c)(1)(C) asset. If the anti-mixing bowl rules were no longer relevant, the portion of the pre-existing section 704(c)(1)(C) basis adjustment that would have been deemed to shift to other partners instead would be reallocated to assets of the divided partnership under Regulation section 1.755-1(c) and would be isolated for the benefit of the section 704(c)(1)(C) partner.

If the Tracing Approach is rejected, there are ambiguities in the context of applying the Pro Rata Approach under the Proposed Regulations that should be clarified. Under the Pro Rata Approach, the partnership interest received by the section 704(c)(1)(C) partner in a pro rata division would carry with it a proportionate part of the section 704(c)(1)(C) basis adjustment based upon the relative fair market value of the interest transferred to the section 704(c)(1)(C) partner as compared to the value of the interests transferred to all partners. If the section 704(c)(1)(C) property was contributed within the last seven years, the section 704(c)(1)(C) basis adjustment attributable to the portion of the interest distributed to the other partners would have to be taken into account in determining the amount of loss recognized under section 704(c)(1)(B) by the section 704(c)(1)(C) partner.⁵²

With regard to the section 704(c)(1)(C) basis adjustment in the hands of the resulting partnership, the results are somewhat confusing. There would be two rules that might apply to coordinate the inside and outside basis relating to the section 704(c)(1)(C) basis adjustment. One rule is the Deemed Section 754 Election Rule that was previously discussed. Alternatively, Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2) might apply. This Proposed Regulation section is part of a segment of the Proposed Regulations addressing the contribution of a section 704(c)(1)(C) property to another partnership and the creation of multiple levels of section 704(c)(1)(C) basis adjustments. The Proposed Regulation section provides that, “[t]o the extent that any section 704(c)(1)(C) basis adjustment in a tiered partnership is recovered under paragraphs (f)(3)(ii)(C) or (D) of this section, or is otherwise

⁵¹If the Tracing Approach is adopted, it may be appropriate to include an anti-abuse rule indicating that, if the division is undertaken with a purpose to avoid the application of section 737 with respect to assets of the divided partnership, gain may be recognized under section 737 in accordance with the Pro Rata Approach.

⁵²Prop. Reg. § 1.704-3(f)(3)(v)(B), 79 Fed. Reg. 3042 (2014).

reduced, upper- or lower-tier partnerships in the tiered structure must make conforming reductions to related section 704(c)(1)(C) basis adjustments to prevent duplication of loss.”⁵³

If the section 704(c)(1)(C) basis adjustment in the resulting partnership interest is taken into account in determining a section 704(c)(1)(C) partner's loss under section 704(c)(1)(B), the loss would be recovered under Proposed Regulation section 1.704-3(f)(3)(ii)(C) as a loss on the sale or exchange of that asset. In this situation, it seems that the recovery of the section 704(c)(1)(C) basis adjustment with respect to the resulting partnership interest would require a “conforming reduction” with respect to the corresponding section 704(c)(1)(C) basis adjustment in the resulting partnership assets.

If section 704(c)(1)(B) does not apply, the portion of the section 704(c)(1)(C) basis adjustment attributable to the resulting partnership interest distributed to other partners would not be taken into account by such partners under section 732, and that basis adjustment instead would be reallocated among the remaining items of the divided partnership property under Regulation section 1.755-1(c).⁵⁴ Under Proposed Regulation section 1.704-3(f)(3)(iv)(B)(2), the shift in the section 704(c)(1)(C) basis adjustment from the resulting partnership interest to remaining assets of the divided partnership should be treated as a circumstance when “the section 704(c)(1)(C) basis adjustment in a tiered partnership . . . is otherwise reduced . . .”⁵⁵ Thus, to the extent that the section 704(c)(1)(C) basis adjustment in the resulting partnership interest is reallocated, the “conforming adjustment” rule would similarly eliminate the section 704(c)(1)(C) basis adjustment in the assets of the resulting partnership.

While the “conforming reduction” concept would prevent the improper utilization of the section 704(c)(1)(C) basis adjustment and preserve inside-outside basis parity related to the pre-existing section 704(c)(1)(C) basis adjustment, the overlap with the Deemed Section 754 Election Rule still must be considered. The Deemed Section 754 Election Rule also could operate in a transaction where a “conforming reduction” is made. In this situation, we recommend that the “conforming adjustment” be made first, and that the Deemed Section 754 Election rule should be applied after application of the “conforming reduction.”⁵⁶ We believe that a rule or example confirming this result and illustrating the application of the “conforming reduction” rule in the context of a partnership division would be helpful.

b.3. *Pre-Existing Section 704(c)(1)(C) Assets with Additional Section 704(c)(1)(C) Built-in Loss.* As with partnership mergers, the proposal discussed above applying the Tracing Approach and related concepts

⁵³Prop. Reg. § 1.704-3(f)(3)(iv)(B)(2)(a), 79 Fed. Reg. 3042 (2014).

⁵⁴Prop. Reg. § 1.704-3(f)(3)(v)(B), 79 Fed. Reg. 3042 (2014).

⁵⁵Prop. Reg. § 1.704-3(f)(3)(v)(B)(2), 79 Fed. Reg. 3049 (2014).

⁵⁶Note that the application of the two rules could be particularly confusing if the Tracing Approach is not adopted for purposes of analyzing newly-created section 704(c)(1)(C) layers.

for partnership divisions in the context of new and pre-existing section 704(c)(1)(C) assets could operate properly in tandem. So long as the section 704(c)(1)(C) partner's economic share of the pre-existing section 704(c)(1)(C) asset does not change in connection with the division, the pre-existing section 704(c)(1)(C) basis adjustment would simply carryover to the resulting partnership and be allocated to the section 704(c)(1)(C) partner in the same manner as was the case with respect to the divided partnership. If the section 704(c)(1)(C) partner's economic share of the section 704(c)(1)(C) asset is reduced, section 704(c)(1)(B) would be triggered by reference to the reduction—if still within the seven-year period—or the shifted basis would be reallocated to the divided partnership assets. Then, for purposes of analyzing the newly-created section 704(c)(1)(C) basis adjustment in the resulting partnership assets, the pre-existing section 704(c)(1)(C) basis adjustment would not be treated as basis of the partnership.⁵⁷ Excluding such basis, the transaction would be analyzed like any assets-over division transaction, and a new section 704(c)(1)(C) basis adjustment would be created and allocated as described above.

b.4. *Identical Ownership or De Minimis Change in Ownership.*

As with partnership mergers, where the indirect ownership of the relevant assets remain essentially the same after a partnership division, the loss shifting concerns that justify the application of section 704(c)(1)(C) would not seem to be present. Treasury and the Service previously have implied that a new section 704(c) layer should not be created for purposes of applying the anti-mixing bowl rules as a result of a pro rata partnership division.⁵⁸ For the same reasons that this result is proper under the anti-mixing bowl rules, we believe that an exception regarding the application of section 704(c)(1)(C) to partnership divisions where the partners' proportionate interests in the divided and resulting partnerships are identical or vary by a *de minimis* amount would be justified.

7. *Coordination of Section 732(f) and Section 704(c)(1)(C)*

a. *Section 704(c)(1)(C) Basis Adjustment Should Not Be Taken Into Account by a Noncontributing Partner for Purposes of Section 732(f).* Under the Proposed Regulations, if a partner receives a distribution of property in which another partner has a section 704(c)(1)(C) basis adjustment, the

⁵⁷Prop. Reg. § 1.704-3(f)(3)(iv)(B)(1), 79 Fed Reg. 3042 (2014).

⁵⁸T.D. 8925, 2001-1 C.B. 496, 499 (preamble) (“To the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the Service and Treasury agree that a partnership division should not create new section 704(c) property or section 737 net pre-contribution gain.”); Notice 2009-70, 2009-34 I.R.B. 255 (“Assuming a partnership division should not create new section 704(c) property (or section 737 net pre-contribution gain) when each partner's overall interest in each partnership property does not change, how should section 704(c) layers be created and maintained when a division is not *pro rata* or other changes in partners or property interests occur at the time of the division?”).

distributee-partner does not take the section 704(c)(1)(C) basis adjustment into account under section 732. Treasury and the Service requested comments on whether a section 704(c)(1)(C) adjustment to distributed stock should be taken into account by a noncontributing partner for purposes of section 732(f), notwithstanding the general rule that section 704(c)(1)(C) adjustments are not taken into account by a noncontributing partner under section 732.

We agree with the Proposed Regulations that the noncontributing partner should not take section 704(c)(1)(C) basis adjustments into account under section 732. If a noncontributing partner took section 704(c)(1)(C) basis adjustments into account in applying section 732(f), losses might be inappropriately eliminated and additional gain might be inappropriately created.

b. *Section 732(f) Background.* Prior to the enactment of section 732(f), a corporate partner could eliminate its built-in gain in its partnership interest by receiving a distribution from a partnership in which it was a partner of stock in a corporation that the distributee-partner controlled immediately after the distribution. That is, prior to the enactment of section 732(f), a partnership could distribute stock to a corporate partner, and although the gain in the distributee-partner's partnership interest would be reflected in the distributed corporate stock, no comparable reduction was required to be made to the basis of the corporation's assets. Thus, the effect of reducing the stock basis in the hands of the distributee-partner could be negated by a subsequent liquidation of the corporation under section 332. Similarly, if the corporate partner and the distributed corporation were to file a consolidated return, their taxable income could be computed without reference to the downward adjustment to the basis of the stock. Congress, therefore, enacted section 732(f), which requires a basis reduction to the property of the distributed corporation where the distributee-corporate partner controls—within the meaning of section 1504(a)(2)—the distributed corporation immediately after such distribution.

c. *Losses.* Generally speaking, there are two ways for a loss to exist in corporate stock. First, the loss could occur as a result of an economic decline in the corporation's assets. Second, the loss could occur because a loss asset was contributed to the corporation. We will consider both situations.

c.1. *Losses Created by Economic Decline in Corporate Asset.* Where a loss is created by an economic decline in the assets, it is appropriate, consistent with general corporate tax theory, that a corporation's gains and

losses are subject to two levels of taxation.⁵⁹ As illustrated by the examples *infra*, taking into account the section 704(c)(1)(C) basis adjustment in applying section 732(f) can inappropriately eliminate the loss in the distributed corporation's hands.

c.1.1. *Section 704(c)(1)(B) Applies.* As illustrated below, where section 704(c)(1)(B) applies, presumably there is no section 704(c)(1)(C) basis adjustment to take into account for purposes of section 732(f).

Example 9: X forms Y, a corporation, by contributing nondepreciable property with a fair market value and an adjusted tax basis of \$150 in exchange for 100% of the Y stock. X and Y are not members of the same consolidated group. The fair market value of Y's assets and, thus, the Y stock, subsequently decreases to \$100. Accordingly, X owns 100% of the Y stock with a built-in loss of \$50 and Y owns nondepreciable property with a built-in loss of \$50. X contributes its Y stock to PRS, a newly formed partnership, and Z contributes land with a fair market value of \$100 and a tax basis of \$100. Sometime later, but within seven years, PRS distributes all of the Y stock to Z in a current distribution. At the time of the distribution, PRS owns Y stock with a fair market value of \$100 and adjusted basis of \$150—taking into account X's \$50 section 704(c)(1)(C) adjustment—and land with a fair market value of \$150 and a tax basis of \$100. Under section 704(c)(1)(B), X recognizes the pre-contribution built-in-loss of \$50 with respect to the Y stock, and the basis in the Y stock is \$100 in PRS' hands immediately before its distribution to Z.⁶⁰ Because PRS has \$100 of basis in the Y stock immediately prior to the distribution, and Z has \$100 of basis in the Y stock immediately after the distribution under section 732(a), section 732(f) does not apply to the distribution. Consequently, Y's basis in its assets remains unchanged after the distribution, and Y's built-in-loss of \$50 in its assets is preserved.

Under the Proposed Regulations, if a partner receives a distribution of property in which another partner has a section 704(c)(1)(C) adjustment, the distributee-partner does not take the section 704(c)(1)(C) adjustment into account under section 732. Consequently, with respect to Z, PRS has \$100 of basis in its Y stock immediately prior to the distribution and Z receives the Y stock with \$100 basis under section 732(a) immediately after the distribution. Section 732(f) does not apply to the distribution of Y stock and Y's

⁵⁹We note that, in the case of a consolidated group, the unified loss rules in Regulation section 1.1502-36 may apply to prevent the inappropriate duplication of losses. The unified loss rules are complicated, and we do not believe that the rules relating to sections 704(c)(1)(C) or 732(f) should be further complicated to address potential avoidance of the unified loss rules. If the Treasury and the Service believe that avoidance of the unified loss rules is of significant enough concern, we believe Treasury and the Service should consider an anti-abuse rule which would provide that, if a member of a consolidated group contributes to a partnership loss stock of another member of the consolidated group with a principal purpose of avoiding the unified loss rules, the Commissioner may make adjustments to the basis of the distributed corporation's assets to carry out the purposes of the unified loss rules.

⁶⁰L.R.C. § 704(c)(1)(B)(iii).

built-in-loss of \$50 in its assets is preserved immediately after the distribution. With respect to X, its section 704(c)(1)(C) basis adjustment of \$50 with respect to Y stock is taken into account in determining X's loss under section 704(c)(1)(B).

c.1.2. *Section 704(c)(1)(B) Does Not Apply.* As illustrated in Example 9, where section 704(c)(1)(B) applies, there is no section 704(c)(1)(C) basis adjustment to be taken into account under section 732(f), and the loss is appropriately preserved in Y's assets. As illustrated in the following example, taking into account the section 704(c)(1)(C) basis adjustment in applying section 732(f) to a partner other than the section 704(c)(1)(C) partner could result in the inappropriate elimination of a built-in loss.

Example 10: Assume the same facts as in Example 9 except that PRS distributes Y stock to Z more than seven years after it was contributed to PRS by X. With respect to Z, and taking into account X's \$50 section 704(c)(1)(C) basis adjustment, PRS has \$150 of basis in the Y stock immediately before the distribution. Because Z's basis in PRS is \$100 immediately before the distribution, Z receives the Y stock with \$100 of basis under section 732(a). Consequently, because the basis in the Y stock is reduced from \$150 to \$100 in the hands of Z immediately after the distribution, Y is required to reduce its basis in its assets by \$50 to \$100 under section 732(f). Thus, Y's built-in-loss of \$50 in its assets is eliminated, which is inappropriate.⁶¹ We note that the Proposed Regulations, for purposes of applying section 732(f), would reach an appropriate result because the section 704(c)(1)(C) basis adjustment would not be taken into account in determining the application of section 732(f) to Z, and thus, Y's \$50 loss in its assets would be preserved.

c.2. *Losses Created by Contribution of Built-in Loss Asset to a Corporation.* In contrast to the above, a loss in contributed corporate stock may exist because a shareholder previously contributed loss property to the corporation. Section 362(e) was also enacted as part of the AJCA in order to avoid the duplication of losses in the corporate context. Since the enactment of section 362(e), if a shareholder has a built-in loss in stock as a result of a contribution, the corporation will not also reflect the loss in its assets.⁶² As illustrated by Example 11, if a section 704(c)(1)(C) basis adjustment is taken into account in applying section 732(f) to a noncontributing partner, section 732(f) might inappropriately create gain in the distributed corporation's assets.

Example 11: Same facts as in Example 10, except X contributed an asset with a fair market of \$100 and an adjusted basis of \$150 to Y. Because the built-in loss assets were acquired in connection with a section 351 transaction,

⁶¹With respect to X, its section 704(c)(1)(C) adjustment of \$50 with respect to the Y stock is preserved because the section 704(c)(1)(C) adjustment of \$50 is reallocated to other assets of PRS under the Proposed Regulations. Prop. Reg. § 1.704-3(f)(3)(v)(B), 79 Fed. Reg. 3042 (2014).

⁶²We note that section 362(e) does not apply in the consolidated group. Reg. § 1.1502-80(h). We believe any potential abuses, however, can be addressed by an anti-abuse rule.

section 362(e) will apply pursuant to 362(a)(1).⁶³ Assume no election under section 362(e)(2)(C) is made. Thus, under section 362(e), Y's basis in the assets acquired in the section 351 transaction will be equal to the assets' fair market value immediately after the contribution transaction, preventing the duplication of losses by keeping the built-in loss only in X's basis in the Y stock. As in Example 10, with respect to Z, and taking into account X's \$50 section 704(c)(1)(C) basis adjustment, PRS has \$150 of basis in the Y stock immediately before the distribution. Because Z's basis in PRS is \$100 immediately before the distribution, Z receives the Y stock with \$100 of basis under section 732(a). Consequently, because the basis in the Y stock is reduced from \$150 to \$100 in the hands of Z immediately after the distribution, Y is required to reduce its basis in its assets by \$50 under section 732(f). Because section 362(e) applied to X's contribution to Y, Y has a \$100 basis in its assets prior to the application of section 732(f). Thus, after the application of section 732(f), Y has a \$50 basis in its assets, resulting in an embedded gain of \$50 in Y's assets, even though Z has a fair market value basis in the Y stock. This inappropriately creates a gain in Y's assets. We note that the Proposed Regulations would reach an appropriate result because the section 704(c)(1)(C) basis adjustment would not be taken into account in determining the application of section 732(f) to Z, and thus, Y's fair market value basis in its assets would be preserved.⁶⁴

As illustrated in the examples above, by requiring a noncontributing partner to take a section 704(c)(1)(C) adjustment into account for purposes of section 732(f), built-in losses could be inappropriately eliminated and built-in gain inappropriately created. We, therefore, recommend that Treasury and the Service retain the rule set forth in Proposed Regulation section 1.704-3(f)(3)(v)(B), that a section 704(c)(1)(C) basis adjustment is not taken

⁶³Section 362(e)(1) provides that the basis of property transferred in a tax-free reorganization is limited to the property's fair market value if the transaction otherwise would result in an "importation of a net built-in loss." An "importation of a net built-in loss" occurs if the transferee's aggregate adjusted bases of certain assets transferred in the transaction would exceed the fair market value of such assets immediately after the transaction. I.R.C. § 362(e)(1)(C).

⁶⁴In making our recommendation, we considered whether the Proposed Regulations would reach an inappropriate result if Z had a gain in its PRS interest at the time of the distribution. For example, assume in Example 11 that Z had an \$80 basis in its PRS interest. If the section 704(c)(1)(C) basis adjustment is not taken into account for purposes of section 732(f), there would be a \$20 reduction required to Y's basis in its assets. This would result in Y having a \$130 basis in its assets. If, however, the section 704(c)(1)(C) basis adjustment is taken into account for purposes of section 732(f), there would be a \$70 reduction required to Y's basis in its assets. This would result in Y having an \$80 basis in its assets. Although the latter may initially seem more appropriate, we believe this inappropriately eliminates basis in the system. Further, we note that if X had made an election under section 362(e)(2)(C) to reduce its basis in the Y stock and for Y to maintain a \$150 basis in its assets, there would be no section 704(c)(1)(C) basis adjustment at the time of X's contribution to PRS. Thus, upon a distribution of the Y stock to Z, there would be a \$20 reduction required to Y's assets. This would result in Y having a basis of \$130 in its assets.

into account in applying Section 732(f) upon a distribution of stock to a partner other than a contributing partner.

8. Provide for Reallocation of Sections 743(b) and 704(c)(1)(C) Basis Adjustments to Properties of Like Character to That of the Distributed Property With Respect to Which the Adjustments Arose Under the Principles of Regulation Section 1.755-1(b)(5)(iii) Rather Than Under Regulation Section 1.755-1(c)

Under Proposed Regulation section 1.704-3(f)(v)(B), upon the distribution of section 704(c)(1)(C) property to a partner other than the section 704(c)(1)(C) partner, the section 704(c)(1)(C) partner reallocates its section 704(c)(1)(C) basis adjustment relating to the distributed property among the remaining items of partnership property under Regulation section 1.755-1(c), which is similar to the rule in Regulation section 1.743-1(g)(2)(ii) related to reallocating section 743(b) adjustments.⁶⁵ Treasury and the Service requested comments on whether the reallocations of section 704(c)(1)(C) basis adjustments and section 743(b) basis adjustments should instead be made under the principles of Regulation section 1.755-1(b)(5)(iii) for purposes of taking into account the partner's allocable share of income, gain, or loss from each partnership asset.⁶⁶

Conceptually, a built-in loss under section 704(c)(1)(C) is similar to a section 743(b) adjustment, in that it reflects an adjustment to the basis of partnership property that is solely of relevance to a transferee-partner. Similar to basis adjustments under section 743(b), a section 704(c)(1)(C) basis adjustment is unique to the section 704(c)(1)(C) partner and does not affect the basis of partnership property or the partnership's computation of any item under section 703. Consequently, we believe it is reasonable to reallocate both section 704(c)(1)(C) and section 743(b) basis adjustments under the principles of Regulation section 1.755-1(b)(5)(iii), taking into account the partner's allocable share of income, gain, or loss from each partnership asset, but only to properties of like character to that of the distributed property with respect to which the adjustments arose. Therefore, we recommend that Treasury and the Service amend existing Regulation section 1.743-1(g)(2)(ii), as well as revise the Proposed Regulations, to allow taxpayers to reallocate sections 704(c)(1)(C) and 743(b) basis adjustments to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustments arose under the principles of Regulation section 1.755-1(b)(5)(iii).

⁶⁵Regulation section 1.755-1(c) provides rules for basis allocations where the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose.

⁶⁶Regulation section 1.755-1(b)(5)(iii) provides rules that allocate the basis adjustment to partnership property with regard to the allocable share of income, gain, or loss in each partnership asset of the partner with respect to whom the basis adjustment is made.

B. *Interaction of Sections 751(b) and 704(c)(1)(C)*

1. *Generally*

The Proposed Regulations consider the effects on the analysis under section 704(c)(1)(C) of a distribution of section 704(c)(1)(C) property by a partnership to one or more of its partners.⁶⁷

a. *Current Distribution of Section 704(c)(1)(C) Property to a Section 704(c)(1)(C) Partner.* The adjusted basis under section 732 (other than section 732(d)) of section 704(c)(1)(C) property distributed to the section 704(c)(1)(C) partner in a current distribution is computed with regard to the section 704(c)(1)(C) property's section 704(c)(1)(C) basis adjustment.⁶⁸ The section 704(c)(1)(C) basis adjustment is also taken into account in determining the amount of any basis adjustment that may be determined under section 734(b) with respect to such a distribution.⁶⁹ However, the section 704(c)(1)(C) basis adjustment is not taken into account in apportioning a basis adjustment determined under section 734(b) among the assets of the distributing partnership in a current distribution to the section 704(c)(1)(C) partner.⁷⁰ The operation of these provisions is illustrated in an example.⁷¹

b. *Liquidating Distribution of Section 704(c)(1)(C) Property to a Section 704(c)(1)(C) Partner.* The basis determination rules of section 732 (other than section 732(d)) generally take into account the entire section 704(c)(1)(C) basis adjustment attributable to a completely withdrawing section 704(c)(1)(C) partner under the Proposed Regulations.⁷² The section 704(c)(1)(C) basis adjustment embedded in any property distributed by the partnership to the completely withdrawing section 704(c)(1)(C) partner is treated as included in the basis of the distributed section 704(c)(1)(C) property immediately before the distribution.⁷³ If the distributed property is not the section 704(c)(1)(C) property, but is of like character to such property, the partnership reallocates any section 704(c)(1)(C) basis adjustment from section 704(c)(1)(C) property retained by the partnership to the distributed property. In contrast, if the section 704(c)(1)(C) property is retained by the partnership and no property of like character is distributed, the section 704(c)(1)(C) property's section 704(c)(1)(C) basis adjustment is not reallocated.⁷⁴

⁶⁷ Considerations raised in the Proposed Regulations of issues under sections 704(c)(1)(B) and 737 are disregarded in the discussion that follows.

⁶⁸ Prop. Reg. § 1.704-3(f)(3)(v)(A), 79 Fed. Reg. 3042 (2014); Prop. Reg. § 1.732-2(c), 79 Fed. Reg. 3042 (2014).

⁶⁹ Prop. Reg. § 1.734-2(c)(1), 79 Fed. Reg. 3042 (2014).

⁷⁰ *Id.*

⁷¹ Prop. Reg. § 1.704-3(f)(3)(v)(D), 79 Fed. Reg. 3060, Ex. (1) (2014).

⁷² But see the exception to this general rule discussed in this Article in the second paragraph below.

⁷³ Prop. Reg. § 1.732-2(c), 79 Fed. Reg. 3042 (2014); Prop. Reg. § 1.704-3(f)(3)(v)(A), 79 Fed. Reg. 3042 (2014).

⁷⁴ Prop. Reg. § 1.734-2(c)(2), 79 Fed. Reg. 3042 (2014).

Any section 704(c)(1)(C) basis adjustment treated as basis in the distributed property under section 732 is taken into account in determining the amount of any basis adjustment that results to the distributing partnership's remaining property under section 734(b) from the liquidating distribution.⁷⁵ This rule applies regardless of whether the property distributed was, or was not, section 704(c)(1)(C) property with respect to the withdrawing section 704(c)(1)(C) partner.⁷⁶

As noted above, the distributing partnership may not include in the basis of property it distributes to the completely withdrawing section 704(c)(1)(C) partner any amount attributable to the withdrawing section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment if there is no property distributed to the completely withdrawing section 704(c)(1)(C) partner that is of a like character to the section 704(c)(1)(C) property in which the section 704(c)(1)(C) basis adjustment is embedded.⁷⁷ Instead, this "orphaned" section 704(c)(1)(C) basis adjustment is treated as a positive section 734(b) basis adjustment of the distributing partnership.⁷⁸ The Proposed Regulations provide a special rule under which the amount of any such positive section 734(b) basis adjustment is netted against any negative section 734(b) basis adjustment that arises with respect to the same distribution to the section 704(c)(1)(C) partner that gave rise to the "orphaned" section 704(c)(1)(C) basis adjustment.⁷⁹ A distributing partnership that does not have in effect an election under section 754 with respect to a liquidating distribution described in this paragraph is deemed to have one for purposes of making any negative section 734(b) basis adjustment that would arise in connection with the distribution.⁸⁰

c. *Current or Liquidating Distribution of Section 704(c)(1)(C) Property to a Non-Section 704(c)(1)(C) Partner.* A non-section 704(c)(1)(C) partner may receive a distribution of section 704(c)(1)(C) property in which is embedded a section 704(c)(1)(C) basis adjustment attributable to another partner. The distributee partner in this situation is not permitted by the Proposed Regulations to take the section 704(c)(1)(C) basis adjustment into account under section 732 in determining its adjusted basis in the distributed section 704(c)(1)(C) property.⁸¹ Instead, the distributing partnership reallocates the section 704(c)(1)(C) basis adjustment in the distributed property among its remaining properties under Regulation section 1.755-1(c).⁸²

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ Prop. Reg. § 1.704-3(f)(3)(v)(C), 79 Fed. Reg. 3042 (2014).

⁷⁸ Prop. Reg. § 1.734-2(c)(2), 79 Fed. Reg. 3042 (2014). An application of this rule is illustrated at Proposed Regulation section 1.734-2(c)(3) Exs. (3)-(4). Fed. Reg. 3062 (2014).

⁷⁹ Prop. Reg. § 1.734-2(c)(2), 79 Fed. Reg. 3042 (2014). An application of this rule is illustrated at Proposed Regulation section 1.734-2(c)(3) Exs. (3)-(4). Fed. Reg. 3062 (2014).

⁸⁰ Prop. Reg. § 1.734-2(c)(2), 79 Fed. Reg. 3042 (2014).

⁸¹ Prop. Reg. § 1.704-3(f)(3)(v)(B), 79 Fed. Reg. 3042 (2014).

⁸² *Id.*

These rules apply regardless of whether the distribution to the non-section 704(c)(1)(C) partner is a current distribution or a liquidating distribution.

2. Section 751(b)

Generally, section 751(b) provides a hypothetical transactional construct to determine the tax consequences to a partner that receives a distribution of more than its share of one class or the other of the distributing partnership's assets. The two classes of assets to which section 751(b) applies are the ordinary income asset class and the capital gain asset class. The ordinary income class of assets is generally composed of property described in section 751(d) that is "substantially appreciated" and section 751(c). Such property is referred to below as the class of "hot" assets. The capital gain asset class is generally composed of anything that is not a hot asset. It is referred to below as the class of "cold" assets, and includes such items as capital assets, assets described in section 1231(b), and money.

a. *Section 751(b) Under the Current Final Regulations.* Final regulations issued under section 751(b) in 1956 generally impose a three-step transactional construct for U.S. federal income tax purposes when a distributee partner receives a distribution from the partnership that changes the distributee's shares of the distributing partnership's hot and cold assets.⁸³ In the "**First Step**," the partnership is treated as if it had distributed to the partner an amount from the class of its assets that the distributee partner was deemed to have relinquished in the distribution. That amount has a value equal to the value of the assets of that class that the distributee was treated under section 751(b) as having relinquished. This distribution is treated for purposes of determining its basis in the hands of the distributee partner as if "the distributee partner had received such property in a *current distribution* immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b)."⁸⁴ In the "**Second Step**," the distributee partner is treated as having exchanged with the distributing partnership the property it received in the First Step for the assets in excess of its share of whichever class it received too much of in the actual distribution. This exchange is treated as a "sale or exchange." Thus, either or both of the participants in the Second Step may recognize gain or loss to the extent it is treated as exchanging property that has a value and basis that differ for other property not coming within any nonrecognition provision.⁸⁵ In the "**Third Step**," the partnership is treated as having distributed the balance of the distribution it actually made to the distributee partner.

Example 12: Partnership PRS has cash (a cold asset) and three pieces of inventory that together are substantially appreciated within the meaning of section 751(b) (ignoring the section 704(c)(1)(C) basis adjustment). PRS's

⁸³ Reg. § 1.751-1(b).

⁸⁴ Reg. § 1.751-1(b)(2)(iii) (emphasis added).

⁸⁵ See I.R.C. § 7701(a)(45).

cash is an amount equal to one-third of the aggregate fair market value of its assets. The inventory items together represent two-thirds of the aggregate fair market value of the assets on PRS' balance sheet. Each inventory asset has a value that exceeds its adjusted basis, disregarding any section 704(c)(1)(C) basis adjustments. One of the inventory items is section 704(c)(1)(C) property; the other two are not. PRS has three equal partners, P, R, and S. P is the section 704(c)(1)(C) partner with respect to PRS' section 704(c)(1)(C) property. S is completely redeemed by PRS in exchange for all of its cash.

Section 751(b) will generally apply to the redemption distribution made by PRS to S as follows. Distributing all of PRS's cash, its only cold asset, to S will be a distribution of cold assets to S in excess of S' share of the cold assets of PRS. PRS and S will be treated under section 751(b) as if PRS had made a current distribution to S of S' share of PRS' hot assets, and then as having purchased that share for the "excess" cold assets (consisting of cash) PRS actually distributed to S.

The current final regulations under section 751(b) explicitly identify the hot assets PRS might have distributed to S in the above example. However, the Regulations under section 751(b) will treat the First Step in many cases like that illustrated above as consisting of section 704(c)(1)(C) property, at least in part, under the existing final regulations.

Proposed Regulation section 1.704-3(f)(3)(v)(B) provides that a non-section 704(c)(1)(C) partner does not take into account, under section 732, a section 704(c)(1)(C) basis adjustment embedded in property distributed to it. Instead, the section 704(c)(1)(C) basis adjustment is reallocated by the distributing partnership from the distributed property to its remaining items of property under the rules of Regulation section 1.755-1(c).

Section 704(c)(1)(C) property having a section 704(c)(1)(C) basis adjustment embedded in it that is hypothetically distributed by a partnership to a non-section 704(c)(1)(C) partner in the First Step sheds that section 704(c)(1)(C) basis adjustment, to the extent that the Regulations under section 751(b) treat the First Step as a distribution of section 704(c)(1)(C) property for purposes of section 704(c)(1)(C). The law is not clear regarding the extent to which the hypothetical transactions undertaken under section 751(b) have collateral effects beyond the recognition of gain or loss pursuant to its terms.⁸⁶ It is clear that section 732 is applied for purposes of determining the adjusted basis of property distributed in the First Step to the deemed

⁸⁶Comm. on P'ships & LLCs, ABA Tax Sec., *Comments Concerning Notice 2006-142* (2007); WILLIAM MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 21.01[3](4th ed. 2007); Monte A. Jackel & Avery I. Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, 98 TAX NOTES (TA) 1557 (Mar. 7, 2003).

distributee of that property.⁸⁷ Such a distribution can result in the property deemed distributed in the First Step having a basis that is lower in the hands of the distributee immediately after the deemed distribution than it did in the hands of the distributing partnership immediately before. Such a deemed distribution in the First Step can also result in gain recognition if the property deemed distributed consists of money in an amount greater than the distributee's adjusted basis in its partnership interest.⁸⁸ Treasury and the Service⁸⁹ and commentators⁹⁰ have questioned whether a basis adjustment under section 734(b) would be required of a partnership having in effect an election under section 754 at a time when the First Step resulted in a basis reduction in the property hypothetically distributed or gain recognition with respect to the money hypothetically distributed. This concern appears to presuppose the application of section 731 to the First Step. The question then arises concerning how many other provisions within and without subchapter K might then apply to the hypothetical First Step and Second Step. For example, there appears to be some concern that regulations under section 1411 would apply the 3.8% Medicare contribution tax on "net investment income" to gains on First Step distributions under section 751(b).⁹¹

Both the Treasury and the Service,⁹² as well as commentators,⁹³ have expressed questions concerning the effect to be given section 704(c) in the determination of the U.S. federal income tax consequences of a distribution subject to section 751(b).⁹⁴ The Proposed Regulations implicate this concern in the context of section 704(c)(1)(C). In Example 12 above, S would be treated as having received a deemed distribution of the section 704(c)(1)(C) property held by PRS in the First Step. Proposed Regulation section 1.704-3(f)(3)(v)(B) provides that S would not take the section 704(c)(1)(C) basis adjustment into account in determining its basis in the distributed section 704(c)(1)(C) property. Instead, the section 704(c)(1)(C) basis adjustment attributable to the section 704(c)(1)(C) property distributed to S would be reallocated among the assets of PRS under Regulation section 1.755-1(c). PRS would then reacquire the hypothetically distributed section 704(c)(1)(C) property the next moment in the Second Step.

⁸⁷ Reg. § 1.751-1(b)(2)(iii) ("The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).").

⁸⁸ I.R.C. § 731(a)(1) (1997).

⁸⁹ Notice 2006-14, 2006-1 C.B. 498.

⁹⁰ Comm. on P'ships & LLCs, *supra* note 86; Jackel & Stok, *supra* note 86.

⁹¹ McKee, *supra* note 86, at ¶ 21.01[3] (text at notes 23.1 to 23.3).

⁹² Notice 2006-14, 2006-1 C.B. 498.

⁹³ Jackel & Stok, *supra* note 86; Comm. on P'ships & LLCs, *supra* note 86.

⁹⁴ The recent proposed regulations under section 751(b) that are discussed in the immediately following section would resolve this uncertainty in favor of taking section 704(c) into account in applying section 751(b).

This approach to the application of section 751(b) raises at least the two following issues, neither of which is addressed by the Proposed Regulations. Does Proposed Regulation section 1.704-3(f)(3)(v)(B) apply to a hypothetical distribution of section 704(c)(1)(C) property to a non-section 704(c)(1)(C) partner in the First Step? If so, is it the appropriate answer to reallocate the section 704(c)(1)(C) basis adjustment attributable to the hypothetically distributed property among the distributing partnership's assets under Regulation section 1.755-1(c)? Applying Proposed Regulation section 1.704-3(f)(3)(v)(B) to the First Step in a distribution to a non-section 704(c)(1)(C) partner subject to section 751(b) would appear to require the distributing partnership to reallocate among its other assets a section 704(c)(1)(C) partner's section 704(c)(1)(C) basis adjustment in any section 704(c)(1)(C) property hypothetically distributed to another partner under section 751(b). This would appear to be the case under the current section 751(b) final Regulations and the Proposed Regulations even though the distributing partnership owns all of the section 704(c)(1)(C) property immediately following the section 751(b) hypothetical distribution and, in reality, never distributed that section 704(c)(1)(C) property to anyone.

In the first instance, it appears the better approach is to apply Proposed Regulation section 1.704-3(f)(3)(v)(B) to the First Step in the analysis of a distribution subject to section 751(b). Thus, the non-section 704(c)(1)(C) partner to which section 704(c)(1)(C) property was hypothetically distributed in the First Step would not take the section 704(c)(1)(C) basis adjustment into account in determining the adjusted basis of the distributed section 704(c)(1)(C) property in its hands. The principle otherwise articulated in the Proposed Regulations of treating the section 704(c)(1)(C) basis adjustment in a manner consistent with the principles of section 743(b) mandates such an approach. Further, permitting the distributee non-section 704(c)(1)(C) partner to take the section 704(c)(1)(C) basis adjustment into account in determining the U.S. federal income tax consequences of the Second Step is inconsistent with the statutory regime of section 704(c)(1)(C).

In the second instance, requiring the distributing partnership to reallocate the section 704(c)(1)(C) basis adjustment attributable to the portion of the section 704(c)(1)(C) property hypothetically distributed to the non-section 704(c)(1)(C) partner under Regulation section 1.755-1(c) in the First Step may give rise to inappropriate results, although it is not possible in the absence of a particular fact pattern to determine whether it would be the taxpayer or the government that would be adversely affected by these results.

We recommend that a section 704(c)(1)(C) basis adjustment attributable to section 704(c)(1)(C) property hypothetically distributed to a non-section 704(c)(1)(C) partner in the First Step that is hypothetically reacquired by the distributing partnership in the related Second Step should remain embedded with the section 704(c)(1)(C) property hypothetically distributed and then reacquired by the distributing partnership under the current regulations under section 751(b). Such an approach would leave the section 704(c)(1)(C)

partner in the same position it would have been with respect to such a section 704(c)(1)(C) property had the non-section 704(c)(1)(C) partner's First Step and Second Step hypothetical transactions under section 751(b) not occurred. The operational rules of Proposed Regulation section 1.704-3(f)(3)(i) could apply to treat the "common basis" of the section 704(c)(1)(C) property as having been adjusted to reflect the fair market value of the portion of the section 704(c)(1)(C) property deemed distributed and reacquired in the First Step and the Second Step, with the section 704(c)(1)(C) basis adjustment remaining in place with respect to the section 704(c)(1)(C) property as a special basis adjustment consistent with the principles of the Proposed Regulations.

b. *Section 704(c)(1)(C) Under the Recent Proposed Section 751(b) Regulations.* Treasury and the Service issued proposed regulations under section 751(b) on October 31, 2014 (which were published in the Federal Register on November 3, 2014) to redress many of the issues noted above and numerous others, as well.⁹⁵ The full details of the Proposed Section 751(b) Regulations are beyond the scope of these Comments. However, the following portions of the Proposed Section 751(b) Regulations appear relevant to these Comments.

Generally, and as relevant here, the Proposed Section 751(b) Regulations provide that the U.S. federal income tax consequences of a distribution to which section 751(b) applies would be determined under any reasonable method.⁹⁶ The Proposed Section 751(b) Regulations go on to provide that "appropriate adjustments" to the basis of distributing partnership property are generally to be made in a manner consistent with the reasonable approach adopted to determine the U.S. federal income tax consequences of the distribution.⁹⁷ Examples generally illustrate these principles by reference to two mechanisms by which the application of section 751(b) to the particular fact pattern is illustrated. We refer to these two mechanisms as the "**Hypothetical Exchange Approach**" and the "**Deemed Recognition Approach**" in the discussion that follows.

The Hypothetical Exchange Approach appears to be largely a restatement of the three-step transactional construct that is applied under the current final regulations under section 751(b) that is discussed in the immediately preceding section, with certain refinements and modifications that are not relevant to these Comments. We recommend that the Proposed Regulations or the Proposed Section 751(b) Regulations be clarified to reflect the recommendations made above with respect to the interaction of sections 704(c)(1)(C) and 751(b) with respect to the Hypothetical Exchange Approach if final regulations adopting the Proposed Section 751(b) Regulations retain the Hypothetical Exchange Approach.

⁹⁵Certain Distributions Treated as Sales or Exchanges, 79 Fed. Reg. 65,151 (Nov. 3, 2014) (to be codified at 26 C.F.R. pt. 1) [hereinafter Proposed Section 751(b) Regulations].

⁹⁶*Id.*

⁹⁷Prop. Reg. § 1.751-1(b)(3)(iii), 79 Fed. Reg. 65,151 (2014).

The portions of the examples in the Proposed Section 751(b) Regulations illustrating the Deemed Recognition Approach appear to require a different clarification under the Proposed Regulations. Generally, one or more of the partners of a partnership applying the Deemed Recognition Approach to a distribution subject to section 751(b) in each of the examples is treated as recognizing an amount of gain under section 751(b). The distributing partnership makes certain adjustments to the basis of its assets reflecting the distributees' gain recognition. However, none of the distributing partnership's property is hypothetically distributed to any partner. The assets *actually* distributed in the pertinent distribution are depicted as having been distributed in each example. However, no distributing partnership asset that is not actually distributed is hypothetically or deemed distributed. Instead, one or more of the distributing partnership's partners recognize gain, in some cases without ever having entered into any sort of objectively identifiable, *actual* transaction, and the distributing partnership adjusts the basis of its assets.

The Deemed Recognition Approach under the Proposed Section 751(b) Regulations raises a number of issues under the Proposed Regulations. Generally, an approach under which a section 704(c)(1)(C) basis adjustment would continue to be embedded in property the basis of which was adjusted under the Proposed Section 751(b) Regulations would appear to represent a sound starting principle upon which to build the rules that coordinate sections 704(c)(1)(C) and 751(b). However, complications can arise that require a review of the relationship between these provisions from the perspective of the policies underlying section 751(b) and the Proposed Section 751(b) Regulations. For example, suppose that the facts of Example 5 in the Proposed Section 751(b) Regulations were changed so that Partner B in that example had a section 704(c)(1)(C) basis adjustment in the real property depicted in that example.⁹⁸ How would the mandatory gain recognition rule under Proposed Section 1.751-1(b)(3)(ii)(A) interact with such a section 704(c)(1)(C) basis adjustment? One logical approach would appear to be to allow B to offset the mandatory gain recognition with Partner B's section 704(c)(1)(C) basis adjustment. However, the question would then arise concerning whether a similar policy should apply if the gain recognition under the Proposed Section 751(b) Regulations was discretionary, rather than mandatory.⁹⁹

The number and depth of the questions and issues that arise in the context of the interplay between the Proposed Regulations and the Deemed Recognition Approach under the Proposed Section 751(b) Regulations implies a process to analyze them that would necessarily delay our rendition of these Comments past a time at which they might be most useful. We have therefore decided to raise these issues for further development in connection with the consideration of the Proposed Section 751(b) Regulations.

⁹⁸ Prop. Reg. § 1.751-1(g), Ex. (6), 79 Fed. Reg. 65,151 (2014) (especially part (v)).

⁹⁹ See Prop. Reg. § 1.751-1(b)(3)(ii)(B), 79 Fed. Reg. 65,151 (2014).

III. The Mandatory Basis Adjustment Provisions

Prior to the enactment of the AJCA, the inside basis of partnership property was adjusted under sections 743 and 734 only if the partnership had a valid section 754 election in effect.¹⁰⁰ The AJCA amended sections 743 and 734 to require a basis adjustment to partnership property in certain circumstances.¹⁰¹ In the case of a transfer of a partnership interest resulting from the sale, exchange, or death of a partner, as amended by AJCA, section 743(a) now requires an inside basis adjustment to partnership property if the partnership has a “substantial built-in loss” in partnership property immediately after such transfer. A “substantial built-in loss” is defined under section 743(d)(1) as the partnership’s adjusted basis in partnership property exceeding the fair market value of such property by more than \$250,000.

In the case of a partnership distribution of property, as amended by AJCA, section 734(a) now requires an inside basis adjustment to partnership property if there is a “substantial basis reduction” with respect to such distribution. There is a “substantial basis reduction” under section 734(d) if the sum of (A) the amount of any loss recognized to the distributee-partner with respect to such distribution under section 731(a)(2), and (B) in the case of distributed property in a liquidating distribution, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)) exceeds \$250,000. In other words, there is a “substantial basis reduction” where, had there been a section 754 election in effect at the time of the distribution, there would have been a downward inside basis reduction under section 734(b) in an amount greater than \$250,000.

Finally, section 743(d)(2) provides that the Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of section 743(d)(1) and section 734(d), “including regulations aggregating related partnerships and disregarding property acquired by the partnership in an attempt to avoid such purposes.”¹⁰² Section 734(d)(2) provides regulatory authority for the Secretary to carry out the purposes of section 734(d) by cross-reference to section 743(d)(2).

According to the House Committee Report, these amendments were made because “[t]he Committee believes that the partnership rules currently allow for the inappropriate transfer of losses among partners. This has allowed partnerships to be created and used to aid tax-shelter transactions.”¹⁰³ In crafting these amendments, the Committee stated that, “[t]he bill limits the ability to transfer losses among partners, while preserving the simplification aspects of

¹⁰⁰I.R.C. §§ 734(b), 743(b), 751, 754 (1986).

¹⁰¹American Jobs Creation Act, Pub. L. No. 108-357, §§ 833(b)(1)-(4)(A), (5), (6)(A), (c)(1)-(5)(A), 118 Stat. 1418 (2004).

¹⁰²§ 743(d)(2).

¹⁰³H.R. REP. No. 548-108, at 283 (2004) (Conf. Rep.).

the current partnership rules for transactions involving smaller amounts.”¹⁰⁴ Additionally, the Conference Committee Report states, “It is not intended that the rules of the conference agreement provisions be avoided through the use of tiered partnerships.”¹⁰⁵

A. *Section 743(b)*

1. *The Timing and Consequence of a Partnership Having a Substantial Built-in Loss Immediately After a Transfer*

The Preamble to the Proposed Regulations indicates that the Proposed Regulations clarify that if a partnership has a substantial built-in loss immediately after the transfer of a partnership interest, the partnership is treated as having a section 754 election in effect for the taxable year in which the transfer occurs, but only with respect to that transfer, unless another transaction is also subject to the mandatory basis adjustment provisions of sections 734 and 743.¹⁰⁶

We agree with the Proposed Regulations’ clarification as to the timing for a partnership’s determination of whether it has a substantial built-in loss being immediately after a transfer. We also agree, subject to our comments herein as to certain subsidiary partnerships within a tiered partnership structure as described further herein, that the appropriate consequence of a partnership having a substantial built-in loss immediately after an interest transfer is to treat the partnership as having a section 754 election in effect only with respect to such transfer.

2. *Disregarding 743(b) and 704(c)(1)(C) Basis Adjustments*

Proposed Regulation section 1.743-1(a)(2)(ii) provides that, for purposes of determining whether a partnership has a substantial built-in loss, as described in Proposed Regulation section 1.743-1(a)(2)(i), any basis adjustments under sections 743 or 704(c)(1)(C) other than those of the relevant transferee, are disregarded.¹⁰⁷ We agree that the determination of a substantial built-in loss for a partnership should be made without regard to any section 743(b) and 704(c)(1)(C) adjustments other than those of any relevant transferee-partner.

3. *The Special Rule for Determining Fair Market Value in a Tiered Partnership Structure*

In determining whether an upper-tier partnership has a substantial built-in loss, Proposed Regulation section 1.743-1(a)(2)(iii) provides a special rule, solely for purposes of computing the upper-tier partnership’s fair market value in a lower-tier partnership as being equal to the sum of (i) the amount of cash that the upper-tier partnership would receive if the lower-tier partnership

¹⁰⁴ *Id.*

¹⁰⁵ H.R. REP. NO. 108-755, at 627 (2004) (Conf. Rep.).

¹⁰⁶ Prop. Reg. § 1.743-1, 79 Fed. Reg. 3063, 3064 (2014).

¹⁰⁷ Prop. Reg. § 1.743-1(a)(2)(ii), 79 Fed. Reg. 3042 (2014).

sold all of its property for cash to an unrelated person for an amount equal to the fair market value of such property, satisfied all of its liabilities (other than Regulation section 1.752-7 liabilities), paid an unrelated person to assume all of its Regulation section 1.752-7 liabilities in a fully taxable, arm's-length transaction, and liquidated and (ii) the upper-tier partnership's share of the lower-tier partnership's liabilities as determined under section 752 and its regulations.¹⁰⁸

We agree with this approach but recommend that Treasury and the Service provide an example to clarify the manner in which contingent liabilities of the lower-tier partnership are taken into account in determining the fair market value.

4. *The Proposed Substantial Built-in Loss Anti-Abuse Rules*

Section 743(d)(2) provides Treasury with the authority to prescribe regulations, as appropriate, to carry out the purposes of the section 743 substantial built-in loss rules, as well as the purposes of the substantial basis reduction rules of section 734(d). Accordingly, Proposed Regulation section 1.743-1(m) provides that in regard to substantial built-in loss transactions described in paragraphs (a), (k), (l), (n), and (o) of the section 743 regulations, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of one or more of such paragraphs, the Service may recast the transaction, as appropriate, to achieve tax results that are consistent with the purpose of the delineated paragraphs. Presumably, the change made to Proposed Regulation section 1.743-1(f) was excluded because Proposed Regulation section 1.743-1(f) is intended to act as a targeted anti-abuse rule.

The Proposed Regulations provide two examples of the result of the anti-abuse provision's applicability as including (i) the aggregation of properties of related partnerships if the properties were transferred to the related partnerships with a principal purpose of avoiding the section 743 substantial built-in loss rules, and (ii) the disregarding of a contribution of property to a partnership if the transfer of the property was made with a principal purpose of avoiding the application of the substantial built-in loss provisions of section 743.

Although we agree with the stated purpose of this anti-abuse rule, we recommend that due to the multiple purposes that exist with the implementation of most commercial transactions, any such section 743(b) substantial built-in loss anti-abuse rule be applicable only in a situation in which "the," as opposed to "a," principal purpose of a transaction, or series of transactions, is to circumvent or avoid the purposes of the substantial built-in loss rules.¹⁰⁹

¹⁰⁸Prop. Reg. § 1.743-1(a)(2)(iii), 79 Fed. Reg. 3042, 3063 (2014).

¹⁰⁹In this regard, we also note that the term "principal" is an adjective that typically connotes the most important, essential, main, prevailing or consequential aspect of the noun being described. As such, it is not clear there can be more than one "principal purpose" for a transaction.

We also recommend that specific examples be provided of transactions having the principal purpose of avoiding the substantial built-in loss rules as well as clarification as to whether the results of the application of such an anti-abuse rule would be limited to the application of the section 743 substantial built-in loss rules.

We also recommend that Treasury and the Service clarify whether any anti-abuse rules will be applicable with respect to a section 734(b) substantial basis reduction and, if so, the situations in which such a rule would be applicable.

5. *Electing Investment Partnerships and Securitization Partnerships*

The Proposed Regulations implement section 743(e) and provide that an “electing investment partnership” (an **EIP**) is not treated as having a substantial built-in loss for purposes of Proposed Regulation section 1.743-1(a)(2)(i) and Code sections 743(b) and (d). In defining an EIP, the Proposed Regulations adopt the framework of section 743(e)(6) and define an EIP as a partnership that satisfies nine requirements: (i) the partnership makes the required election; (ii) the partnership would be an “investment company” but for certain exemptions; (iii) the partnership has never been engaged in a trade or business; (iv) substantially all of the assets of the partnership are held for investment; (v) at least 95% of the assets contributed to the partnership consist of money; (vi) no assets contributed to the partnership had an adjusted basis in excess of fair market value at the time of contribution; (vii) all partnership interests of the partnership are issued by the partnership pursuant to a private offering within 24 months of the first capital contribution; (viii) the partnership agreement has substantive restrictions on a partner’s ability to cause a redemption; and (ix) the partnership agreement’s term is 15 years or less (20 years or less for partnerships in existence when the AJCA was enacted).¹¹⁰ Congress intended that EIPs would include venture capital funds, buyout funds, and funds of funds.¹¹¹ Most of the rules and much of the guidance with respect to them that are set forth in the Proposed Regulations may be found in Notice 2005-32.¹¹²

The AJCA also directed Treasury to provide regulations under which the particular issues raised with respect to the EIP rules by tiered partnership structures could be addressed.¹¹³ Congress was concerned about the use of tiered partnerships to avoid the requirements of section 743(e)(6).¹¹⁴ The Proposed Regulations address one of the more important concerns under the EIP rules arising in connection with tiered partnership structures by providing that an upper-tier partnership is not considered engaged in a trade or business, and thus it is not disqualified from being an EIP under EIP qualifi-

¹¹⁰Prop. Reg. § 1.743-1(n)(6)(i)-(ix), Fed. Reg. 3042 (2014).

¹¹¹See H.R. Rep. No. 108-755, at 626 (2004) (Conf. Rep.).

¹¹²Notice 2005-32, 2005-1 C.B. 895.

¹¹³I.R.C. § 743(e)(7).

¹¹⁴See H.R. Rep. 108-755, at 627 (2004) (Conf. Rep.).

cation requirement (iii), above, if: (i) it owns an interest in a lower-tier partnership; and (ii) at all times, the adjusted basis of the upper-tier partnership's interest in the lower-tier partnership is less than 25% of the total capital that is required to be contributed to the upper-tier partnership by its partners (the **25% Requirement**).¹¹⁵

The Proposed Regulations request comments in four areas concerning an EIP: (i) the effect of debt on the 25% Requirement applicable to tiered partnership structures; (ii) the "substantive restrictions" upon an EIP's ability to redeem the interests in it held by its partners that are described in EIP qualification requirement (viii), above (the **Substantive Restriction Rule**); (iii) an EIP that fails to satisfy all of the EIP qualification requirements set forth above during a period after it makes an EIP election but which then returns to full compliance with those requirements in future periods; and (iv) an EIP that has been permitted to revoke but wishes to re-elect EIP status.¹¹⁶

a. *Tiered Partnerships and the 25% Requirement.* We recommend that debt allocations under section 752 by a lower-tier partnership to an upper-tier partnership be disregarded when determining whether the adjusted basis of an upper-tier partnership's interest in a lower-tier partnership is less than 25% of the total capital that is required to be contributed to the upper-tier partnership by the partners of the upper-tier, so that the 25% Requirement is satisfied. This recommended rule should apply without regard to where in the tiered structure a borrowing partnership is located.

Leverage is an essential part of the activities of private equity funds, venture capital funds, buyout funds, and funds of funds. Further, many of these funds operate in tiered partnership structures. It is thus critical to the proper construction of the EIP rules that they apply to tiered partnership structures in the manner Congress intended, being neither more restrictive nor more permissive than Congress intended.

The Proposed Regulations compare the total capital commitments of the partners in an upper-tier partnership to the upper-tier partnership's adjusted basis in a lower-tier partnership in applying the 25% Requirement, as did Notice 2005-32.¹¹⁷ This approach appears to be an effort to identify a situation in which a lower-tier partnership is so material to an upper-tier partnership that the trade or business activities of the lower-tier should be imputed to the upper-tier for the limited purpose of determining whether the upper-tier may qualify to be an EIP, although neither Notice 2005-32 nor the preamble to the Proposed Regulations expressly so provides.¹¹⁸

¹¹⁵ Prop. Reg. § 1.743-1(n)(7)(ii), 79 Fed. Reg. 3042 (2014).

¹¹⁶ See 79 Fed. Reg. 3051-3052 (2014).

¹¹⁷ *Id.*

¹¹⁸ However, see a similar rule serving a similar purpose with respect to tiered partnership structures at section 731(c)(3)(C)(iv) and Regulation section 1.731-2(e)(4)(ii) (the trade or business activities of a lower-tier partnership are not imputed to an upper-tier partnership if, among other things, the interest in the lower-tier partnership held by the upper-tier partnership is less than 20% of the total profits and capital interests in the lower-tier partnership).

An upper-tier partnership's adjusted basis in its interest in a lower-tier partnership will be increased by its allocable share of the liabilities of the lower-tier partnership. This situation will increase the likelihood that an upper-tier partnership will fail the 25% Requirement even where its total capital commitment to the lower-tier partnership is less than 25% of all of the partners' capital commitments to the upper-tier partnership. A fund otherwise qualifying to be an EIP would be especially likely to fail the 25% Requirement to the extent that it engages in more highly leveraged acquisitions. A policy rationale for denying EIP eligibility and applying mandatory basis adjustments to a partnership's indirect investments based in significant part on whether the proportion of debt used to acquire them is high (rather than low) appears nowhere in the legislative or regulatory history relevant to an understanding of the 25% Requirement.

The Proposed Regulations do not expressly provide guidance concerning the application of the 25% Requirement in more complex tiered partnership structures. For example, a tiered structure may have a "top-tier" partnership through which ultimate investors invest and a "lowest-tier" partnership holding the assets, the operation of which is treated as a trade or business for federal income tax purposes and which constitutes the ultimate investment. There may be intervening "middle tiers" of partnerships between the top-tier and the lowest-tier. Some of these middle-tier partnerships may borrow money in "mezzanine" financings. Other middle-tier partnerships may be holding entities that do not borrow funds. The 25% Requirement must be satisfied during the entire term of the "upper-tier partnership," but the Proposed Regulations do not specify what an "upper-tier partnership" is in a tiered partnership structure consisting of more than two tiers.¹¹⁹ A middle-tier partnership would appear to be a "lower-tier" entity with respect to any partnerships that have an equity interest in it, under Proposed Regulation section 1.743-1(n)(7)(ii).

The failure of a middle-tier partnership to satisfy the 25% Requirement with respect to the lowest-tier partnership may deny the relevant top-tier partnership eligibility to elect EIP status under a reasonable interpretation of the relevant Proposed Regulations. This outcome may be appropriate in some circumstances but inappropriate in others. We believe that the Proposed Regulations should clarify that the eligibility of a top-tier partnership to elect EIP status should be unaffected by the number of tiers of partnerships below it.

Middle-tier and lowest-tier partnerships in a multi-tier "EIP eligible" partnership structure tend to have relatively few partners.¹²⁰ Many partnerships that Congress meant to be EIPs have multiple tiers of partnerships, some of which will have incurred debt.

¹¹⁹ Prop. Reg. § 1.743-1(n)(7)(ii), 79 Fed. Reg. 3042 (2014).

¹²⁰ See 79 Fed. Reg. 3042, 3050 (2014).

It is foreseeable that a middle-tier partnership may fail the 25% Requirement with respect to a lowest-tier partnership. Proposed Regulation section 1.743-1(n)(7) might be interpreted such that the trade or business of the lowest-tier partnership would then be imputed to the middle-tier partnership for the limited purpose of determining whether the top-tier partnership may qualify as an EIP. The top-tier partnership could then fail the 25% Requirement taking into account its share under section 752 of any asset-based financing at the lowest-tier level and any mezzanine financing at a middle-tier level.

This situation would appear most likely to occur where the middle-tier partnership and the lowest-tier partnership is each a borrower in connection with the top-tier partnership's investment in them. In such a case, the middle-tier partnership's adjusted basis in its interest in the lowest-tier partnership is high compared to the middle-tier partnership's total capital commitment with respect to the lowest-tier partnership. The eligibility of the top-tier partnership to elect EIP status would then be tested against its adjusted basis in the highest middle-tier partnership. This highest middle-tier partnership could have its own mezzanine borrowings and its share of the liabilities of lower middle-tier and lowest-tier partnerships. The effect of the aggregation of these debt shares on the adjusted basis of the top-tier partnership in the highest middle-tier partnership could cause the top-tier partnership to fail the 25% Requirement. An inappropriate finding of ineligibility to elect EIP status could occur where the top-tier partnership would have satisfied the 25% Requirement had it borrowed the mezzanine financing directly rather than through a middle-tier partnership.

It appears consistent with the purposes of the 25% Requirement to determine an upper-tier partnership's adjusted basis in its interest in a lower-tier partnership without taking into account any share of the liabilities of the lower-tier partnership for purposes of the 25% Requirement, whether those lower-tier liabilities are direct obligations of the lower-tier or allocated to the lower-tier under section 752 and the regulations thereunder by any partnerships in which the lower-tier directly or indirectly holds an interest. We recommend that the Proposed Regulations be clarified to so provide.

b. *The Substantive Restriction Rule.* Proposed Regulation section 1.743-1(n)(6)(viii) contains the Substantive Restriction Rule.¹²¹ The Substantive Restriction Rule generally provides that a partnership may elect to be an EIP if its partnership agreement sets forth "substantive restrictions" on each partner's ability to cause a redemption of its interest in the electing partnership. Proposed Regulation section 1.743-1(n)(8) permits an exception under which a redemption may be permitted in order to avoid a violation of state, federal, or local laws (such as the Employee Retirement Income Security Act of 1974 ("ERISA") or the Bank Holding Company Act), the imposition of a federal excise tax, or a change in the tax-exempt status of

¹²¹Prop. Reg. § 1.743-1(n)(6)(viii), 79 Fed. Reg. 3042 (2014).

a tax-exempt partner.¹²² Most partnership agreements for partnerships that would otherwise qualify for EIP status restrict partner redemptions in the manner contemplated by the Substantial Restriction Rule. The exceptions to the Substantive Restriction Rule noted in Proposed Regulation section 1.743-1(n)(8) generally correspond to the principal exceptions to the restrictions on partner redemptions found in most of these partnership agreements.

However, an additional event under which an investor may cause its redemption that is common in partnerships that are otherwise eligible to elect EIP status arises when the partner's investment would cause the partner to be engaged in a "prohibited transaction" for purposes of ERISA. Prohibited transactions are violations of law because they cause an employee benefit plan to violate a fiduciary duty to the plan's beneficiaries.¹²³ Therefore, as one of the expressly stated exceptions to the Substantive Restriction Rule set forth at Proposed Regulation section 1.743-1(n)(8), we recommend that Treasury and the Service permit redemptions that allow an investor to avoid a "prohibited transaction" under ERISA.

c. Transitory Failures to Satisfy the Qualification Requirements to be an EIP. We recommend that a partnership that has properly elected to be an EIP be permitted to cure a transitory failure to satisfy the terms of section 743(e) and Proposed Regulation section 1.743-1(n). We also recommend that such a transitory failure be disregarded following the electing partnership's return to compliance with Proposed Regulation section 1.743-1(n) if no interests in the electing partnership had been transferred during the period that the electing partnership was out of compliance with these rules.

We also request that guidance be provided with respect to situations in which an interest in the electing partnership was transferred during the period that the electing partnership was out of compliance with these rules such that the basis adjustments required for built-in losses under sections 743(b) and (d) would have been required but for EIP status. In such a situation, we recommend that final regulations require the noncompliant electing partnership to adjust the basis of its property as otherwise required by sections 743(b) and (d) with respect to each of its partners that acquired an interest in it in a manner described in section 743(b), during the period that the electing partnership was out of compliance with sections 743(e) and finalized Proposed Regulation section 1.743-1(n).

Because of the compliance difficulties for electing partnerships that may be noncompliant for short periods, we recommend that an electing partnership be permitted to disregard its transitory noncompliance with section 743(e) and Proposed Regulation section 1.743-1(n), and to compute and allocate its taxable income and loss as if it had been continuously in compliance with these provisions if it cured its noncompliance by the time for filing its return for the year in which its noncompliance arose, including extensions.

¹²² Prop. Reg. § 1.743-1(n)(8), 79 Fed. Reg. 3042, 3065-66 (2014).

¹²³ See 29 U.S.C. § 1106 (2012).

d. *Re-Election Following Affirmative Revocation of EIP Election.* The statute and the Proposed Regulations each provide that a partnership's EIP election may be revoked with the consent of the Secretary.¹²⁴ An electing partnership is required to adjust the basis of its assets upon the first transfer of a partnership interest following a revocation of its EIP election.¹²⁵ Neither the statute nor the Proposed Regulations place any restrictions on the ability of a qualifying partnership to elect to be an EIP following such a revocation.

We recommend that a re-electing partnership be required to maintain and apply any basis adjustments under sections 743(b) and (d) that arose following its revocation of its EIP election and before its re-election of EIP status. We further recommend that final guidance clarify that a re-electing partnership can treat itself as having continuously been in compliance with an EIP election under section 743(e) and Proposed Regulation section 1.743-1(n) in either of the two following circumstances. The first circumstance would arise if there were no transfers with respect to which a basis adjustment under sections 743(b) or (d) would have been required during the period between the partnership's revocation and its re-election of EIP status. The second circumstance would arise if the partnership properly re-elected EIP status with its timely filed return, including extensions, for the year in which consent for its revocation became effective.

B. *Mandatory Basis Adjustments in Tiered Partnerships*

1. *The Proposed Regulations*

The Proposed Regulations provide guidance on several aspects of the provisions concerning substantial built-in losses and substantial basis reductions, notably with regard to tiered partnerships. According to the Proposed Regulations, in determining whether an upper-tier partnership has a substantial built in loss under section 743(d)(1), a lower-tier partnership interest will be valued by determining:

(A) the amount of cash that the upper-tier partnership would receive if the lower-tier partnership sold all of its property for cash to an unrelated person for an amount equal to the fair market value of such property, satisfied all of its liabilities (other than section 1.752-7 liabilities), paid an unrelated person to assume all of its section 1.752-7 liabilities in a fully taxable, arm's-length transaction, and liquidated; and (B) the upper-tier partnership's share of the lower-tier partnership's liabilities as determined under section 752 and the regulations.¹²⁶

The Proposed Regulations' preamble states that the reason for adding the allocated share of lower-tier partnership liabilities to the fair market value is

¹²⁴I.R.C. § 743(e)(6) (flush language); Prop. Reg. § 1.743-1(n)(10)(v), 79 Fed. Reg. 3042, 3066 (2014).

¹²⁵Prop. Reg. § 1.743-1(n)(10)(v)(B), 79 Fed. Reg. 3042, 3066 (2014).

¹²⁶Prop. Reg. § 1.743-1(a)(2)(iii), 79 Fed. Reg. 3042, 3063 (2014).

that otherwise, the regulations could “inappropriately treat a lower-tier partnership interest as a loss asset.”¹²⁷

Further, the Proposed Regulations provide that if an event occurs with respect to an upper-tier partnership, and such event causes a mandatory adjustment under either section 734(a) or section 743(a), each lower-tier partnership must also be treated as though it had made a section 754 election (but only with respect to that specific event).¹²⁸ The preamble to the Proposed Regulations cites section 743(d)(2) as authority for making lower-tier adjustments mandatory and requests comments on the scope of the rule and on measures to ease administrative burdens in complying with the rule.¹²⁹ The Proposed Regulations include an anti-abuse rule with regard to the mandatory section 743 adjustment tiered partnership provision under which, if a principal purpose of a transaction is to avoid the application of the substantial built-in loss rules with respect to a transfer, the Commissioner can recast the transaction for federal income tax purposes as appropriate to achieve tax results that are consistent with the purpose of the provisions. For example, property held by related partnerships may be aggregated and a contribution of property to a partnership may be disregarded in applying the substantial built-in loss provisions in section 743 and the regulations thereunder if the property was transferred with a principal purpose of avoiding the application of such provisions.¹³⁰

The Proposed Regulations also include reporting provisions relating to the mandatory basis adjustment rules. With regard to substantial basis reduction situations, a partnership must comply with the reporting provisions of Regulation section 1.734-1(d) (requiring the partnership to attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated).¹³¹ Similarly, with regard to substantial built-in loss situations, a partnership must comply with the reporting provisions of Regulation section 1.743-1(k)(1) (requiring the partnership to attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated).¹³² Additionally, in substantial built-in loss situations, the Proposed Regulations require transferees to comply with the notice requirements under Regulation section 1.743-1(k)(2)¹³³ and require the partnership that is required to adjust the basis of its properties in a sub-

¹²⁷ 79 Fed. Reg. 3042, 3050 (2014).

¹²⁸ Prop. Reg. § 1.734-1(f)(1), 79 Fed. Reg. 3042, 3061 (2014); Prop. Reg. § 1.743-1(l)(1), 79 Fed. Reg. 3042, 3065 (2014).

¹²⁹ 79 Fed. Reg. 3042, 3050 (2014).

¹³⁰ Prop. Reg. § 1.743-1(m)(1), 79 Fed. Reg. 3042, 3065 (2014).

¹³¹ Prop. Reg. § 1.734-1(d), 79 Fed. Reg. 3042, 3061 (2014).

¹³² Prop. Reg. § 1.743-1(k)(1)(iii), 79 Fed. Reg. 3042, 3064 (2014).

¹³³ Prop. Reg. § 1.743-1(k)(2)(iv), 79 Fed. Reg. 3042, 3064 (2014).

stantial built-in loss situation to comply with the reliance and related provisions of current Regulation section 1.743-1(k)(3), (k)(4), and (k)(5).¹³⁴

2. *Mandatory Adjustments to the Basis of Lower-Tier Partnership Property*

We believe that requiring a lower-tier partnership to adjust the inside basis of its partnership assets when such partnership does not have a section 754 election in effect will be highly burdensome for many partnerships. Further, we believe that requiring such a lower-tier partnership to make adjustments when it does not have a substantial built-in loss is beyond the intent and plain meaning of the statute and is contradictory to existing authority under Rev. Rul. 87-115, a ruling cited by the preamble to the Proposed Regulations in regard to providing guidance on the application of section 743(b) adjustments in tiered partnership situations generally.¹³⁵

Under Rev. Rul. 87-115, an event that causes a basis adjustment to property held in an upper-tier partnership triggers an adjustment to the basis of property held in a lower-tier partnership only if a section 754 election is in effect for both the upper-tier partnership and the lower-tier partnership.¹³⁶ The ruling rationalizes an adjustment to the basis of lower-tier partnership property upon the sale or exchange of an interest in an upper-tier partnership where each of the upper-tier partnership and lower-tier partnership has made a section 754 election in that such elections are indicative of “manifesting an intent” to be treated as an aggregate for purposes of sections 754 and 743. Because of such intent, the ruling concludes, for purposes of sections 743 and 754, it is appropriate to treat the sale of a partnership interest in an upper-tier partnership as a deemed sale of an interest in a lower-tier partnership and to adjust the inside basis of lower-tier partnership assets accordingly. Conversely, where a lower-tier partnership has not made an election under section 754, its partners have not “manifested an intent” to be treated as an aggregate and the deemed lower-tier partnership interest exchange should not impact the inside basis of lower-tier partnership assets.

Similarly, Rev. Rul. 92-15 analyzes the basis consequences of a distribution by an upper-tier partnership of an interest in a lower-tier partnership or other assets.¹³⁷ In situation 1 of the ruling, an upper-tier partnership, that owns a partnership interest in a lower-tier partnership distributes one-half of a capital asset (X) to a partner (A), reducing the value of partner A’s partnership interest.¹³⁸ Each of the upper-tier partnership and the lower-tier partnership has a section 754 election in effect. The distribution causes the upper-tier partnership to increase the adjusted basis of its remaining property under section 734(b)(1)(B). The ruling explains that, because both the upper-tier part-

¹³⁴ Prop. Reg. § 1.743-1(k)(1)(iii), 79 Fed. Reg. 3042, 3064 (2014).

¹³⁵ Rev. Rul. 87-115, 1987-2 C.B. 163.

¹³⁶ *Id.* at 1.

¹³⁷ Rev. Rul. 92-15, 1992-1 C.B. 215.

¹³⁸ *Id.* at 1.

nership and the lower-tier partnership made elections under section 754, it is appropriate to treat the upper-tier partnership's distribution of one-half of asset X to partner A and the increase to the upper-tier partnership's basis in its lower-tier partnership interest as an event that triggers a section 734(b) basis increase to the upper-tier partnership's share of the lower-tier partnership's assets.¹³⁹ In situation 2, an upper-tier partnership distributes its partnership interest in a lower-tier partnership to partner A, in order to reduce partner A's interest in the upper-tier partnership.¹⁴⁰ Under section 734(b)(1)(B), the upper-tier partnership increases the adjusted basis of its remaining property (asset X). The ruling explains that the upper-tier partnership makes the basis adjustment only because both the upper-tier partnership and the lower-tier partnership have elections in effect under section 754 (note that under the flush language of section 734(b), a partnership does not make a positive section 734(b)(1)(B) adjustment if the distributed property is an interest in another partnership that does not have an election in effect under section 754).¹⁴¹ The ruling further explains that the upper-tier partnership's distribution of its interest in the lower-tier partnership is treated as an exchange of the interest in the lower-tier partnership for purposes of section 743, and, because the lower-tier partnership has a section 754 election in effect, under section 743(b)(2), the lower-tier partnership would decrease the adjusted basis of its property.¹⁴²

Treasury and the Service cite section 743(d)(2) as the authority for a rule requiring a lower-tier partnership to adjust the inside basis of its partnership assets when such partnership does not have either a section 754 election in effect or a substantial built-in loss.¹⁴³ However, we do not believe the statute provides authority for the position asserted given that section 743(d)(1) specifically only applies to partnerships that have a substantial built-in loss at the time an interest is transferred. Further, the legislative history specifically indicates only that tiered partnerships should not be used to avoid the anti-loss trafficking rules. The legislative history clearly does not suggest that the basis of property in a lower-tier partnership should be adjusted in all situations where there is a substantial built-in loss in an upper-tier partnership that holds an interest in a lower-tier partnership. For example, if an upper-tier partnership purchases a small interest in another partnership as an investment and subsequently there is a sale of an interest in the upper-tier partnership at a time when the upper-tier partnership has a substantial built-in loss that is completely unrelated to the lower-tier partnership interest, it is difficult to see the justification for requiring the lower-tier partnership to adjust the basis of its property (which adjustment might even be upward, rather than down-

¹³⁹ *Id.* at 4.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.* at 5.

¹⁴³ 79 Fed. Reg. 3042, 3050 (2014).

ward). Therefore, we believe that it is beyond the clear meaning and purpose of section 743(d)(1) to require a lower-tier partnership to make an adjustment to the basis of its assets when it does not have a substantial built-in loss and an actual section 754 election is not in effect.¹⁴⁴

Section 743(d)(2) provides that Treasury may prescribe regulations that aggregate related partnerships and disregard property acquired by a partnership in abusive situations.¹⁴⁵ The anti-abuse rule provided in the Proposed Regulations ought to be sufficient for these purposes and for carrying out the legislative intent that tiered partnerships should not be used to avoid adjustments required by section 743(d). If Treasury and the Service require a lower-tier partnership that does not have a section 754 election in effect to step down the inside basis of its assets upon a transfer of an interest in an upper-tier partnership, we believe such a rule should be limited in its application. For example, the rule could be limited to interest transfers where the upper-tier partnership and lower-tier partnership are related to each other under section 707(b)(1)(B) and there is a substantial built-in loss in the lower-tier partnership. Alternatively Treasury and the Service should consider, at a minimum, a *de minimis* rule that would only require a step down to a lower-tier partnership's inside asset basis in situations where a substantial amount of lower-tier interests are deemed transferred as a result of a transfer of an interest in an upper tier partnership.

The reporting provisions in the Proposed Regulations make lower-tier partnerships that are required to make basis adjustments under sections 743 and 734 under the substantial built-in loss and substantial basis reduction provisions, respectively, subject to reporting such basis adjustments.¹⁴⁶ However, the Proposed Regulations do not include a clear mechanism for an upper-tier partnership to provide the necessary information to provide notice of an event at the upper-tier partnership and information to enable a lower-tier partnership to compute basis adjustments in its properties. Often, in tiered partnership situations, it is difficult for a lower-tier partnership to know about the events that occur at the upper-tier partnership. Thus, under the Proposed Regulations, it would be difficult for lower-tier partnerships to make the necessary computations and to comply with reporting any basis adjustment under the tiered partnership provisions relating to substantial built-in losses and substantial basis reductions. Similarly, a lower-tier partnership in a situation governed by the Proposed Regulations would also have to comply with the

¹⁴⁴Moreover, the proposal might create a fungibility concern for many publicly traded partnerships, which generally have to ensure that each partnership interest within a class of interests is fungible with any other interest in such class. If adopted, the proposal might require certain publicly traded partnerships to alter their current structures in a manner that would create administrative burdens as noted below without promoting the purposes of the enactment of the mandatory basis adjustment rules.

¹⁴⁵I.R.C. § 743(d)(2).

¹⁴⁶Prop. Reg. § 1.734-1(d), 79 Fed. Reg. 3042, 3061 (2014); Prop. Reg. § 1.743-1(n)(11), 79 Fed. Reg. 3042, 3066 (2014).

reporting rules. We recommend that, if final regulations require basis adjustments for properties held by a lower-tier partnership, as a result of an event at an upper-tier partnership, final regulations should include clear mechanisms with respect to the providing of information by the upper-tier partnership to the lower-tier partnership, the providing of notice of upper-tier partnership triggering events, and the providing of computational information that would be needed by the lower-tier partnership to make its computations (*e.g.*, the portion of 734(b) adjustment of upper-tier partnership that is allocated to its interest in lower-tier partnership).

IV. The Section 755 Basis Allocation Rules

A. *The Section 755(c) Limitation*

Section 755(c) was enacted in response to the Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (the **JCT Enron Report**), which recommended that the partnership basis rules be altered to preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner or related party.¹⁴⁷ In its present form the statute reads as follows:

No Allocation of Basis Decrease to Stock of Corporate Partner. – In making an allocation under subsection (a) of any decrease in the adjusted basis of partnership property under section 734(b) –

- (1) no allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) and 707(b) (1) to such corporation) which is a partner in the partnership, and
- (2) any amount not allocable to stock by reason of paragraph (1) shall be allocated under subsection (a) to other partnership property.

Gain shall be recognized to the partnership to the extent that the amount required to be allocated under paragraph (2) to other partnership property exceeds the aggregate adjusted basis of such other property immediately before the allocation required by paragraph (2).¹⁴⁸

Proposed Regulation section 1.755-1(e) generally restates the statutory language of section 755(c), although the regulation attempts to resolve what is suggested to be inaccurate legislative language, by changing the statute's conjunctive reference to sections 267(b) and 707(b)(1) to the disjunctive.¹⁴⁹ Additionally the Proposed Regulations include a single example of a “hook” structure in which a partnership owns stock of a partner.¹⁵⁰ As originally promulgated, the regulatory example set forth facts which would have not impli-

¹⁴⁷ See STAFF OF JT. COMM. ON TAX'N, 108TH CONG., JCS-3-03, REP. OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 30 (Joint-Comm. Print 2003).

¹⁴⁸ I.R.C. § 755(c) (emphasis added).

¹⁴⁹ Prop. Reg. § 1.775-1(e), 79 Fed. Reg. 3042, 3053 (2014).

¹⁵⁰ *Id.*

cated section 755(c). The example has now been adjusted factually such that section 755(c) would be implicated.¹⁵¹ We have four comments on the revised Proposed Regulation section 1.755-1(e).

First, the Proposed Regulation's use of disjunctive, rather than conjunctive, language in regard to the application of the related party reference in section 755(c) was apparently made because Treasury and the Service believe that Congress's intent in enacting 755(c) is inconsistent with a conjunctive application of the related party rule. Specifically, the Preamble to the Proposed Regulations states that:

Given Congress's intent to prevent taxpayers from shifting tax gain to stock of a corporate partner or corporation related to a corporate partner, the Treasury Department and the IRS believe it is appropriate to interpret section 755(c) to apply broadly to related persons under either section 267(b) or section 707(b)(1)... If section 755(c) only applied to persons treated as related within the meaning of both section 267(b) and section 707(b)(1), then the provision would apply in very limited circumstances, significantly restricting the scope of section 755(c).¹⁵²

Disregarding the conjunctive versus disjunctive question for the moment, we believe that the language of existing section 755(c)(1) is confusing in that it implies that a basis adjustment might be prohibited from being made to the basis of a noncorporate person. The reference to a relationship existing under section 707(b)(1) furthers that confusion. Because we believe that section 755(c) was intended to prevent basis reductions only to stock, we recommend that Treasury and the Service pursue a legislative technical correction to adjust section 755(c)(1) such that the statute reads as follows:

No allocation may be made to stock directly or indirectly owned by a partnership in which such corporation is a partner or to stock of a corporation that is directly or indirectly owned by such partnership and that is related (within the meaning of section 267(b)(1)) to a corporation that is a partner in such partnership.

As noted, under the existing statutory language, we fail to see the circumstance in which a section 707(b)(1) relationship is relevant, provided section 755(c) is directed at preventing basis reductions only in corporate stock. Use

¹⁵¹The original example described a situation in which a distribution would cause a negative basis adjustment to partnership property of \$100 at a time when the distributing partnership owned two assets – Capital Asset 2 with a fair market value of \$50 and an adjusted basis of \$150 and stock of a partner, which had a fair market value and tax basis of \$150. In such a situation, section 755(c) should not have applied to prevent a basis reduction in the stock of the partner in that Regulation section 1.755-1(c) would currently require that the negative basis adjustment be allocated first to property with unrealized depreciation, *i.e.*, Capital Asset 2. The example was revised so that the partnership's adjusted basis in the stock of its partner would be \$250 instead of \$150, implicating section 755(c). See corrections made to Prop. Reg. § 1.755-1(e), 79 Fed. Reg. 21,164 (2014).

¹⁵²Fed. Reg 3042, 3053 (2014).

of the proposed disjunctive approach might be read to prevent an upper-tier partnership from making a negative basis adjustment to a lower-tier partnership in a situation in which the upper-tier and lower-tier partnerships are related within the meaning of section 707(b)(1). Again, we do not believe this is consistent with the purpose of section 755(c) and if the existing statutory language is retained, we believe that the Proposed Regulations should confirm that the provision is only intended to prohibit basis reductions in stock of a partner or a corporation that is related to such partner.

Second, we recommend that the Proposed Regulation clarify that where a negative basis adjustment is allocable to "other partnership property" under Proposed Regulation section 1.755-1(e)(1)(B), the rules set forth in Regulation section 1.755-1(c) apply such that a negative adjustment must be allocated to partnership property of a character similar to that of the distributed property to which the negative adjustment arose.

Third, consistent with the effect of a subsequent basis adjustment made under the carryover rule in Regulation section 1.755-1(c)(4), we recommend that the Proposed Regulation clarify that the gain recognized under Proposed Regulation section 1.755-1(e)(2) should be allocated to all partners in the partnership in accordance with the general rules of section 704(b).

Finally, we request that Treasury and the Service provide examples as to the interaction of sections 337(d), 755(c), and 732(f) when finalizing the Proposed Regulation.¹⁵³

B. *Modification of Basis Allocation Rules for Substituted Basis Transactions*

1. *Allocations Between Classes of Property*

Proposed Regulation section 1.755-1(b)(5) would modify the existing section 755 basis allocation rules for substituted basis transactions to permit an allocation of basis increases and decreases to partnership property even where the partnership has no overall net unrealized built-in gain or loss in such property.¹⁵⁴ In this regard, we agree with the changes proposed that would provide that if there is an increase in the basis to be allocated to partnership assets under Regulation section 1.755-1(b)(5), the increase must be allocated to capital gain property and ordinary income property in proportion to, and to the extent of, gross gain or gross income that would be allocated to the transferee from a hypothetical sale of all property in each class, while a decrease must be allocated between capital gain and ordinary income property in proportion to, and to the extent of, the gross loss that would be allocated to the transferee from a similar hypothetical sale of all property in each class.

¹⁵³We note that the 2014-2015 Priority Guidance Plan includes a regulatory project under Reg. § 1.337(d)-3. DEP'T OF TREASURY, 2014-2015 PRIORITY GUIDANCE PLAN 21 (Aug. 26, 2014).

¹⁵⁴Prop. Reg. § 1.755-1(b)(5), 79 Fed. Reg. 3042, 3067 (2014).

2. Allocations Within Classes of Property

Regulation section 1.755-1(b)(5)(iii)(C) limits a transferee's negative basis adjustment within a class of property to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.¹⁵⁵ The Proposed Regulations expand the current limitation such that, if a decrease in basis must be allocated to partnership property and the amount of the decrease exceeds the transferee's share of the adjusted basis to the partnership of all assets in that class, the basis of such property is reduced to zero, that is, the negative basis adjustment is no longer limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in a class.¹⁵⁶

It appears that the purpose of the proposed modification to Regulation section 1.755-1(b)(5)(iii)(C) is to reduce the likelihood of any excess transferee negative basis adjustment being carried over and made to future acquired property under Regulation section 1.755-1(b)(5)(iii)(D), which might have the effect of accelerating income to a transferee.

Example 13: Assume A, B, and C are partners in a partnership, UTP. The value of each partner's interest is \$100. Each of A and B has a basis of \$100 in its UTP interest, while C has zero basis in its UTP interest. UTP is a ten percent partner in another partnership, LTP, with a value and basis in its LTP interest of \$100. LTP owns a capital asset, with a value of \$50 and a basis of \$100, and inventory, with a value of \$950 and a basis of \$900. UTP distributes its interest in LTP to C in liquidation of C's interest in UTP at a time that each of UTP and LTP has a section 754 election in effect. C takes a zero basis in the distributed LTP interest.

Under Regulation section 1.755-1(b)(5)(ii), C's negative basis adjustment must be allocated to LTP's capital asset.¹⁵⁷ Under Regulation section 1.755-1(b)(5)(iii)(B), LTP would reduce the basis of its capital asset in an amount equal to C's share of the unrealized depreciation in such capital asset (a negative \$5 basis adjustment) and then would further reduce the basis of such capital asset by C's share of the capital asset's basis (a further negative \$5 basis adjustment).¹⁵⁸ Because the amount of the required decrease for C, \$100, exceeds the transferee's share of the adjusted basis to LTP of its depreciated property, that is, the capital asset, by \$90, the remaining \$90 negative basis adjustment would be carried over, under Regulation section 1.755-1(b)(5)(iii)(D), and applied to future acquired LTP property of a like character to which the adjustment could be made.

In contrast, under the Proposed Regulations, LTP's basis in its capital asset with respect to transferee C would be reduced by the asset's basis in excess of C's \$10 share, that is, by an additional \$90. Thus, whereas under the current regulations had the LTP capital asset been sold immediately after C

¹⁵⁵ Prop. Reg. § 1.755-1(b)(5)(iii)(C), 79 Fed. Reg. 3042, 3068 (2014).

¹⁵⁶ *Id.*

¹⁵⁷ Reg. § 1.755-1(b)(5)(ii).

¹⁵⁸ Reg. § 1.755-1(b)(5)(iii)(B).

acquired its LTP interest for \$50, C would recognize \$5 of gain, the Proposed Regulations would apparently require that C recognize \$95 of gain.

We believe it would be helpful to include an example of the proposed modification to Regulation section 1.755-1(b)(5)(iii)(C), similar to Example 13, and to clarify that to the extent a transferee's negative basis adjustment exceeds the transferee's share of basis in property to which the negative adjustment is made, the responsibility for tracking any excess adjustment is the responsibility of the partnership under Regulation section 1.743-1(k).

V. Succeeding to a Transferor's Basis Adjustment – Proposed Regulation Section 1.743-1(f)(2) Substituted Basis Transactions

Under Regulation section 1.743-1(f), a transferee partner's basis adjustment under section 743 is determined without regard to any basis adjustment that a transferor partner may have had in the transferred interest.¹⁵⁹ Proposed Regulation section 1.743-2(f)(2) would amend this rule for transferee partners who receive their interest in a substituted basis transaction (a substitute basis transferee).¹⁶⁰ Under the Proposed Regulations, a substitute basis transferee "succeeds to that portion of the transferor's basis adjustment attributable to the transferred partnership interest." In addition, the basis adjustment to which the substitute basis transferee succeeds is taken into account for purposes of determining the transferee's share of the adjusted basis of the partnership's property for purposes of Regulation sections 1.743-1(b) and 1.755-1(b)(5).¹⁶¹

In explaining the rationale for this change, the preamble to the Proposed Regulations states that the current rule in Regulation section 1.743-1(f) "can lead to inappropriate results" in substituted basis transactions.¹⁶² The preamble does not provide any examples of, or any specificity as to, such inappropriate results, but Treasury and the Service were presumably concerned that a partner could use a substituted basis transaction to shift its existing section 743(b) basis adjustment among the partnership's assets in a favorable manner without recognizing any gain.

Example 14: A purchased a 50% interest in a partnership for \$120. The partnership's assets consisted of two separate pieces of land: P9 and P10. Each piece of land had a basis of \$100 and a fair market value of \$120. If the partnership had a section 754 election in effect at the time of the sale of the partnership interest, A would have had a positive basis adjustment of \$10 in P9 and a positive basis adjustment of \$10 in P10. Over time, P9 decreased in value to \$100 and P10 increased in value to \$140. On a sale of P10, A would recognize a gain of \$10 [\$20 allocation of gain (50% of the total partnership gain of \$40) - \$10 basis adjustment].

¹⁵⁹Reg. § 1.743-1(f).

¹⁶⁰Prop. Reg. § 1.743-1(f)(2), 79 Fed. Reg. 3042, 3063 (2014).

¹⁶¹*Id.*

¹⁶²79 Fed. Reg. 3042, 3046 (2014).

Under the current regulations, if A were to transfer its interest in a nonrecognition transaction to its wholly owned Corporation A shortly before the sale of P10, the amount of gain recognized by Corporation A on the sale of P10 would be less than the gain recognized by A. A's \$10 basis adjustment in each of P9 and P10 would not carry over to Corporation A. Corporation A would determine its section 743 basis adjustment independent of A's prior adjustment. Corporation A's basis in the partnership interest (outside basis) would be \$120 (a carryover of A's basis). Corporation A's share of the basis of the partnership assets (inside basis) would be \$100 (calculated as \$120 cash on liquidation - \$20 share of gain). Because Corporation A's basis in its partnership interest (\$120) would be greater than its share of the basis of partnership assets (\$100), Corporation A would have a positive section 743(b) basis adjustment of \$20. The amount of Corporation A's positive basis adjustment is the same as the amount of A's positive basis adjustment, but Corporation A's basis adjustment would be allocated among the partnership assets under the substituted basis transaction rules of Regulation section 1.755-1(b)(5)(iii)(A). Under this basis adjustment provision, Corporation A's \$20 basis increase would be allocated entirely to P10 because P10 is the only asset with unrealized appreciation at the time of the substituted basis transaction. Upon the sale of P10, Corporation A would recognize a gain of \$0 (\$20 allocation of gain (50% of the total partnership gain of \$40) - \$20 basis adjustment). The practical effect of the contribution to Corporation A is to shift A's \$10 basis adjustment in P9 to P10 and to eliminate an additional \$10 of gain on the sale of P10.

The Proposed Regulations would change this result. Under Proposed Regulation section 1.743-1(f)(2), Corporation A would "succeed" to A's \$20 basis adjustment and would have to "take this basis adjustment into account" for purposes of determining its share of the adjusted basis of the partnership's property for purposes of Regulation sections 1.743-1(b) and 1.755-1(b)(5). While the Proposed Regulations do not make it explicitly clear, the practical effect of the Proposed Regulations is to treat A's section 754 basis adjustment as if it were part of A's share of the partnership's inside basis for purposes of determining Corporation A's basis adjustment. For example, by treating Corporation A as succeeding to A's basis adjustment, Corporation A's share of the inside partnership basis of P9 and P10 would not be \$50 for each property (as it is for A), but would be \$60 for each property (50% of the common basis of \$100 + A's \$10 section 743 adjustment) for a total inside basis of \$120. Because Corporation A's outside basis in its interest is \$120 and its share of inside basis under the Proposed Regulations is determined to be \$120, the total amount of the section 743 basis adjustment would be zero and, under the first sentence in Regulation section 1.755-1(b)(5)(ii), there would be no basis adjustment for Corporation A. Like A, Corporation A would have a \$10 basis adjustment in P9 and a \$10 basis adjustment in P10. As this example illustrates, the practical effect of the Proposed Regulations is that a substituted basis transferee will often simply step into the shoes of the

transferor partner's section 743 basis adjustment in situations in which the transferee's basis in the partnership interest is a carryover of the transferor's basis in the interest.

We have four comments with respect to this portion of the Proposed Regulations. First, while the Proposed Regulations may eliminate or reduce basis shifts in a substituted basis transaction, such a rule is inconsistent with the statutory provisions of section 743 and the current section 743 regulations. The flush language in section 743(b) states that a basis adjustment under section 743 "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only." Regulation section 1.743-1(j)(1) confirms that a section 743 adjustment is "an adjustment to the basis of partnership property with respect to the transferee only." The Proposed Regulations, however, provide that a transferee partner succeeds to the transferor's basis adjustment and that the transferor's basis adjustment must be taken into account for determining the transferee's share of the basis of partnership property. As illustrated by example 14, the effect of the Proposed Regulations will often be that the transferee partner simply steps into the shoes of the section 743 basis adjustment of the transferor. We believe this result is inconsistent with both the statutory language and the existing regulations under section 743. The flush language in section 743(b) does contain the proviso "under regulations prescribed by the Secretary," but we believe this language is better interpreted as referring to Treasury's ability to implement the provision, rather than an expression of permission for the Treasury to ignore the rule altogether.

Second, the Proposed Regulations appear in large part to be designed to prevent a partner from electing out of the basis adjustment rules of Regulation section 1.755-1(b)(2)-(4) and into the substituted basis adjustment rules of Regulation section 1.755-1(b)(5). If a partner acquires a partnership interest in a recognition event when a section 754 election is in effect, any basis adjustment to partnership property is determined under the "mark-to-market" provisions of Regulation section 1.755-1(b)(2)-(4). If the fair market value of the partnership property subsequently changes, the partner could transfer its interest in a substituted basis transaction and the transferee-partner would determine its basis adjustment under the substituted basis provisions of Regulation section 1.755-1(b)(5), as in the case involving P10 in Example 14. The Proposed Regulations will eliminate this "electivity" in many situations; however, as illustrated below, the Proposed Regulations will not eliminate such basis shifts in several common situations. By creating a basis adjustment rule that will apply for some substituted basis transactions, but not all, the Proposed Regulations create an additional patchwork of rules that creates different results for similar transactions and will only complicate the application of Subchapter K.

We believe that the Proposed Regulations prevent a basis shift only in situations where two factors are present: (1) the transferee's basis in its interest is equal to the transferor's basis in its interest and (2) the transferor's outside

basis in its interest is equal to the sum of the transferor's share of the inside basis of partnership assets and the transferor's section 743 adjustment. In this situation, a basis shift will not occur because the transferee-partner's outside basis and its share of inside basis (once adjusted to include the transferor's section 743 basis adjustment) are the same.¹⁶³ There are several common situations, however, in which one or more of these factors will not apply and a substitute basis transaction will often result in a basis shift.

Even if a transferee acquires its partnership interest in a substituted basis transaction, the transferee's basis in such interest might not always be equal to the transferor's basis in the interest. This can occur in situations where an upper-tier partnership distributes an interest in a lower-tier partnership to a partner and the transferee partner's basis in the distributed interest is increased or decreased under section 732(a)(2) or section 732(b). In addition, the transferor's outside basis in its interest might not be equal to the sum of the transferor's share of the partnership's inside basis and the transferor's section 743 basis adjustment. This situation can easily occur if the transferor acquired its partnership interest without making a section 754 election.

Example 15: The facts are the same as Example 14, except A acquired its partnership interest when a section 754 election was not in effect. The substituted basis transfer to Corporation A would have resulted in a basis increase of \$20 in the basis of P10 for Corporation A. This result occurs because Corporation A's basis in its interest would be \$120, but its share of the inside basis of the partnership assets would only be \$100. This basis increase would presumably occur even if A explicitly caused the partnership to fail to have a section 754 election in effect upon A's original acquisition of the partnership interest with the intention of ultimately making a substituted basis transfer to use the basis adjustment rules in Regulation section 1.755-1(b)(5).

There may be other situations in which a transferor's outside basis in its interest does not equal its share of inside basis. This can occur, for example, if another partner has contributed property subject to the ceiling rule of Regulation section 1.704-3(b)(1) and the partnership uses the traditional method under section 704(c).

Example 16: Assume A contributes \$100 cash and B contributes depreciable P11 with a basis of \$0 and a value of \$100 to an equal partnership. Once P11 is fully depreciated for capital account purposes, A will have an outside basis of \$100 because there is no tax depreciation on P11 under the traditional method, but A's share of the partnership's inside basis will be only \$50 (\$50 cash on liquidation - \$0 gain (assuming fair market value of P11 is equal to its 704(b) book value of \$0 for P11 for ease of illustration) + \$0 loss). If the partnership were to use the \$100 cash to buy several different properties and the value of these properties subsequently changed, A could transfer its interest in a substituted basis transaction and a basis shift could easily occur under Regulation section 1.755-1(b)(5).

¹⁶³ See Reg. § 1.755-1(b)(5)(ii) (first sentence).

The potential for electivity also exists when a partner acquires an interest in a transaction that causes a technical termination of the partnership under section 708(b)(1)(B). When a partnership is technically terminated, a section 754 election can be made by either the terminated partnership or the newly-created partnership or by both partnerships.¹⁶⁴ If a section 754 election is in effect for both the terminated partnership and the newly-created partnership, the Proposed Regulations would effectively override the election by the newly-created partnership because the interest in the newly-created partnership is transferred to the purchasing partner in a substituted basis transaction under the section 708(b)(1)(B) regulations. As a result, the purchasing partner's basis adjustment would be determined under the rules of Regulation section 1.743-1(b)(2)-(4) for the first section 754 election and the election by the newly-created partnership would have no effect. If, however, the terminated partnership did not have a section 754 election in place, but the newly-created partnership had a section 754 election in effect, the Proposed Regulation would not apply because the transferor partner did not have a section 743 basis adjustment. The partner's basis adjustment in that situation would be determined under the basis adjustment rules of Regulation section 1.755-1(b)(5).

Third, the example in the Proposed Regulations notes that the positive basis adjustment for C, the transferee-partner, would be recovered pursuant to Regulation section 1.743-1(j)(4)(i)(B).¹⁶⁵ Under that regulation, the positive basis adjustment would generally be recovered as if it were newly-purchased property. This restart of the depreciable life, however, appears inconsistent with the underlying theory of the Proposed Regulations. The Proposed Regulations effectively treat the transferor's section 743 basis adjustment as common inside basis for both the transferor and transferee. The transferee steps in the shoes of the remaining depreciable life for the actual common inside basis transferred from the transferor. If the section 743 basis of the transferor is treated as common inside basis under the Proposed Regulations for purposes of determining the transferee's basis adjustment under section 743, then, as a matter of consistency, it should be treated the same as inside basis for purposes of determining the recovery period for any increased basis adjustment, at least with respect to the portion of the transferee's basis adjustment that is a step-in-the-shoes of the transferor's basis adjustment. Under this approach, all of C's net positive basis adjustment in the example in the Proposed Regulations would be depreciated over the remaining useful life of the property.

In addition to being inconsistent with the underlying theory of the Proposed Regulations, the conclusion in the example also appears inconsistent with the substantive language of Proposed Regulation section 1.743-1(f)(2), which states that "the transferee succeeds to that portion of the transferor's basis

¹⁶⁴ See Reg. § 1.761-1(e).

¹⁶⁵ Prop. Reg. § 1.743-1(f)(2)(ii), 79 Fed. Reg. 3042, 3063 (2014).

adjustment attributable to the transferred partnership interest.” By stating that the transferee “succeeds” to the transferor’s adjustment, we believe this language could easily be interpreted as providing that the transferee steps-into-the-shoes of both the amount and the remaining depreciable life of the transferor’s basis adjustment. If the final regulations retain the rule set forth in Proposed Regulation section 1.743-1(f)(2), we believe the substantive language of the Proposed Regulations should be amended to make it clear that the transferee does not succeed to the remaining depreciable life associated with the basis adjustment.

We also note that this issue of restarting depreciable lives is related to the long-standing issue of the proper treatment of a section 743(b) basis adjustment upon a section 708(b)(1)(B) termination. The last sentence of Regulation section 1.743-1(h)(1) provides that a partner with a basis adjustment in a partnership that terminates under section 708(b)(1)(B) “will continue to have the same basis adjustment” with respect to property deemed contributed to the new partnership, regardless of whether the new partnership makes a section 754 election. It has been unclear whether a section 743(b) basis adjustment in depreciable property is restarted over a new depreciable life after the section 708(b)(1)(B) termination because, under the general rule of section 168(i)(7)(B), a partnership must restart the life of its depreciable assets in the event of a section 708(b)(1)(B) termination. By stating that a partner “will continue to have the same basis adjustment” after a technical termination and that a transferee partner will “succeed” to a transferor’s section 743(b) basis adjustment, the current section 743 regulation and the Proposed Regulations imply, unclearly, that the recovery period of the basis adjustment is not affected by the transfer. It would be helpful to clarify the issue and provide whether section 743(b) basis adjustments must be restarted in substituted basis transactions and section 708(b)(1)(B) terminations.

Finally, the application of the Proposed Regulations may be unclear in the context of tiered partnerships. Proposed Regulation section 1.743-1(l) provides that, if an interest in an upper-tier partnership is transferred by sale or exchange, and both the upper-tier and the lower-tier partnerships have a section 754 election in place, then an interest in the lower-tier partnership “will be deemed similarly transferred.”¹⁶⁶ When an interest in an upper-tier partnership is transferred in a substituted basis transaction, the interest in the lower-tier partnership is not actually transferred. The lower-tier partnership interest is held by the upper-tier partnership at all times. It would be helpful if the final regulation clarified whether the interest in the lower-tier partnership is also treated as having been transferred in a substituted basis transaction when an interest in the upper-tier partnership is transferred in a substituted basis transaction.

In light of the questions raised herein regarding the authority for Proposed Regulation section 1.743-1(f)(2) and the continued ability of taxpayers to

¹⁶⁶Prop. Reg. § 1.743-1(l)(2)(iv)(1), 79 Fed. Reg. 3042, 3065 (2014).

avoid the intended effect of Proposed Regulation and elect into the substituted basis rules of Regulation section 1.755-1(b)(5) in many circumstances, we recommend that Treasury and the Service consider withdrawing Proposed Regulation section 1.743-1(f)(2). If the Proposed Regulations are finalized, we recommend that Proposed Regulation section 1.743-1(f)(2) be modified so as to address the comments herein.

VI. Layering Versus Netting in Applying Section 704(c)

A. *The Proposed Guidance*

The Proposed Regulations contain guidance regarding the treatment of a revaluation of section 704(c) property held by a partnership. Specifically, they provide that a partner's pre-valuation built-in gain or built-in loss in the property does not take into account any decreases and increases, respectively, to the property's section 704(b) book value pursuant to a revaluation under Regulation section 1.704-1(b)(2)(iv)(f).¹⁶⁷ Under this proposed rule, revaluations, do not reduce the pre-valuation amount of built-in gain or built-in loss in partnership property. Instead, the proposed rules effectively require any existing section 704(c) amount and each revaluation amount for an asset to be treated as a separate layer with regard to the revalued asset for purposes of applying section 704(c) principles to that asset. In effect, the Proposed Regulations prohibit what is known as netting—reducing the built-in gain or built-in loss in an asset by a negative or positive revaluation amount, respectively.

The Preamble to the Proposed Regulations indicates that Treasury proposes to prohibit netting because of a concern that a netting approach could lead to distortions.¹⁶⁸ Although the Preamble does not describe the perceived distortion that could arise under a netting approach, it is likely that Treasury and the Service are concerned about the distortion that would result from a form of netting that allows a section 704(c) partner to reduce its section 704(c) amount by the portion of a revaluation amount attributable to another partner.

On the other hand, Treasury and the Service acknowledge in the Preamble that maintaining section 704(c) layers may result in additional administrative burden.¹⁶⁹ Therefore, the Preamble requests comments on when it is appropriate for partnerships to use a netting approach—for example, in the case of small partnerships.

The Proposed Regulations provide limited guidance on how a partnership should take various layers into account for section 704(c) purposes and provide flexibility in making this determination, stating that a partnership may use “any reasonable method to allocate the items of income, gain, loss, and

¹⁶⁷ Prop. Reg. § 1.704-3(a)(6)(i), 79 Fed. Reg. 3042, 3056 (2014).

¹⁶⁸ 79 Fed. Reg. 3042, 3054 (2014).

¹⁶⁹ *Id.*

deduction associated with an item of property among the property's forward and reverse section 704(c) layers."¹⁷⁰

The Proposed Regulations would apply to partnership contributions and transactions occurring on or after the date of publication of the Treasury Decision adopting the rules as final regulations in the Federal Register.

B. *Public Comments Received in Response to Notice 2009-70*

The preamble to the Proposed Regulations acknowledges the receipt of comments pursuant to Notice 2009-70 regarding the proper treatment of revaluations under section 704(c).¹⁷¹ These comments generally suggested one of two approaches. Under a layering approach, a partnership creates and maintains multiple section 704(c) layers for each partnership asset. Each revaluation creates a new layer, which in effect could be treated as a separate section 704(c) asset. In contrast, under a netting approach as described in the Notice 2009-70 comments, the partnership would net an opposite-sign revaluation amount against an existing built-in gain or built-in loss amount; and, therefore, the partnership would treat an opposite-sign revaluation amount as reducing the existing built-in gain or built-in loss in each section 704(c) property.

An opposite-sign revaluation amount is an amount that would reduce the existing built-in gain or loss in an asset.

Example 17: P12 has a \$100 book basis and a \$20 tax basis on the partnership's books. The partnership revalues its property when P12's fair market value is \$60, generating a negative \$40 revaluation amount. The negative \$40 revaluation amount would be an opposite sign revaluation amount for P12. One form of netting would treat P12's built-in gain amount being reduced from \$80 to \$40.

As stated above, the Proposed Regulations would not permit a partnership to use a netting approach because of the perception that a netting approach could lead to distortions. Treasury and the Service, however, requested comments on when it would be appropriate for a partnership to use a netting approach.

C. *Potential Distortion Caused by Netting*

In evaluating the relative merits of layering and netting, it is important to keep in mind that the ultimate goal of section 704(c) is to prevent a shift of pre-contribution gain or loss from a section 704(c) partner (or contributing partner) to other partners. This goal is reflected in the statute and the existing Regulations, which require that the allocation of tax items with respect to a section 704(c) asset to be made in a manner that results in the reduction, and

¹⁷⁰ Prop. Reg. § 1.704-3(a)(6)(iii), 79 Fed. Reg. 3042, 3056 (2014).

¹⁷¹ 79 Fed. Reg. 3042, 3046 (2014).

hopefully an eventual elimination, of the disparity between the section 704(c) partner's section 704(b) book and tax capital account amounts.¹⁷²

With that goal in mind, we begin the netting versus layering analysis with an attempt at understanding the perceived distortion that caused Treasury and the Service to propose prohibiting netting. Although the preamble to the Proposed Regulations does not specifically identify the perceived distortion potential that concerned Treasury and the Service, it is likely that the concern is the possibility that one partner's section 704(c) attribute would be affected by another partner's share of a subsequent book up or book down adjustment (or opposite-sign revaluation amount).

Example 18: A contributes property with a fair market value of \$100 and a tax basis of \$20 to a partnership in exchange for a 50% interest, and B contributes \$100 of cash for the other 50% interest. Initially, A's built-in gain in the contributed property is \$80, an amount that is reflected in the disparity between A's section 704(b) book capital account of \$100 and A's tax capital account of \$20. When the property contributed by A is worth \$60, C is admitted into the partnership for a one-third interest, and A's and B's section 704(b) book capital accounts are adjusted accordingly, and A's contributed property's book basis is adjusted to \$60, leaving only a \$40 difference between the property's book basis and tax basis.¹⁷³ It is easy to see that A and B have shared the \$40 post-contribution economic decline in value of the contributed asset equally, \$20 apiece.

The form of netting discussed in the public comments to Notice 2009-70 would have resulted in a reduction of A's section 704(c) taint from \$80 to \$40 even though A's share of the \$40 decline in value of the asset was only \$20. This type of netting produces a distortion to both A and B in that A bore only \$20 of the \$40 decline in the contributed asset's fair market value. By giving A the "benefit" of the entire \$40 decline in value of the property, even though A suffered only a \$20 economic loss, this type of netting would result in the tax consequences not following the economic consequences of the asset's decline in fair market value. For the tax consequences to follow the economic consequences, A's section 704(c) amount should be reduced solely by A's share of the economic "book down" (or by \$20). Moreover, B's \$20 share of the book down should also be given effect for tax purposes. After the book down, B's tax capital account of \$100 exceeds B's section 704(b) book capital account of \$80 by, not surprisingly, \$20.

In contrast to netting that simply offsets prior built-in gain with a revaluation loss, a layering approach should generally not produce the type of distortion alluded to in the preamble and illustrated by Example 16. By treating each revaluation of an asset as a separate section 704(c) property

¹⁷² See I.R.C. § 704(c); Reg. § 1.704-3(a)(1).

¹⁷³ The terms "book basis" and "tax basis" as used herein are intended as references to "book value" and "adjusted tax basis," respectively, as those terms are used in Regulation section 1.704-3.

and by keeping track of each partner's share of each layer (or asset), layering would generally be expected to eliminate the potential for one partner's section 704(c) taint to be affected by another partner's share of the opposite-sign revaluation of a section 704(c) property. This is a clear benefit of layering over the type of netting referred to in the comments to Notice 2009-70. There are, however, at least two significant costs to a layering approach. The first relates to the difficult issues of allocating the partnership's single tax basis in an asset among the multiple layers into which the asset is divided. This is a practical, administrative cost. The second cost, a complexity cost, relates to the increased operative effect of the ceiling rule that will occur by dividing a single asset into multiple section 704(c) properties and applying the ceiling rule separately with respect to each identified layer. These costs will be illustrated in the simple examples below.

The ceiling rule creates the potential for distortions under section 704(c). It frustrates the goal of section 704(c) in preventing a complete elimination of a partner's section 704(c) disparity, and it prevents a noncontributing partner from receiving either the tax deductions or loss that it is entitled to, or forces the noncontributing partner to recognize income or gain that should be recognized by the section 704(c) partner. As a general rule, the impact of the ceiling rule is lessened by being able to draw upon a larger universe of tax items with respect to an asset to allocate in accordance with section 704(c) principles. Consequently, dividing a single asset into smaller and smaller pieces and applying the ceiling rule with respect to each separate piece increases the possibility that the ceiling rule will apply. Flexibility in allocating the partnership's single basis among the separate layers creates planning opportunities that exacerbate this potential distortion.

The best section 704(c) approach would be one that achieved each of the following goals: First, it would avoid the difficult practical issues inherent in any system that required a partnership's single basis in an asset to be apportioned among multiple layers. Second, it would avoid increasing the application and the effect of the ceiling rule. Third, it would ensure that a given partner's section 704(c) taint should be affected only by that partner's share of the subsequent upward or downward revaluations of the section 704(c) asset.

A netting approach would achieve the first of these goals since there is no need to allocate basis among separate layers. Whether the latter two goals are achieved depends on the particular type of netting approach utilized. The distortion identified above under the form of netting described above is not, however, fatal to the overall concept of netting. What is needed is a form of netting which achieves the simplification that a single-layer-per-asset approach offers without creating or increasing the potential for the other two identified distortions. Fortunately, there is a form of netting that accomplishes all three of the listed goals, and that approach is set forth below. Before discussing the proposed alternate netting approach, we first discuss certain issues associated with the layering approach as suggested by the Proposed Regulations.

D. *Pros and Cons of Layering*

We are concerned that layering raises many difficult practical issues in regard to how a partnership's basis in its assets is to be apportioned among layers and how opposite-sign layers should be treated. Moreover, treating each separate revaluation layer as a separate section 704(c) asset can lead to other distortions that will have the effect of increasing the application of the ceiling rule. On the other hand, layering facilitates the ability of a partnership to use different methods (for example, the traditional, traditional with curatives, or remedial methods) for different revaluation layers. On balance, we believe that the administrative burdens imposed upon partnerships by requiring layering, as well as the fact that layering will not in all cases avoid the types of distortions alluded to in the preamble, support allowing partnerships to use netting in many situations. For these reasons, we recommend that partnerships be permitted to use an appropriate netting approach, subject to anti-abuse principles consistent with those in Regulation section 1.704-3(a)(10).

1. *Layering and Reasonable Methods*

Example 19: A contributes a machine, P13, with a fair market value of \$100 and a tax basis of \$70 to the AB Partnership in exchange for a 50% interest, and B contributes cash of \$100 for a 50% interest. P13 is depreciable. For simplicity, however, unless provided otherwise, assume that no book or tax depreciation will be taken on the contributed property between the contribution date of the property and the first revaluation event. When P13's value is \$60, C contributes \$80 to the AB Partnership in exchange for a one-third interest. Each of A and B equally share the \$40 unrealized loss associated with P13 (*i.e.*, \$20 to A and \$20 to B). P13 is depreciated to zero after C's admission.

The netting approach that apparently raised concerns for Treasury and the Service would have eliminated A's forward section 704(c) gain of \$30. In particular, \$20 of the partnership's revalued \$60 book basis in P13 would be allocated to each partner, while \$20 of tax basis recovery would be allocated to C and, presumably, \$25 of tax basis recovery would be allocated to each of A and B.¹⁷⁴ As a result, A would have a \$60 book and a \$45 tax capital account, B would have a \$60 book and a \$75 tax capital account, and C would have both a \$60 book and tax capital account.

In contrast to the above, the layering approach would presumably retain for A its \$30 of forward section 704(c) built-in gain attribute in P13, but it would also create a \$20 book loss (or section 704(c) attribute) for each of A and B that the partnership would be required to take into account in determining the tax allocations of P13's \$70 tax basis recovery through depreciation. The Proposed Regulations do not provide specific guidance on how

¹⁷⁴The \$25 of tax basis recovery allocated to each of A and B would reflect each partner's share of the \$20 book basis recovery and a \$5 share of the excess of the \$70 tax basis over the \$60 book basis following the revaluation.

the partnership should take these attributes into account. Rather, Proposed Regulation 1.704-3(a)(6)(iii) provides that, “[a] partnership may use any reasonable method to allocate the items of income, gain, loss, and deduction associated with an item of property among the property’s forward and reverse section 704(c) layers.” This language raises a number of questions. For example, the Proposed Regulations do not provide guidance on how such a partnership should make reasonable allocations regarding the layers. Two possible alternatives would be to treat the \$40 revaluation loss as either (1) a separate asset or (2) a separate attribute. Which alternative is adopted and the section 704(c) method applied can have a significant effect on the tax results for the partners. Below we discuss various approaches to the revaluation layer and what might be a reasonable method in making allocations for the forward layer and the reverse layer.

2. Treating Layers as Separate Assets and Applying the Traditional Method to Each Layer

a. *No Modification in Book Basis or Tax Basis on the Forward Layer and Use of the Traditional Method.* **Example 20:** Continuing the facts of the Example 19, assume the partnership treats P13 as consisting of both a \$100 book basis and \$70 tax basis (in the forward section 704(c) component), and a (\$40) book basis and \$0 tax basis (in the reverse section 704(c) component).¹⁷⁵ The partnership adopts the traditional method for both layers. For the forward section 704(c) component, over P13’s entire depreciation period, the partnership would allocate (\$33.33) of book basis recovery to each of A, B and C; it would allocate a matching (\$33.33) of tax basis recovery to each of B and C and (\$3.34) of tax basis recovery to A. For the reverse section 704(c) component, the partnership would allocate \$13.33 of book income to each partner and no tax income to each partner. The allocations would leave each partner with a \$60 book capital account, which makes sense assuming the depreciation of P13 is the only relevant item. The allocations would result in book-tax disparities for each partner as A’s tax capital account would be \$66.67 (*i.e.*, \$6.66 higher than its book capital account), B’s tax capital account would be \$66.67 (*i.e.*, \$6.67 higher than its book capital account), and C’s tax capital account would be \$46.67 (*i.e.*, \$13.33 lower than its book capital account). In effect, the approach above has created a ceiling rule distortion for B even though P13’s tax basis of \$70 is enough to cover both B’s share of the total section 704(b) loss allocated to B (\$20 of revaluation loss plus \$20 of book depreciation), as well as C’s share (\$20 of book depreciation). In fact, the approach above has even created a distortion for A, the contributing partner, where one does not seem appropriate (as explained below).

We believe that the above results produce the incorrect answer from a policy perspective, especially given that there is enough tax basis recovery to produce

¹⁷⁵We show the reverse layer as a negative book basis asset for illustration purposes.

the “correct” policy result. The disparity offset method (“**DOM**”) approach described below would achieve a more appropriate allocation of tax depreciation and one that does not encounter a ceiling rule limitation. Under DOM, the \$70 of tax depreciation would be allocated \$10 to A (the amount of A’s book/tax disparity after taking into account A’s \$20 share of the revaluation loss), \$40 to B (B’s share of the total economic loss in P13) and \$20 to C (C’s share of the book basis recovery in P13), resulting in a complete elimination of the disparity between each partner’s book and tax capital accounts.

b. *Modification to the Book Basis and Tax Basis on the Forward Layer and Use of the Traditional Method.* Using an alternative to the layering approach above, the partnership could adjust the book and tax basis attributable to each layer to reflect the revaluation while maintaining the forward section 704(c) gain attributable to A and recognizing the \$20 revaluation loss allocated to each of A and B. Under such an alternative, the partnership could treat the forward section 704(c) component as having a \$60 book basis and a \$30 tax basis, which would retain A’s \$30 built-in gain in the forward section 704(c) component, and treat the reverse section 704(c) component as having a \$0 book basis and a \$40 tax basis. Doing so would reflect the \$40 revaluation loss attributable to P13.

Regarding the forward section 704(c) component, over P13’s entire depreciation period, the partnership would allocate \$20 of book basis recovery to each partner. Because A is the contributing partner on the forward section 704(c) component, the partnership would allocate the \$30 of tax basis recovery to B and C before allocating any remaining tax basis recovery attributable to the forward layer to A. In this case, the partnership has only \$30 of tax basis recovery to allocate to B and C because the partnership treated the forward section 704(c) component as having a \$60 book basis and a \$30 tax basis.

Arguably, the partnership would be reasonable in allocating the \$30 of tax basis recovery from the forward section 704(c) component among B and C based on a number of approaches, including (i) a ratable approach, based on the book basis recovery allocated to each noncontributing partner (\$15 of tax depreciation to each of B and C), (ii) a first-in approach, that is, first to B to make B whole, or (iii) first to C based on a last-in principle. As evidenced by the public comments received in response to Notice 2009-70, there is no consensus as to how this basis allocation among the layers is to be done. Some argue for allocating the basis to the oldest layer first while others argue that it is more appropriate to allocate the basis to the last layer and still others

argue that basis should be allocated proportionately among the layers.¹⁷⁶ The Proposed Regulations provide that the basis may be allocated among the layers under any reasonable method.¹⁷⁷ While such a rule provides a generous amount of flexibility, allowing partners to allocate the basis among the layers could result in the creation of ceiling rule distortions in a manner inconsistent with the purposes of section 704(c).

No matter how the partnership allocates the \$30 of tax basis recovery attributable to the forward section 704(c) component between B and C, there will be an unfavorable \$10 book-tax disparity for B and C in total. It would seem quite inappropriate for them to suffer such a result under the facts of the example. In particular, C arguably viewed the partnership's P13 as worth \$60 with a tax basis of \$70 when it made its investment, suggesting that C would not have expected a ceiling rule limitation regarding C's basis recovery of P13.¹⁷⁸ Nonetheless, it is not clear that the Proposed Regulations would prevent such a result from occurring. As to the partnership's reverse section 704(c) component, the partnership would allocate \$0 book basis recovery to each partner and \$20 of tax basis recovery to each of A and B to reflect the \$20 revaluation loss allocated to each of them.

Once again, it is interesting to note that under DOM, described below, there would be no ceiling rule limitation under these facts. A, B, and C would have received allocation of \$10, \$40, and \$20, respectively, of tax depreciation, a result that does not encounter a ceiling rule limitation.

The above example involved only one amortizable asset, only one revaluation event and only three partners. One can easily see how complicated layering can be on such a simplified set of facts. It is clear that many partnerships will be overwhelmed if required to maintain multiple layers for

¹⁷⁶ See Barksdale Hortenstine, Telma Nadvorny & Jeffrey Helm, *Multi-Layered Partnership Assets; Divergent Results Under the Separate Layer and Single Asset Methods of Allocating Gain, Loss and Depreciation under Section 704(c)* (PowerPoint slides), PLI (2014); Roger Pillow & Glenn Dance, *Notice 2009-70: A Focus on Complex Section 704(c) Netting vs. Layering Issues*, 111 J. TAX'N 336 (2009); *NYSBA Tax Section Comments on Treatment of Layers in Partnership Mergers, Divisions and Tiered Partnerships*, 2010 TAX NOTES TODAY 16-22 (Jan. 22, 2010); *A Response to Notice 2009-70*, 2009 TAX NOTES TODAY 175-79 (Aug. 26, 2009).

¹⁷⁷ Prop. Reg. § 1.704-3(a)(3)(iii), 79 Fed. Reg. 3042, 3056 (2014).

¹⁷⁸ The potential for creating ceiling rule implications for persons such as C is more apparent if P13 had a \$40 tax basis. In that case, A's forward section 704(c) gain would be \$60; each of A and B would again suffer a \$20 revaluation loss. If the partnership adopted the above approach to determining the book basis and tax basis of the forward and reverse section 704(c) components, it would allocate \$60 of book basis and \$0 of tax basis to the forward section 704(c) component, and allocate \$0 book basis and \$40 tax basis to the reverse section 704(c) component. As above, the partnership would allocate \$20 of book basis recovery to C regarding the forward section 704(c) component. Under the ceiling rule and the traditional method, the partnership would not be able to allocate any tax basis recovery to C, a result that might surprise C given that the partnership has \$40 of tax basis and C, as a one-third partner, could not be blamed for expecting an allocation of \$20 of both book and tax basis recovery. Given that the Proposed Regulations leave the ceiling rule intact, one could see practitioners concluding that it is reasonable to adopt the preceding approach to the layering of the revaluation loss.

multiple assets with multiple section 704(c) partners. Moreover, it is not clear that layering will always achieve the results that we suspect Treasury and the Service intended in issuing the Proposed Regulations. For these reasons, we propose that a partnership should be given the option to either adopt a netting approach or adopt a layering approach for revaluations, subject to an anti-abuse rule similar to Regulation section 1.704-3(a)(10). We also propose that a partnership should be able to adopt the DOM approach in addressing revaluation amounts. We discuss DOM more fully below.

E. *A Modified Netting Approach Without a Distortion*

Before discussing the proposed DOM alternative, we summarize the above by stating that we agree with adopting a system in which a section 704(c) partner's built-in gain or loss in an asset should not be affected by a noncontributing partner's share of any subsequent upward or downward revaluation amount allocated to the asset. On the other hand, the case can be made that it is appropriate to reduce a section 704(c) partner's built-in gain or loss by such partner's share of any subsequent revaluation of the section 704(c) property. A netting methodology that reduces a section 704(c) partner's built-in gain or loss by such partner's share of the subsequent revaluation of the section 704(c) property does not result in the distortion alluded to in the preamble.

The goal, therefore, should be to ensure that a section 704(c) partner's built-in gain or loss is affected only by such partner's share of any subsequent revaluation book up or down. Moreover, by applying section 704(c) to a single unified asset rather than multiple layers of an asset, the application of section 704(c) principles would be much easier to accomplish. A netting approach applied in this manner can achieve the policy goal of layering in a simpler way that avoids other potential distortions that can be created by a layering approach.

F. *Pros and Cons of the Disparity Offset Method (DOM)*

As noted above, we believe there is another approach beyond layering and the type of netting described in the Notice 2009-70 that we recommend adopting. This third approach, which many people view as an alternative modified netting methodology, achieves the policy goals of the layering approach (*i.e.*, preventing the identified distortion) without the additional ceiling rule distortions and practical problems of allocating basis. We, and other commentators, refer to this third approach as the disparity offset method, or DOM.¹⁷⁹

¹⁷⁹ See John G. Schmalz & Elizabeth Amoni, *Applying the Disparity Offset Method to Achieve Tax-Follows-Economics Results*, 115 J. TAX'N 133, 133 (2011); see also John G. Schmalz & Mark B. Brumbaugh, *Disparity Offset Method Can Automate the Calculations in the Final 704(c) Regulations*, 11 J. PARTNERSHIP TAX'N 183, 183 (1994).

1. *Description of the Disparity Offset Method*

DOM is a disparity-based, rather than a layer-based, approach to the application of section 704(c). Layers are not maintained under DOM. Instead, the partnership determines its overall book/tax disparity for each partnership asset that has forward or reverse section 704(c) gain or loss. The partnership then calculates each partner's share of that disparity. A partner's share of the partnership's overall disparity in a section 704(c) asset is determined by reference to any forward section 704(c) built-in gain or loss in such asset attributable to that partner as adjusted only by such partner's share of any upward or downward revaluation amount allocated to such property.

A partner's share of the partnership's disparity with respect to an asset is represented by a disparity offset amount ("**DOA**"), which can be positive or negative depending upon the specific revaluations attributable to such partner with respect to that asset. A given partner's DOA is not adjusted by any other partner's share of the upward or downward revaluation of the asset. This is the major difference between DOM and the type of netting proscribed in the Proposed Regulations. It is, therefore, impossible for one partner's DOA in a given asset to be affected by revaluations of other assets. This DOA is maintained in a manner similar to how a revaluation account is maintained in a securities partnership that utilizes the aggregate method for allocating gains and losses from the disposition of qualified financial assets under Regulation section 1.704-1(e)(3) with one major difference. A revaluation account in a securities partnership is maintained on a portfolio-wide basis, whereas the DOA is maintained strictly under an asset-by-asset approach. Because a partner's DOA with respect to a partnership section 704(c) property is adjusted solely by that partner's share of the upward or downward revaluation of such property, it is not possible to create the netting distortions alluded to in the preamble to the Proposed Regulations.

Each partner will have a separate DOA in each partnership asset in which that partner has forward or reverse section 704(c) gain or loss. The maximum number of DOAs in a partnership will be equal to the number of section 704(c) partners times the number of section 704(c) assets. For example, a partnership with 10 partners and 15 assets will have up to 150 DOAs, each specific to each partner and each asset.

If the section 704(c) asset is depreciable or amortizable, a partner's DOA is amortized over the depreciation or amortization life of the asset. This is done under the existing rules applicable to the recovery period for the asset under the section 704(c) method utilized by the partnership with respect to that asset (for example, the traditional method, traditional method with curatives, or the remedial method). Once a partner's DOA in an asset is calculated, the partner's tax allocation is determined by the following formula: book allocation minus DOA is equal to tax allocation. For example, in Example 17, A would have had a DOA in P13 of \$10 (\$30 of built-in gain less \$20 of revaluation loss), B would have had a DOA of (\$20) (\$20 of revaluation

loss), and C would have had a DOA of \$0.¹⁸⁰ A's tax basis recovery allocation would have been \$10 (\$20 book basis recovery allocation less \$10 DOA), B's tax basis recovery allocation would have been \$40 (\$20 book basis recovery allocation less (\$20) DOA), and C's tax basis recovery allocation would have been \$20 (\$20 book basis recovery allocation less \$0 DOA). Appropriate adjustments would need to be made for cases subject to the ceiling rule under the traditional method. (See the discussion below.)

The following two examples illustrate how DOM would be applied in two situations where a forward section 704(c) asset is the subject of two subsequent revaluations. In Example 21, an asset contributed with built-in gain is revalued up and then down. Example 22 involves an asset that is contributed with a built-in loss that is revalued up and then down.

2. Contributed BIG Asset Revalued Up and Then Down

Example 21: A contributes a depreciable asset P14 with a fair market value of \$100 and a tax basis of \$80 to a partnership. A's \$20 forward section 704(c) gain is reflected in the disparity between A's book capital account (*i.e.*, \$100) and A's tax capital account (*i.e.*, \$80). A therefore starts out with a DOA of \$20 in P14. B contributes \$100 in cash for his interest and has a \$0 DOA in P14. Before any depreciation is taken, P14 declines in value from \$100 to \$60, and C contributes \$80 for a one-third interest in the partnership. The cash invested by B is invested in an asset that retains its \$100 fair market value. The section 704(b) book basis of P14 is reduced from \$100 to \$60. The \$40 decline in the value of P14 is shared \$20 by A and \$20 by B and is reflected by a \$20 decline in each of A's and B's book capital accounts. A's forward DOA of \$20 is reduced to zero and B's initial DOA of zero is reduced to (\$20). If, at that point, P14 were depreciated from \$60 to \$0, the \$60 of section 704(b) book depreciation would have been allocated \$20 to each of A, B and C. The \$80 of tax depreciation on the asset would have been allocated \$20 to each of A and C (*i.e.*, each of such partner's book allocation of \$20 minus such partner's DOA of zero), and \$40 to B (B's book allocation of \$20 minus B's (\$20) DOA). The result would be that each partner would have an equal book and tax capital account following the above allocations.

Alternatively, suppose that, after the value of P14 has declined from \$100 to \$60 but before any depreciation is taken by the partnership, D contributed \$100 for a 25% interest at a time when the value of P14 had appreciated from \$60 to \$120. In this instance, the DOA of each of A, B, and C in the property would have been adjusted by each partner's share of the \$60 book up in the section 704(b) book basis of the asset. The prior DOA of zero of each of A and C would have been increased to \$20, while B's prior DOA of (\$20)

¹⁸⁰The DOA amount for each partner matches the book-tax difference in each partner's book and tax capital account—A has an \$80 book capital account and a \$70 tax capital account, B has an \$80 book capital account and a \$100 tax capital account, and C has an \$80 book and tax capital account.

would have been increased to \$0. The \$120 of book depreciation would then have been allocated \$30 to each of A, B, C, and D; the \$80 of tax depreciation would then be allocated \$10 to each of A and C (*i.e.*, each of A and C's book allocation of \$30 minus its DOA of \$20) and \$30 to each of B and D (*i.e.*, each of B and D's book allocation of \$30 less its DOA of zero). This allocation would have then equalized each partner's book and tax capital account.

The foregoing example illustrates that DOM is a simple and effective method for applying section 704(c) principles to multiple revaluations of partnership property. The example can be extended to illustrate several other applications of DOM. With respect to the determination of the amount of pre-contribution gain for purposes of sections 704(c)(1)(B) and 737, DOM can make that determination in the case of an asset that was revalued several times after the original contribution. In the example, A's forward section 704(c) gain, and therefore its pre-contribution gain, was completely eliminated by the first downward revaluation of the property, such that A's section 704(c)(1)(B) taint should be permanently reduced to zero even though the property was subsequently booked up by the second revaluation. Because A's DOA was ultimately attributable to the revaluation gain, which is not subject to section 704(c)(1)(B), rather than forward section 704(c) gain, sections 704(c)(1)(B) and 737 should be inapplicable for that asset.

Additionally, DOM can also be used to determine a partner's share of inside basis in an asset. Using the methodology, a partner's share of inside basis is equal to that partner's share of book basis minus that partner's DOA in the asset. In the preceding example, each of A's and C's share of inside basis immediately after D's admission would be \$10 apiece, while each of B's and D's share would be \$30 apiece. This type of a derivative benefit would be useful in determining a person's section 743(b) adjustment, for instance, clearly a desirable goal in coordinating sections 704(c) and 743(b).¹⁸¹

3. *Contributed BIL Asset Revalued Up and Down*

Example 22, which has two parts (Example 22A and 22B), applies DOM to an asset that is contributed with a section 704(c)(1)(C) loss and that is subsequently revalued upward upon an admission of a new partner. The example addresses the issue of whether DOM should be applied by taking the section 704(c)(1)(C) loss into account as part of that partner's DOA, after which it is adjusted by subsequent revaluations, or whether the section 704(c)(1)(C) loss should be strictly segregated and available only to the section 704(c)(1)(C) partner, despite a later upward revaluation of the contributed property. Strict application of the prohibition on netting would preserve the contributing partner's section 704(c)(1)(C) basis adjustment attributable to the forward section 704(c) loss without regard to the subsequent upward revaluation of

¹⁸¹The discussion herein is intended to describe the DOM methodology in regard to layering versus netting. Additional examples of the derivative benefits of applying DOM have been developed and are available if requested.

the contributed asset. While this approach may be more consistent with the statutory language in section 704(c)(1)(C), Example 22B illustrates why this version of the rule might result in unintended distortions. Both examples apply the traditional method.

a. *Section 704(c)(1)(C) Basis Adjustment Segregated and Not Reflected in the Contributor's DOA.* **Example 22A:** E contributes property, P15, with a value of \$100 and a tax basis of \$150 for a 50% interest, implicating section 704(c)(1)(C). Where the section 704(c)(1)(C) amount is treated as separate and strictly for E's benefit, E has a \$0 DOA, as section 704(c)(1)(C) requires that only E benefit from P15's \$50 adjusted basis in excess of its fair market value. In that regard, counting the section 704(c)(1)(C) amount of \$50 as part of the DOA would duplicate the \$50 built-in loss. Regarding the other partners, section 704(c)(1)(C) mandates that they must treat P15 as having a basis no greater than the fair market of \$100. F contributes \$100 of cash and has an initial DOA of \$0.

P15 appreciates in value to \$200, after which G is admitted for \$150 of cash in exchange for an equal one-third interest in the partnership. P15 is revalued upward to \$200 concurrent with G's admission and the revaluation gain of \$100 is allocated equally between E and F, or \$50 apiece. The \$50 revaluation gain allocated to E adjusts E's DOA to \$50. E retains the \$50 section 704(c)(1)(C) amount. F now has a \$50 DOA to reflect its share of the \$100 revaluation gain. F's and G's cash is invested in nondepreciable assets that retain their value.

Assume P15 subsequently declines in value from \$200 to \$140 and H is admitted as an equal 25% partner in exchange for a contribution of \$130 of cash, causing P15 to be revalued down by \$60, to \$140. The \$60 book loss would be allocated equally among E, F, and G, that is, \$20 to each. E's DOA would accordingly be reduced to \$30 (*i.e.*, \$0 initial DOA, adjusted for \$50 revaluation gain, and adjusted for (\$20) revaluation loss), F's DOA would be \$30 (*i.e.*, \$0 initial DOA, adjusted for \$50 revaluation gain, and adjusted for (\$20) revaluation loss), and G's DOA would be (\$20) (*i.e.*, \$0 initial DOA, adjusted for \$20 revaluation loss). H's DOA would be \$0. Although this downward revaluation of the property has the effect of recreating a portion of E's forward section 704(c) loss, that loss is attributable to revaluation loss, not E's forward section 704(c) loss and section 704(c)(1)(C) would not apply to this downward revaluation. The partnership would allocate \$35 of book basis recovery to each partner. E would be allocated tax depreciation of \$5 (*i.e.*, an amount equal to E's book depreciation of \$35 minus E's DOA of \$30), F would be allocated tax depreciation of \$5 (*i.e.*, F's book depreciation of \$35 minus F's DOA of \$30), G would each be allocated tax depreciation of \$55 (*i.e.*, an amount equal to G's book depreciation of \$35 minus G's (\$20) DOA), and H would be allocated tax depreciation of \$35 (*i.e.*, an amount equal to H's book depreciation, given H's DOA of \$0). These allocations eliminate the disparities of all partners in the asset and limit the partnership's tax depreciation to \$100, with E being allocated an additional \$50 of

tax depreciation under section 704(c)(1)(C). Because there is no ceiling rule limitation applicable under these facts, the result is the same, alternatively, if E's initial DOA takes the forward \$50 built-in loss into account such that the partnership is treated as having tax depreciation of \$150.

b. *Section 704(c)(1)(C) Basis Adjustment Reflected in the Contributor's DOA Where the Ceiling Rule Applies.* In contrast to a situation such as Example 22A in which the ceiling rule does not apply, in a situation where a partner has a section 704(c)(1)(C) basis adjustment and the ceiling rule is applicable, a strong argument can be made that the contributing partner's section 704(c)(1)(C) basis adjustment should be considered as part of the overall DOM analysis. Under this view of the world, which is illustrated in Example 22B, the contributing partner's section 704(c)(1)(C) built-in loss would be included in the contributing partner's DOA and adjusted by the contributing partner's share of the upward revaluation of the asset. Moreover, the contributing partner's section 704(c)(1)(C) built-in loss would be permanently reduced by the contributing partner's share of an upward revaluation of the contributed asset. The basis attributable to the original built-in loss would then be available to generate deductions that would be allocated to partners who are allocated the corresponding book deductions attributable to the property. Example 22B, therefore, includes the original section 704(c)(1)(C) basis adjustment in the contributing partner's DOA and illustrates how the segregation of the forward section 704(c)(1)(C) layer can produce distortions that would be overcome by applying DOM in a manner that does not segregate the section 704(c)(1)(C) basis adjustment.

c. *Section 704(c)(1)(C) Ceiling Rule Limited Asset Revalued and DOM Applied.* **Example 22B:** As in Example 22A, E contributes P15 with a value of \$100 and a tax basis of \$150 for a 50% interest, implicating section 704(c)(1)(C), and F contributes \$100 of cash for a 50% interest. At a later time, when P15 has appreciated in value to \$600, G contributes \$350 for a one-third interest. E's DOA takes into account the original \$50 built-in loss. E's DOA is subsequently adjusted from (\$50) to \$200 by E's share of the revaluation gain and F has a DOA of \$250, reflecting F's share of that revaluation gain. G has a DOA of \$0. The section 704(c)(1)(C) book depreciation deductions allowable on the \$600 of book basis in P15 are then allocated equally among E, F, and G, \$200 each. Each partner's DOA is applied to that partner's share of the book deductions with the following results: E's positive DOA of \$200 is applied against E's book allocation of \$200 with the result that E is entitled to tax deductions of \$0. Similarly, F's DOA of \$250 is applied against F's book allocation of \$200 resulting in no tax deductions for F. G's DOA of \$0 is applied against G's book allocation of \$200, with the result that G would be entitled to \$200 of tax deductions, but because the ceiling rule is applicable, G can only receive \$150 representing the tax basis in the asset.

As a result of the above allocations, E would have a \$150 book and tax capital account, F would have a \$150 book capital account and a \$100 tax

capital account (reflecting \$50 of gain that F shifts to G due to the traditional method being used and the ceiling rule applying), and G would have a \$150 book capital account and a \$200 tax capital account (where the \$50 disparity has been caused by the application of the ceiling rule).

Alternatively, if the section 704(c)(1)(C) basis adjustment of \$50 had been segregated for E, after the revaluation E would have had a positive DOA of \$250, which, applied against E's book depreciation of \$200, would have resulted in E having tax deductions of \$0. Under section 704(c)(1)(C), as in Example 22A, the partnership would allocate \$50 of tax depreciation to E. Each of F and G would have had the same DOA to apply against its \$200 of book depreciation, resulting in F being entitled to no tax deductions and G being entitled to \$200 of tax deductions. G's entitlement to tax deductions would then be limited by the ceiling rule to \$100, as opposed to \$150 above. As a result, each of E and F would have a book capital account of \$150 and a tax capital account of \$100 and G would have a \$150 book capital account and a \$250 tax capital account.

This example highlights the consequence of utilizing E's section 704(c)(1)(C) basis adjustment to reduce distortions caused by the ceiling rule, as recommended above in these Comments, and illustrates that DOM will achieve that result to the extent a section 704(c)(1)(C) basis adjustment is incorporated into a section 704(c)(1)(C) partner's DOA.

4. *Benefits of DOM*

DOM is compatible with any of the three section 704(c) methods described in the existing regulations. In cases where the available tax items are limited by the ceiling rule under the traditional method, there will not be enough tax items to allocate to each partner what that partner is entitled to receive under the "book minus DOA" formula. In those cases, the available items are allocated among the partners in relation to the amount that each partner is entitled to after applying the "book minus DOA" formula over the sum of the amounts to which all partners are entitled. This ensures that all partners affected by the ceiling rule will share in the limitation proportionately.

DOM has several significant advantages when compared to a layering methodology. First, DOM provides a simple, direct, and straightforward approach which results in allocations that reduce or eliminate a section 704(c) partner's book/tax disparity. This disparity reduction is accomplished by applying a very simple mathematical formula that works with a wide range of section 704(b) book allocations.

Second, DOM is a faithful reflection of the statutory language of section 704(c). Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership shall be allocated in a manner that takes into account the variation between the property's value and tax basis at contribution. Distilling this language down to its essence, section 704(c) directs tax items to be allocated in a manner that takes into account

the disparity between the value and tax basis of section 704(c) property. This is exactly what DOM does in a very direct and straightforward manner.

Third, DOM avoids the difficult issues of how to allocate the partnership's tax basis with respect to a section 704(c) asset among the various layers created in a layering approach. As evidenced by the public comments received in response to Notice 2009-70, there is no clear understanding of how this basis allocation among the layers is to be done. The Proposed Regulations imply that the basis can be allocated among the layers under any reasonable method. While such a rule provides a generous amount of flexibility, allowing partners to allocate the basis among the layers as they deem appropriate creates planning opportunities that might permit the partners to create ceiling rule distortions wherever and whenever they wish by simply allocating more or less basis to a particular layer. (See, for instance, Examples 19 and 20 above.)

Fourth, DOM avoids the problems associated with negative layers. No satisfactory answer has been proposed for determining how much basis should be allocated to a negative layer. Downward revaluations (or negative layers) do not cause problems under DOM since DOM does not allocate tax basis in an asset among layers. As explained previously, a given partner's DOA can either be positive or negative. A negative DOA attracts tax deductions in excess of book deductions in the amount of the DOA and deflects tax gain in the same amount without requiring the need to allocate basis to a negative layer. (See, for instance, Examples 21, 22A and 22B above.)

Fifth, DOM is capable of handling a large number of revaluations with respect to a particular section 704(c) asset. This is evidenced by the fact that securities partnerships using the aggregate method for allocations quite successfully maintain a revaluation account for each partner that takes into account all of the successive upward and downward revaluations of the partnership portfolio. For example, a securities partnership with monthly break periods will adjust each partner's revaluation count 12 times a year. Over a 10-year period, a given partner's revaluation account, therefore, will be adjusted 120 times. A positive revaluation account attracts gains and a negative revaluation account attracts losses. Consider the administrative burdens and the complexity of having to maintain 120 layers under a layering methodology. In contrast to the simplicity offered by DOM, the complications resulting from and potential distortions potentially caused by layering rapidly increase as the number of layers increase.

Sixth, as discussed above, as a derivative benefit, DOM provides an easy mechanism for tracking a section 704(c) partner's section 704(c)(1)(B) exposure. Even when a section 704(c) partner's forward section 704(c) gain is adjusted upward or downward by subsequent revaluations of that property, the section 704(c) partner's adjusted forward section 704(c) gain or loss

can be tracked separately as a component of that partner's overall DOA.¹⁸² Accordingly, as long as a section 704(c) partner's DOA is equal to or greater than such partner's adjusted original contributed property DOA (*i.e.*, the remaining forward section 704(c) gain or loss), the section 704(c) partner's section 704(c)(1)(B) and section 737 exposure will be preserved and, therefore, equal to the adjusted original contributed property DOA. If a section 704(c) partner's current year DOA is reduced below the partner's adjusted original contributed property DOA, the section 704(c) partner's section 704(c)(1)(B) and section 737 exposure will be permanently reduced by the excess. If the disparity relating to the section 704(c) property is later increased by a revaluation, the increased DOA should not be subject to section 704(c)(1)(B) and/or section 737 because such disparity relates to reverse section 704(c) gain or loss as opposed to forward section 704(c) gain or loss. (See, for instance, Examples 19 and 20 above.)

Seventh, a similar mechanism to that described in the immediately preceding paragraph can be used to analyze the application of section 704(c)(1)(C) to subsequent upward or downward revaluations of the property contributed with a built-in loss. (See, for instance, Example 21 above.)

Eighth, another derivative benefit is that DOM can provide a valuable link between the analysis under section 704(c) and basis adjustments upon transfers pursuant to section 743(b). In fact, the determination of a partner's share of inside basis under the existing regulations under section 743 is based on a DOA-like formula. A transferee partner's share of inside basis is equal to the amount that the partner would receive on liquidation of his partnership interest minus the gain and plus the loss that would be allocated to that partner upon a hypothetical sale of the partnership assets for fair market value. This "minus the gain plus the loss" concept is basically a DOA adjusted to fair market value at the time of the sale or exchange of the property. Adoption of DOM would therefore help coordinate the rules under sections 704(c) and 743.

Ninth, application of DOM principles to basis adjustments under sections 734(b) and 755 would result in a more appropriate allocation of the section 734(b) basis adjustment among the partnership assets. The basis adjustment under section 734(b) should be allocated among the remaining partnership assets under section 755 in a manner that tracks a distributee-partner's DOA on its share of the partnership assets at the time of the section 734(b) event.

Tenth, DOM principles can be used in determining a partnership's carryover tax basis allocable to partial interests in an asset distributed to more than one of its partners. Such an allocation of basis is necessary, for example, in the context of an assets-up merger or division where the partnership distributes its assets to its partners. Neither section 732 nor the Regulations

¹⁸²The contributing partner's forward section 704(c) built-in gain or loss will, of course, be eliminated as the property is depreciated or amortized, resulting in an adjusted original contributed property DOA.

under section 732 provide explicit rules concerning how such an allocation of a partnership's basis in its assets is to be made. In the absence of guidance, many practitioners assume the allocation is to be made on the basis of relative fair market value. Such an allocation of basis can lead to distortions and basis shifting opportunities as a result of basis being shifted from one asset to another. Moreover, the re-allocation of basis can create an unnecessary administrative nightmare for partnerships and partners. It would be far more appropriate to preserve each partner's share of inside basis in each asset to the extent possible. This can be accomplished by allocating a partnership's carry-over tax basis among the partial interest distributed to distributee-partners in a manner that takes into account the partners' relative DOAs in the distributed asset. Such an allocation would eliminate basis shifting in many cases.

As noted above, we believe that a netting methodology that reduces a section 704(c) partner's built-in gain or loss by such partner's share of the subsequent revaluation of the section 704(c) property should not cause the distortion concerns referred to in the Preamble. For the above reasons, we recommend that DOM be allowed as an alternative to a layering approach.

G. The Ceiling Rule and the Three Approaches

Both layering and DOM are compatible with any of the three methods outlined in the existing Regulations with respect to the ceiling rule. In cases where the available tax items are limited by the ceiling rule under the traditional method, there will not be enough tax items to give each partner what that partner is entitled to under either a layering or DOM approach. Under DOM, in those cases, the available items are allocated among the partners in relation to the amount that each partner is entitled to after applying the "book minus DOA" formula over the sum of the amounts to which all partners are entitled to. This ensures that all partners affected by the ceiling rule will share in the limitation proportionately. The following example is a variant of Example 19 and used to illustrate how ceiling rule limitations can reasonably be addressed.

1. Ceiling Rule Application

Example 23: A contributes a machine, P16, with a fair market value of \$100 and a tax basis of \$50 to the AB Partnership in exchange for a 50% interest, and B contributes cash of \$100 for a 50% interest. P16 is depreciable. (For simplicity, unless provided otherwise, assume that no book or tax depreciation will be taken on the contributed property between the contribution date of the property and the first revaluation event.) When P16's value is \$60, C contributes \$80 to the AB in exchange for a one-third interest. A and B equally share the \$40 unrealized loss associated with P16 (*i.e.*, \$20 to A and \$20 to B). P16 is then depreciated to zero after C's admission.

A netting approach would result in the partnership allocating \$20 of book basis recovery to each partner, reducing each partner's book capital account to \$60. The partnership would allocate \$20 of tax basis recovery to each of

B and C, and \$10 of tax basis recovery to A. Those allocations would leave A with a book capital account (*i.e.*, \$60) that exceeds its tax capital account (*i.e.*, \$40) by the \$20 revaluation loss allocated B. In that regard, B's book capital account (*i.e.*, \$60) would be \$20 less than its tax capital account (*i.e.*, \$80). As in Example 19, the netting of the entire \$40 revaluation loss against A's forward section 704(c) produces what might be the distortion that caused Treasury and the Service to propose prohibiting netting.

Nonetheless, as we noted regarding Example 20, the layering approach might not prevent such distortions, and it appears that the retention of the ceiling rule indicates that Treasury and the Service accept that layering can produce distortions. For example, could the partnership be treated as reasonably allocating basis among the layers if it treated P16 as having a forward section 704(c) component with a \$60 book basis and a \$10 tax basis (preserving A's built-in gain) and a reverse section 704(c) component with a \$0 book basis and a \$40 tax basis (preserving A's and B's revaluation loss share)? If so, on the forward layer, the partnership would allocate \$20 of book basis recovery to each partner and have only \$10 of tax basis recovery available to allocate to B and C (the two noncontributing partners on that layer), short-changing them by a total of \$30. On the reverse layer, it would allocate \$20 of tax basis recovery to each of A and B. Those allocations would leave A with a \$60 book capital account and a \$30 tax capital account, and each of B and C with a \$60 book capital account and a \$75 tax capital account. As with Example 20, this result might surprise C given that C, as a one-third partner, would have seen P16 as having plenty of tax basis (*i.e.*, \$50) to match C's \$20 share of potential book basis recovery.

DOM would produce results seemingly consistent with the goal of reducing the potential for distortions. A would have had a forward section 704(c) built-in gain of \$50 (*i.e.*, \$100 fair market value minus \$50 tax basis) after A's contribution. As such, A's beginning DOA would have been \$50. B's beginning DOA would have been \$0. As a result of the revaluation prior to C's admission, each of A and B would have had a negative \$20 adjustment to its respective DOA. A would have a \$30 DOA after the revaluation (*i.e.*, \$50 original section 704(c) disparity, minus A's share of the book down, \$20), and B would have a negative \$20 DOA.

It is clear that there will not be enough tax deductions to allocate to each partner what each is entitled to receive. Under DOM, B is entitled to \$40 of tax deductions, and C is entitled to \$20 of tax deductions, but the partnership only has \$50 of tax deductions to allocate. This \$10 shortfall is reflective of the fact that A's DOA of \$30 is not fully absorbed by A's \$20 section 704(b) book allocation. We suggest that the available \$50 tax basis be shared between B and C relative to the tax deductions each is entitled to when applying DOM without regard to the ceiling rule. Under this approach, B would be allocated approximately \$33 of tax deductions (*i.e.*, \$50 of tax basis available \times 40 (*i.e.*, B's entitlement under DOM)/60 (*i.e.*, B's and C's total entitlement under DOM)), and C would be allocated approximately \$16 of tax

deductions (*i.e.*, \$50 of tax basis available x 20 (*i.e.*, C's entitlement under DOM)/60 (*i.e.*, B's and C's total entitlement under DOM)).

Other alternatives recommended by practitioners include prioritizing allocations to either the first or the last section 704(c) gain or loss (*i.e.*, the "LIFO" and "FIFO" methods).¹⁸³ We believe the partners should be able to negotiate as to how to divide the \$50 of tax basis recovery, including the approaches mentioned above.

2. Ceiling Rule Distortions

The above discussion highlights that layering will not in all cases eliminate the distortions alluded to in the preamble to the Proposed Regulations. Moreover, Proposed Regulation section 1.704-3(a)(6)(iii) leaves open the possibility of creating ceiling rule distortions where none existed. In addition, as noted above and in the preamble to the Proposed Regulations, the prohibition on netting creates administrative complexity. In that regard, increased complexity might not result in the desired goal of eliminating or reducing potential distortions.

The ceiling rule in the existing regulations often frustrates the goal of section 704(c) in that it can prevent a complete elimination of a contributing partner's section 704(c) disparity, and it can prevent a noncontributing partner from receiving the items that it is entitled to, or can force the noncontributing partner to recognize income or gain that, as an economic matter, should be recognized by the Section 704(c) partner. Because the Proposed Regulations do not amend the ceiling rule, it appears that Treasury and the Service are not attempting to eliminate all potential distortions by prohibiting netting and requiring layering and will tolerate certain distortions through the partnership's choice of a reasonable method in its treatment of multiple layers. The above discussion illustrates that layering has the potential of reducing the potential for creating the distortions that perhaps concerned Treasury and the Service, but that potential benefit will come with complications. One complication relates to the difficult issues of allocating an asset's single tax basis among the multiple layers attributable to the asset. This is

¹⁸³ See *supra* note 176. Another reasonable mechanism for determining how the \$50 of tax basis should be shared among the three partners, after taking into account the revaluation, would focus on each partner's relative section 704(c) position regarding the asset. Each partner would have a positive or negative "claim" on the tax basis based on its section 704(c) position regarding the gain and loss in the asset. In that regard, under this "claim approach," A would have a negative claim of \$10 on the \$50 of tax basis recovery (\$50 of forward gain less \$20 of reverse loss and a \$20 share of book basis recovery), B would have a positive claim of \$40 (\$20 of book loss and a \$20 share of book basis recovery), and C would have a positive claim of \$20 (\$20 share of book basis recovery). See Barksdale Hortenstine, Telma Nadvorny & Jeffrey Helm, *Multi-Layered Partnership Assets: Divergent Results Under the Separate Layer and Single Asset Methods of Allocating Gain, Loss and Depreciation Under Section 704(c)* (PowerPoint Slides), PLI (2014). As under DOM, the claim approach cannot make both B and C whole in terms of matching each partner's economic results with tax allocations, but it would ensure that A is not allocated any tax basis recovery.

particularly difficult when negative layers are involved. Another complication relates to the increased effect of the ceiling rule that will be caused by dividing a single asset into multiple section 704(c) properties and applying the ceiling rule separately with respect to each identified layer. We believe that DOM is consistent with the purposes of section 704(c) and in many cases will not come with these complications.

H. *Recommendations*

We believe that a partnership should be permitted to use the netting approach where the parties agree to do so and the adoption of netting does not violate Regulation Section 1.704-3(a)(10). Alternatively, we believe a partnership should be permitted to use the netting approach where the gross value of its assets is less than \$20 million, adjusted for inflation, as of the date of any revaluation event. A partnership that has adopted either a netting approach or a layering approach should consistently apply such approach to all assets and revaluations. In particular, we recommend that the final regulations provide a grandfather rule that allows an existing partnership to continue using the netting approach where such approach has been adopted prior to the promulgation of final regulations until the partnership terminates for federal tax purposes, including terminations under sections 708(b)(1)(B) and 708(b)(2).

If netting is prohibited as a choice in addressing revaluation amounts, we recommend that the final regulations clarify what satisfies the reasonable allocation of basis requirement in Proposed Regulation section 1.704-3(a)(6)(iii).¹⁸⁴

We recommend that the final regulations include a safe harbor rule stating that the treatment of layers in a manner that is consistent with the elimination of the book-tax differences for all of the partners will be considered reasonable under Proposed Regulation section 1.704-3(a)(6)(iii).

We recommend that the final regulations also clarify the role of the ceiling rule under a layering approach to revaluations. Where the ceiling rule exists, the potential for creating ceiling rule distortions as discussed in the examples in the Proposed Regulations cannot be considered unreasonable in all cases. Parties should be able to negotiate an approach to layering that reflects the application of the ceiling rule, subject to the anti-abuse principles described in Regulation section 1.704-3(a)(10) as described above.

¹⁸⁴ Because the section 704(c) attribute of a partner influences the allocation and calculation of a number of partnership items, the requirement of layering revaluation amounts could produce a number of unanticipated consequences under partnership tax provisions other than section 704(c). For example, a partner's section 704(c) attribute can affect the partner's allocation of nonrecourse liabilities and creditable foreign tax expenditures. It is relevant under section 751(a) and the applicable regulations. It can also affect the determination of the partnership's taxable year under section 706(b) and a transferee partner's section 743(b) adjustment. It also can affect the application of the section 751(b) rules. For these reasons, the final regulations should produce as much certainty as possible in determining when a partnership satisfies the reasonable basis allocation standard in the Proposed Regulations.

We also recommend that the final regulations state that a methodology that reflects the principles of DOM or the claim approach described above will be considered an approach that is consistent with the elimination of book-tax differences for all partners. A lack of a safe harbor rule on the treatment of revaluation layers will likely lead to considerable confusion in how to treat the layers and how to address the ceiling rule. Additionally, the lack of guidance on what is reasonable could produce results inconsistent with the expressed goal of preventing distortions. Regarding the ability under layering to create distortions, the final regulations should provide examples of approaches that are considered reasonable (such as results consistent with DOM or the claim approach) and those that are not considered reasonable.