April 18, 2008

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

Re: Comments on Proposed Regulations Concerning Consequences of Certain Mergers under Section 704(c)(1)(B) and 737

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations concerning consequences of certain mergers under section 704(c)(1)(B) and 737. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
COMMENTS ON PROPOSED REGULATIONS CONCERNING
CONSEQUENCES OF CERTAIN PARTNERSHIP MERGERS
UNDER SECTIONS 704(c)(1)(B) and 737

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

Principal responsibility for preparing these Comments was exercised by Jennifer Alexander, Patrick J. Browne, Jr., Christopher McLoon, and Glenn Mincey of the Section’s Partnerships & LLCs Committee (the “Committee”). Substantive contributions were made by Matthew Lay and Eric Sloan. Additional helpful comments were made by Howard Abrams, Neil Barr, David Benz, Diana Española, Phillip Gall, Monte Jackel, AnnMarie Johnson, Robert Keatinge, Steven Klig, Erik Loomis, Bahar Schippel, Marc Schultz, Jeanne Sullivan, Malinda Susalla, and Magda Szabo. The Comments were reviewed by Eric Sloan, Committee Chair. The Comments were further reviewed by Michael Grace of the Section’s Committee on Government Submissions and by Barbara Spudis De Marigny, Council Director for the Committee.

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

Contacts: Jennifer Alexander
(202) 879-5649
jenniferalexander@deloitte.com

Glenn Mincey
(212) 492-4271
gmincey@deloitte.com

Date: April 18, 2008
EXECUTIVE SUMMARY

On August 22, 2007, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“Service”) issued a notice of proposed rulemaking that would implement the principles of Revenue Ruling 2004-43 (the “Proposed Regulations”). In response to the request for comments on the Proposed Regulations, we recommend that the final Regulations:

1. Provide that reverse section 704(c) gain or loss does not affect existing forward or reverse section 704(c) amounts and modify Proposed Regulation sections 1.704-4(c)(4)(ii)(C)(2) and 1.704-4(c)(4)(ii)(F), Example 3, accordingly. Alternatively, clarify that revaluations affect prior section 704(c) amounts only with respect to mergers and not for any other purpose.

2. Incorporate a rule (the “Continuing Partner Exception”) providing that, if property that was deemed contributed by a transferor partnership in a merger is distributed by the transferee partnership to a former partner of the transferor partnership, sections 704(c)(1)(B) and 737 apply as if the transferor partnership had distributed that property to that former partner.

3. If the Continuing Partner Exception is not adopted, provide standards and accompanying examples to assist taxpayers in determining partners’ undivided interests in property of the transferor partnership, including a safe harbor to be applied on an asset by asset basis.

4. Modify the ordering rules in Proposed Regulation sections 1.704-4(c)(4)(ii)(C)(I) and 1.737-2(b)(1)(ii)(C) (the “Ordering Rules”) to provide that if a transferee partnership distributes or sells less than all of a particular section 704(c) asset after a merger, proportionate amounts (based on relative values) of each partner’s Contributed Amount, Merger Amount, and Residual Amount are deemed distributed or sold, as the case may be. To the extent a distribution is made to the contributing partner, then proportionate amounts (based on relative value) of the Contributed Amount, the Merger Amount, and the Residual Amount deemed contributed by such partner are deemed distributed.

5. Permit partnerships that adopt the safe harbor (see item 3 above) to apply a special rule for determining basis of the undivided interests deemed contributed to the transferee partnership.

---


2 All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to regulations are to the Treasury Regulations issued under the Code.
6. With respect to the identical ownership exception (the “IOE”) and the de minimis change in ownership exception in Proposed Regulation sections 1.704-4(c)(4)(ii)(E) and 1.737-2(b)(1)(ii)(E):

(i) Clarify that, for purposes of determining whether either exception is satisfied, the partnership’s section 704(b) “book” items, rather than its tax items, are relevant;

(ii) Reduce the threshold percentage under the de minimis change in ownership exception from its current 97 percent threshold to an 80 percent threshold;

(iii) Eliminate the consideration of liabilities in the IOE and the de minimis change in ownership exception; and

(iv) Confirm whether the partners of the transferor and transferee partnerships may restructure in anticipation of a merger to satisfy the requirements of the IOE or the de minimis change in ownership exception.

7. Clarify that the rules for determining the undivided interests that each partner in the transferor partnership is treated as contributing to the transferee partnership apply for purposes of the like-kind exception in section 704(c)(2).

8. Provide that the Regulations are effective only for distributions of property contributed in mergers occurring after January 19, 2005.

9. Include a technical correction to the ordering rules of Proposed Regulation sections 1.704-4(c)(4)(ii)(C)(1) and 1.737-2(b)(1)(ii)(C) to avoid a literal interpretation that would require gain recognition in inappropriate circumstances.
BACKGROUND

Sections 704(c)(1)(B) and 737 (the “Anti-Mixing Bowl Rules”) were enacted in 1989 and 1992, respectively, to prevent the shifting of pre-contribution gain and loss among partners upon partnership distributions of property. In 1995, Treasury and the Service promulgated Regulations under sections 704(c)(1)(B) and 737, that provide, among other things, that the Anti-Mixing Bowl Rules do not apply to transactions, such as assets-over partnership mergers, involving the contribution by a partnership of all of its assets and liabilities to another partnership, followed by the liquidation of the transferor partnership. In these cases, Regulation sections 1.704-4(c)(4) and 1.737-2(b) (the “Subsequent Distribution Rules”) provide that a subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to the Anti-Mixing Bowl Rules “to the same extent” that a distribution by the transferor partnership would have been subject to such rules.

Revenue Ruling 2004-43 (the “Ruling”) interpreted the “to the same extent” language contained in the Subsequent Distribution Rules as applied to an assets-over partnership merger. The Ruling addressed the tax consequences of an assets-over merger of partnership CD into partnership AB. In an assets-over partnership merger, the transferor partnership is deemed to contribute all of its assets and liabilities to the transferee, or resulting, partnership in exchange for an interest in the transferee partnership and, immediately thereafter, the transferor partnership is deemed to distribute interests in the transferee partnership to its partners in liquidation of the transferor partnership. The Ruling applied the Subsequent Distribution Rules (i) only with respect

---

3  Section 704(c)(1)(B) provides that, if “section 704(c) property” is distributed to a partner other than the contributing partner within seven years of its contribution, the contributing partner recognizes gain or loss in an amount equal to the gain or loss that would have been allocated to the contributing partner under section 704(c)(1)(A) if the partnership sold such property for its fair market value at the time of the distribution. Section 737 provides that, if a partnership distributes property (other than cash) to the contributo of section 704(c) property within seven years of contribution, the contributing partner must recognize gain in an amount equal to the lesser of (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of the partner’s interest in the partnership immediately before the distribution, reduced (but not below zero) by the amount of money received in the distribution (the “excess distribution”), or (2) the “net precontribution gain” of the partner. “Section 704(c) property” or a “section 704(c) asset” is property contributed to a partnership if its fair market value at the time of contribution differs from its adjusted tax basis at such time. Reg. § 1.704-3(a)(3)(i). In addition, the term also includes successor property under Reg. § 1.704-3(a)(8). “Net precontribution gain” is defined as the net gain, if any, that the distributee-partner would have recognized under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee-partner within seven years of the distribution that is still held by the partnership were distributed to another partner.


5  Reg. §§ 1.704-4(c)(4) and 1.737-2(b). The “terminating” partnership in an assets-over partnership merger is a transferor partnership because it is deemed to transfer its assets to the resulting partnership and then liquidate. Reg. § 1.708-1(c)(3)(i).

6  2004-1 C.B. 842.

7  Reg. § 1.708-1(c)(3). All mergers discussed in these Comments are assets-over partnership mergers.
to property contributed to the transferor partnership before the merger, and (ii) only to the extent of any “forward” section 704(c) amounts remaining in such property immediately before the merger.\(^8\) Accordingly, with respect to such “forward” section 704(c) amounts, the seven-year period in the Anti-Mixing Bowl Rules did not restart. The Ruling did not, however, apply the Subsequent Distribution Rules to the forward section 704(c) gain or loss created upon the merger. Instead, with respect to this newly created gain or loss, a new seven-year period started on the date of the merger.\(^9\)

Prior to the issuance of the Ruling, it was believed by many practitioners that the Subsequent Distribution Rules prevented the creation of a new seven-year period for purposes of the Anti-Mixing Bowl Rules with respect to both original forward section 704(c) amounts and newly created section 704(c) amounts. On January 19, 2005, after receiving numerous comments arguing that the Ruling was inconsistent with the plain language of the Subsequent Distribution Rules and that, in any event, the Ruling’s conclusions should not be applied retroactively,\(^10\) the Service revoked the Ruling\(^11\) and issued Notice 2005-15 (the “Notice”),\(^12\) stating that Treasury and the Service intended to promulgate regulations under sections 704 and 737 that would apply the principles of the Ruling effective for distributions occurring after January 19, 2005.

On August 22, 2007, Treasury and the Service issued the Proposed Regulations, which include provisions regarding:

(i) The application of the Anti-Mixing Bowl Rules to the original and new section 704(c) gain or loss in property of the transferor partnership;

(ii) The manner in which section 704(c) gain and loss in property contributed by the transferor partnership is attributed to the partners of the transferor partnership;

(iii) “Ordering rules” for post-merger partial distributions of section 704(c) property of the transferor partnership and post-merger revaluations;

\(^8\) As was discussed above, section 704(c) property is property contributed to a partnership with a fair market value at the time of contribution different from its adjusted tax basis. Reg. § 1.704-3(a)(3)(i). Built-in gain or loss amounts in section 704(c) property are generally referred to as “forward” section 704(c) amounts. “Reverse” section 704(c) gain or loss is gain or loss that results from the revaluation under Reg. § 1.704-1(b)(2)(iv)(f), rather than from the contribution, of property. Reg. § 1.704-3(a)(6)(i).

\(^9\) The Ruling also confirmed that the Anti-Mixing Bowl Rules do not apply to property that is merely revalued by a partnership under Reg. § 1.704-1(b)(2)(iv)(f). Accordingly, the Ruling concluded that the Anti-Mixing Bowl Rules do not apply to revaluation gain or loss created by a revaluation of the property in the transferee partnership.


\(^12\) 2005-1 C.B. 527.
(iv) The treatment of reverse section 704(c) amounts in the transferee partnership;

(v) The treatment of subsequent mergers;

(vi) Allocations under section 704(c)(1)(A) with respect to the property contributed by the transferor partnership; and

(vii) Exceptions to the application of the Anti-Mixing Bowl Rules in cases in which the ownership of the transferor partnership and transferee partnership is identical or nearly identical.

The Proposed Regulations divide the gain or loss in the property of the transferor partnership into two categories. The first is the remaining original (or forward) section 704(c) gain or loss (the “Original Section 704(c) Gain or Loss”).\(^{13}\) Thus, the Original Section 704(c) Gain or Loss in an asset is generally the difference, at the time of the merger, between an asset’s fair market value and the contributing partner’s adjusted basis in such asset at the time the asset was contributed to the transferor partnership, as reduced by decreases in such difference preceding the asset’s transfer to the transferee partnership.\(^{14}\) The second is the “New Section 704(c) Gain or Loss,” which is the gain or loss, as determined under section 704(b), in the transferor partnership’s property in excess of the amount of the Original Section 704(c) Gain or Loss, both as measured at the time of the merger.\(^ {15}\)

Consistent with the Ruling, the Proposed Regulations provide that the seven-year period in sections 704(c)(1)(B) and 737 would not restart with respect to Original Section 704(c) Gain or Loss. Accordingly, a subsequent distribution by the transferee partnership of property with Original Section 704(c) Gain or Loss generally would be subject to sections 704(c)(1)(B) and 737 with respect to such Original Section 704(c) Gain or Loss only if the distribution occurs within seven years of the contribution of such property to the transferor partnership. With respect to any New Section 704(c) Gain or Loss, the Proposed Regulations provide that the seven-year period would begin on the date of the merger. Thus, a subsequent distribution by the transferee partnership of property with New Section 704(c) Gain or Loss generally would be subject to sections 704(c)(1)(B) and

\(^{13}\) Prop. Reg. § 1.704-4(c)(4)(ii)(A). The Preamble notes that property contributed with original section 704(c) loss may be subject to the provisions of section 704(c)(1)(C). According to the Preamble, the Service and Treasury are currently developing guidance with respect to section 704(c)(1)(C). Therefore, the Proposed Regulations do not address the impact of section 704(c)(1)(C) on property of the transferor partnership that has original section 704(c) loss. See 72 Fed. Reg. at 46,933.

\(^{14}\) See Reg. § 1.704-3(a)(3)(ii). The Proposed Regulations also adjust the Original Section 704(c) Gain or Loss for prior revaluations to the extent such prior revaluations caused a reduction in the Original Section 704(c) Gain or Loss. As discussed in the Comments below, we recommend that final regulations provide that the Original Section 704(c) Gain or Loss does not reflect pre-merger revaluations or adjustments made in connection with the merger.

\(^{15}\) Prop. Reg. § 1.704-4(c)(4)(ii)(B).
with respect to gain or loss attributable to that layer if the distribution occurs within seven years of the merger.
DISCUSSION

The following discussion responds to requests for comments that Treasury and the Service made in the preamble to the Proposed Regulations and also addresses additional issues and suggests technical corrections to the Proposed Regulations.

I. Shares of Original and New Section 704(c) Gain or Loss

A. Application of Existing Regulations

Under the Proposed Regulations, a transferor partner’s share of Original and New Section 704(c) Gain or Loss is determined by reference to the manner in which such gain or loss would be allocated under the principles of Regulation sections 1.704-3(a)(7) and 1.704-3(a)(9).

Regulation section 1.704-3(a)(7) contains a “successor rule” providing that if a contributing partner (i.e., a partner that contributed section 704(c) property) transfers its partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Under this rule, if the contributing partner transfers only a portion of its partnership interest, a share of built-in gain or loss “proportionate to the interest transferred” must be allocated to the transferee partner. Regulation section 1.704-3(a)(9) provides that if a partnership contributes section 704(c) property to a second partnership (the “lower-tier partnership”), or if a partner that has contributed section 704(c) property to a partnership contributes its partnership interest to a second partnership (the “upper-tier partnership”), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner’s remaining built-in gain or loss.

The Proposed Regulations would take into account pre-merger revaluations only if such revaluations reduce the Original Section 704(c) Gain or Loss. The effect of pre-merger revaluations is illustrated by Proposed Regulation section 1.704-4(c)(4)(ii)(F), Example 3. In addition, the Proposed Regulations provide that post-merger revaluations will reduce New Section 704(c) Gain or Loss before reducing Original Section 704(c) Gain or Loss. As discussed below, taking revaluations into account in such a manner not only conflicts with the treatment of reverse section 704(c) amounts under section 704(c)(1)(A), but also produces a different result in a post-merger distribution of the property than would occur in the absence of a merger.

Most practitioners believe that the existing Regulations under section 704(c)(1)(A) make clear that reverse section 704(c) gain or loss does not affect existing forward or reverse section 704(c) amounts (or “layers”). Instead, reverse section 704(c) layers are distinct from forward and other reverse section 704(c) layers with respect to a particular asset. This is evidenced, for example, by the fact that partnerships may use a

---


different allocation method for reverse section 704(c) layers than for forward layers with respect to the same property.\textsuperscript{18} In addition, partnerships are not required to use the same allocation method for reverse section 704(c) allocations each time the partnership revalues its property.\textsuperscript{19} If reverse layers impacted forward or other reverse layers, these rules would often have no application, as prior layers would often be eliminated by subsequent revaluations.

B. \textbf{Inconsistency With Existing Example}

Moreover, the Proposed Regulations produce a result that is theoretically inconsistent with Example 2 of Regulation section 1.704-3(d)(7), which is set forth below.

Remedial allocations on sale--(i) Facts. N and P form partnership NP and agree that each will be allocated a 50 percent share of all partnership items. The partnership agreement provides that NP will make allocations under section 704(c) using the remedial allocation method under this paragraph (d). N contributes Blackacre (land) with an adjusted tax basis of $4,000 and a fair market value of $10,000. Because N has a built-in gain of $6,000, Blackacre is section 704(c) property. P contributes Whiteacre (land) with an adjusted tax basis and fair market value of $10,000. At the end of NP’s first year, NP sells Blackacre to Q for $9,000 and recognizes a capital gain of $5,000 ($9,000 amount realized less $4,000 adjusted tax basis) and a book loss of $1,000 ($9,000 amount realized less $10,000 book basis). NP has no other items of income, gain, loss, or deduction. If the ceiling rule were applied, N would be allocated the entire $5,000 of tax gain and N and P would each be allocated $500 of book loss. Thus, at the end of NP’s first year N’s and P’s book and tax capital accounts would be as follows:

\textsuperscript{18} Reg. § 1.704-3(a)(6)(i).

\textsuperscript{19} \textit{Id.}
(ii) Remedial allocation. Because the ceiling rule would cause a disparity of $500 between P’s allocation of book and tax loss, NP must make a remedial allocation of $500 of capital loss to P and an offsetting remedial allocation to N of an additional $500 of capital gain. These allocations result in capital accounts at the end of NP’s first year as follows:

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Contribution</td>
<td>$10,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Sale of Blackacre</td>
<td>&lt;500&gt;</td>
<td>5,000</td>
</tr>
<tr>
<td>Remedial Allocations</td>
<td>500</td>
<td>&lt;500&gt;</td>
</tr>
<tr>
<td>Total</td>
<td>$9,500</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

The example does not address a revaluation of NP’s assets of the partnership to reflect the $1,000 decline in the value of Blackacre. If, though, NP had revalued its assets, N and P would each have been allocated $500 of book loss. If NP then sold Blackacre for its fair market value of $9,000, NP would have recognized a $5,000 tax gain, all of which would have been allocated to N as the contributor of Blackacre. In addition, NP would have allocated $500 of remedial loss to P and $500 of remedial gain to N to ensure that P received tax allocations equal to P’s book allocations. Stated differently, the revaluation would not have changed the results at all.

More significantly, if NP had distributed Blackacre to P immediately after the revaluation, N would have recognized $5,500 of gain under section 704(c)(1)(B). Under the logic of Example 3 of the Proposed Regulations, however, the results would have been different. N’s Original Section 704(c) Gain in Blackacre would be $5,000. As a result, if NP distributed Blackacre, N would recognize only $5,000 of gain.
C. **Recommendations**

For the reasons discussed above, we recommend that the Proposed Regulations provide that reverse section 704(c) gain or loss, whether created before, in connection with, or after the merger, does not affect existing forward or reverse section 704(c) amounts. In addition, we recommend that Example 3 be modified to conform to our recommendation. If this recommendation is not adopted, and if Example 3 remains substantively unchanged in the final regulations, we recommend that the Regulations, when finalized, clarify whether revaluations change prior section 704(c) layers for all purposes or only with respect to mergers.

II. **Continuing Partner Exception**

A. **Theoretical Support**

The purpose of the Proposed Regulations is to prevent partners from using a merger to circumvent the Anti-Mixing Bowl Rules, which are intended to prevent the shifting of pre-contribution built-in gain or loss. If a distribution could have been made before the merger without shifting pre-contribution built-in gain or loss, then such a distribution after the merger does not offend the Anti-Mixing Bowl Rules, and the Regulations should preserve the ability to make such a post-merger distribution. Stated differently, if a transferee partnership distributes an asset of the transferor partnership to a former partner of the transferor partnership, and the transferor partnership could have distributed the asset before the merger without implicating the Anti-Mixing Bowl Rules, there has been no shift that offends those rules, and those rules should not be implicated. Nevertheless, under the Proposed Regulations, such a distribution could result in gain recognition.

B. **Prior Recommendation Reiterated**

In comments submitted in connection with the issuance of the Notice,\(^\text{20}\) we recommended that the Proposed Regulations contain a Continuing Partner Exception that would provide that if property contributed by a transferor partnership to a transferee partnership were distributed by the transferee partnership to a former partner of the transferor partnership (the “Continuing Partner”),\(^\text{21}\) sections 704(c)(1)(B) and 737 would

---


\(^{21}\) For this purpose, a Continuing Partner should include the successor to a Continuing Partner. This would be consistent with the “successor rule” of Reg. § 1.704-3(a)(7), which provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. The Anti-Mixing Bowl Rules contain analogous successor partner provisions. See Reg. § 1.704-4(d)(2) (the transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) to the extent of the share of built-in gain or loss allocated to the transferee partner); Reg. § 1.737-1(c)(2)(iii) (the transferee of all or a portion of a contributing partner’s partnership interest succeeds to the transferor’s net precontribution gain, if any, in an amount proportionate to the interest transferred).
apply as if the transferor partnership had distributed that property to that former partner.\textsuperscript{22} For the reasons discussed in the Notice Comments, we renew our recommendation that the final regulations adopt a Continuing Partner Exception. In addition, as was noted above, this recommendation is consistent with the policy of the Anti-Mixing Bowl Rules (and is consistent with the Ruling and the Notice).

C. **Example**

The operation of the Continuing Partner Exception is illustrated by the following example.

**Example 1: Continuing Partner Exception.** On January 1, 2007, A contributes Asset 1 (a nondepreciable capital asset) with a fair market value of $300 and an adjusted basis of $200, to partnership AB in exchange for a 50 percent interest in AB. On the same date, B contributes $300 of cash to AB in exchange for a 50 percent interest in AB. Also on January 1, 2007, C contributes Asset 2 (a nondepreciable capital asset) with a fair market value of $200 and an adjusted basis of $100, to partnership CD in exchange for a 50 percent interest in CD. Also on the same date, D contributes $200 of cash to CD in exchange for a 50 percent interest in CD.

On January 1, 2011, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3). At the time of the merger, AB’s only assets are Asset 1, with a fair market value of $900, and $300 in cash, and CD’s only assets are Asset 2, with a fair market value of $600, and $200 in cash. No partner contributes property to AB after the merger.

On January 1, 2015, AB holds the following assets: $500 in cash, Asset 1, with a fair market value of $1,900 (\textit{i.e.}, since the merger, Asset 1 has appreciated by $1,000), and Asset 2, with a fair market value of $600. On that date, AB distributes Asset 2 to D.\textsuperscript{23}

\textsuperscript{22} This exception was termed the “Continuity Rule” in the Notice Comments.

\textsuperscript{23} D’s capital account balance was increased from $200 to $400 at the time of the merger, reflecting D’s 50 percent share of the appreciation in Asset 2 at the time of the merger. Immediately before the distribution, AB revalues its property under Reg. § 1.704-1(b)(2)(iv)(f)(5)(ii) and reflects the results of the revaluation in the capital account balances of its partners. As a 20 percent partner in AB, D is allocated 20 percent (or $200) of the increase in value of Asset 1. As a result, D’s capital account balance is increased to $600.
Under the Continuing Partner Exception, neither C nor D would recognize gain under the Anti-Mixing Bowl Rules. This is because the tax consequences to C and D would be determined as if CD had distributed Asset 2 to D. If the merger had not occurred, and CD had distributed Asset 2 to D, C would not have recognized any gain or loss under section 704(c)(1)(B) because C contributed Asset 2 to CD more than seven years before the distribution of Asset 2 by AB. (In addition, section 704(c)(1)(B) would not have applied to the New Section 704(c) Gain or Loss, which would have been reverse section 704(c) gain in CD.) D would not have recognized gain under section 737 because D did not have any net precontribution gain with respect to CD (because D did not contribute section 704(c) property to CD). We think the application of the Anti-Mixing Bowl Rules to cause C or D to recognize gain in Example 1 is beyond the intended scope of those rules.

The Continuing Partner Exception would limit the application of the Proposed Regulations to those situations the Anti-Mixing Bowl Rules and the Ruling were intended to address. Moreover, as is discussed in greater detail below, the “undivided interest” approach taken by the Proposed Regulations is quite complex. Accordingly, we recommend that the Regulations, when finalized, incorporate such an exception.

III. Deemed Contributions of Undivided Interests

A. Need for a Safe Harbor

As was discussed above, we strongly recommend that the Continuing Partner Exception be adopted. If, however, this recommendation is not adopted, we believe that it is very important that the Regulations, when finalized, include a safe harbor upon which taxpayers may rely in determining the undivided interests in property of the transferor partnership deemed contributed by partners of the transferor partnership. In the following discussion, we recommend a safe harbor (the “Safe

24 Without the Continuing Partner Exception, C would recognize $200 of gain. That is, although section 704(c)(1)(B) would not apply to the Original Section 704(c) Gain (because the distribution of Asset 2 to D occurs more than seven years after C’s contribution of Asset 2 to CD), section 704(c)(1)(B) would apply to C’s share of the New Section 704(c) Gain with respect to Asset 2 because the distribution of Asset 2 occurs within seven years of the merger.

25 It may be possible for taxpayers to abuse the Continuing Partner Exception. For example, assume the same facts as Example 1, except that AB distributes Asset 2 to A. A was not a partner in the transferor partnership, so the Continuing Partner Exception would not apply, and both C and D would recognize New Section 704(c) Gain. If, however, A had contributed $1 to CD immediately before the merger and were treated as a partner in the transferor partnership, the Continuing Partner Exception would apply to permit AB to distribute Asset 2 to A without triggering New Section 704(c) Gain to C or D. We therefore recommend that the Regulations, when finalized, also incorporate an anti-abuse rule with respect to the Continuing Partner Exception that would make the Continuing Partner Exception inapplicable to situations in which a person becomes a partner in the transferor partnership with the principal purpose of taking advantage of the Continuing Partner Exception.

26 Because, under the Continuing Partner Exception, the Anti-Mixing Bowl Rules would apply as if the transferor partnership had made such distribution, it is not necessary to determine a partner’s undivided
Harbor”) for making this determination. The Safe Harbor is, regrettably, extraordinarily complex, reflecting the myriad issues that must be considered in connection with an “undivided interests” approach.

B. **Background on Undivided Interests**

As was discussed above, under the Proposed Regulations, sections 704(c)(1)(B) and 737 would apply to a distribution of property with New Section 704(c) Gain or Loss contributed by the transferor partnership if (i) the distribution occurs within seven years of the merger, and (ii) the distribution is made to a partner other than the “contributing partner.” For purposes of determining whether a distribution of property is made to the “contributing partner,” the Proposed Regulations provide that each partner of the transferor partnership is deemed to have contributed an undivided interest in the property of the transferor partnership.  

Although the current Regulations under sections 704(c)(1)(B) and 737 contain provisions addressing undivided interests, those rules do not provide any guidance regarding their application to distributions following partnership mergers. To address this, the Proposed Regulations provide that, in connection with a merger, the determination of the partners’ undivided interests must be made by the transferor partnership using any “reasonable method.” The Proposed Regulations do not, however, provide any standards to assist taxpayers in determining whether a particular method is reasonable, nor do they contain any examples of what would constitute a reasonable method.

C. **Need for Guidance on Reasonableness**

We recommend that Treasury and the Service provide a safe harbor standard and accompanying examples to assist taxpayers in determining how to attribute undivided interests in the property of a transferor partnership to the partners in the transferor partnership. Consistent with the principles used to determine a transferor partner’s share of Original and New Section 704(c) Gain or Loss, we suggest that the Regulations, when finalized, adopt the Safe Harbor described below, which should be applied on an asset-by-asset basis.

---


28  Under Reg. § 1.704-4(c)(6) and Reg. § 1.737-2(d)(4) (the “Undivided Interest Rules”), the Anti-Mixing Bowl Rules do not apply to the distribution of an undivided interest in property to the extent that the undivided interest distributed does not exceed the undivided interest, if any, contributed by the distributee partner in the same property.


30  The Safe Harbor does not address the impact of basis adjustments made to transferor partnership property under section 734(b) and 743(b), “section 1.752-7” liabilities under Reg. § 1.752-7(b)(3), or the treatment of partnership minimum gain under Reg. § 1.704-2(d). Each of these topics raises complex
As discussed above, the Safe Harbor is extraordinarily complex. The Safe Harbor, though, merely determines the undivided interests in the property of the transferor partnership that should be attributed to the partners in the transferor partnership. Significantly, this determination is made in a manner intended to ensure that, after the merger, the transferor partner can receive, without triggering the application of the Anti-Mixing Bowl Rules, a distribution of property of the transferor partnership so long as the gain or loss inherent in the distributed property does not exceed the partner’s Original or New Section 704(c) Gain or Loss. Thus, sections (i) and (ii) of the Safe Harbor (see suggested language below) generally provide that a transferor partner is deemed to contribute to the transferee partnership an undivided interest in the property of the transferor partnership in an amount equal to the sum of (i) the then-current section 704(b) book value of the section 704(c) property contributed by such partner to the transferor partnership, and (ii) such partner’s New Section 704(c) Gain or Loss in such property.

Because one or more partners may have contributed property to the transferor partnership with a fair market value equal to its tax basis or because the transferor partnership may have acquired property other than by contribution, the Safe Harbor must determine how the partners of the transferor partnership are deemed to contribute this other property.\textsuperscript{31} Because this other property does not have any Original or New Section 704(c) Gain or Loss associated with it,\textsuperscript{32} the transferor partners’ undivided interests in this property is not entirely clear or static. We considered several options, but ultimately concluded that the partners’ relative fair market value capital accounts best reflects their shares of this property for purposes of a safe harbor. Thus, although at first blush complicated, section (iii) of the Safe Harbor simply determines the transferor partners’ undivided interests in this other property based on the partners’ relative fair market value capital accounts.

It should be noted that the Safe Harbor does not determine the manner in which inside basis should be allocated. This is addressed separately.

D. \textbf{Recommended Safe Harbor}

1. \textbf{Suggested Text}

For purposes of determining whether property has been distributed to the partner that contributed such property:

\textsuperscript{31} As described further below, as long as a partner in the transferor partnership does not have any Original Section 704(c) Gain or Loss still subject to the seven-year period under section 704(c)(1)(B), the partner should be able to receive a distribution of this other property without triggering any New Section 704(c) Gain or Loss.

\textsuperscript{32} Such property does not have any Original Section 704(c) Gain or Loss or it would be accounted for by section (i) of the Safe Harbor. To the extent the property has changed in value, the change in value is captured in section (ii) of the Safe Harbor.
If the partner\textsuperscript{33} contributed section 704(c) property\textsuperscript{34} to the transferor partnership, the partner should be deemed to contribute to the transferee partnership an undivided interest in such property equal to such property’s Adjusted Book Value\textsuperscript{35} at the time of the merger (the “Contributed Amount”);\textsuperscript{36}

The partner should be deemed to contribute to the transferee partnership an undivided interest in each property of the transferor partnership in an amount equal to the partner’s share at the time of the merger of the New Section 704(c) Gain or Loss with respect to such property (the “Merger Amount”); and

The partner should be deemed to contribute to the transferee partnership an undivided interest in each property of the transferor partnership to the extent not taken into account in (i) and (ii) above (the “Residual Amount”) in an amount equal to the product of (A) the Residual Amount of such asset, multiplied by (B) such partner’s Residual Amount Percentage.

A partner’s “Residual Amount Percentage” should be the percentage, expressed as a fraction, (I) the numerator of which is such partner’s share (at the time of the merger) of the aggregate amount of the transferor partnership’s Residual Amounts (as determined below) and (II) the denominator of which is the aggregate amount of the transferor partnership’s Residual Amounts.

For this purpose, the partner’s share of the aggregate amount of the transferor partnership’s Residual Amounts should equal the sum of:

a) Such partner’s share of the transferor partnership’s aggregate Residual Amount. For this purpose, the partners share the transferor partnership’s aggregate Residual Amount in proportion to and to the extent of the partners’ Reduced FMV Capital Account Balances. For this purpose, a partner’s “Reduced FMV Capital

\textsuperscript{33} For purposes of the Safe Harbor, a partner should include successor partner(s) under Reg. § 1.704-3(a)(7).

\textsuperscript{34} For purposes of the Safe Harbor, such property should include successor property under Reg. § 1.704-3(a)(8).

\textsuperscript{35} “Adjusted Book Value” means, on a particular date with respect to an asset contributed to the transferor partnership, the gross fair market value of the asset at the time of its contribution to the transferor partnership, as adjusted through the date of determination under Reg. § 1.704-1 (but not taking into account adjustments made in connection with revaluations under Reg. § 1.704-1(b)(2)(iv)(f), regardless of whether such revaluations occur before or in connection with the merger).

\textsuperscript{36} This description assumes that Regulations, when finalized, incorporate our recommendation that pre-merger revaluations are not taken into account in determining the Original Section 704(c) Gain or Loss and modify Prop. Reg. § 1.704-4(c)(4)(ii)(F), Example 3, accordingly. If our recommendation is not adopted, the determination of the Contributed and Merger Amounts would have to be modified accordingly.
Account Balance” would be determined by reducing the partner’s FMV Capital Account Balance37 by the amounts deemed contributed by such partner under (i) and (ii) above; plus

b) Such partner’s share of any remaining Residual Amount. For this purpose, the partners share any remaining amount of the Residual Amount in proportion to their FMV Capital Account Balances.

2. **Examples**

The operation of the Safe Harbor is illustrated in the following examples.38

**Example 2: Partnership with New Section 704(c) Gain or Loss, but no Original Section 704(c) Gain or Loss** – On January 1, 2007, C and D each contribute $500 to partnership CD in exchange for a 50 percent interest in CD. On the same date, CD acquires Asset 1 (a nondepreciable capital asset) for $1,000.

On January 1, 2010, when Asset 1 is worth $1,200 and has an adjusted basis of $1,000, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3).

Neither C nor D contributed section 704(c) property to CD. Accordingly, under section (i) of the Safe Harbor, neither C nor D should be deemed to contribute any portion of Asset 1 as a Contributed Amount.

Because there is no Original Section 704(c) Gain, the New Section 704(c) Gain equals $200, the excess of the total section 704(c) amount attributable to Asset 1 ($200) over the Original Section 704(c) Gain ($0). Because C and D are equal partners, C and D should each have $100 of New Section 704(c) Gain with respect to Asset 1. Thus, under section (ii) of the Safe Harbor, C and D should be deemed to contribute a $100 undivided interest in Asset 1 as a Merger Amount.

Under section (iii) of the Safe Harbor, there is a $1,000 Residual Amount, which is the amount of Asset 1 remaining after the application of sections (i) and (ii) of

---

37 A partner’s “FMV Capital Account Balance” would equal the partner’s capital account balance in the transferor partnership adjusted as if, immediately before the merger, the transferor partnership revalued its assets under Reg. § 1.704-1(b)(2)(iv)(f) and reflected the resulting gains and losses in the capital accounts of its partners.

38 None of the partnerships in the examples in these Comments (i) holds any unrealized receivables or inventory within the meaning of section 751(c) or (d); or (ii) would be treated as an investment company within the meaning of section 351(e) if it were incorporated. Further, none of the contributions or distributions in the examples in these Comments is treated as part of a disguised sale under section 707(a)(2)(B).
the Safe Harbor. Because CD owns only one asset, under section (iii)(a) of the Safe Harbor, C and D should be deemed to contribute an amount of the $1,000 Residual Amount in proportion to and to the extent of their Reduced FMV Capital Account Balances. For this purpose, each partner’s Reduced FMV Capital Account Balance should be determined by (1) first, determining the partner’s FMV Capital Account Balance, and (2) second, reducing the partner’s FMV Capital Account Balance by the amounts deemed contributed by such partner under sections (i) and (ii) of the Safe Harbor. In Example 2, if, immediately before the merger, CD revalued its assets, C and D would each be allocated $100 of section 704(b) book gain, increasing each partner’s capital account balance to $600. Thus, each partner’s FMV Capital Account Balance is $600. To arrive at the partner’s Reduced FMV Capital Account Balance, this balance would be reduced by the $100 of the Merger Amount deemed contributed by the partner under section (ii) of the Safe Harbor. Thus, C and D would each have a $500 Reduced FMV Capital Account Balance. Because their Reduced FMV Capital Account Balances would be equal, C and D would each be deemed to contribute $500 of the $1,000 Residual Amount. (Because there is no amount of Asset 1 remaining after application of section (iii)(a) of the Safe Harbor, no amount is deemed contributed under section (iii)(b) of the Safe Harbor.) Accordingly, in total, C and D would each be deemed to have contributed a $600, or 50 percent ($600 value deemed contributed/$1,200 total value), undivided interest in Asset 1.

In Example 2, no amount was deemed contributed by C or D under section (iii)(b) of the Safe Harbor because CD had not incurred any liabilities. Example 3 illustrates how contributions of undivided interests in property of the transferor partnership may be determined when the partnership has incurred liabilities.

**Example 3: Partnership with New Section 704(c) Gain, but no Original Section 704(c) Gain; Partnership Has Incurred Liabilities** – On January 1, 2007, C and D each contribute $100 to partnership CD in exchange for a 50 percent interest in CD. On the same day, CD borrows $800 and acquires Asset 1 (a nondepreciable capital asset) for $1,000.

On January 1, 2010, when Asset 1 is worth $1,200 and has an adjusted basis of $1,000, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3).

Neither C nor D contributed section 704(c) property to CD. Under section (i) of the Safe Harbor, neither C nor D should be deemed to contribute any portion of Asset 1 as a Contributed Amount.

Because there is no Original Section 704(c) Gain, the New Section 704(c) Gain equals $200, the excess of the total section 704(c) amount attributable to Asset 1 ($200) over the Original Section 704(c) Gain ($0). Because C and D are equal partners, C and D should each have $100 of New Section 704(c) Gain with respect to Asset 1.
Thus, under section (ii) of the Safe Harbor, C and D should each be treated as having contributed a $100 undivided interest in Asset 1 as a Merger Amount.

Under section (iii) of the Safe Harbor, there is a $1,000 Residual Amount, which is the amount of Asset 1 remaining after the application of sections (i) and (ii) of the Safe Harbor. Because CD owns only one asset, under section (iii)(a) of the Safe Harbor, C and D should be deemed to contribute an amount of the $1,000 Residual Amount in proportion to and to the extent of their Reduced FMV Capital Account Balances. For this purpose, each partner’s Reduced FMV Capital Account Balance should be determined by (1) first, determining the partner’s FMV Capital Account Balance, and (2) second, reducing the partner’s FMV Capital Account Balance by the amounts deemed contributed by such partner under sections (i) and (ii) of the Safe Harbor. In Example 3, if, immediately before the merger, CD revalued its assets, C and D would each be allocated $100 of section 704(b) book gain, increasing each partner’s capital account balance to $200. Thus, each partner’s FMV Capital Account Balance is $200. To arrive at the partner’s Reduced FMV Capital Account Balance, this balance would be reduced by the $100 of the Merger Amount deemed contributed by the partner under section (ii) of the Safe Harbor. Thus, C and D would each have a $100 Reduced FMV Capital Account Balance. Because their Reduced FMV Capital Account Balances would be equal, C and D would each be deemed to contribute $100 of the $1,000 Residual Amount under section (iii)(a) of the Safe Harbor.

C’s and D’s share of the remaining $800 Residual Amount is determined under section (iii)(b) of the Safe Harbor. Under section (iii)(b) of the Safe Harbor, C and D share the remaining $800 Residual Amount in proportion to their FMV Capital Account Balances. As calculated above, C and D each has a FMV Capital Account Balance of $200. Thus, C and D should each be treated as having contributed a 50 percent undivided interest in the remaining $800 Residual Amount. Accordingly, in total, C and D would each be deemed to have contributed a $600, or 50 percent ($600 value deemed contributed/$1,200 total value), undivided interest in Asset 1.

Examples 2 and 3 provide fairly simple fact patterns in which the partners of the transferor partnership contributed equal capital and have equal shares of built-in gain. Matters become more complex if, for example, partners of the transferor partnership did not contribute equal capital.

**Example 4: No Original Section 704(c) Gain or Loss and Disproportionate Share of Initial Capital** – Same facts as Example 2, except that on January 1, 2009, when Asset 1 has a fair market value of $1,200 and an adjusted basis of $1,000, E contributes $600 to CD in exchange for a one-third interest in CD. On the same date, CD uses the $600 contributed by E to purchase Asset 2. Immediately before E’s contribution, CD revalues its assets under Regulation section 1.704-1(b)(2)(iv)(f)(5)(i).
On January 1, 2011, when Asset 1 has a fair market value of $1,500, and Asset 2 has a fair market value of $600, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3).

None of C, D, or E contributed section 704(c) property to CD. Under section (i) of the Safe Harbor, none of C, D, or E should be deemed to contribute any portion of Asset 1 or Asset 2 as a Contributed Amount.

Because there is no Original Section 704(c) Gain, the New Section 704(c) Gain with respect to Asset 1 equals $500, the excess of the total section 704(c) amount attributable to Asset 1 ($500) over the Original Section 704(c) Gain ($0). C and D should each have $200, and E should have $100, of New Section 704(c) Gain, with respect to Asset 1. Thus, under section (ii) of the Safe Harbor, C and D should each be treated as having contributed a $200 undivided interest, and E should be treated as having contributed a $100 undivided interest, in Asset 1, as a Merger Amount.

Under section (iii) of the Safe Harbor, Asset 1 has a $1,000 Residual Amount, and Asset 2 has a $600 Residual Amount, which are the amounts of each asset not taken into account under sections (i) and (ii) of the Safe Harbor. C, D, and E should be deemed to contribute to the transferee partnership an undivided interest in the Residual Amount of each asset in an amount equal to the product of (A) the Residual Amount of such asset multiplied by (B) the partner’s Residual Amount Percentage. A partner’s Residual Amount Percentage is the percentage, expressed as a fraction, (I) the numerator of which is such partner’s share (at the time of the merger) of the aggregate amount of the transferor partnership’s Residual Amounts and (II) the denominator of which is the aggregate amount of the transferor partnership’s Residual Amounts.

In Example 4, the aggregate amount of Residual Amounts is $1,600 (i.e., $1,000 with respect to Asset 1 and $600 with respect to Asset 2). Under section (iii)(a) of the Safe Harbor, C, D, and E should share an amount of the $1,600 aggregate Residual Amount in proportion to and to the extent of their Reduced FMV Capital Account Balances. For this purpose, each partner’s Reduced FMV Capital Account Balance should be determined by (1) first, determining the partner’s FMV Capital Account Balance, and (2) second, reducing the partner’s FMV Capital Account Balance by the amounts deemed contributed by such partner under sections (i) and (ii) of the Safe Harbor. In Example 4, if, immediately before the merger, CD revalued its assets, each

---

39 There is no New Section 704(c) Gain or Loss with respect to Asset 2 because it has a basis equal to its fair market value.

40 The New Section 704(c) Gain is allocated among the partners in the following manner: (i) the first $200 of gain in Asset 1 (i.e., the excess of Asset 1’s $1,200 fair market value at the time of E’s admission over its $1,000 adjusted basis) would be allocated $100 each to C and D as a result of CD’s revaluation of its assets immediately before E’s contribution; and (ii) the remaining $300 of gain in Asset 1 (i.e., the excess of Asset 1’s $1,500 fair market value at the time of the merger over its $1,200 fair market value at the time of E’s admission) would be allocated $100 each to C, D, and E.
partner would each be allocated $100 of section 704(b) book gain, increasing each partner’s capital account balance to $700.\(^{41}\) Thus, each has a FMV Capital Account Balance of $700. To arrive at their Reduced FMV Capital Account Balances, C’s and D’s FMV Capital Account Balances would be reduced by the $200, and E’s FMV Capital Account Balance would be reduced by the $100, of the Merger Amount deemed contributed by each under section (ii) of the Safe Harbor. Thus, C and D would each have a $500, and E would have a $600, Reduced FMV Capital Account Balance. (Because there is no Residual Amount remaining after section (iii)(a) of the Safe Harbor, no amount is deemed contributed under section (iii)(b) of the Safe Harbor.) Accordingly, C and D each have a 31.25 percent, and E has a 37.5 percent, Residual Amount Percentage.

C, D, and E would be deemed to contribute an undivided interest in Asset 1 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset (i.e., $1,000) multiplied by (B) such partner’s Residual Amount Percentage (i.e., 31.25 percent, 31.25 percent, and 37.5 percent for C, D, and E, respectively). Thus, C and D would each be deemed to contribute a $312.50, and E would be deemed to contribute a $375, undivided interest in Asset 1 as a Residual Amount. In total, C and D would each be deemed to have contributed a $512.50, or 34 percent ($512.50 value deemed contributed/$1500 total value), undivided interest in Asset 1. E would be deemed to have contributed a $475, or 32 percent ($475 value deemed contributed/$1500 total value), undivided interest in Asset 1.

With respect to Asset 2, each of C, D, and E would be deemed to contribute an undivided interest in Asset 2 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset (i.e., $600) multiplied by (B) such partner’s Residual Amount Percentage (i.e., 31.25 percent, 31.25 percent, and 37.5 percent for C, D, and E, respectively). Thus, C and D would each be deemed to contribute a $187.50, and E would be deemed to contribute a $225, undivided interest in Asset 2 as a Residual Amount.

Accordingly, in total, C and D would each be deemed to have contributed a $187.50, or 31.25 percent ($187.50 value deemed contributed/$600 total value), undivided interest in Asset 2. E would be deemed to have contributed a $225, or 37.5 percent ($225 value deemed contributed/$600 total value), undivided interest in Asset 2.

Example 5 illustrates a fact pattern in which the transferor partnership has both an Original Section 704(c) Gain and a New Section 704(c) Gain.

**Example 5: Original Section 704(c) Gain and New Section 704(c) Gain** – On January 1, 2007, C contributes Asset 1 (a nondepreciable capital asset) with a fair market value of $600 and an adjusted basis of $300 to partnership

\(^{41}\) It should be noted that C’s and D’s capital account balances already reflect the $100 of gain that accrued before E’s admission to CD.
CD in exchange for a 50 percent interest in CD. On the same date, D contributes Asset 2 (also a nondepreciable capital asset) with a fair market value and adjusted basis of $600 in exchange for a 50 percent interest in CD.

On January 1, 2010, when Asset 1 has a fair market value of $900 and an adjusted basis of $300, and Asset 2 continues to have a fair market value and adjusted basis of $600, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3).

At the time of the merger, only C should be deemed to contribute an asset as a Contributed Amount because C is the only partner that contributed section 704(c) property to the transferor partnership. Under section (i) of the Safe Harbor, C is deemed to contribute an undivided interest in Asset 1 equal to such property’s Adjusted Book Value at the time of the merger. Because Asset 1 is a nondepreciable asset, Asset 1’s Adjusted Book Value is $600. Thus, C is deemed to contribute $600 of Asset 1 as a Contributed Amount.

The New Section 704(c) Gain in Asset 1 equals $300, the excess of the total section 704(c) gain attributable to Asset 1 at the time of the merger ($600) over the Original Section 704(c) Gain ($300). Because C and D are equal partners, C and D should each have $150 of New Section 704(c) Gain with respect to Asset 1. Thus, under section (ii) of the Safe Harbor, C and D should each be treated as having contributed a $150 undivided interest in Asset 1 as a Merger Amount.

Under section (iii) of the Safe Harbor, Asset 1 has a $0 Residual Amount, and Asset 2 has a $600 Residual Amount, which are the respective amounts of each asset not taken into account in sections (i) and (ii) of the Safe Harbor. C and D should be deemed to contribute to the transferee partnership an undivided interest in Asset 2 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset multiplied by (B) the partner’s Residual Amount Percentage.

In Example 5, the aggregate amount of the Residual Amounts is $600 (i.e., the $600 Residual Amount of Asset 2). Under section (iii)(a) of the Safe Harbor, C and D should be deemed to contribute an amount of the $600 aggregate Residual Amount in proportion to and to the extent of such partners’ Reduced FMV Capital Account Balances. In Example 5, if, immediately before the merger, CD revalued its assets, C and D would each be allocated $150 of section 704(b) book gain, increasing each partner’s capital account balance to $750. Thus, C and D each have a $750 FMV Capital Account Balance. To arrive at their Reduced FMV Capital Account Balances, C’s FMV Capital Account would be reduced by $600, the Contributed Amount deemed contributed by C under section (i) of the Safe Harbor, and both C’s and D’s FMV Capital Account Balances would be reduced by $150, the Merger Amount deemed contributed by C and D under section (ii) of the Safe Harbor. Thus, C would have a $0 Reduced FMV Capital Account, and D would have a $600 Reduced FMV Capital Account Balance. (Because
there is no Residual Amount remaining after section (iii)(a) of the Safe Harbor, no amount is deemed contributed under section (iii)(b) of the Safe Harbor. Accordingly, C has a 0 Residual Amount Percentage, and D has a 100 Residual Amount Percentage.

D would be deemed to contribute an undivided interest in Asset 2 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset (i.e., $600) multiplied by (B) D’s Residual Amount Percentage (i.e., 100 percent). Thus, D would be deemed to contribute a $600 undivided interest in Asset 2 as a Residual Amount. Accordingly, in total, C would be deemed to have contributed a $750, or 83 percent ($750 value deemed contributed/$900 total value), undivided interest in Asset 1, and D would be deemed to have contributed a $150, or 17 percent ($150 value deemed contributed/$900 total value), undivided interest in Asset 1. C would not be deemed to have contributed any portion of Asset 2, and D would be deemed to have contributed $600, or 100 percent ($600 value deemed contributed/$600 total value), undivided interest in Asset 2.

As is summarized in the following table, all of CD’s property is taken into account under the Safe Harbor.

Example 5 Table - Deemed Undivided Interest Contributions for AB

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>C’s Share</th>
<th>D’s Share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FMV</td>
<td>AB</td>
<td>Built in Gain</td>
</tr>
<tr>
<td>Asset 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Original Section 704(c) Gain</td>
<td>$600</td>
<td>$300</td>
<td>$300</td>
</tr>
<tr>
<td>New Section 704(c) Gain</td>
<td>$300</td>
<td>$0</td>
<td>$300</td>
</tr>
<tr>
<td>Total Asset 1</td>
<td>$900</td>
<td>$300</td>
<td>$600</td>
</tr>
<tr>
<td>Asset 2</td>
<td>$600</td>
<td>$600</td>
<td>$0</td>
</tr>
<tr>
<td>Total AB</td>
<td>$1,500</td>
<td>$900</td>
<td>$600</td>
</tr>
</tbody>
</table>
The need for the Safe Harbor to address as many fact patterns as possible makes it a very complex rule. Because we suspect that there are fact patterns that are not addressed under the Safe Harbor, we recommend that the Service and Treasury retain the flexibility under the final Regulations to provide additional safe harbors (and to expand the Safe Harbor) in revenue rulings, revenue procedures, or private letter rulings.42

E. Need for Two Special Rules if the Undivided Interests Construct is Retained

If the undivided interest construct is retained in the final Regulations, two special rules are needed to ensure that the correct results are reached. As discussed above, if a distribution could have been made before the merger without offending the Anti-Mixing Bowl Rules, final Regulations should preserve the ability to make such distribution after the merger.

1. Recommendation No. 1

The first recommended rule accomplishes this purpose. Specifically, we recommend that, for purposes of determining whether a distribution of property is made to the contributing partner, the distributee partner should treat as previously contributed property any interest in property contributed by the distributee partner to the transferor partnership, including any part of such property that might be deemed contributed by another transferor partner. The following example illustrates this issue.

Example 6: Original Section 704(c) Gain and New Section 704(c) Gain – On January 1, 2007, C contributes Asset 1 (a nondepreciable capital asset) with a fair market value of $300 and an adjusted basis of $100 and Asset 2 (a nondepreciable capital asset) with a fair market value of $200 and an adjusted basis of $100 to partnership CD in exchange for a 50 percent interest in CD. On the same date, D contributes Asset 3 (also a nondepreciable capital asset) with a fair market value and adjusted basis of $500 in exchange for a 50 percent interest in CD.

On January 1, 2010, when Asset 1 has a fair market value of $300 and an adjusted basis of $100, Asset 2 has increased in value to $300 with an adjusted basis of $100, and Asset 3 has a fair market value and adjusted basis of $500, CD merges into partnership AB. CD is the

---

42 Cf. Reg. § 1.707-4(e) (providing that the Service may provide, by guidance published in the Internal Revenue Bulletin, that certain payments or transfers to a partner are not treated as part of a disguised sale of property); Prop. Reg. § 1.707-7(h) (providing a similar rule with respect to disguised sales of partnership interests).
terminating partnership under Regulation section 1.708-1(c)(3).

On January 1, 2013, when the values and adjusted bases of the assets have not changed, AB distributes Asset 2 to C.

At the time of the merger, only C should be deemed to contribute an asset as a Contributed Amount because C is the only partner that contributed section 704(c) property to the transferor partnership. Under section (i) of the Safe Harbor, C is deemed to contribute an undivided interest in Asset 1 and Asset 2 equal to such property’s Adjusted Book Value at the time of the merger. Because Asset 1 and Asset 2 are nondepreciable assets, Asset 1’s Adjusted Book Value is $300 and Asset 2’s Adjusted Book Value is $200. Thus, C is deemed to contribute $300 of Asset 1 and $200 of Asset 2 as Contributed Amounts.

There is no New Section 704(c) Gain in Asset 1 because the total section 704(c) gain attributable to Asset 1 at the time of the merger ($200) does not exceed the Original Section 704(c) Gain ($200). The New Section 704(c) Gain in Asset 2 equals $100, the excess of the total section 704(c) gain attributable to Asset 2 at the time of the merger ($200) over the Original Section 704(c) Gain ($100). Because C and D are equal partners, C and D should each have $50 of New Section 704(c) Gain in Asset 2. Thus, under section (ii) of the Safe Harbor, C and D should each be treated as having contributed a $50 undivided interest in Asset 2 as a Merger Amount.

Under section (iii) of the Safe Harbor, Asset 1 and Asset 2 have $0 Residual Amounts, and Asset 3 has a $500 Residual Amount, which are the respective amounts of each asset not taken into account in sections (i) and (ii) of the Safe Harbor. C and D should be deemed to contribute to the transferee partnership an undivided interest in Asset 3 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset multiplied by (B) the partner’s Residual Amount Percentage.

In Example 6, the aggregate amount of the Residual Amounts is $500 (i.e., the $500 Residual Amount of Asset 3). Under section (iii)(a) of the Safe Harbor, C and D should share an amount of the $500 aggregate Residual Amount in proportion to and to the extent of such partners’ Reduced FMV Capital Account Balances. In Example 6, if, immediately before the merger, CD revalued its assets, C and D would each be allocated $50 of section 704(b) book gain, increasing each partner’s capital account balance to $550. Thus, each has a FMV Capital Account Balance of $550. To arrive at their Reduced FMV Capital Account Balances, C’s FMV Capital Account Balance would be reduced by the $500 of the Contributed Amount deemed contributed by C under section (i) of the Safe Harbor, and both C’s and D’s FMV Capital Account Balances would be reduced by the $50 of the Merger Amount deemed contributed by C and D under section (ii) of the Safe Harbor. Thus, C would have a $0 Reduced FMV Capital Account, and D would have a $500 Reduced FMV Capital Account Balance. (Because there is no Residual Amount remaining after section (iii)(a) of the Safe Harbor, no amount is deemed contributed under section (iii)(b) of the Safe Harbor.) Accordingly, C has a 0 percent, and D has a 100 percent, Residual Amount Percentage.
D would be deemed to contribute an undivided interest in Asset 3 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset (i.e., $500) multiplied by (B) D’s Residual Amount Percentage (i.e., 100 percent). Thus, D would be deemed to have contributed a $500 undivided interest in Asset 3 as a Residual Amount. Thus, C would be deemed to have contributed $300, or 100 percent, undivided interest in Asset 1. With respect to Asset 2, C would be deemed to have contributed $250, or 83 percent ($250 value deemed contributed/$300 total value), undivided interest, and D would be deemed to have contributed a $50, or 17 percent ($50 value deemed contributed/$300 total value), undivided interest. C would not be deemed to have contributed any portion of Asset 3, and D would be deemed to have contributed a $500, or 100 percent ($500 value deemed contributed/$500 total value), undivided interest in Asset 3.

Because AB’s distribution of Asset 2 to C occurs within seven years of C’s actual contribution to CD and C’s deemed contribution to AB, section 737 is implicated. C has (i) $200 of net precontribution gain with respect to the Original Section 704(c) Gain in Asset 1, (i.e., the $200 of gain that C would recognize under section 704(c)(1)(B) if the Original Section 704(c) Gain in Asset 1 were distributed to another partner); (ii) $100 of net precontribution gain with respect to the Original Section 704(c) Gain in Asset 2, (i.e., the $100 of gain that C would recognize under section 704(c)(1)(B) if the Original Section 704(c) Gain or Loss in Asset 2 were distributed to another partner); and (iii) $50 of net precontribution gain with respect to the New Section 704(c) Gain in Asset 2, (i.e., the $50 share of gain in the New Section 704(c) Gain that C would recognize under section 704(c)(1)(B) if the New Section 704(c) Gain in Asset 2 were distributed to another partner). The excess distribution is $100 (the $300 fair market value of Asset 2 over C’s outside basis of $200). Accordingly, C could recognize $100 of gain under section 737.

Although C was deemed to have contributed an 83 percent undivided interest in Asset 2, and D was deemed to have contributed a 17 percent undivided interest in Asset 2, C should be treated as having contributed all of Asset 2 for purposes of the previously contributed property exceptions (the “PCPE”) because C actually contributed Asset 2 to CD. This is because, if CD had not merged with AB, CD would have been able to distribute all of Asset 2 to C without implicating section 737.\footnote{43} The merger should not change that result. For this reason, we recommend that final Regulations provide that, for purposes of determining whether a distribution of property is made to the contributing partner, the distributee partner should be treated as having contributed any interest in property actually contributed by the distributee partner to the transferor partnership, including any part of such property deemed contributed by another partner of

\footnote{43} Similarly, D would not have recognized any of its $50 of New Section 704(c) Gain under section 704(c)(1)(B) because there would not have been any New Section 704(c) Gain created had there been no merger. For the same reasons discussed in the text, above, we do not believe that D should recognize gain under section 704(c)(1)(B) in this case because the transferor partnership could have made such distribution absent the merger, and this result does not thwart the purposes of the Anti-Mixing Bowl Rules.
the transferor partnership as a Merger Amount or Residual Amount under the Safe Harbor.

2. **Recommendation No. 2**

Second, we believe that if the undivided interest construct is retained in the final Regulations, a special rule is needed to ensure that the construct does not undermine section 737 in situations in which property contributed in a merger has an Original Section 704(c) Gain that is still subject to the seven-year period under the Anti-Mixing Bowl Rules. Specifically, in those situations, treating a partner of the transferor partnership as having contributed undivided interests in property under sections (ii) or (iii) of the Safe Harbor when the partner did not actually contribute that property to the transferor partnership might permit partnerships to distribute property after a merger without application of section 737, even though section 737 would have been applicable to such a distribution before the merger. The following example illustrates this issue.

**Example 7: Original Section 704(c) Gain and New Section 704(c) Gain** – On January 1, 2007, C contributes Asset 1 (a nondepreciable capital asset) with a fair market value of $300 and an adjusted basis of $100 to partnership CD in exchange for a 50 percent interest in CD. On the same date, D contributes Asset 2 (also a nondepreciable capital asset) with a fair market value and adjusted basis of $300 to CD in exchange for a 50 percent interest in CD.

On January 1, 2010, when Asset 1 has a fair market value of $300 and an adjusted basis of $100 and Asset 2 has increased in value to $900 with an adjusted basis of $300, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3).

On January 1, 2013, when the values and adjusted bases of Assets 1 and 2 have not changed, AB distributes $300 of Asset 2 to C.

At the time of the merger, only C should be deemed to contribute an asset as a Contributed Amount because C is the only partner that contributed section 704(c) property to the transferor partnership. Under section (i) of the Safe Harbor, C is deemed to contribute an undivided interest in Asset 1 equal to such property’s Adjusted Book Value at the time of the merger. Because Asset 1 is a nondepreciable asset, Asset 1’s Adjusted Book Value is $300. Thus, C is deemed to contribute $300 of Asset 1 as a Contributed Amount.

There is no New Section 704(c) Gain in Asset 1 because the total section 704(c) gain attributable to Asset 1 at the time of the merger ($200) does not exceed the Original Section 704(c) Gain ($200). The New Section 704(c) Gain in Asset 2 equals $600, the excess of the total section 704(c) gain attributable to Asset 2 at the time of the
merger ($600) over the Original Section 704(c) Gain ($0). Because C and D are equal partners, C and D should each have $300 of New Section 704(c) Gain with respect to Asset 2. Thus, under section (ii) of the Safe Harbor, C and D should each be treated as having contributed a $300 undivided interest in Asset 1 as a Merger Amount.

Under section (iii) of the Safe Harbor, Asset 1 has a $0 Residual Amount, and Asset 2 has a $300 Residual Amount, which are the respective amounts of each asset not taken into account in sections (i) and (ii) of the Safe Harbor. C and D should be deemed to contribute to the transferee partnership an undivided interest in Asset 2 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset multiplied by (B) the partner’s Residual Amount Percentage.

In Example 7, the aggregate amount of the Residual Amounts is $300 (i.e., the $300 Residual Amount of Asset 2). Under section (iii)(a) of the Safe Harbor, C and D should be deemed to contribute an amount of the $300 aggregate Residual Amount in proportion to and to the extent of such partners’ Reduced FMV Capital Account Balances. In Example 7, if, immediately before the merger, CD revalued its assets, C and D would each be allocated $300 of section 704(b) book gain, increasing each partner’s capital account balance to $600. Thus, each has a FMV Capital Account Balance of $600. To arrive at their Reduced FMV Capital Account Balances, C’s FMV Capital Account Balance would be reduced by the $300 of the Contributed Amount deemed contributed by C under section (i) of the Safe Harbor, and both C’s and D’s FMV Capital Account Balances would be reduced by the $300 of the Merger Amount deemed contributed by C and D under section (ii) of the Safe Harbor. Thus, C would have a $0 Reduced FMV Capital Account, and D would have a $300 Reduced FMV Capital Account Balance. (Because there is no Residual Amount remaining after section (iii)(a) of the Safe Harbor, no amount is deemed contributed under section (iii)(b) of the Safe Harbor.) Accordingly, C has a 0 Residual Amount Percentage, and D has a 100 Residual Amount Percentage.

Thus, D would be deemed to contribute an undivided interest in Asset 2 as a Residual Amount in an amount equal to the product of (A) the Residual Amount of such asset (i.e., $300) multiplied by (B) D’s Residual Amount Percentage (i.e., 100 percent). As a result, D would be deemed to contribute a $300 undivided interest in Asset 2 as a Residual Amount.

In summary, C would be deemed to contribute a $300, or 100 percent, undivided interest in Asset 1. With respect to Asset 2, C would be deemed to contribute a $300, or 1/3 ($300 value deemed contributed/$900 total value), undivided interest, and D would be deemed to contribute a $600, or 2/3 ($600 value deemed contributed/$900 total value), undivided interest.

Because AB’s distribution of $300 of Asset 2 to C occurs within seven years of C’s contribution of Asset 1 to CD, section 737 would be implicated. C has $200 of net precontribution gain with respect to the Original Section 704(c) Gain in Asset 1 (i.e, the $200 of gain that C would recognize under section 704(c)(1)(B) if the Original Section 704(c) Gain in Asset 1 were distributed to another partner). C has $300 of net
precontribution gain with respect to the New Section 704(c) Gain in Asset 2, (i.e., the $300 share of gain in the New Section 704(c) Gain that C would recognize under section 704(c)(1)(B) if the New Section 704(c) Gain in Asset 2 were distributed to another partner). Under the Proposed Regulations, the distribution to C of an undivided interest in Asset 2 would be deemed to carry with it C’s $300 share of New Section 704(c) Gain in Asset 2 and would thus be considered a distribution to C of previously contributed property. Thus, C would not have to recognize gain under section 737.

For the same reasons that we believe the rule proposed above (and discussed in connection with Example 6) is necessary to prevent inappropriate gain recognition, we believe that the result illustrated by Example 7 is inappropriate. If CD had not merged with AB, a distribution of an undivided interest in Asset 2 would have caused C to recognize gain under section 737. The result should not be different if the transferee partnership distributed Asset 2 after a merger. For this reason, we recommend that if the undivided interest construct is retained, the final Regulations should contain a rule that provides that, for purposes of the PCPE, for so long as a partner has net precontribution gain with respect to property such partner contributed to the transferor partnership that is transferred to the transferee partnership in a merger, such partner will be deemed to have contributed to the transferee partnership only property actually contributed by the partner to the transferor partnership.

IV. The Ordering Rule

A. Administrative Benefits

The application of the Anti-Mixing Bowl Rules is not clear in situations in which, following a merger, the transferee partnership distributes a portion of a particular section 704(c) asset with respect to which more than one former partner of the transferor partnership is the deemed contributor. Specifically, in those situations, it is necessary to

---

44 Because the excess distribution is $200 (the $300 fair market value of the distribution of Asset 2 over C’s outside basis of $100), and C’s total net precontribution gain is $500, C’s gain under section 737 would be limited to $200.

45 This result would be the same if Asset 2 had been acquired by, rather than contributed to, CD.

46 C’s net precontribution gain would have equaled $200, or the $200 of gain that C would recognize under section 704(c)(1)(B) if Asset 1 were distributed to another partner. The excess distribution is $200 (the $300 fair market value of the distribution of Asset 2 over C’s outside basis of $100).

47 We note that the undivided interest approach would allow a partner in the transferor partnership to receive a distribution from the transferee partnership without triggering the application of section 737 even if that partner had contributed built-in gain property to the transferee partnership within seven years of the distribution. For example, C contributes cash to CD. Later, CD merges into AB, with AB surviving the merger. Under the undivided interest approach, C is treated as having contributed to AB a portion of CD’s assets. C contributes appreciated property to AB (either before or after the merger). Within seven years of that contribution, AB distributes to C some of the property C was deemed to contribute to AB in the merger. Because that property is previously contributed property as to C, the Anti-Mixing Bowl Rules are not implicated. We believe that this result is consistent with the undivided interest approach (and with the Continuing Partner Exception).
determine which portion of the asset should be deemed distributed to determine whether and to what extent gain (or loss) under sections 704(c)(1)(B) and 737 must be recognized. The Proposed Regulations address those situations by providing that if the transferee partnership distributes a portion of a particular section 704(c) asset after a merger, then a proportionate amount of the Original Section 704(c) Gain or Loss and the New Section 704(c) Gain or Loss must be recognized under section 704(c)(1)(B).

B. Recommended Clarifications

We generally support the approach taken by the Proposed Regulations. If the Continuing Partner Exception is not adopted, however, and the Safe Harbor is, we believe that some modifications are warranted. First, because, as was stated above, it is possible that an asset may have a Residual Amount, it is necessary for the Ordering Rule to address the Residual Amount. We recommend that final Regulations provide that if the transferee partnership distributes less than all of a particular section 704(c) asset after a merger, then proportionate amounts (based on relative value) of the Contributed Amount, the Merger Amount, and the Residual Amount are deemed distributed under section 704(c)(1)(B).

Second, we recommend that the final Regulations provide that to the extent the distribution is made to the contributing partner, then proportionate amounts (based on relative value) of the Contributed Amount, the Merger Amount, and the Residual Amount deemed contributed by such partner are deemed distributed. The following example illustrates why such a modification of the ordering rule as applied to a contributing partner is necessary.

Example 8: Original Section 704(c) Gain and New Section 704(c) Gain – Same facts as Example 7, except that AB distributes $300 of Asset 2 to C on January 1, 2015.

As was stated in Example 7, C would be deemed to contribute a $300, or 100 percent, undivided interest in Asset 1. With respect to Asset 2, C would be deemed to contribute a $300, or 1/3, undivided interest, and D would be deemed to contribute a $600, or 2/3, undivided interest.

In Example 8, however, AB’s distribution of $300 of Asset 2 to C occurs more than seven years after C’s contribution of Asset 1 to CD. Under the Proposed Regulations, AB would be deemed to distribute a portion of the amount of Asset 2

---

48 Prop. Reg. § 1.704-4(c)(4)(ii)(C)(1). As is discussed below in Section IX.A of these Comments, we recommend below that the Ordering Rule be clarified to ensure that it does not, of itself, result in the recognition of gain or loss.

49 If the Continuing Partner Exception is adopted, these modifications to the ordering rule contained in the Proposed Regulations would not be necessary because, under the Continuing Partner Exception, it is not necessary to determine a transferor partner’s undivided interest in transferor partnership property.
deemed contributed by D. This would require C to recognize gain under section 737, and D to recognize gain under section 704(c)(1)(B). Consistent with the undivided interest rule of Regulation section 1.704-3(a)(8), however, we believe that C should be able to receive its undivided interest in Asset 2 (i.e., $300 or 1/3 of Asset 2) as a distribution of previously contributed property. Thus, we recommend that the Regulations, when finalized, contain a rule under which C would be deemed to receive the $300 interest in Asset 2 deemed contributed by C. This would result in C not recognizing gain under section 737, and D not recognizing gain under section 704(c)(1)(B).

Third, we recommend that the Ordering Rule be modified to address “loss layers.” That is, a Merger Amount attributable to a New Section 704(c) Loss will have a fair market value of zero. Accordingly, it may be argued that no portion of such a Merger Amount would be treated as having been distributed under the Ordering Rule. We do not believe this is the correct policy answer. Thus, we recommend that, solely for purposes of the Ordering Rule, a Merger Amount with a New Section 704(c) Loss have a fair market value equal to the absolute value (i.e., its numerical value without regard to the fact that the number is less than zero) of the New Section 704(c) Loss.

Fourth, we recommend that the Ordering Rule be modified to apply to a sale by the transferee partnership of a portion of a particular section 704(c) asset after a merger. We do not believe, in this case, that a distribution of the section 704(c) asset should produce a result different from a sale of the section 704(c) asset. Indeed, if section 704(c)(1)(B) applies, the consequences to the contributing partner are determined as if the partnership sold the section 704(c) property.

V. Need for Rules to Determine Basis of the Contributed Amount

The Safe Harbor determines only the undivided interests in the property deemed contributed by partners of the transferor partnership. It does not determine the basis of partnership property that is associated with those undivided interests.\(^{50}\) We believe that guidance regarding basis allocation is needed to ensure that the appropriate amount of built-in gain or loss is preserved in partnership property. Therefore, we recommend that if a partnership adopts the Safe Harbor, the final Regulations should provide that the basis of the undivided interests deemed contributed to the transferee partnership should be determined under the following rule (the “Basis Rule”):

(i) The Contributed Amount should attract basis equal to the adjusted basis of the property at the time of contribution (as adjusted to reflect amortization or other cost recovery adjustments).

\(^{50}\) It is significant that the Undivided Interest Rules of the existing regulations do not address how to determine the basis of property distributed to the contributing partner if less than all of the property is distributed. It seems clear that the distribution of a partner’s undivided interest in property contributed to the partnership should attract the remaining adjusted basis of the property at the time of contribution (as adjusted to reflect amortization or other cost recovery adjustments).
(ii) If the Merger Amount is

(a) attributable to New Section 704(c) Gain, then it should attract no basis; and

(b) attributable to New Section 704(c) Loss, then,

(1) if that New Section 704(c) Loss is attributable to property also accounted for in the Contributed Amount, it should attract no basis; and

(2) if that New Section 704(c) Loss is attributable to property also accounted for in the Residual Amount, it should attract basis in amount equal to such New Section 704(c) Loss.

If less than all of a particular asset’s Contributed Amount and Merger Amount is distributed, the distributed asset should attract a proportionate amount of the basis allocable to such Amount.

The suggested allocation of basis is driven by the need to preserve gain or loss in the appropriate place, taking into account the manner in which the Contributed and Merger Amounts are determined. Original Section 704(c) Gain or Loss is determined by reference to the basis of contributed section 704(c) property.\textsuperscript{51} Thus, to preserve the Original Section 704(c) Gain or Loss, section (i) of the Basis Rule provides that the Contributed Amount should attract the adjusted basis of the property at the time of contribution (as adjusted to reflect amortization or other cost recovery adjustments).

After the application of section (i) of the Basis Rule, the transferor partnership should have no remaining basis in section 704(c) property contributed to the transferor partnership. Thus, if a Merger Amount, whether a New Section 704(c) Gain or a New Section 704(c) Loss, is attributable to property accounted for in the Contributed Amount, such Merger Amount should attract no basis. If, however, a Merger Amount is attributable to property accounted for in the Residual Amount, because such property was not section 704(c) property contributed to the transferor partnership, any New Section 704(c) Loss created on the merger should attract basis in an amount equal to such New Section 704(c) Loss, and, any New Section 704(c) Gain created upon the merger should have no basis associated with it.

It should be noted that it is not necessary to determine the adjusted basis attributable to the Residual Amount deemed contributed to the transferee partnership by

\textsuperscript{51} More technically, Original Section 704(c) Gain or Loss is the difference, at the time of the merger, between an asset’s fair market value and the contributing partner’s adjusted basis in such asset at the time the asset was contributed to the transferor partnership, as adjusted to reflect amortization or other cost recovery adjustments.
each partner because there is no built-in gain or loss in such Amount at the time of the merger and, thus, no built-in gain or loss for which a Basis Rule is needed to preserve.

These principles can be illustrated by the following example.

**Example 9: Original Section 704(c) Gain and New Section 704(c) Gain; Distribution** – Same facts as Example 5 above, except that on January 1, 2013, AB distributes $600 of Asset 1 to C.

In Example 5, under section (i) of the Safe Harbor, C would be deemed to contribute $600 of Asset 1 as a Contributed Amount. Under section (ii) of the Safe Harbor, C and D would each be deemed to contribute a $150 undivided interest in Asset 1 as a Merger Amount. Under section (iii) of the Safe Harbor, D would be deemed to contribute a $600 undivided interest in Asset 2 as a Residual Amount. Thus, in total, C would be deemed to contribute a $750, or 83 percent, undivided interest in Asset 1, and D would be deemed to contribute a $150, or 17 percent, undivided interest in Asset 1. C would not be deemed to contribute any portion of Asset 2, and D would be deemed to contribute a $600, or 100 percent undivided interest in Asset 2.

A subsequent distribution by AB of $600 of Asset 1 to C would, under the Ordering Rule, be treated as a distribution of proportionate amounts (based on relative values) of property deemed contributed as Contributed Amounts, Merger Amounts, and Residual Amounts.\[^{52}\] The distribution to C would first consist of undivided interests in Asset 1 that C was deemed to have contributed to AB.\[^{53}\] As discussed above, C would be treated as having contributed (i) a $600 undivided interest in Asset 1 as a Contributed Amount and (ii) a $150 undivided interest in Asset 1 as a Merger Amount. Accordingly, the distribution by AB of $600 of Asset 1 to C would be treated as a distribution of (i) a $480 undivided interest of the Contributed Amount in Asset 1,\[^{54}\] and (ii) a $120 undivided interest of the Merger Amount in Asset 1.\[^{55}\]

The basis of the $600 of Asset 1 distributed by AB to C should be determined in a manner that preserves the built-in gain in the Original and New Section

\[^{52}\] This treatment is consistent with our recommendations in the Comments above with respect to the Ordering Rule of Prop. Reg. § 1.704-4(c)(4)(ii)(C)(1).

\[^{53}\] Under the Undivided Interest Rules, the Anti-Mixing Bowl Rules would not apply to the distribution of an undivided interest in Asset 1 to the extent that the undivided interest distributed does not exceed the undivided interest contributed by C in Asset 1. Reg. §§ 1.704-4(c)(6) and 1.737-2(d)(4).

\[^{54}\] The proportionate amount of the distribution of property of the Contributed Amount is determined by multiplying the amount of the distribution ($600) by a fraction, the numerator of which is an amount equal to the property C contributed as a Contributed Amount ($600), and the denominator of which is the total amount of property C contributed as Contributed and Merger Amounts ($750).

\[^{55}\] The proportionate amount of the distribution of property of the Merger Amount is determined by multiplying the amount of the distribution ($600) by a fraction, the numerator of which is an amount equal to the property C contributed as a Merger Amount ($150), and the denominator of which is the total amount of property C contributed as Contributed and Merger Amounts ($750).
704(c) Gain. As we have suggested, under section (i) of the Basis Rule, at the time of the merger, C’s deemed contribution of a $600 undivided interest in Asset 1 as a Contributed Amount should have attracted Asset 1’s $300 adjusted basis at the time of contribution (as adjusted to reflect amortization or other cost recovery adjustments). Under section (ii)(a), C’s deemed contribution of a $150 undivided interest in Asset 1 as a Merger Amount should not have attracted any basis. A proportionate distribution of the undivided interest of such Amounts should attract a proportionate amount of the basis of such Amount. Accordingly, the distribution of a $480 undivided interest of the Contributed Amount in Asset 1 should attract $240 of adjusted basis,\(^{56}\) and (ii) the distribution of a $120 undivided interest of the Merger Amount in Asset 1 should not attract any basis.\(^{57}\)

Separately maintaining basis attributable to each Amount that C was deemed to contribute and that was distributed to C preserves C’s $450 of built-in gain in Asset 1. The $600 distribution to C of Asset 1 will carry with it C’s built-in gain of $360.\(^{58}\) The remaining $300 undivided interest in Asset 1 retained by AB will preserve C’s remaining built-in gain of $90.\(^{59}\) As a result, C’s total built-in gain of $450 in Asset 1 is preserved.

It is important to recognize that it is only necessary to determine the basis of the Contributed and Merger Amounts if the property associated with such Amounts is distributed to the contributing partner; if the property is sold or is distributed to another partner, the Basis Rule is not relevant. The Proposed Regulations describe how to determine a partner’s share of Original and New Section 704(c) Gain or Loss. Thus, if the Contributed and Merger Amounts were sold by the transferee partnership, the contributing partner would recognize his or her Original and New Section 704(c) Gain or Loss and the purchaser’s basis would be determined under section 1012. Similarly, if the property were distributed to a partner other than the contributing partner, the contributing partner would recognize his or her Original and New Section 704(c) Gain or Loss under section 704(c)(1)(B) and appropriate basis adjustments would be made under section 704(c)(1)(B).\(^{60}\)

\(^{56}\) The proportionate amount of basis in property distributed is determined by multiplying the total basis $300 by a fraction, the numerator of which is equal to the property distributed from the Contributed Amount ($480), and the denominator of which is the pre-distribution amount of the property in the Contributed Amount ($600).

\(^{57}\) Because the Merger Amount had a basis of zero, the distribution should not attract any basis.

\(^{58}\) The distribution of a $480 undivided interest in Asset 1 with a $240 adjusted basis will preserve a $240 built-in gain in Asset 1. The distribution of a $120 undivided interest in Asset 1 with a zero basis will preserve a $120 built-in gain in Asset 1.

\(^{59}\) AB will retain a $120 undivided interest in Asset 1 with a $60 adjusted basis with respect to C’s Contributed Amount, and a $30 undivided interest in Asset 1 with a zero basis with respect to C’s Merger Amount.

\(^{60}\) Reg. § 1.704-4(e)(2).
VI. The Identical Ownership and De Minimis Change in Ownership Exceptions

The Proposed Regulations contain an identical ownership exception and a de minimis change in ownership exception. Specifically, under the IOE, the Proposed Regulations provide that section 704(c)(1)(B) will not apply to, and section 737 net precontribution gain will not include, gain or loss relating to the New Section 704(c) Gain or Loss in any property deemed contributed in a merger if the ownership of both partnerships is identical or if there is only a de minimis difference in ownership. For this purpose, the transferor partnership and the transferee partnership are owned by the same owners in the same proportions if each partner owns identical interests in book capital and in each item of income, gain, loss, deduction, and credit, and identical shares of distributions and liabilities in the transferor and transferee partnerships. A difference in ownership is de minimis if 97 percent of the interests in book capital and in each item of income, gain, loss, deduction and credit and shares of distributions, and liabilities of the transferor and transferee partnerships are owned by the same owners in the same proportions.

A. Recommended Clarifications of Both Exceptions

Because the word “book” appears before the word “capital” in the text of the Proposed Regulations, it is not entirely clear whether the items of income, gain, loss, deduction and credit to which the Proposed Regulations refer are section 704(b) book items or tax items. To remove this ambiguity, we recommend that the language be modified to clarify that, for purposes of the IOE and the de minimis change in ownership exception, the relevant items of income, gain, loss, deduction and credit are the partnership’s section 704(b) book items, not the partnership’s tax items.

B. Suggested Modifications to the de Minimis Change in Ownership Exception

1. Modify the “Threshold” Language

As was noted above, the de minimis change in ownership exception applies if there is 97 percent identity of ownership (as determined under the Proposed Regulations). It seems apparent that the de minimis change in ownership exception was intended to set forth a threshold requirement, rather than only one percentage interest at which the exception would apply. Accordingly, we recommend that the language of the de minimis change in ownership exception be modified to provide that a change in ownership is de minimis if “at least” the requisite percentage is met.

---


62 Id.

63 The Proposed Regulations set 97 percent as the required percentage. As is discussed below, we believe that 80 percent is more appropriate.
2. **Reduce the Ownership Threshold to 80 Percent**

As we observed in the Ruling Comments:

All partnership mergers are, in some sense, merely a reorganization of the ownership of assets in modified partnership form. In those situations in which related partnerships merge, the potential for taxpayers to use the merger to effectuate a sale would seem to be substantially diminished. Therefore, we recommend that the Service and Treasury provide that any regulations promulgated will not apply to a merger of partnerships in which the same persons own eighty percent (80 percent) or more of the interests in the capital and profits of the merging partnerships. For purposes of this exception, the ownership of capital and profits should be determined in accordance with the constructive ownership rules of sections 267(c)(1) and 267(c)(5) (to the extent it related to section 267(c)(1)).

It is clear that Treasury and the Service agree in principle with the above comment because the Preamble explains that “[w]here ownership of both partnerships is identical, the merger more accurately represents a change in form, and should have no substantive tax consequences. The same principles apply where the change in ownership is *de minimis*.” According to the Proposed Regulations, a 3 percent difference is *de minimis*. We continue to believe that, although a 20 percent difference is not *de minimis*, 80 percent identity of ownership should be significant enough to benefit from the exception contained in the Proposed Regulations. Thus, we recommend that the threshold in the *de minimis* change in ownership exception be reduced from its current 97-percent identity of ownership requirement to an 80-percent threshold.

---

64 *Cf.* Reg. § 1.368-1(b) (the purpose of the reorganization provisions of section 368 is to exempt from current tax those transactions that “effect only a readjustment of continuing interest in property under modified corporate form”).

65 *Supra* note 10.


67 Other authority is supportive of an 80-percent threshold. For example, section 368(a)(1)(C) provides that, to qualify as a reorganization under that section, “substantially all” of the assets of the target corporation must be acquired by the acquiring corporation. In Rev. Proc. 77-37, 1977-2 C.B. 586, the Service held that, for advance ruling purposes, the term “substantially all” means 70 percent of gross assets and 90 percent of net assets. In addition, recently finalized Regulations under section 368 provide that (i) if members of a qualified group own controlling interests in a partnership, any stock owned by such partnership is treated as owned by members of the qualified group, and (ii) a transaction otherwise qualifying as a reorganization under section 368(a) is not disqualified as a result of a subsequent transfer of the acquired assets or stock to a controlled partnership. Under those Regulations, the term “control” is defined under section 368(c) as ownership of stock possessing at least 80 percent of the total voting power.
3. **Eliminate Requirement for Identity of Allocation of Liabilities**

Under the IOE and the *de minimis* change in ownership exception, liabilities of the transferor and transferee partnerships must be owned by the same owners in the same proportions or the difference in ownership may be no more than 3 percent, respectively. The requirement that the owners of the transferor and transferee partnerships have identical shares of liabilities will preclude the application of these exceptions in many, if not all, situations (including, for example, those situations in which the partnerships have nonrecourse liabilities). We believe that Treasury and the Service should eliminate the consideration of liabilities in the IOE and the *de minimis* change in ownership exception to take into account the fact the allocation of nonrecourse liabilities under section 752 may cause partners to have varying allocations of partnership nonrecourse liabilities even though the partners maintain identical economic interests in the partnerships. 68

C. **Timing Issue Under the IOE and the *de minimis* Change in Ownership Exception**

Before the issuance of the Proposed Regulations, the Service addressed the application of the IOE. In PLR 200631014, 69 the Service concluded that sections 704(c)(1)(B) and 737 did not apply to a distribution following an assets-over partnership merger in which there was identical ownership of the merging partnerships. In the letter ruling, an individual owned all of the stock of two S corporations, each of which, along with the individual, was a partner in a separate partnership. The other partners in the partnerships owned equal interests in each partnership. The two S corporations merged. Immediately thereafter, the two partnerships merged. The ruling concluded, without analysis, that the partnership merger fell “within the identical ownership exception set forth in Notice 2005-15.” 70

---

68 The Service has issued three revenue rulings (as well as two general counsel memoranda and numerous private letter rulings) concluding that the resulting entity in a partnership conversion is treated as the continuation of the converting partnership even if the allocation of partnership liabilities changes as a result of the conversion (tax is imposed only to the extent that there is a reallocation of partnership liabilities that causes a deemed distribution to a partner under section 752(b) in excess of the partner’s basis in its partnership interest). See Rev. Rul. 84-52, 1984-1 C.B. 157; Rev. Rul. 95-37, 1995-1 C.B. 130; Rev. Rul. 95-55, 1995-2 C.B. 313.

69 May 1, 2006.

70 The IOE described in the Notice, which was issued prior to the private letter ruling, tests identity of ownership by the “same owners in the same proportions” formulation that is used in the Proposed Regulations. See Notice 2005-15, 2005-1 C.B. 527.
The letter ruling highlights an important timing issue that is not addressed by the Proposed Regulations. Specifically, it is unclear how long before a merger the requisite level of identical ownership must exist. The examples illustrating the application of the IOE in the Proposed Regulations are not particularly helpful in this regard because the partners of the transferor and transferee partnerships in those examples held their interests for 15 years before the mergers. The final Regulations should confirm whether (and, if so, in what situations) the partners of the transferor and transferee partnerships may restructure in anticipation of a merger to satisfy the requirements of the identical ownership exception or the de minimis change in ownership exception.

VII. Like-Kind Exception Under Section 704(c)(2)

A. In General

Section 704(c)(2) provides that, subject to certain limitations described below, section 704(c)(1)(B) does not apply if property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the noncontributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner’s income tax return for the taxable year of the distribution to the noncontributing partner (the “Like-Kind Exception”).

In determining whether contributions to a partnership are considered transfers to an investment company within the meaning of section 721(b), the Service has ruled favorably upon transactions occurring before a contribution that are designed to ensure that the contribution does not have the effect of achieving diversification. See, e.g., PLR 200317011 (Jan. 7, 2003) (husband and wife exchanged individually-owned securities and real estate so that each owned an undivided interest in each asset, such that the contribution of property to the partnership was not subject to application of section 721(b)); PLR 9811022 (Dec. 4, 1997) (husband transferred stock to himself and his wife as tenants in common so that they owned undivided interests in the stock equal to their existing ownership interests in a partnership; section 721(b) did not apply to subsequent contribution of the stock to the partnership); PLR 9012024 (Dec. 19, 1989) (husband and wife engaged in pre-contribution exchange of their investment assets so that each held a percentage of each asset equal to his or her interest in the partnership after the contribution; section 721(b) did not apply to the subsequent contribution to the partnership).

Section 704(c)(2) provides as follows:

Under regulations prescribed by the Secretary, if—

(A) property contributed by a partner (hereinafter referred to as the “contributing partner”) is distributed by the partnership to another partner, and

---


72 In other contexts, the Service and Treasury have recognized that anticipatory restructuring transactions should not prevent characterization of a transaction as a reorganization. Rev. Rul. 96-29, 1996-1 C.B. 50 (changes in shareholders and assets resulting from other, albeit factually related, transactions do not violate the requirements of section 368(a)(1)(F) that there be no change in the existing ownership or assets of the corporation). See also Prop. Reg. § 1.368-2(m) (Aug. 12, 2004) (providing that related events that precede or follow the transaction or series of transactions that constitutes a mere change in identity, form, or place of organization will not cause that transaction or series of transactions to fail to qualify as a reorganization under section 368(a)(1)(F)).
The Like-Kind Exception applies only to the extent that the built-in gain or loss in the distributed like-kind property in the hands of the contributing partner is not less than the built-in gain or loss that would, but for the Like-Kind Exception, have been recognized under section 704(c)(1)(B).⁷⁴

The Regulations under section 737 provide that a distributee partner’s net precontribution gain is reduced by the amount of built-in gain that a partner would have recognized under section 704(c)(1)(B) but for the application of the Like-Kind Exception.⁷⁵ Those Regulations also provide, however, that a distributee partner’s net precontribution gain is not reduced if the property contributed by the distributee partner is not distributed to another partner in a distribution related to the section 737 distribution.⁷⁶

B. Deemed Transactions in Mergers

As discussed above, for purposes of determining the tax consequences of a post-merger distribution of property by a transferee partnership, the Proposed Regulations generally provide that each partner of the transferor partnership is treated as having contributed an undivided interest in the property of the transferor partnership.⁷⁷ The Proposed Regulations do not directly address whether this deemed contribution treatment applies for purposes of the Like-Kind Exception. We believe that such treatment is appropriate and therefore recommend that the final Regulations clarify that such treatment applies for purposes of the Like-Kind Exception.⁷⁸

Further, it is not clear whether the transferee partnership may “complete” a section 704(c)(2) transaction that began before a merger with the contribution of property

(B) other property of a like kind (within the meaning of section 1031) is distributed by the partnership to the contributing partner not later than the earlier of—

(i) the 180th day after the date of the distribution described in subparagraph (A),

or

(ii) the due date (determined with regard to extensions) for the contributing partner’s return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs,

then to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).

⁷⁴ Reg. § 1.704-4(d)(3).
⁷⁵ Reg. § 1.737-1(c)(2)(iv).
⁷⁶ Reg. § 1.737-1(c)(2)(v).
⁷⁸ If the Continuing Partner Exception is adopted, we recommend the final regulations contain a rule that provides that, solely for purposes of the Like-Kind Exception, the determination of the partners’ undivided interests in transferor partnership property be made using any reasonable method. Because the Like-Kind Exception is used relatively infrequently, we believe that adopting the Safe Harbor or any other complex regime to determine the partners’ undivided interests in property is unnecessary.
to the transferor partnership. We believe that the transferee partnership should be considered to be the transferor partnership for purposes of section 704(c)(2) and that the Like-Kind Exception should apply to a distribution by the transferee partnership that “completes” a section 704(c)(2) transaction begun before the merger.\footnote{This assumes, of course, that the Like-Kind Exception would have applied to the distribution if the merger had not occurred. For a discussion of issues relating to the Like-Kind Exception, see Terrence Floyd Cuff, Final Regs. Explain Rules Governing Partnership Contributions and Distributions, 13 J. PARTNERSHIP TAX’N 219 (1996).} Permitting this treatment does not violate the principles of the Anti-Mixing Bowl Rules and is consistent with the Proposed Regulations because a partner that contributed property to the transferor partnership is deemed under the Proposed Regulations to have contributed undivided interests in such property to the transferee partnership.

**VIII. Effective Date of the Proposed Regulations**

The Proposed Regulations are proposed to be effective for distributions of property after January 19, 2005 if such property was contributed in a merger occurring after May 3, 2004.\footnote{See Prop. Reg. §§ 1.704-4(g) and 1.737-5.} In the Notice Comments, we suggested that any Regulations should be effective as of the date of issuance of the Notice. For the reasons set forth in the Notice Comments, we continue to recommend that the final Regulations apply to distributions of property contributed in mergers occurring after January 19, 2005.

We also note that certain changes were made to the existing Regulations to reflect changes made to the Code by the Taxpayer Relief Act of 1997. (Those changes lengthened the applicable time period under the Anti-Mixing Bowl Rules from five years to seven years.\footnote{P.L. 105-34, § 1063.}) While it is clear that the amendments under the Taxpayer Relief Act of 1997 were effective upon the Act’s effective date,\footnote{The changes to the Anti-Mixing Bowl Rules were effective for property contributed to a partnership after June 8, 1997. P.L. 105-34, § 1063.} the Preamble provides that the “[p]rovisions relating to the change in the regulations in § 1.704-4 and § 1.737-1 from the previous five-year rule to the seven-year rule will be effective August 22, 2007.” This language in the Preamble may be read by some as implying that the seven-year time period under the Anti-Mixing Bowl Rules applies prospectively only. We recommend that the final Regulations make clear that the change in the time period under the Anti-Mixing Bowl Rules was effective upon the effective date of the changes to the Anti-Mixing Bowl Rules made by the Taxpayer Relief Act of 1997.\footnote{It is possible that the prospective effective date was chosen because of the prohibition of section 7805(b)(1) (providing that no temporary, proposed, or final regulation may apply before the earliest of (i) the date on which the Regulation is filed with the Federal Register, (ii) in the case of any final Regulation, the date on which any proposed or temporary regulation to which such final Regulation relates was filed with the Federal Register, and (iii) the date on which any notice substantially describing the expected contents of any Regulation is issued to the public).}
IX. Technical Corrections

We believe that the following technical corrections should be made to provisions under the Proposed Regulations.

A. **Recommended Corrections of the Ordering Rules to Ensure That They Do Not Create Recognition Events**

We recommend that Regulations, when finalized, include corrections to the Ordering Rules to avoid a literal interpretation that would require gain recognition in what we believe are inappropriate circumstances. Proposed Regulation section 1.704-4(c)(4)(ii)(C)(1) provides that:

For purposes of [Regulation section 1.704-4], if less than all of a section 704(c) property is distributed, then a proportionate amount of original and new section 704(c) gain or loss must be recognized. (Emphasis added.)

Read literally, this rule would require gain or loss to be recognized on a distribution of a partial interest in section 704(c) property, even if, under other provisions of Regulation section 1.704-4, section 704(c)(1)(B) would not apply to the distribution. It seems clear, though, that this rule was not intended to require recognition of gain or loss, but only to specify which portion of a section 704(c) asset was deemed distributed. With this determination made, the balance of the Anti-Mixing Bowl Rules, including exceptions, should apply, as illustrated by the following example.

**Example 10: Ordering Rules** - On January 1, 2007, C contributes Asset 1 (a nondepreciable capital asset) with a fair market value of $200 and an adjusted basis of $100 to partnership CD in exchange for a 50 percent interest in CD. On the same date, D contributes $200 to CD in exchange for a 50 percent interest in CD.

On January 1, 2010, CD merges into partnership AB. CD is the terminating partnership under Regulation section 1.708-1(c)(3). At the time of the merger, Asset 1 has a fair market value of $300 and an adjusted basis of $100. Thus, with respect to Asset 1, there is $100 of Original Section 704(c) Gain, and $100 of New Section 704(c) Gain.

---

84 For example, if either the undivided interest rule of Reg. § 1.704-4(c)(6) or section 704(c)(2) applied, section 704(c)(1)(B) would not apply to at least a part of the distribution.
On January 1, 2015, when Asset 1 has a fair market value of $300 and an adjusted basis of $100, AB distributes $150 of Asset 1 to B, a historic partner of AB.

Because the distribution occurs within seven years of the merger, but not within seven years of C’s contribution of Asset 1 to CD, C and D each would recognize its share of the New Section 704(c) Gain, or $25 each, under section 704(c)(1)(B), but C should not recognize any Original Section 704(c) Gain. Under the literal language of Proposed Regulation section 1.704-4(c)(4)(ii)(C), however, a proportionate share of gain with respect to each layer must be recognized. This would require C to recognize its proportionate share of the Original Section 704(c) Gain, or $50, in addition to C and D each recognizing its share of the New Section 704(c) Gain. This is inconsistent with the overarching principle of the Proposed Regulations (and, significantly, is inconsistent with what would happen if all of Asset 1 were distributed).

The language of Proposed Regulation section 1.737-2(b)(1)(ii)(C) presents a similar issue. Proposed Regulation section 1.737-2(b)(1)(ii)(C) provides that:

For purposes of [Regulation section 1.737-2], if a partner is required to recognize gain under this section, the partner shall recognize a proportionate amount of original and new section 704(c) gain. (Emphasis added.)

Although the language in the Proposed Regulations under section 737 is clearer than that of its section 704(c)(1)(B) counterpart because it is conditioned upon the partner recognizing gain, the proposed language of the section 737 regulation nevertheless mandates that a proportionate amount of original and new section 704(c) gain must be recognized. It seems clear, though, that this rule was not intended to require recognition of gain or loss, but only to specify that proportionate amounts of original and new section 704(c) gain must be recognized if otherwise required under the Anti-Mixing Bowl Rules. Accordingly, we recommend that final Regulations provide that gain should be recognized under the operative rules under the current section 737 regulations.

B. Technical Corrections of Effective Dates

As noted above, the Proposed Regulations provide that they are effective for distributions of property after January 19, 2005 if such property was contributed in a merger after May 3, 2004. The section 737 portion of the Proposed Regulations uses the

85 Assume in Example 10 that AB does not distribute part of Asset 1 to B, but instead distributes Asset 2, with a fair market value of $100, to C. Asset 2 had been acquired by AB for cash and had not been contributed to AB by any partner. Because the Original Section 704(c) Gain in Asset 1 is more than seven years old, and the New Section 704(c) Gain is less than seven years old, C’s net precontribution gain would be $25. Thus, C should be required to recognize only $25 of gain under section 737. The Proposed Regulations, if interpreted literally, would require C to recognize a proportionate amount of both the $100 Original Section 704(c) Gain and the $50 New Section 704(c) Gain.
distribution date of the contributed property as a reference for the effective date. This reference is incorrect because section 737 is applicable only if property other than the contributed property is distributed to the contributing partner. We understand that this reference will be corrected in the final Regulations to refer to the distribution of property other than the contributed property.

Additionally, Example 5 of Proposed Regulation sections 1.704-4(c)(4)(ii)(F) and 1.737-2(b)(1)(ii)(F) discuss the application of the Anti-Mixing Bowl Rules to distributions of property in 2006 by partnerships formed in 1990. These examples provide that sections 704(c)(1)(B) and 737 do not apply to the facts described under the examples because the distribution by the transferee partnership “occurs more than seven years after the formation of the partnerships.” These examples have two shortcomings. Specifically, the references to “seven years” in this context are inaccurate. For contributions of property to partnerships on or before June 8, 1997, the applicable period for the Anti-Mixing Bowl Rules was five years, rather than seven years. To address this, we suggest that Example 5 in both cases be revised to provide that the partnerships were formed in 1998. In addition, the relevant date is not the date the partnership was formed, but rather the date the property was contributed. Thus, we further recommend that both examples be revised to analyze the distribution by the transferee partnership by reference to the date that property was contributed to the partnerships.

*     *     *

---

86 See Prop. Reg. § 1.737-5.