October 26, 2011

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

Re: Comments on the Application of Section 362(e) to Partnership Interests

Dear Commissioner Shulman:

Enclosed are comments on the application of section 362(e) to partnership interests. 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,

William M. Paul  
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service  
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ABA SECTION OF TAXATION
COMMENTS ON THE APPLICATION OF SECTION 362(e) TO PARTNERSHIP INTERESTS

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

Principal responsibility for preparing these Comments was exercised by Matthew Lay, Stanley E. Ramsay, Michael Scaramella, and Ben Solaimani of the Partnerships and LLCs Committee of the Section of Taxation. Substantive contributions were made by Eric Sloan and James Sowell. The Comments were reviewed by Bahar Schippel, Chair of the Partnerships and LLCs Committee. The Comments were further reviewed by Joseph Pari and David Strong of the Corporate Tax Committee, Steven R. Schneider of the Section’s Committee on Government Submissions and by Eric Sloan, Council Director for the Partnerships and LLCs Committee.

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

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October 26, 2011
EXECUTIVE SUMMARY

Section 362(e) limits the importation or transfer of built-in losses in the context of a transfer described in section 351(a) or a reorganization under section 368(a). When applicable, section 362(e) overrides the general carryover basis rules applicable to section 351 transactions and corporate reorganizations and limits the transferee corporation’s bases in the transferred properties based on the fair market values of those properties.

On October 23, 2006, the Department of the Treasury and the Internal Revenue Service (the “Service”) issued a notice of proposed rulemaking in the Federal Register containing Proposed Regulations under section 362(e) (the “Proposed Regulations”). The preamble to the Proposed Regulations specifically requests comments regarding how the provisions of section 362(e)(2) apply to the transfer of a partnership interest in exchange for stock in a section 351 transaction.

Because a partner’s share of a partnership’s liabilities increases the partner’s adjusted basis in its partnership interest (“outside basis”), but does not increase the fair market value of the interest, the presence of partnership liabilities can create the appearance of a built-in loss. If the partner sells the interest, however, the mere inclusion of a partnership’s liabilities in a partner’s outside basis will not cause the partner to realize a loss because the partner’s share of those liabilities also must be included in the partner’s amount realized.

Accordingly, these Comments recommend that the regulations, when finalized, provide that if a partner transfers a partnership interest to a corporation in a transaction to which section 362(e) applies, the fair market value of that partnership interest is deemed to be the sum of (i) the amount of cash that the corporation would receive if the corporation sold the partnership interest to an unrelated person for cash in an arm’s-length transaction and (ii) the corporation’s share of the partnership’s liabilities as determined under section 752 and the regulations thereunder (the “Deemed FMV Approach”).

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

2 For ease of discussion, these Comments focus on the application of section 362(e)(2) to transfers of partnership interests described in section 351(a). Our recommendations, however, apply to transfers under both section 362(e)(1) and (2).

3 I.R.C. § 752(d).
DISCUSSION

I. Enactment of Section 362(e)\textsuperscript{4}

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock in the corporation and, immediately after the exchange, the transferors control the corporation.\textsuperscript{5} Subject to certain adjustments and limitations, the transferor’s basis in the stock of the transferee corporation received in the exchange is the same as the adjusted basis of the property contributed to the transferee corporation.\textsuperscript{6} A transferor’s basis in the stock of the transferee corporation generally is reduced by the amount of liabilities the transferee corporation assumes, or takes property subject to, in the exchange.\textsuperscript{7} The basis of property received by the transferee corporation generally is the same as the adjusted basis in the hands of the transferor, increased by the amount of any gain recognized by the transferor.\textsuperscript{8}

In some situations, the general rules described above can duplicate a single economic loss. This result can occur because, in a tax-free exchange, a transferor generally takes a substituted basis in the stock it receives, and the corporation generally takes a carryover basis in the property it receives. Thus, a transferor of built-in loss property would receive corporate stock with a basis reflecting the same economic loss that is reflected in the transferee corporation’s basis in the contributed property. This result also makes it possible to use a corporation to import an economic loss that arose outside the U.S. tax system into the U.S. tax system. Congress believed that both of these results were inappropriate and sought to prevent them through the enactment of section 362(e).\textsuperscript{9}

Section 362(e) contains two exceptions to the general rules under section 362(a). First, under section 362(e)(1), if net built-in loss property is transferred in a section 351 transaction or a corporate reorganization by a transferor that is not subject to U.S. tax on gain or loss with respect to such property to a transferee that is subject to U.S. tax on gain or loss with respect to such property, the basis of the transferred property is equal to its fair market value. For this purpose, a net-built in loss exists if the aggregate adjusted basis of properties described in the preceding sentence exceeds the aggregate fair market value of those properties.\textsuperscript{10}

\textsuperscript{4} This background discussion is drawn largely from S. Rep. No. 108-192, at 124-126 (2003).
\textsuperscript{5} I.R.C. § 351.
\textsuperscript{6} I.R.C. § 358.
\textsuperscript{7} I.R.C. § 358(d)(1).
\textsuperscript{8} I.R.C. § 362(a). A similar carryover rule under section 362(b) governs corporate reorganizations.
\textsuperscript{9} S. Rep. No. 108-192, at 125 (2003). These substituted and carryover basis rules also can result in the duplication of economic gains. Congress has not disturbed the gain duplication aspect of these rules.
\textsuperscript{10} I.R.C. § 362(e)(1)(C).
Second, under section 362(e)(2), if the aggregate adjusted basis of properties contributed by a transferor to a corporation in a section 351 transaction\textsuperscript{11} exceeds the aggregate fair market value of the properties transferred, the transferee corporation’s aggregate basis of the properties generally is limited to the aggregate fair market value of the transferred properties.\textsuperscript{12} The reduction in basis required by section 362(e)(2) is allocated among the transferred properties in proportion to their respective built-in losses immediately before the transaction.\textsuperscript{13} In lieu of limiting the bases in the properties transferred, a transferor and transferee may elect under section 362(e)(2)(C) to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred properties.\textsuperscript{14}

II. Application to Partnership Interests in General

A. Partnership Interest is “Property”

Partnership interests are considered to be “property” for purposes of sections 351, 362, and 368.\textsuperscript{15} Therefore, the determination of whether a partnership interest that is contributed to a corporation has a built-in loss should be determined by reference to whether the transferee corporation would recognize a loss upon a sale of that interest, rather than by reference to whether the corporation would be allocated a share of losses if the partnership sold all of its assets.\textsuperscript{16}

\textsuperscript{11} Section 362(e)(2) can apply to reorganizations as well. See Prop. Reg. § 1.362-4(b)(5); REG—110405–05, 71 Fed. Reg. 62,067, 62,068 (Oct. 23, 2006).

\textsuperscript{12} Section 362(e)(2) can apply to a transfer only if section 362(e)(1) does not apply to that transfer.

\textsuperscript{13} I.R.C. § 362(e)(2)(B).

\textsuperscript{14} No similar election is available in transactions that are subject to section 362(e)(1).

\textsuperscript{15} The Service has ruled that the transfer of partnership interests to a corporation in exchange for stock of the corporation qualifies for non-recognition treatment under section 351(a), thus acknowledging that partnership interests are property for such purposes. Rev. Rul. 84-111, 1984-2 C.B. 88, \textit{Situation 3}.

\textsuperscript{16} There is no indication in the language of the statute or the legislative history that a partnership interest should be treated as an aggregate for purposes of applying section 362(e). \textit{Cf.} section 311(b)(3) (authorizing Secretary to issue regulations providing that gain is determined without regard to losses if corporation contributes property to a partnership in exchange for an interest in that partnership for the principal purpose of recognizing such loss, and then distributes that interest to one or more shareholders; to date, no such regulations have been issued).
B. **Section 752**

A partner’s share of partnership liabilities affects the partner’s outside basis. Among other adjustments, a partner’s outside basis is increased for contributions to the partnership\(^{17}\) and decreased by distributions from the partnership.\(^{18}\) Under section 752, an increase in a partner’s share of partnership liabilities is treated as a contribution of money by the partner to the partnership, and a decrease in a partner’s share of partnership liabilities is treated as a distribution of money to the partner by the partnership.

The fact that a partner’s share of partnership liabilities is included in the partner’s outside basis can create the appearance of an unrealized loss in a partnership interest. When a partnership incurs a liability, it usually does not increase the net fair market value of the partnership and, thus, also usually does not increase the aggregate fair market value of the interests in that partnership. As a result, a partner’s outside basis may be increased by its share of partnership liabilities, while the fair market value of its partnership interest remains the same. This could result in a partner having an outside basis in excess of the interest’s fair market value, giving the appearance that the partner has an unrealized loss in the partnership interest.

The mere inclusion of partnership liabilities in a partner’s outside basis, however, will not cause or increase a loss upon a sale or liquidation of the partner’s interests in the partnership. Like a seller of an encumbered asset, a partner is deemed to receive either additional sale proceeds or a cash distribution from the partnership when the partner disposes of its partnership interest. In the case of a sale or exchange of an interest in a partnership, section 752(d) requires partnership liabilities to be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. The amount realized from a sale or exchange of a partnership interest generally includes the amount of liabilities from which the transferor is discharged as a result of the sale or exchange, as illustrated by the following example.\(^{19}\)

**Example 1 – No Unrealized Loss.** P, R, and S each contribute $1 million to LLC, a limited liability company classified as a partnership. LLC borrows $6 million from an unrelated party, and no member provides any credit support with respect to the loan. LLC then purchases a capital asset for $6 million. After the purchase, the net fair market value of LLC’s property (including cash) is $3 million ($3 million cash, plus $6 million property, less $6 million liability), and the fair market values of the interests owned by P, R, and S are each $1 million. Each member in LLC has an outside basis of $3 million attributable to its cash contribution of $1 million and its share of LLC’s liability of $2 million.

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\(^{17}\) I.R.C. §§ 722, 705(a).

\(^{18}\) I.R.C. §§ 733, 705(a)(2).

\(^{19}\) I.R.C. § 752(d); Reg §§ 1.752-1(h), 1.1001-2(a)(1).
None of the members would recognize a loss if it sold its LLC interest for cash of $1 million, the fair market value of the interest. The amount realized from the sale would be $3 million, the sum of $1 million cash and $2 million of liability from which the transferor would be discharged as a result of the sale. Thus, no net gain or loss would be recognized on the transfer.

Similarly, none of the members would recognize a gain or loss if LLC redeemed its LLC interest for $1 million in cash. After the redemption, the distributee no longer would be allocated any of LLC’s liability and thus would be deemed to receive a distribution of $2 million under section 752(b). The actual and deemed distributions would reduce the partner’s outside basis of $3 million to zero, resulting in no gain or loss.

C. **Basis Adjustments under Section 743(b)**

Under section 743(a), the basis of partnership property generally is not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner. Under section 743(b), however, if an election under section 754 is in effect or the partnership has a substantial built-in loss immediately after the transfer, the partnership must increase the adjusted basis of partnership property by the excess of the transferee’s outside basis over the transferee’s share of the partnership’s basis in partnership property (“inside basis”), or decrease the basis of partnership property by the excess of the transferee’s share of inside basis over the transferee’s outside basis. Basis adjustments constitute an adjustment to the basis of partnership property only with respect to the transferee partner. For purposes of section 743, a partnership has a “substantial built-in loss” with respect to a transfer of a partnership interest if the partnership’s adjusted basis in its property exceeds the fair market value of its property by more than $250,000. If the transferee of a partnership interest receives a basis adjustment under section 743(b), that basis adjustment is allocated among the partnership’s assets under section 755 and the regulations thereunder.

Treasury Regulation section 1.755-1(b) provides two regimes for allocating a section 743(b) adjustment among partnership assets. The first regime (the “general rules”) is found in Treasury Regulation section 1.755-1(b)(2) through (b)(4). Under the general rules, a transferee in a taxable sale may receive positive basis adjustments with respect to some assets while receiving negative basis adjustments with respect to other assets. The second regime (the “substituted basis rules”) is found in Treasury Regulation section 1.755-1(b)(5) and is an exception to the general rule that applies only to a section

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20 The Regulations under section 743 adopt a specific definition of “inside basis” that is based on a disposition by the partnership of all of its assets immediately after the transfer of the partnership interest. See Reg. § 1.743-1(d)(1). A discussion of these rules is beyond the scope of these Comments.

21 I.R.C. § 743(d)(1).

22 I.R.C. § 743(c).
specifically, Treasury Regulation section 1.755-1(b)(5) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee’s basis in the partnership interest is determined in whole or in part by reference to the transferor’s basis in that interest, as well as to transactions that result from exchanges in which the transferee’s basis in the partnership interest is determined by reference to other property held at any time by the transferee. Treasury Regulation section 1.755-1(b)(5)(i) specifically provides that the substituted basis rules apply “if a partnership interest is contributed to a corporation in a transaction to which section 351 applies.” Under the substituted basis rules, a transferee may receive only a positive or negative basis adjustment with respect to partnership property.

D. Basic Example Illustrating Transfer of Partnership Interest in Transaction Potentially Subject to Section 362(e)

If a partner transfers its partnership interest to a corporation in exchange for stock in a transaction qualifying for non-recognition treatment under section 351(a), the Service has ruled that, in determining a transferor’s basis in the stock of the transferee corporation and potential gain under section 357(c), the transferor is treated as transferring the partnership interest subject to the transferor partner’s share of partnership liabilities.26 The potential application of section 362(e) to such a transfer is illustrated by the following example.

Example 2 – Potential for Section 362(e)(2) to Create Unintended Results. The facts are the same as in Example 1, except that, when the value of LLC’s capital asset continues to be $6 million, P transfers its entire LLC interest to a corporation (“Newco”) in exchange for Newco stock in a section 351 transaction. P and Newco do not make an election under section 362(e)(2)(C). After the contribution, LLC’s liability continues to be allocated equally between Newco, R, and S (i.e., $2 million each).

23 Reg. § 1.755-1(b)(5). Section 7701(a)(42) provides that the term “substituted basis property” means “transferred basis property” and “exchanged basis property.” Section 7701(a)(43) provides that the term “transferred basis property” means property the basis of which is “determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.” Section 7701(a)(44) provides that the term “exchanged basis property” means property the basis of which is “determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.”

24 Reg. § 1.755-1(b)(5)(i).

25 Reg. § 1.755-1(b)(5)(ii).

26 Rev. Rul. 80-323, 1980-2 C.B. 124 (liabilities allocated under section 752 to transferring partners exceeded their adjusted bases in their interest resulting in recognition of gain under section 357(c)); see also Rev. Rul. 84-111, 1984-2 C.B. 88, Situation 3 (Service addressed the incorporation of a partnership and expressly acknowledged that the form chosen by the taxpayer to incorporate partnership assets is the form that will govern the tax consequences of the incorporation); Rev. Rul. 81-38, 1981-1 C.B. 386 (transfer of partnership interest to corporation qualifies under section 351(a)).
P would be treated as transferring its LLC interest subject to its share of LLC’s liability. Thus, P would have an adjusted basis of $1 million in the stock it received ($3 million outside basis less P’s share of LLC’s liability taken subject to by Newco). If, for purposes of section 362(e)(2), the fair market value of the contributed LLC interest is $1 million, then Newco’s adjusted basis in the contributed interest would be limited to $1 million. If Newco later were to sell its LLC interest for $1 million, the fair market value of that interest, Newco’s amount realized would be $3 million because Newco’s share of LLC’s liability would be included in Newco’s amount realized under sections 752(d) and 1001. As a result, rather than eliminating a duplicated loss, section 362(e) would create a $2 million non-economic gain. Moreover, if LLC has a section 754 election in effect, LLC would be required to reduce the basis of its property under section 743(b) by $2 million (the excess of Newco’s share of LLC’s inside basis, $3 million, over its outside basis, $1 million), thereby creating the potential for future non-economic tax gain upon the LLC’s sale of its capital asset.

The results in Example 2 would be clearly incorrect. Section 362(e) should not be interpreted in a manner that creates non-economic gain in contributed partnership interests. As stated above, the legislative history of section 362(e) explains that its purpose is to prevent the importation or duplication of losses in connection with the contribution of built-in loss properties to a corporation. As demonstrated by Example 2, however, with respect to partnership interests, no loss importation or duplication takes place as a result of the contribution of a high basis partnership interest where the excess basis merely reflects the partner’s share of the partnership’s liabilities as governed by section 752. This is because, upon a subsequent sale or exchange of the partnership interest by the transferee corporation, the corporation will be treated as receiving consideration in the form of liability relief equal to the amount of the liabilities included in its outside basis. Indeed, the erroneous application of section 362(e) in these situations would cause the transferee corporation to recognize phantom or non-economic taxable gain on a subsequent sale of the partnership interest or the partnership’s properties.

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27 I.R.C. §§ 358(a)(1), (d)(1).
28 It is unclear whether this basis adjustment would be allocated under the general rules or the substituted basis rules of Treasury Regulation section 1.755-1. We recommend that the Service consider providing guidance regarding the extent to which the substituted basis rules apply to transactions in which a corporation’s basis in property is reduced under section 362(e)(1) or (2). Specifically, we recommend that consideration be given to situations in which (i) the partnership interest has a fair market value in excess of its tax basis, (ii) at least one of the properties contributed to the corporation, other than the partnership interest, has a fair market value in excess of its tax basis, and (iii) in the aggregate, all properties contributed to the corporation have a tax basis in excess of fair market value. If all of the properties contributed to the corporation by the transferor have a tax basis in excess of fair market value, the substituted basis rules may not apply, but in all other cases the substituted basis rules should apply.
29 In addition, the contribution of a partnership interest should not be treated dramatically less favorably than a direct contribution of the property in that partnership. In Example 2, if P contributed one third of LLC’s property and cash, with an aggregate fair market value of $3 million, subject to P’s share of
I. **Deemed Fair Market Value of Partnership Interest Under Section 362(e)**

To prevent the results in Example 2, we recommend that the regulations, when finalized, provide that if a partner transfers a partnership interest to a corporation in a transaction to which section 362(e) applies, the fair market value of that partnership interest is deemed to be the sum of (i) the amount of cash that the corporation would receive if the corporation sold the partnership interest to an unrelated person for cash in an arm’s length transaction and (ii) the corporation’s share of the partnership’s liabilities as determined under section 752 and the regulations thereunder. As discussed more fully below, this approach would prevent section 362(e) from creating unintended results, while fully protecting the government from the types of transactions to which section 362(e) was intended to apply. The operation of this approach to the facts of Example 2 is illustrated by the following example.

**Example 3 – No Built-in Loss.** The facts are the same as in Example 2. $P$ would be treated as transferring its LLC interest subject to its share of LLC’s liability. Thus, $P$ would have an adjusted basis of $1 million in the stock it received ($3 million outside basis less $P$’s share of LLC’s liability). Under the Deemed FMV Approach, for purposes of section 362(e), the fair market value of the transferred LLC interest would be deemed to be $3 million, the sum of (i) $1 million, the amount of cash that Newco would receive if Newco sold the LLC interest to an unrelated person for cash in an arm’s length transaction and (ii) $2 million, Newco’s share of LLC’s liability as determined under section 752 and the regulations thereunder. Using the Deemed FMV Approach, the LLC interest would not be treated as having an adjusted basis in excess of its fair market value because the adjusted basis of the interest in $P$’s hands (as well as Newco’s hands) is $3 million. Consequently, section 362(e) would not reduce Newco’s adjusted basis in the interest. As a result, Newco would not receive a negative basis adjustment under section 743(b).
and would not recognize gain if it were to dispose of its interest or LLC were to sell its property.

Importantly, the Deemed FMV Approach would not prevent section 362(e) from eliminating the importation or duplication of actual economic losses in partnership interests, as illustrated by the following example.

**Example 4 – Partnership Interest with Built-in Loss.** The facts are the same as in Example 3, except that when P contributes its interest in LLC to Newco, the value of LLC’s capital asset has decreased to $4.5 million, and the value of P’s interest has decreased to $500,000. As in Example 2, P would be treated as transferring its LLC interest subject to its share of LLC’s liability. Thus, P would have an adjusted basis of $1 million in the stock it received ($3 million outside basis less P’s share of LLC’s liability). Under the Deemed FMV Approach, the fair market value of the transferred LLC interest would be deemed to be $2.5 million, the sum of (i) $500,000, the amount of cash that Newco would receive if Newco sold its LLC interest to an unrelated person for cash in an arm’s-length transaction and (ii) $2 million, Newco’s share of LLC’s liability as determined under section 752 and the regulations thereunder. Using the Deemed FMV Approach, the LLC interest would be treated as having an adjusted basis in excess of fair market value because the adjusted basis of the interest in P’s hands (as well as Newco’s hands) is $3 million. Consequently, section 362(e) would reduce Newco’s adjusted basis in the interest to $2.5 million, its deemed fair market value. Newco also would receive a negative basis adjustment under section 743(b) of $500,000. Thus, if Newco were to sell its LLC interest for $500,000, Newco would not recognize gain or loss. Similarly, Newco would not recognize gain or loss if LLC were to sell its property for $4.5 million. Specifically, Newco’s share of LLC’s loss would be $500,000, but this loss would be entirely offset by the recovery of the negative $500,000 basis adjustment under section 743(b). Note that this basis adjustment would be mandatory under section 743(b) whether or not LLC makes an election under section 754 because the aggregate adjusted basis of LLC’s properties, $9 million, exceeds the aggregate fair market value of those properties by more than $250,000.

The preamble to the Proposed Regulations specifically requests comments regarding the interaction of section 362(e)(2) and the partnership provisions in situations where the partnership does not make an election under section 754. As illustrated by Example 4, if section 362(e)(2) requires the corporation to reduce its outside basis in a partnership interest that has a built-in loss, and the partnership does not have a section

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33 Id.
34 I.R.C. § 743(d).
754 election in effect, a basis adjustment to the partnership’s properties will result under section 743(b) provided the partnership’s properties have a substantial built-in loss.\textsuperscript{36}

The Deemed FMV Approach also would not prevent section 362(e) from eliminating the importation or duplication of actual economic losses in property other than a partnership interest that is contributed in the same transaction, as illustrated by the following example.

\textbf{Example 5 – Contribution of Partnership Interest with No Built-in Loss and Other Property with Built-in Loss.} The facts are the same as in Example 3, except that when P contributes its interest in LLC to Newco, P also contributes land with an adjusted basis of $5 million and a fair market value of $3 million. As described in Example 3, under the Deemed FMV Approach, the fair market value of the transferred LLC interest would be deemed to be $3 million, which is equal to its adjusted basis. All of the property contributed by P would have an aggregate built-in loss of $2 million, attributable entirely to the land. The basis reduction required by section 362(e) would be allocated entirely to the land, the only contributed property with a built-in loss. Consequently, section 362(e) would not reduce Newco’s adjusted basis in its LLC interest, and Newco would not receive a negative basis adjustment under section 743(b) with respect to its LLC interest. Thus, Newco would not recognize gain if it were to sell its interest or LLC were to sell its property. Newco would, however, reduce its basis in the land to $3 million, its fair market value.

\textbf{II. Alternative Methods for Determining Deemed Fair Market Value of Partnership Interest}

We considered, but do not recommend, two alternative methods for determining the “deemed fair market value” of a partnership interest. First, we considered a rule that would have deemed the fair market value of a partnership interest that is transferred in a transaction subject to section 362(e) to be the amount that the transferring partner would realize under section 1001 and the regulations thereunder (including the transferor’s share of the partnership’s liabilities as determined under section 752 and the regulations thereunder) if the partner sold the partnership interest to an unrelated person for cash in an arm’s length transaction (the “Transferor Section 1001 Approach”). We rejected this formulation of the Deemed FMV Approach because it might be difficult to apply to situations in which the transferring partner’s share of partnership liabilities is different from the transferee corporation’s share of partnership liabilities.

Second, we considered a rule that would have deemed the fair market value of a partnership interest that is transferred in a transaction subject to section 362(e) to be the

\textsuperscript{36} If a partnership interest has a built-in loss, but the partnership’s properties do not have a substantial built-in loss, and the partnership does not have a section 754 election in effect, a basis adjustment under section 743(b) would not be made. We do not believe that this situation requires any special rules under section 362(e).
amount that the transferee corporation would realize under section 1001 and the regulations thereunder (including the corporation’s share of the partnership’s liabilities as determined under section 752 and the regulations thereunder) if the corporation sold the partnership interest to an unrelated person for cash in an arm’s length transaction (the “Transferee Section 1001 Approach”). We rejected this formulation of the Deemed FMV Approach because it might be difficult to apply in situations in which the transferee corporation’s share of partnership liabilities is different from the deemed purchaser’s share of partnership liabilities.

Both of these situations are illustrated by the following example.

**Example 6 – Transferee Corporation’s Share of Partnership Liabilities Not Equal to Deemed Purchaser’s Share of Partnership Liabilities.** Q, R, and S each contributes $1 million to LLC, a limited liability company classified as a partnership. LLC borrows $6 million from Parent, a corporation that is not related to Q, R, or S. The liability is allocated equally to Q, R, and S under Treasury Regulation section 1.752-3. LLC then purchases a capital asset for $9 million. After the purchase, the net fair market value of LLC’s property is $3 million, and the fair market values of the interests owned by Q, R, and S are each $1 million. Each member in LLC has an outside basis of $3 million attributable to its cash contribution of $1 million and its share of LLC’s liability of $2 million.

At a time when the value of LLC’s capital asset continues to be $9 million, Q transfers its LLC interest to Newco, a newly formed corporation, in exchange for 10 percent of Newco’s stock, and Parent contributes $10 million of cash to Newco in exchange for 90 percent of Newco’s stock. The contributions to Newco by Q and Parent qualify for non-recognition under section 351. Q and Newco do not make an election under section 362(e)(2)(C). After the contributions, Parent is related to Newco under Treasury Regulation section 1.752-4. Therefore, after the contributions, LLC’s liability is allocated entirely to Newco under Treasury Regulation section 1.752-2.

But for the application of section 362(e), Newco would have an adjusted basis of $7 million in the contributed LLC interest. It is unclear, however, whether (i) Q would be treated as contributing an LLC interest with a $3 million outside basis subject to a liability of $2 million, followed by a deemed contribution of $4 million by Newco under section 752(a) or (ii) Q would be treated as making a deemed contribution of $4 million under section 752(a), and then contributing the LLC interest to Newco with a $7 million outside basis subject to a liability of $6 million. Although we believe that the first interpretation is correct, there is very little guidance on this question. While guidance on this issue would be helpful as a general matter, it is not necessary to resolve this question in connection with the guidance to be issued under section 362(e). The Deemed FMV Approach avoids this question by focusing on how much cash Newco would receive in a deemed sale of its interest and then adding Newco’s share of liabilities immediately after the contribution by Q. Under our recommended Deemed FMV Approach, the fair market
value of the contributed interest would be deemed to be $7 million for purposes of section 362(e).\(^\text{37}\)

Note that on a deemed sale of the LLC interest by Newco to an unrelated person, the same issue arises. That is, although Newco’s share of the liability would be $6 million immediately before the deemed sale of its LLC interest, the unrelated purchaser’s share of the liability would be $2 million (immediately after the purchase). It is unclear whether (i) Newco would be treated as selling an LLC interest with an outside basis of $7 million subject to a liability of $6 million followed by a deemed distribution of $4 million to the hypothetical purchaser under section 752(b) or (ii) Newco would be treated as receiving a deemed distribution of $4 million under section 752(b) and then selling the LLC interest to the hypothetical purchaser with an outside basis of $3 million subject to a liability of $2 million. While guidance on this issue would be helpful as a general matter, it is not necessary to resolve this question in connection with the guidance to be issued under section 362(e). Once again, the Deemed FMV Approach avoids this question by asking how much cash Newco would receive in a deemed sale of its interest and then adding Newco’s share of LLC liability immediately after the contribution by Q.\(^\text{38}\)

\(^{37}\) Regardless of how the shift of LLC’s liability is analyzed, it may be possible to implement the Transferor Section 1001 Approach in a manner that would reach a correct result. Various assumptions and special rules likely would be required, however, to accomplish this objective. In Example 6, if Q were properly treated as contributing an LLC interest with a $3 million outside basis subject to a liability of $2 million, followed by a deemed contribution of $4 million by Newco under section 752(a), then the amount that Q would realize in a deemed sale would be $3 million (cash of $1 million plus Q’s share of LLC liability, $2 million). Newco’s initial adjusted basis in the property would be $3 million immediately after the contribution of the LLC interest (but before the deemed contribution of cash). As long as the regulations determined the fair market value of Newco’s interest before the deemed contribution of cash by Q to LLC or otherwise took this deemed contribution into account in determining the fair market value of Newco’s interest, the LLC interest would not have a built-in loss. If, instead, Q were properly treated as making a deemed contribution to LLC of $4 million under section 752(a), and then contributing the LLC interest to Newco with a $7 million outside basis subject to a liability of $6 million, then the amount that Q would realize in a deemed sale would depend on whether that deemed sale occurs before or after Q’s deemed contribution to LLC under section 752(a). Before the deemed contribution, the amount that Q would realize is $3 million ($1 million cash and $2 million share of LLC liability). After the contribution, the amount that Q would realize is $7 million ($1 million cash and $6 million share of LLC liability). The regulations would need to determine the amount realized in a deemed sale by Q after the deemed contribution of cash.

\(^{38}\) Regardless of how the shift of LLC’s liability is analyzed, it may be possible to implement the Transferee Section 1001 Approach in a manner that would reach a correct result. Various assumptions and special rules likely would be required, however, to accomplish this objective. In Example 6, if Newco were properly treated as selling an LLC interest with an outside basis of $7 million subject to a liability of $6 million followed by a deemed distribution of $4 million to the hypothetical purchaser under section 752(b), then Newco would have an amount realized of $7 million in the hypothetical sale of its interest, and the Transferee Section 1001 Approach would treat the fair market value of the LLC interest as $7 million. If, instead, Newco were properly treated as receiving a deemed distribution of $4 million under section 752(b) and then selling the LLC interest to the hypothetical purchaser with an outside basis of $3 million subject to a liability of $2 million, Newco would have an amount realized of $3 million in the hypothetical sale of its interest, and the Transferee Section 1001 Approach would treat the fair market value of the LLC interest as $3 million. As long as the regulations determined the fair market value of Newco’s interest before the deemed contribution of cash by Q or Newco to LLC or otherwise took this deemed contribution into
III. Similar Issues Raised by Other Code Sections

Although the discussion above focused on section 362(e), a similar issue can arise in determining whether a partnership in a tiered partnership structure has a substantial built-in loss under section 743(d)(1). As discussed above, a partnership must adjust the basis of its property upon a transfer of an interest in the partnership if the partnership has a substantial built-in loss immediately after the transfer. For purposes of section 743, a partnership has a “substantial built-in loss” with respect to a transfer of a partnership interest if the partnership’s adjusted basis in its property exceeds the fair market value of its property by more than $250,000.

If applied literally, section 743(d)(1) could treat an upper-tier partnership (“UTP”) as having a substantial built-in loss in its property as the result of UTP’s ownership of an interest in a lower-tier partnership (“LTP”). Specifically, because of the inclusion of UTP’s share of LTP liabilities in UTP’s outside basis in its LTP interest, UTP’s outside basis in its LTP interest could be treated as exceeding the fair market value of that interest even though a disposition of the LTP interest would not result in a loss. For example, in Example 1, assume that P is classified as a partnership for U.S. federal income tax purposes and that P’s only property is its interest in LLC. If an interest in P were transferred after LLC borrowed money, a literal interpretation of section 743(d) would suggest that P has a substantial built-in loss in its only property, its interest in LLC, because the adjusted basis of the LLC interest would be $3 million and its fair market value would be $1 million. This result clearly is incorrect because, as illustrated by Example 1 above, there is no built-in loss in the LLC interest.

Similar issues could arise under section 334(b)(1)(B), which contains a rule like that of section 362(e). (Section 334(b)(1)(B) applies in the case of a tax-free liquidation by a domestic corporation of its foreign corporate subsidiary.)

account in determining the fair market value of Newco’s interest, the LLC interest would not have a built-in loss.