January 29, 2020

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations Under Section 337(d) Regarding Partnership Transactions Involving Equity Interests of a Partner

Dear Commissioner Rettig:

Enclosed please find comments on the Proposed Regulations under Section 337(d) of the Internal Revenue Code issued on March 25, 2019 regarding partnership transactions involving equity interest of a partner. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Tom Callahan
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Jeffrey Van Hove, Senior Advisor, Office of Tax Policy, Department of the Treasury
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
John Cross, Associate Tax Legislative Counsel, Department of the Treasury
Michael Novey, Associate Tax Legislative Counsel, Department of the Treasury
Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
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Robert H. Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Under Section 337(d) Regarding Partnership Transactions Involving Equity Interests of a Partner

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 Natasha Khemani, Jennifer Alexander, Craig Gerson, Tim Leska, and Didi Borden. The Comments were reviewed by Grace Kim, Chair of the Section’s Committee on Partnerships and LLCs. The Comments were further reviewed by Gary Huffman of the Section’s Committee on Government Submissions and by Eric B. Sloan, Vice Chair for Government Relations for the Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 29, 2020
EXECUTIVE SUMMARY

In General Utilities & Operating Co. v. Helvering, the Supreme Court held that corporations generally could distribute appreciated property to their shareholders without the recognition of any corporate level gain (the “General Utilities Doctrine”). Congress repealed the General Utilities Doctrine by enacting section 311(b), which requires gain to be recognized by a corporation distributing appreciated property, and section 336(a), which requires gain and loss to be recognized by a corporation distributing property in a complete liquidation. Under current law, sections 311(b) and 336(a) require a corporation that distributes appreciated property to its shareholders to recognize gain determined as if the property were sold for its fair market value. Additionally, Congress enacted section 337(d) as part of the Tax Reform Act of 1986 to permit the Secretary to prescribe regulations that are necessary or appropriate to carry out the purposes of the General Utilities repeal, “including regulations to ensure that [the repeal of the General Utilities Doctrine] may not be circumvented through the use of any provision of law or regulations.”

In response to a series of transactions undertaken by taxpayers using partnerships to avoid sections 311(b) and 336(a) (“May Company Transactions”), the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service (“Service”) proposed regulations under section 337(d) in 1992. Those proposed regulations were withdrawn on June 12, 2015, when Treasury and the Service issued temporary regulations under section 337(d) (the “2015 Temporary Regulations”) and new proposed regulations. On June 8, 2018, Treasury and the Service issued final regulations under section 337(d) adopting (with only minor, nonsubstantive clarifications) the 2015 Temporary Regulations (the “2018 Final Regulations”). When the 2018 Final Regulations were issued, Treasury and the Service indicated that amendments to the 2018 Final Regulations were under consideration and that the government may publish new proposed regulations under section 337(d). On March 25, 2019, Treasury and the Service

1 296 U.S. 200 (1935).
2 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and regulation references are to the Regulations promulgated under the Code (the “Regulations” or “Reg. §,” “Temporary Regulations” or “Temp. Reg. §,” and “Proposed Regulations” or “Prop. Reg. §”), unless otherwise indicated.
3 In a May Company Transaction, a corporate partner of a partnership could contribute appreciated property to the partnership. The partnership also would obtain stock of the corporate partner, which the partnership could then distribute to the corporate partner. Because section 1032 provides that a corporation does not recognize gain with respect to its own stock, the corporate partner could permanently avoid recognizing the gain attributable to the appreciated property by effectively using the partnership to exchange the appreciated property for its own stock. Although sections 704(c)(1)(B) and 737 would generally apply to require gain recognition upon the distribution of stock to the corporate partner, these provisions have a limited period of application, and taxpayers could avoid recognizing gain under these provisions by waiting seven years to distribute the stock.
issued proposed regulations under section 337(d) that would modify certain provisions of the 2018 Final Regulations (the “2019 Proposed Regulations”).

We appreciate the efforts of Treasury and the Service to balance the interests of taxpayers and the government in drafting the 2019 Proposed Regulations. We respectfully request that Treasury and the Service consider the following recommendations with respect to the 2019 Proposed Regulations:

1. We agree with the expanded definition of Stock of the Corporate Partner provided for in the 2019 Proposed Regulations and with the addition of the requirement that the Controlling Corporation have a direct or indirect interest in the Corporate Partner. We recommend that those provisions of the 2019 Proposed Regulations be adopted with the modifications described immediately below.

2. We recommend that, with respect to a Controlling Corporation, the definition of Stock of the Corporate Partner be limited to reflect the percentage of stock of a Corporate Partner held, directly or indirectly, by the Controlling Corporation.

3. If the Affiliated Group Exception is removed, we recommend that final Regulations provide a “grandfather” rule pursuant to which a transaction undertaken by a partnership that would have qualified for the Affiliated Group Exception prior to the issuance of final regulations would continue to be excluded from treatment as a Section 337(d) Transaction following the issuance of final regulations.

4. We recommend that final Regulations retain the Disposition Exception in Regulation section 1.337(d)-3(f)(2), but remove the Disposition Exception Exclusion and the Sale or Distribution Requirement.

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7 Capitalized terms used in these recommendations are defined below.
DISCUSSION

I. Definition of Stock of the Corporate Partner

A. Attribution Rules

1. Background

Regulation section 1.337(d)-3(b) provides that the 2018 Final Regulations apply when a partnership, either directly or indirectly, owns, acquires, or distributes stock of the corporate partner. Under Regulation section 1.337(d)-3(c)(1), a corporate partner is a person that is classified as a corporation for U.S. federal income tax purposes and holds or acquires an interest in a partnership (the “Corporate Partner”). Regulation section 1.337(d)-3(c)(2) provides that stock of the corporate partner includes the Corporate Partner’s stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of section 304(c), except that section 318(a)(1) and (3) do not apply (“Stock of the Corporate Partner”). Stock of the Corporate Partner also includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner. 8 Stock of the Corporate Partner does not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership’s capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner (the “Affiliated Group Exception”). 9 If a transaction has the effect of an exchange by a Corporate Partner of its interest in appreciated property for an interest in Stock of the Corporate Partner (a “Section 337(d) Transaction”), the Corporate Partner recognizes gain to the extent that the Corporate Partner’s interest in appreciated property is reduced in exchange for an interest in Stock of the Corporate Partner. 10

The 2019 Proposed Regulations would modify how section 318 constructive ownership applies to determine whether stock owned by a partnership is treated as Stock of the Corporate Partner. Specifically, Proposed Regulation section 1.337(d)-3(c)(2)(i) provides that Stock of the Corporate Partner includes equity interests in a corporation that controls the Corporate Partner within the meaning of section 304(c). The exception in the 2018 Final Regulations from the application of section 318(a)(1) and (3) would be removed for purposes of determining control under section 304(c). For purposes of classifying an equity interest in the corporation that controls the Corporate Partner (within the meaning of section 304(c)) (the “Controlling Corporation”), the 2019 Proposed Regulations also would add a requirement that the Controlling Corporation have a direct or indirect equity interest in the Corporate Partner. 11 For purposes of this proposed rule, a direct or indirect ownership of an equity interest in the Corporate Partner

8 Reg. § 1.337(d)-3(c)(2).
9 Reg. § 1.337(d)-3(c)(2)(ii).
10 Reg. §§ 1.337(d)-3(3)(3) and 1.337(d)-3(d).
includes ownership of Stock of the Corporate Partner that would be attributed to a person under section 318(a)(2) (except that the 50% ownership limitation in section 318(a)(2)(C) does not apply) and under section 318(a)(4) (but otherwise without regard to section 318). In effect, an equity interest in the Controlling Corporation would be considered Stock of the Corporate Partner if the Controlling Corporation owns stock of the Corporate Partner (i) directly or (ii) indirectly through a vertical chain of ownership, regardless of the amount of stock owned directly or indirectly. Under this proposed rule, an equity interest in the Controlling Corporation would not be considered Stock of the Corporate Partner if the Controlling Corporation is only in a brother-sister relationship with the Corporate Partner.

Treasury and the Service requested comments regarding the provisions detailing the definition of Stock of the Corporate Partner in the 2019 Proposed Regulations.

2. Recommendation

We agree with the expansion of the section 318 attribution rules for this purpose, as well as the addition of the requirement that the Controlling Corporation have a direct or indirect interest in the Corporate Partner, and thus recommend that these provisions be adopted as set forth in the Proposed Regulations, with certain modifications described below.

3. Explanation

The preamble to the 2019 Proposed Regulations (the “2019 Preamble”) indicates that Treasury and the Service felt the expansion of section 318 principles for purposes of defining Stock of the Corporate Partner was necessary in order to capture transactions that could produce results inconsistent with repeal of the General Utilities Doctrine.12 We agree that the definition of Stock of the Corporate Partner in the 2018 Final Regulations could result in certain transactions escaping application of section 337(d) and the intent of General Utilities repeal. For example:

Example 1. Corporation P owns all of the stock of S1 and S2. S1 and S2 each own 49% of S3. S3 is a partner in PRS and, accordingly, is a Corporate Partner of PRS.13

Because the 2018 Final Regulations determine section 304(c) control without regard to section 318(a)(3) attribution, stock of neither S1 nor S2 is Stock of the Corporate Partner under the 2018 Final Regulations.14 If PRS were to acquire stock of S1 or S2, the transaction would not be a Section 337(d) Transaction under the 2018 Final Regulations. However, S1 and S2 each economically owns, indirectly, an interest in the assets of S3, and, as a result, if PRS acquired stock of either S1 or S2, they would, indirectly, be exchanging an interest in an asset for an interest in their own stock. Under

13 S1, S2, S3, and S4 are corporations for purposes of all examples described in these Comments.
14 Because section 318(a)(3)(C) does not apply, S1 and S2 are not attributed each other’s interest in S3 for purposes of determining if stock of either is Stock of the Corporate Partner.
the 2019 Proposed Regulations, S1 and S2 would each be attributed the other’s interest in S3, and stock of each of S1 and S2 would be treated as Stock of the Corporate Partner. Accordingly, under the 2019 Proposed Regulations, if PRS were to acquire stock of S1 or S2, that stock would be treated as Stock of the Corporate Partner and the acquisition would be a Section 337(d) Transaction. Although the inclusion of these attribution rules may result in additional complexity, we believe the complexity is necessary to ensure that the definition of Stock of the Corporate Partner captures transactions that indirectly involve an economic corporate contraction.

We also agree that applying the attribution rules of section 318 without modification could result in a definition of Stock of the Corporate Partner that is overly broad. The 2019 Preamble details the intent of the modifications to section 318 in the 2018 Final Regulations:

The exclusion of attribution under sections 318(a)(1) and 318(a)(3) in the 2015 regulations and the final regulations was intended to limit section 304(c) control to entities that own a direct or indirect interest in the Corporate Partner, while excluding entities that do not own a direct or indirect interest in the Corporate Partner. To implement this intent more precisely, the Treasury Department and the IRS propose to limit the proposed scope of section 304(c) control to ownership, direct or indirect, of an interest in the Corporate Partner. 15

Accordingly, the 2019 Proposed Regulations require a Controlling Corporation to have a direct or indirect interest in a Corporate Partner in order to constitute Stock of the Corporate Partner. This modification to the application of section 318 allows entities that are brother-sister to a Corporate Partner but have no direct or indirect interest in the Corporate Partner to avoid being characterized as Stock of the Corporate Partner. We agree with this modification and believe it appropriately excludes transactions that generally do not circumvent General Utilities repeal. For example:

Example 2. Corporation P owns all of the stock of S1 and S2. S1 and S2 each own 49% of S3. P also owns stock of S4, which does not own any interests in S1, S2, S3, or PRS (i.e., S4 is brother-sister to S1 and S2). S3 is a partner in PRS and, accordingly, is a Corporate Partner of PRS.

Stock of S4 is not Stock of the Corporate Partner, and an acquisition of S4 stock by PRS would not be considered a Section 337(d) Transaction under either the 2018 Final Regulations or the Proposed Regulations. Because S4 does not own a direct or indirect interest in P, S1, S2 or S3, none of P, S1, S2 or S3 would indirectly economically exchange an interest in an appreciated asset for an interest in its own stock as a result of PRS’s acquisition of S4 stock. Furthermore, if PRS were to distribute stock of S4 to S3, section 732(f) would apply to preserve any built-in gain in S3’s partnership interest in the assets of S4. 16 Neither an acquisition of S4 stock by PRS nor its distribution to S3


16 Section 732(f) generally provides that if a corporation receives a distribution from a partnership of stock in another corporation, the corporate partner has control of the distributed corporation immediately after the
circumvents the repeal of the *General Utilities* Doctrine, and it is appropriate that the stock of S4 does not constitute Stock of the Corporate Partner.

Accordingly, we agree that the expanded definition of Stock of the Corporate Partner in the 2019 Proposed Regulations more accurately captures transactions that may circumvent *General Utilities* repeal and recommend the expanded definition, along with the requirement that the Controlling Corporation have a direct or indirect ownership interest in the Corporate Partner, be adopted with the modification described immediately below.

B. Amount of Stock of the Corporate Partner

1. Background

As noted above, Proposed Regulation section 1.337(d)-3(c)(2)(i) would modify the definition of Stock of the Corporate Partner to take into account the attribution rules of sections 318(a)(1) and (3) and also would add a requirement that the Controlling Corporation have a direct or indirect equity interest in the Corporate Partner. In effect, an equity interest in the Controlling Corporation would be considered Stock of the Corporate Partner if the Controlling Corporation owns stock of the Corporate Partner (i) directly or (ii) indirectly through a vertical chain of ownership, regardless of the amount of stock owned directly or indirectly. Under this rule, regardless of the Controlling Corporation’s percentage ownership interest in the Corporate Partner, all of the stock of the Controlling Corporation held by the partnership would be considered Stock of the Corporate Partner.

2. Recommendation

We recommend that, with respect to a Controlling Corporation, the definition of Stock of the Corporate Partner be limited to reflect the percentage of stock of a Corporate Partner held by the Controlling Corporation.

3. Explanation

Although, as discussed above, we agree that the modified attribution rules in the 2019 Proposed Regulations are necessary to capture transactions that may circumvent *General Utilities* repeal, the 2019 Proposed Regulations in their current form may result in taxpayers recognizing more (or less) gain than would otherwise have been eliminated.

\[\text{distribution (or at any time thereafter), and the partnership’s adjusted basis in the stock of the distributed corporation immediately before the distribution exceeds the corporate partner’s adjusted basis in the stock of the distributed corporation immediately after the distribution, the basis of property held by the distributed corporation must be reduced by the excess amount. Under Regulation section 1.732-3(a), whether a corporate partner that is a member of a consolidated group has control of a distributed corporation for purposes of section 732(f) is made by applying the aggregate stock ownership rules of Regulation section 1.1502-34.}\]

\[\text{Prop. Reg. § 1.337(d)-3(c)(2)(i) (2019).}\]
This result may occur in situations in which a partnership owns stock of a Controlling Corporation rather than the Corporate Partner itself.

Under the 2019 Proposed Regulations, the amount of gain recognized may be inconsistent with the amount of gain potentially eliminated by a Section 337(d) Transaction. The potential for over-inclusion could be eliminated by treating as Stock of a Corporate Partner only a portion of the stock of a Controlling Corporation equal to its direct or indirect ownership percentage in the Corporate Partner.

II. Affiliated Group Exception

A. Background

As described above, Regulation section 1.337(d)-3(b) provides that the 2018 Final Regulations apply when a partnership, either directly or indirectly, owns, acquires, or distributes stock of the corporate partner. Under the 2018 Final Regulations, Stock of the Corporate Partner does not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership’s capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner (the “Affiliated Group Exception”). This exception applies only if all of the interests are held by members of the same affiliated group; if any interest is held by an outside partner, regardless of the size of the interest, the Affiliated Group Exception is not applicable.

The 2019 Proposed Regulations would remove the Affiliated Group Exception. Treasury and the Service requested comments describing situations in which a more tailored version of the Affiliated Group Exception would be warranted.

B. Recommendation

If the Affiliated Group Exception is removed, we recommend that final Regulations provide a “grandfather” rule pursuant to which a transaction undertaken by a partnership that would have qualified for the Affiliated Group Exception prior to the issuance of final regulations would continue to be excluded from treatment as a Section 337(d) Transaction following the issuance of final regulations.

C. Explanation

The Affiliated Group Exception provides a reasonable approach for situations in which there would be no reason to require gain recognition. The preamble to the 2015 Temporary Regulations (the “2015 Preamble”) indicated that Treasury and the Service determined that the Affiliated Group Exception is appropriate because “the purpose of these regulations is not implicated if a partnership is owned entirely by affiliated

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18 Reg. § 1.337(d)-3(c)(2)(ii).
corporation.” By applying only in instances in which all interests in the partnership’s capital and profits are held by members of an affiliated group, the Affiliated Group Exception demonstrates that the 2018 Final Regulations were meant to capture corporate contractions of the overall affiliated group rather than a specific legal entity. Consider the following example:

**Example 3.** Corporation P owns all of the stock of S1 and S2. Together, P, S1, and S2 are members of an affiliated group within the meaning of section 1504(a). S1 and S2 own all the interests in the capital and profits of a partnership, PRS. PRS uses cash to acquire some of the stock of S1 previously held by P.

In this instance, the stock of S1 held by PRS is Stock of the Corporate Partner for purposes of section 337(d) under the 2018 Final Regulations. However, because the Corporate Partners of PRS, S1 and S2, are members of an affiliated group, the Affiliated Group Exception applies to eliminate gain recognition on the acquisition of the stock of S1 by PRS. Although PRS has acquired Stock of the Corporate Partner, the transaction in effect has not caused a contraction of the overall group. Before the transaction, all cash and interests in S1 were held by P directly and indirectly; after the transaction, similarly, all cash and interests in S1 are held by P directly and indirectly. The Affiliated Group Exception achieves its stated objective because there has been no change in the overall assets of the group.

However, the Affiliated Group Exception may cause the regulations to fail to capture some situations in which there is a corporate contraction of the group. Consider the following example:

**Example 4.** Corporation P is the parent of corporate subsidiaries S1 and S2. S2 is wholly owned by P, while 5% of the interests in S1 are held by members of the public. Together, P, S1, and S2 are members of an affiliated group within the meaning of section 1504(a). S1 and S2 own all the interests in the capital and profits of a partnership, PRS. PRS uses cash to acquire the stock of S1 previously held by members of the public.

In this instance, the stock of S1 held by PRS is Stock of the Corporate Partner for purposes of section 337(d) under the 2018 Final Regulations. However, because the Corporate Partners of PRS, S1 and S2, are members of an affiliated group, the Affiliated Group Exception applies to eliminate gain recognition on the acquisition of the stock of S1 by PRS.

In this case, however, there has been a corporate contraction of the overall group (as well as of S1, the Corporate Partner, individually); interests in the group previously held by the public are now held by the group, and cash previously held within the group is now outside the group. In this situation, the Affiliated Group Exception appears to provide an incorrect result given that the intent of the regulations is to capture situations in which there is a corporate contraction of the group.

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Although we believe that the facts of most common business transactions are more similar to those of Example 3, rather than to those of Example 4, we understand that the Affiliated Group Exception does not currently capture all situations in which the repeal of the General Utilities Doctrine may be circumvented. As discussed further below, if the Affiliated Group Exception is removed, we believe other changes to the final regulations will provide relief for taxpayers that may enter into bona fide business transactions that result in transitory ownership of Stock of the Corporate Partner that may have otherwise qualified for the Affiliated Group Exception.

However, we believe that the elimination of the Affiliated Group Exception could prove burdensome to taxpayers who have structures in place that currently qualify for the Affiliated Group Exception. Although the final regulations could provide for a transition period before certain provisions are effective, it would be difficult (and possibly not commercially feasible) to unwind these structures within a short period of time. Therefore, we recommend that final Regulations provide a “grandfather” rule pursuant to which a transaction undertaken by a partnership that would have qualified for the Affiliated Group Exception prior to the issuance of final regulations would continue to be excluded from treatment as a Section 337(d) Transaction in perpetuity following the issuance of final regulations.\(^{21}\) This exception should be narrowly crafted.

### III. Exceptions for Certain Interests in Stock of the Corporate Partner

#### A. Background

As described above, Regulation section 1.337(d)-3(b) provides that the 2018 Final Regulations apply when a partnership, either directly or indirectly, owns, acquires, or distributes stock of the corporate partner. The 2018 Final Regulations provide an exception for certain dispositions (the “Disposition Exception”) in which stock is disposed of by sale or distribution (the “Sale or Distribution Requirement”):

**Regulation section 1.337(d)-3(f)(2) Certain dispositions of stock.** Unless acquired as part of a plan to circumvent the purpose of this section, this section does not apply to Stock of the Corporate Partner that—

(i) Is disposed of (by sale or distribution) by the partnership before the due date (including extensions) of its federal income tax return for the taxable year during which the Stock of the Corporate Partner is acquired (or for the taxable year in which the Corporate Partner becomes a partner, whichever is applicable); and

(ii) Is not distributed to the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of section 304(c), except that section 318(a)(1) and (3) shall not apply.

\(^{21}\) We believe limiting the exclusion to a number of years following the issuance of final regulations would be difficult to administer and may require (or motivate) taxpayers to restructure their investments when they would not otherwise have commercial objectives to do so.
The 2018 Final Regulations do not include examples of situations that are considered to be part of a plan to circumvent the purposes of Regulation section 1.337(d)-3 (the “Disposition Exception Exclusion”), nor does the preamble to the 2018 Final Regulations (the “2018 Preamble”) include a description of which situations are intended to be captured with the Disposition Exception Exclusion. The Proposed Regulations do not modify the Disposition Exception, nor do they clarify when the Disposition Exception Exclusion is intended to apply.

B. Recommendation

We recommend the final Regulations retain the Disposition Exception, but remove the Disposition Exception Exclusion and the Sale or Distribution Requirement.

C. Explanation

We appreciate the need to address transactions that may be abusive or entered into with a primary goal of circumventing the intent of section 337(d). However, the Disposition Exception Exclusion provides an unadministrable standard for taxpayers to meet, as it is unclear what constitutes a plan to circumvent the purpose of the regulations. In addition, if the Affiliated Group Exception is removed in the final regulations, more taxpayers may rely on the Disposition Exception, increasing the need for clarity with respect to this provision. Consider the following example:

Example 5. Corporations A and B are both publicly traded on a national stock exchange. A and one of its wholly-owned corporate subsidiaries own all of the interests in PRS, a partnership. A intends to acquire all of the stock of B. In order to effect the acquisition, PRS will use cash and stock of A to acquire stock of B from shareholders of B. As a result, PRS will have a transitory interest in A, a Corporate Partner of PRS.

In this instance, PRS holds Stock of the Corporate Partner for a brief period. That stock is then transferred to shareholders of B. It is not distributed to a Corporate Partner of PRS or a corporation that controls any Corporate Partner within the modified meaning of section 304(c).

It appears the facts of this example could qualify for the Disposition Exception in Regulation section 1.337(d)-3(f)(2) above, provided PRS did not acquire the stock of A as part of a plan to circumvent the purpose of the 2018 Final Regulations so that the Disposition Exception Exclusion did not apply. It is unclear if this is a situation that is intended to be captured by the Disposition Exception Exclusion, or how PRS may substantiate that its transitory acquisition of A was not part of such a plan.

In addition, the Disposition Exception requires that stock be disposed of by sale or distribution. By limiting application of this exception only to those situations in which stock is sold or distributed, other, legitimate business transactions that are not undertaken.

with the intent of circumventing the General Utilities Doctrine may be excluded. For example:

**Example 6.** Corporation A is a Corporate Partner of partnership PRS. Employees of PRS are granted stock options in A as part of their employment with PRS. When the options are exercised, A contributes its stock to PRS. Immediately thereafter, PRS transfers the stock as compensation to the employees exercising the options. PRS is able to deduct the value of the stock as compensation expense and employees include the value of the stock as income.\(^{23}\)

This arrangement is not a transaction that otherwise would have implicated section 337(d) as there is no elimination of gain that ordinarily would be recognized under section 311(b), nor has A decreased its interest in appreciated property of PRS. However, the Disposition Exception requires that PRS dispose of the stock of A by sale or distribution, and, in this case, PRS is disposing of the stock by transferring the stock to its employees as compensation. We see no reason why the Disposition Exception should be limited to situations in which the partnership disposes of stock solely by sale or distribution, and for that reason believe the Sale or Distribution Requirement should be removed. Even if the Sale or Distribution Requirement is retained, we recommend that consideration be given to modifying it to include all taxable dispositions rather than being limited to sales, which would include the fact pattern described above.

As noted above, if the Affiliated Group Exception is removed in the final regulations, many taxpayers entering into bona fide business transactions that previously would have qualified for the Affiliated Group Exception may now need to rely on the Disposition Exception to avoid improper gain recognition under section 337(d).\(^{24}\) Therefore, we recommend that the Disposition Exception Exclusion and the Sale or Distribution Requirement be removed, in order to provide clarity as to the application of the Disposition Exception. If the Disposition Exception Exclusion in the 2018 Final Regulations is retained, then we recommend the final Regulations modify the Sale or Distribution Requirement and provide examples of when the Disposition Exception Exclusion may apply.

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\(^{23}\) This is similar to the facts of Rev. Rul. 99-57, 1999-2 C.B. 678, in which a partnership used stock of a corporate partner contributed by that partner to compensate an individual for services provided to the partnership, and to Treas. Reg. § 1.1032-3(e), Example 3, in which stock of the partner’s parent (i.e., the parent corporation of Company A in this example) was used by the partnership to compensate an individual for the purchase of a truck, rather than stock of the partner itself.

\(^{24}\) Consider Example 5, in which all of the capital and profits interests in PRS were owned by corporation A and its wholly owned subsidiary. Under the 2018 Final Regulations, if A and its subsidiary are members of an affiliated group as defined in section 1504(a), the Affiliated Group Exception would apply to the transfer described in Example 5. If, however, the Affiliated Group Exception is repealed, then A and PRS may need to rely on the Disposition Exception to avoid improperly triggering gain under section 337(d).