American Bar Association Section of Taxation Comments on Proposed Regulations Under Section 751(b)

Abstract

The American Bar Association Section of Taxation (the "Section") released comments (the "Comments") on proposed regulations issued by the Treasury and the Service concerning section 751(b), which was included in Subchapter K when first enacted in 1954, and has been amended slightly since then. Section 751(b) applies to a distribution of property from a partnership to a partner if the effect of the distribution is to effect an exchange of the distributee's share of unrealized receivables and substantially appreciated inventory "in exchange for" an increased share of other assets, or vice versa. Thus, section 751(b) is directed at distributions that have the effect of shifting ordinary income among partners.

Regulations under section 751(b) were promulgated in 1956 and were focused on distributions that shift partners' shares of the value of a partnership's ordinary income assets. The regulations have not been amended since their original promulgation. The examples in those regulations determine a partner's interest in section 751 property by reference to the partner's share of the gross value of the partnership's assets (the "gross value" approach), not by reference to the partner's share of the unrealized gain or loss in the property. If a distribution results in a shift between the partner's interest in the partnership's section 751 property and the partnership's other property, those regulations require a deemed asset exchange of both section 751 property and other property between the partner and the partnership to determine the tax consequences of the distribution (the "asset exchange" approach). With their focus on value, the 1956 regulations were found to yield results that were both internally inconsistent and inconsistent with the goals of the statute. In response to this well-recognized problem, the government issued Notice 2006-14, proposing a new approach to implementing section 751(b). In the Notice, the government asked for comments on (1) replacing the gross asset value approach with a "hypothetical sale" approach for purposes of determining a partner's interest in the partnership's section 751 property and (2) replacing the asset exchange approach with a "hot asset sale" approach to determine the tax consequences when it is determined that section 751(b) applies.

The proposed 751(b) regulations adopt many of the principles described in Notice 2006-14. The proposed regulations (1) provide rules for determining partners' interests in section 751 property, (2) set forth the test to determine whether section 751(b) applies to a partnership distribution, including

anti-abuse principles that may apply in certain situations in which the test would not otherwise be satisfied, (3) explain the tax consequences of a section 751(b) distribution, and (4) describe certain ancillary issues. The proposed regulations withdraw the asset exchange approach of the current regulations, but do not require the use of a particular approach for determining the tax consequences of a section 751(b) distribution. Rather, the partnership must use a reasonable approach that is consistent with the purpose of section 751(b). The drafters of the proposed regulations signal that the "hot asset sale" approach and a "deemed gain" approach are reasonable in many or most situations.

In the Comments, the Section stated that it strongly supports the general approach adopted in the proposed regulations as compared with the approach taken in the 1956 regulation. Additionally, while supporting the general approach of the proposed regulations, the Section recommended numerous changes and additions, notably with respect to: (1) determining substantial appreciation in inventory; (2) permitting certain special allocations (*i.e.*, synthetic revaluations) to obtain the same results as a revaluation; (3) addressing the overlap of section 751(b) with section 704(b) substantiality; (4) revising certain aspects of the capital gain recognition provisions in the proposed regulation; (5) providing for information reporting by lower tier partnerships to upper tier partnerships; (6) coordinating the interaction of section 751(b) with section 1245; (7) allocating section 734(b) adjustments; (8) illustrating the interaction of section 751(b) and section 1254; (9) clarifying that if the deemed gain approach is adopted, the resulting deemed sale will not be given effect for any other purpose as a partnership-level sale of assets; (10) resolving the interaction of section 751(b) and section 1248; and (11) addressing certain aspects of the anti-abuse rules in the proposed regulations. The comments provide detailed explanations, often with numerical examples, in each of these areas.

These 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 Howard E. Abrams and Erich P. Hahn. Substantive contributions were made by Deanna W. Harris, Victoria Louie, and Julie Marion. The Comments were reviewed by Thomas E. Yearout, Chair of the Partnerships and LLCs Committee (the "Committee"), and Jeanne M. Sullivan, former Chair of the Committee. The Comments were further reviewed by William H. Caudill for the Section's Committee on Government Submissions, Roberta Mann, Council Director for the Committee, and Peter H. Blessing, the Section's Vice Chair (Government Relations).

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.

I. Executive Summary

The taxation of partnerships and their partners is governed by the rules in Subtitle A (Income Taxes), Chapter 1 (Normal Taxes and Surtaxes), Subchapter K (Partners and Partnerships) of the Internal Revenue Code.[1] Subchapter K was added to the Internal Revenue Code as part of the Tax Reform Act of 1954 and has been amended from time to time ever since. Section 751(b), the focus of this report, was included in Subchapter K when first enacted in 1954 and has been amended slightly since then.[2] Regulations under section 751(b) were promulgated in 1956.[3]

By its express terms, section 751(b) applies to a distribution of property from a partnership to a partner if the effect of the distribution is to effect an exchange of the distributee's share of unrealized receivables and substantially appreciated inventory "in exchange for" an increased share of other assets, or vice versa. Thus, while section 751(a) addresses a possibility of inappropriately converting ordinary income into capital gain, section 751(b) speaks not to ordinary income conversion, but rather to distributions that have the effect of shifting ordinary income among partners.

The regulations promulgated in 1956 focused on distributions that shift partners' shares of the value of a partnership's ordinary income assets. Because the amount of ordinary income in such assets is dependent on both their value and on their adjusted basis, focusing on value alone caused the 1956 regulations to yield results that were both internally inconsistent and inconsistent with the goals of the statute. In response to this well-recognized problem, the government proposed a new approach to implementing section 751(b) in Notice 2006-14,[4] and the Proposed Regulations[5] are based on that Notice and on the comments received by the government in response thereto. We strongly support the general approach adopted in the Proposed Regulations as compared with the approach taken in the current regulations.

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[1] Title 26 of the United States Code is commonly referred to as the Internal Revenue Code. References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[2] The substantial appreciation test in section 751(b)(3) originally included not only the existing appreciation test in section 751(b)(3)(A) but also a requirement that the partnership's inventory exceed 10% of the partnership's property (other than cash). In addition, none of the flush language following section 751(c)(2) (referenced in section 751(b)(1)(A)(i)) was included in the statute as enacted in 1954.

[3] T.D. 6175, 1956-1 C.B. 211 (May 23, 1956).

[4] 2006-1 C.B. 498.

[5] REG-151416-06, 79 Fed. Reg. 65,151 (2014) (the Proposed 751 Regulations).

One novel feature of the Proposed Regulations is the way they address distributions of section 751(b) assets triggering a step-down in basis under section 732(a). If such a distribution is made and the partnership has an election in effect under section 754, the resulting positive inside basis adjustment would have the effect of reducing the ordinary income shares of the nondistributee partners at the expense of the distributee partner. In such circumstances, the Proposed Regulations provide that the distributee partner recognizes capital gain (as if the partnership purchased a portion of the distributee partner's share of partnership's assets) immediately prior to the distribution and increases outside basis by the gain so recognized (*i.e.*, mandatory recognition of capital gain). Similarly, if no section 754 election is in effect for the taxable year of distribution, the effect of such a step-down in basis is to increase the distributee partner's share of ordinary income without any reduction in the shares of the nondistributee partners, and in such circumstances the distributee partner is permitted to recognize capital gain to avoid the basis step-down (*i.e.*, elective recognition of capital gain).

While supporting the general approach of the proposed regulations, we recommend the following changes and additions:

1. We recommend that final Regulation section 1.751-1(d)(1) include the following sentences: "The determination of whether a partnership's inventory items are substantially appreciated is determined immediately before a distribution (or immediately before the first distribution in a series of related distributions). A partnership's inventory items immediately after a distribution (or after a series of related distributions) shall be treated as substantially appreciated if and only if the partnership's inventory items were substantially appreciated immediately prior to the distribution (or immediately prior to the first distribution in a series of related distributions)."

2. We suggest that the language in Proposed Regulation section 1.751-1(d)(1) excluding unrealized receivables from the substantial appreciation computation be withdrawn.

3. We recommend that the requirement in Proposed Regulation section 1.751-1(b)(2)(iv), that a partnership revalue its assets immediately prior to any distribution if the partnership owns any section 751(b) assets immediately prior to the distribution, be relaxed to allow a partnership to achieve the same results as a revaluation through the use of special allocations (*i.e.*, a synthetic revaluation).

4. We propose that the final regulations include the following statement: "An allocation of unrealized book appreciation in distributed unrealized receivables or an item of substantially appreciated inventory to a distributee partner will not be invalid for want of substantiality if the only net reduction to total tax liability of the partners arises from the reduction (including the elimination) of the applicability of section 751(b) to the distribution."

5. Recommendations related to Capital Gain Recognition

(i) We recommend that, in situations where the partner may elect to recognize capital gain, the final regulations provide for an extension of time to make the election.

(ii) We recommend that, in lieu of mandatory gain recognition, consideration be given to allowing the section 734(b) adjustment pursuant to a section 754 election to be allocated solely to the distributee partner rather than to common partnership basis.

(iii) When recognition of capital gain is elective by a distributee as the result of a distribution, we recommend that final regulations provide clearly that the basis adjustment associated with the distributee partner's capital gain recognition attaches to the partner's share of gain, including section 704(c) gain. We recommend that such adjustment be made to a capital asset; a partnership with no such asset should suspend the basis adjustment until additional capital gain property is acquired (similar to the rule in Regulation section 1.755-1(c)(4)).

(iv) If recommendation (iii) is not accepted, we recommend that the final regulations provide that the mandatory and elective capital gain recognition be treated as gain from the sale or exchange of a capital asset other than a collectible and should not be treated to any extent as unrecaptured section 1250 gain. Further, we recommend that the final regulations provide that the gain be treated as long-term or short-term based on the distributee partner's holding period in his partnership interest.

6. We suggest that every partnership in which a partnership is a partner be required to report to its partners their shares of the partnership's ordinary income assets at the end of each partnership year as well as whenever the reporting partnership revalues its assets, and that the reporting partnership be permitted to base this computation on the fair market value or on the book value of its assets.

7. In coordinating the interaction of section 751(b) with section 1245 (and any similar provision), we recommend that the final regulations provide that any increase in basis allocated to ordinary income property is taken into account in computing recomputed basis and adjusted basis for purposes of section 1245(a)(1).

8. We recommend that the final regulations should either (a) omit section (c)(2)(iv) of Proposed Regulation section 1.755-1 in its entirety or (b) provide that a basis adjustment provided by section 734(b)(1)(B) triggered by the distribution of an asset described in section 1231 should be made to undistributed assets of the partnership described in section 1231 to the extent the partnership owns such assets.

9. We recommend that an example be provided that illustrates the interaction of sections 751(b) and 1254 when a partnership uses the remedial allocation method for property contributed to the partnership that is subject to an allowance for depletion. Such an example would clarify how section 751(b) applies when such property has generated depletion deductions in

excess of basis, which are not recaptured as ordinary income under section 1254(a)(1)(A)(ii).

10. We recommend that the final regulations under section 751(b) clarify that, if the deemed gain approach is adopted by a partnership in connection with a distribution triggering application of section 751(b), the resulting deemed sale will not be given effect for any other purpose as a partnership-level sale of assets. For example, we recommend that the deemed gain approach not be the basis for application of section 304 if the distributing partnership owns section 1248 stock and has a controlling partner.

11. We recommend that final regulations resolve ambiguities regarding the interaction among sections 1248(a) and (g), 902 and 751(b). In particular, we recommend an example or examples illustrating distributions by a domestic partnership and a foreign partnership, respectively, having domestic and foreign partners. We recommend that, if a partner or a partnership recognizes ordinary income as a result of a distribution taxable under section 751(b), then the ordinary income recognized should be treated as a deemed dividend that carries the possibility of a section 902 deemed-paid credit for domestic corporate partners to the extent it relates to a section 1248(a) amount, regardless of whether the partnership adopts the deemed gain or the hot asset approach for purposes of applying section 751(b).

12. If section 1248 stock is held by a domestic partnership, which has both domestic partners owning (taking into account attribution rules) 10 percent or more of the voting power of the issuer of the stock and other partners, and is distributed to less than all partners, there is a different tax treatment depending on whether the partnership adopts the deemed gain approach or the hot asset sale approach. We believe that the hot asset sale approach is reasonable in such circumstances even though it avoids taxation under section 751(b) on the distribution, and we recommend that an example be added to make this point clear.

13. Stock of a controlled foreign corporation owned by a foreign partnership, regardless of the citizenship, residence or place of incorporation of its partners, does not constitute section 1248 stock in the hands of the foreign partnership. We believe this result is inappropriate if some or all of the partners are U.S. persons, and we recommend that Proposed Regulation section 1.751-1(b)(2)(ii) be changed to provide that a foreign partnership is treated as an aggregate of its partners for purposes of section 751(b). Specifically, we recommend that it be made clear in Regulations section 1.751-1(b)(2)(ii) that an “allocation” includes each partner’s share of gain from the deemed sale by the partnership of section 1248 stock, and that this be without regard to the otherwise applicable recharacterization in Regulation section 1.1248-1(a)(4).

14. Proposed Regulation section 1.751-1(b)(4) describes one of the purposes underlying section 751(b) as preventing the monetization of a partnership interest without the recognition of income. We strongly recommend that this language be eliminated because it is unsupported by the words of the statute, the legislative history, the contemporaneous understanding of the

role section 751(b) was intended to play, and the current understanding of the role section 751(b) plays.

15. We recommend that Proposed Regulation section 1.751-1(b)(4) be modified to provide a list of factors the Internal Revenue Service (the "Service") will consider in applying the facts and circumstances test set forth in the general rule or provide examples of transactions or circumstances that the Service may find abusive. Assuming presumptions are retained, we recommend that the presumptions be rebuttable and that disclosure be required on Form 8275, rather than on Form 8275–R.

II. Detailed Analysis and Recommendations

A. *Technical Issues*

1. *Substantial Appreciation: Timing*

A partner's section 751(b) amount is determined by comparing the partner's share of the partnership's ordinary income immediately prior to the distribution with the partner's share of ordinary income immediately after the distribution, including ordinary income in any property distributed to the partner. Because "substantial appreciation" of a partnership's inventory items is determined by reference to the inventory items as a whole, a distribution that includes partnership inventory items can affect whether the remaining partnership inventory items are "substantially appreciated" immediately after the distribution. For determining each partner's section 751(b) amount, the question arises as to when the computation determining substantial appreciation should be made: (1) immediately prior to the distribution; (2) immediately after the distribution; or (3) both immediately before and immediately after the distribution.

While the Proposed Regulations do not expressly address this issue, it seems from the language of Proposed Regulation sections 1.751-1(b)(2)(ii)-(iii) that substantial appreciation is determined both before and after a distribution. We draw this inference from the definition of a partner's section 751(b) amount being determined by its share of ordinary income immediately prior to a distribution as compared with its share immediately after, in each case with its share being determined based on a hypothetical sale of all the partnership's section 751(b) assets for cash.[6] If such a sale actually took place, presumably substantial appreciation would be determined immediately prior to the sale. We believe that this point should be clarified in the final regulations.

We suggest Proposed Regulation section 1.751-1(d)(1) include the following sentences: "The determination of whether a partnership's inventory items are substantially appreciated is determined immediately before a distribution (or immediately before the first distribution in a series of related distributions). A partnership's inventory items immediately after a distribution (or after a series of related distributions) shall be treated as substantially

[6] *See* Prop. Reg. § 1.751-1(e).

appreciated if and only if the partnership's inventory items were substantially appreciated immediately prior to the distribution (or immediately prior to the first distribution in a series of related distributions)."

2. *Substantial Appreciation: Computation*

Hot assets for purposes of section 751(a) include "unrealized receivables" as defined in section 751(c) as well as "inventory items" as defined in section 751(d). For purposes of section 751(b), hot assets include unrealized receivables as well as inventory items only if the inventory items are "substantially appreciated" as defined in section 751(b)(3). Subject to an anti-abuse rule applicable to inventory items acquired for a tax avoidance purpose,[7] a partnership's inventory items are substantially appreciated if the aggregate value of all inventory items exceeds 120% of the adjusted basis of the inventory items.[8]

Under section 751(d), inventory items of a partnership include not only conventional inventory as described in section 1221(a)(1), but also "any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231."[9] Because a receivable generally is not treated as a capital asset or as property described in section 1231, most receivables fall within the statutory definition of "inventory." If such receivables also are unrealized, then they will fall within the definition of an unrealized receivable as well as the definition of partnership inventory items. Thus, "accounts receivable acquired in the ordinary course of business constitute inventory items . . . *as do any unrealized receivables*."[10]

Substantial appreciation of a partnership's inventory items is not determined on an asset-by-asset basis but rather on the basis of all of a partnership's inventory items taken in the aggregate.[11] As a result, it is not inconsistent to say that a particular inventory item has a built-in loss even though the partnership's inventory items are substantially appreciated. Similarly, it is possible that a particular inventory item has significant appreciation even though the partnership's inventory items are not substantially appreciated. Under the statute, all inventory items are treated as substantially appreciated (and so subject to section 751(b)) if "their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property."[12]

Treating unrealized receivables as "inventory items" does not cause a partnership's unrealized receivables to be captured by section 751(b): unrealized receivables *always* are captured by section 751(b) directly without regard to the partnership's inventory items or whether those inventory items are

[7] *See* I.R.C. § 751(b)(3)(B).
[8] I.R.C. § 751(b)(3)(A).
[9] I.R.C. § 751(d)(2).
[10] Reg. § 1.751-1(d)(2)(ii) (emphasis added).
[11] Reg. § 1.751-1(d)(1).
[12] I.R.C. § 751(b)(3)(A).

"substantially appreciated." The only consequence of treating *unrealized* receivables as inventory is to make the partnership's aggregate inventory items more likely to be "substantially appreciated" because the unrealized appreciation in unrealized receivables will increase the ratio of the value of inventory to its adjusted basis. Treating *realized* receivables as inventory items, on the other hand, has the opposite effect.

The Proposed Regulations do not modify the definition, quoted above, of "inventory items."[13] As a result, even if the Proposed Regulations are finalized as proposed, unrealized receivables will continue to be included within the category of "inventory items." However, the Proposed Regulations amend the definition of substantially appreciated inventory items by providing that "the terms 'inventory items which have appreciated substantially in value' or 'substantially appreciated inventory' refer to the aggregate of all partnership inventory items *but do not include any unrealized receivables*."[14] The current version of this provision includes identical language but omits the italicized language. That is, under the current regulations, it is clear that both the value and the adjusted basis (usually zero) of unrealized receivables contribute to the "substantial appreciation" calculation.

It is important to understand what is at stake in this proposed change. Excluding unrealized receivables from the computation of substantial appreciation is only significant if a partnership actually owns unrealized receivables. Accordingly, regardless of whether a partnership's inventory is substantially appreciated, the partnership's distributions will be burdened by the complexities of section 751(b) if it owns unrealized receivables. Further, if the partnership's conventional inventory items (that is, its statutory inventory items excluding unrealized receivables) are substantially appreciated, then inclusion or exclusion of the unrealized receivables in the computation of substantial appreciation is meaningless. In short, the proposed change to the computation of unrealized receivables affects only partnerships that (1) already are subject to the complexities of section 751(b) by reason of owning unrealized receivables, and (2) own conventional inventory that is not independently substantially appreciated.

Conventional inventory that is not substantially appreciated either has little or no appreciation or a built-in loss (of any magnitude). If the conventional inventory has little or no appreciation, then including the partnership's unrealized receivables in the computation of substantial appreciation has, by definition, little or no revenue effect. But for a partnership that owns considerable loss inventory, including unrealized receivables in the computation of substantial appreciation can have a significant impact.

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[13] The definition of "inventory items" is in section 751(d) and repeated in Regulation section 1.751-1(d)(2)(ii).

[14] Prop. Reg. § 1.751-1(d)(1) (emphasis added).

Consider a partnership that owns both inventory and unrealized receivables.[15] Also assume that times are hard and the partnership's inventory has declined in value. If one of the partners wishes to cash out of the venture, the partner's exit can be accomplished in at least three different ways: (1) the partner can sell his partnership interest; (2) the partner can receive a liquidating distribution of property from the partnership, and then the partner can sell the distributed property; or (3) the partner can receive a liquidating distribution of cash from the partnership.

If the exiting partner sells his interest to a third party (or to another partner), the exiting partner's share of the inventory loss is recognized as an ordinary loss by reason of section 751(a). If the exiting partner instead receives a liquidating distribution of his share of the receivables and the unsold inventory, any loss recognized if he sells the distributed inventory within five years again will be ordinary.[16] But if he exits by receiving a cash distribution from the partnership, the exiting partner's share of the inventory loss will be ordinary only if the inventory is substantially appreciated. This is where the proposed exclusion of unrealized receivables from the substantial appreciation computation would be particularly pernicious. By making it more likely that inventory losses will be treated as capital losses when an exiting partner receives a liquidating distribution of cash (but not if any other form of exit is adopted), the Proposed Regulations needlessly exacerbate the elevation of form over substance.

The drafters of the Proposed Regulations do not explain the motivation for ignoring unrealized receivables in the computation of substantially appreciated inventory items. Indeed, the preamble to the Proposed Regulations describes this change as a mere clarification.[17] Perhaps the drafters of the Proposed Regulations wanted to allow some partnerships to avoid the administrative burden of section 751(b) if its conventional inventory was not substantially appreciated. But as discussed above, if that was their intention it was misguided because partnerships owning unrealized receivables must grapple with the complexities of section 751 without regard to the partnership's inventory.

We believe this change to the computation of substantial appreciation should not be finalized. It is clear that unrealized receivables are "inventory items" within the meaning of section 751(d), and the Proposed Regulations do not change that. Nothing in the statute suggests that the substantial appreciation computation is made by excluding unrealized receivables, [18]and when Congress wishes to exclude certain inventory items from the computation, it

[15]While sales of inventory generally require accrual accounting, Regulation section 1.446-1(c)(2)(i), and so will not generate unrealized receivables in the ordinary course of business, a taxpayer engaged in more than one trade or business is permitted to use a different method of accounting for each trade or business, section 446(d).

[16]I.R.C. § 735(a)(2).

[17]*See* 79 Fed. Reg. 65,151, *supra* note 5 (Summary of Comments and Explanation of Provisions (Substantial Appreciation Test)).

[18]*See* I.R.C. § 751(b)(3)(A) ("their" refers to "[i]nventory items" without limitation).

knows how to do so.[19] While no court has addressed this part of the statute, commentators have for many years (and without contradiction) found that unrealized receivables contribute to the substantial appreciation computation.[20] The description of the change as a mere clarification seems to us especially troubling.

3. *Property Revaluations*

According to the Preamble, the legislative intent underlying section 751(b) is to "inhibit tax avoidance by applying special rules to prevent the shifting between partners of potential ordinary gain attributable to substantially appreciated inventory and unrealized receivables owned by the partnership."[21] The Proposed Regulations achieve this objective in part by mandating the partnership revalue all partnership property immediately before a distribution if a partnership distributes money or other property to a partner as consideration for an interest in the partnership and the partnership owns section 751 property immediately after the distribution.[22] The revaluation insures that each partner's share of pre-distribution ordinary income is fully preserved in the partner's capital account after the distribution. Provided the selection of section 704(c) methods and conventions affecting the allocation of tax items arising from the revaluation meets the requirements of section 704(c) and accompanying regulations, and, in particular, Regulation section 1.704-3(a)(10), the partners' shares of unrealized ordinary income should not change as a result of a distribution of cash or other non-section 751(b) property,[23] and so the distribution should not cause gain or loss to be recognized pursuant to section 751(b).

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[19] *See* I.R.C. § 751(d)(3)(B).

[20] *See, e.g.*, Richard Doernberg, Howard Abrams, et al., Federal Income Taxation of Corporations and Partnerships 686 (1st ed. 1987); George Mundstock, A Unified Approach to Subchapters K & S 132 (2d ed. 2006).

[21] J. Paul Jackson, Mark H. Johnson, et al., *The Internal Revenue Code of 1954: Partnerships*, 54 Colum. L. Rev. 1183, 1214 (1954).

[22] Prop. Reg. § 1.751-1(b)(2)(iv). Regulation section 1.704-1(b)(2)(iv)(f) requires that the capital account adjustments made pursuant to a revaluation be based on the fair market value of the partnership property (taking into account section 7701(g)) on the date of the adjustment and that the adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in the property that has not been reflected in capital accounts previously would be allocated among the partners if there were a taxable disposition of the property for fair market value on that date.

[23] Certain section 704(c) methods may allow for the shifting of built in gain or loss. The regulations under section 704(c) contain an anti-abuse rule that provides that a method is not reasonable if, for example, the event that results in a reverse section 704(c) allocation and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or built-in loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. According to the Preamble to the Proposed Regulations, the Service and Treasury believe that the anti-abuse provision under section 704(c) properly polices the possibility that taxpayers might select a section 704(c) method to shift ordinary income.

That said, if each partner's share of unrealized ordinary income with respect to partnership section 751 property remains the same after the distribution as it was immediately before the distribution, the distribution should not cause gain or loss to be recognized pursuant to section 751(b) regardless of whether partnership properties are revalued. For example, a pro-rata distribution of cash or non-section 751 property made by the partnership to its partners that does not alter the partner's interests in section 751 property would not change the partners' shares of ordinary income with respect to section 751 property retained by the partnership. Even if a distribution would otherwise alter the partner's shares of ordinary income, however, the partnership agreement may be amended to ensure that the amount of post-distribution income allocated to the distributee with respect to section 751 property is the same as the pre-distribution amount without the need for the partnership to revalue all of its assets. Provided that, after the distribution, there are no further changes to the terms of the partnership agreement or other events that alter the partners' shares of unrealized ordinary income, the distribution should not result in the recognition of gain or loss pursuant to section 751(b).

> Example: A, B, and C are equal partners in partnership ABC. ABC holds cash of $600 and a section 1231 asset having a fair market value of $600, a recomputed basis of $600,[24] and a book value and adjusted basis of $300. ABC distributes cash of $200 equally to A, B and C.
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> Before the distribution, the amount of income or loss that would be allocated to each partner if ABC disposed of all partnership assets for cash equal to the assets' fair market value would be $100, which is equal to each partner's share of the total gain of $300 that would be recognized by ABC upon a sale of the section 1231 property and treated as ordinary income pursuant to section 1245(a). After the distribution of $600 in cash, A, B and C remain one-third partners and would continue to be allocated the same $100 from a disposition of the section 1231 property.
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> If instead, ABC distributed the $200 of cash solely to A, the distribution would result in a reduction in A's proportionate interest in the partnership from one-third to one-fifth and increase the interests of B and C in ABC from one-third to two-fifths. A's post-distribution share of ordinary income from ABC would be reduced from $100 (one-third of $300) to $60 (one-fifth of the $300).

If ABC failed to revalue its assets immediately before the cash distribution, a later sale of the section 1245 property would result in an allocation of ordinary income of $60 to A and $120 to each of B and C. If, however, the partnership agreement were amended so as to specially allocate gain from a later disposition of the section 1231 property first among the partners in an amount equal to the amount of ordinary income they would have been allocated had the property been sold for its fair market at the time of the cash

[24] *See* I.R.C. § 1245(a)(2)(A).

distribution (*i.e.*, \$100 to each of A, B and C), with the rest of the gain being allocated in accordance with the partners' percentage interests, the amount of each partner's share of ordinary income would not change. Thus, if the property were later sold for \$600 at a time when the book value and adjusted basis were \$200 (assume ABC claimed \$100 of additional depreciation with respect to the property after the cash distribution), under the amended partnership agreement, A would be allocated \$120 of ordinary income (\$100 plus one-fifth of the additional recapture of \$100 accrued by ABC after the distribution), while B and C would be allocated \$140 of ordinary income each.

Regulation section 1.704-1(b)(5), Example 14(iv), describes a situation in which unrealized gain inherent in partnership property immediately before a contribution is "locked in" among the partners pursuant to an amendment. In that Example, MC and RW each contribute \$10,000 to a general partnership in exchange for equal interests, which the partnership invests in nonmarketable securities. In paragraph (ii) of the Example, at a time when the securities have appreciated from \$20,000 to \$50,000, SK makes a \$25,000 contribution to the partnership in exchange for a one-third interest. In the first part of Example 14, upon SK's contribution, the partnership assets are revalued, and the capital accounts of MC and RW are adjusted upward from \$10,000 each to \$25,000 each in accordance with Regulation section 1.704-1(b)(2)(iv)(f). When the securities are later sold for \$74,000, the \$24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and in accordance with section 704(c) principles, the tax gain is shared \$23,000 to MC, \$23,000 to RW, and \$8,000 to SK. In paragraph (iv) of the example, the facts are the same as before, except that, upon the admission of SK, the capital accounts of MC and RW are not each adjusted upward. Instead, upon SK's admission, the partnership agreement is amended to allocate the first \$30,000 of taxable gain equally between MC and RW, and to allocate all other income, gain, loss, and deduction equally among MC, RW, and SK. When the securities are sold for \$74,000, the partnership allocates the resulting \$54,000 of section 704(b) book gain and taxable gain in accordance with the amended agreement. The example concludes these allocations of taxable gain have substantial economic effect.

Synthetically revaluing the partnership's section 751 property by way of a partnership amendment that specially allocates the partners' shares of income in partnership section 751 property immediately before a distribution (a "synthetic revaluation") can ensure there is no change in the amount of ordinary income allocable to a partner by reason of the distribution. This avoids the need for the partnership to revalue all of its assets, and it avoids the cost to the taxpayer of determining the fair market value of non-section 751 property. It also avoids the secondary effects of the revaluation, most notably, the tracking of actual reverse section 704(c) layers in depreciable property. Permitting synthetic revaluations of section 751 property in cases where the purposes of section 751(b) can be achieved by such means simplifies and thereby encourages compliance.

The Proposed Regulations already recognize synthetic revaluations and, in fact, the Service and the Treasury have requested comments regarding them. Under Proposed Regulations section 1.751-1(b)(2)(iv), if a partnership does not maintain capital accounts in accordance with Regulation section 1.704-1(b)(2)(iv) with which to reflect the revaluation gains and losses, the partnership must nonetheless take into account the pre-distribution computed shares of gain or loss under section 704(c) principles (making subsequent adjustments for cost recovery and other events that affect the basis of the property). In addition, if a partnership (the "upper-tier partnership") owns directly or indirectly 50 percent or less of the interests in a lower-tier partnership, the upper-tier partnership must allocate its distributive share of the lower-tier partnership's items among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its partnership property. Given the Proposed Regulations' reliance on allocations in lieu of revaluations in these cases, it seems unnecessary to require revaluations of all partnership property in cases were the objectives can be achieved in a simpler fashion.

Because a synthetic revaluation does not actually adjust the book value of partnership property or reflect such adjustments in partner capital accounts, subsequent changes to the book value of partnership property would not take the synthetic revaluation allocations into account. Thus, a synthetic revaluation cannot easily accommodate subsequent adjustments to the manner in which gains and losses are shared from synthetically revalued assets. If an asset with unrealized gain at the time of an initial synthetic book up later declines in value, there will be no actual book loss and so the implicit book loss will tacitly be shared only among those partners who otherwise would have shared in the revaluation.

For example, assume that immediately before the admission of a new equal partner D, a partnership owns ordinary income asset X with a zero adjusted basis and $300 fair market value so that the amount of ordinary income that would be allocated from Property X to partners A, B and C is $100 each. If Property X were actually revalued upon D's admission, the adjusted book value of Property X would be increased to $300, and the capital accounts of A, B and C would be increased by $100 each. If, instead of a revaluation, the ABC partnership agreement were amended to provide that the first $300 of gain from the disposition of Property X would be shared equally among A, B and C, there would be no adjustment to the book value of Property X or to the capital accounts of A, B, and C.

If after the admission of D, property X were sold for $400, under the synthetic revaluation allocations, A, B and C would be allocated $125 of gain, and D would be allocated $25 of gain. The same outcome would result if property X had been revalued: the partnership would recognize $100 of book gain that would be allocated under section 704(b) equally to A, B, C, and D, and of the $400 tax gain, $300 would be allocated under section 704(c) principles equally to A, B, and C and the remainder would be allocated equally among A, B, C, and D.

However, if the partnership used synthetic revaluation allocations and property X were eventually sold for only $240 (that is, for $60 less than its value at the time of the admission of D), the partnership would recognize $240 of book and tax gain. Pursuant to the synthetic revaluation allocations, the partnership would allocate income to A, B and C in an amount up to their shares of the unrealized appreciation in the property immediately prior to D's admission. Because the partnership recognizes $240 of income, that means A, B and C would each be allocated $80 of book and tax income while D will be allocated neither income nor loss. Thus, the capital accounts and outside bases of A, B and C would equal $80 each and D's capital account and outside basis would equal $100.

Had the property been revalued to $300 immediately before D's admission, the same sale of the property would yield a book loss of $60 as well as a tax gain of $240. The book loss would be allocated equally among A, B, C, and D while the tax gain would be allocated only among A, B, and C. This yields a very different result from the synthetic revaluation in terms of the economics but not in the taxes.

Here, an actual revaluation followed by the later loss would have caused each partner to have a capital account of $85 (A's, B's, and C's capital account would be $100 each, reflecting the revaluation gain and D's capital account would equal $100, reflecting contributed money, minus $60 of total book loss ($100 – $15 book loss each = $85)).

Assuming the partnership has elected to use the traditional method to address this ceiling limitation issue,[25] A, B and C would each have an outside basis of $80 (the $240 of tax gain would be shared equally among them) and D would have no loss allocation to reflect the book loss (because of the ceiling rule) and would retain an outside basis of $100.

As this example shows, use of a synthetic revaluation will in some circumstances affect how the partners share the economic benefits and burdens arising from the enterprise (that is, it can affect capital account balances), and it completely mimics the tax consequences of the section 704(c) traditional method for addressing ceiling limitation problems. Because the traditional method is permitted under existing regulations, the result yielded by synthetic revaluations already is sanctioned. As a result, we see no reason why synthetic revaluations should not be allowed.

The Proposed Regulations already require partnerships that do not maintain section 704(b) capital accounts and those that own minority interests in lower tier partnerships to take section 704(c) principles into account in allocating gains and losses for ordinary income property. Thus, the Proposed

[25] *See* Reg. § 1.704-3(b). There is no tax loss equal to the book loss of $60, causing a ceiling rule limitation.

Regulations require section 704(c) compliance regardless of whether the partnership property is actually revalued or synthetic revaluation allocations are used. Concerns about the complexity associated with tracking the partners' shares of ordinary income or the opportunity for a taxpayer to shift ordinary gain or loss in a manner inconsistent with section 704(c) do not justify prohibiting synthetic revaluations of section 751 property for partnerships that maintain capital accounts. All partnerships should be allowed to use synthetic revaluations achieved through special allocations.

4. *The "Substantiality" Requirement*

Tax allocations of a partnership as reflected in the partnership agreement will be given effect only if they have "substantial economic effect."[26] Under current regulations, the statutory requirement of "substantial economic effect" is divided into two separate sub-requirements, the requirement of economic effect and the requirement of substantiality.[27] In general, the requirement of economic effect demands that tax allocations be consistent with the economic arrangements of the partners.[28] This is accomplished by reflecting allocations in the partners' capital accounts, which are used to determine the amount received by any partner upon liquidation of the partner's interest in the partnership.[29] The substantiality requirement demands that there be a reasonable possibility that each allocation (or set of allocations) affect the dollar amounts to be received by the partners, independent of tax consequences.[30] In particular, a set of allocations will together be insubstantial if each taken separately affects a partner's capital account but taken together have no net effect on the partners' capital accounts, either in a single year[31] or across multiple tax years.[32]

Because a partnership distribution invariably involves a revaluation of partnership property[33] and a restatement of partnership capital accounts,[34] a distribution will trigger (as part of the capital account restatement) partnership allocations that are subject to the substantial economic effect requirement. As discussed below, the section 751(b) implication of a partnership distribution can be reduced, in some circumstances, by a set of allocations that arguably

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[26] I.R.C. § 704(b).

[27] Reg. § 1.704-1(b)(2)(i).

[28] Reg. § 1.704-1(b)(2)(ii)(a).

[29] Reg. § 1.704-1(b)(2)(ii)(b).

[30] Reg. § 1.704-1(b)(2)(iii)(a).

[31] Reg. § 1.704-1(b)(2)(iii)(b) ("shifting" allocations).

[32] Reg. § 1.704-1(b)(2)(iii)(c) ("transitory" allocations).

[33] Distributed property must be revalued to current fair market value immediately prior to the distribution. Reg. § 1.704-1(b)(2)(iv)(e)(1). Under current regulations, partnerships are permitted to revalue undistributed assets immediately prior to a distribution in most circumstances. Reg. § 1.704-1(b)(2)(iv)(f). Under the proposed regulations, such revaluations will become mandatory if the partnership owns any unrealized receivables or items of substantially appreciated inventory immediately after the distribution. Prop. Reg. § 1.751-1(b)(2)(iv).

[34] *See* Reg. § 1.704-1(b)(2)(iv)(g).

fail the test of substantiality. Some commentators to Notice 2006-14 suggested that rules specifically authorizing such allocations be included in the section 751(b) regulations, but that suggestion was rejected as "it is beyond the scope of these regulations and would impact other provisions of subchapter K."

While we agree that regulations promulgated under section 751(b) are not the appropriate place to revisit or revise the general rules applicable to tax allocations, we believe that the overlap of section 751(b) with the substantiality requirement can and should be addressed in a narrowly tailored rule. As discussed more fully below, we suggest that final regulations under section 751(b) include the following statement: "An allocation of unrealized book appreciation in distributed unrealized receivables or an item of substantially appreciated inventory to a distributee partner will not be invalid for want of substantiality if the only net reduction to total tax liability of the partners arises from the reduction (including the elimination) of the applicability of section 751(b) to the distribution."

To understand the issue raised by the overlap of section 751(b) and the substantiality requirement, consider the following three-person partnership, XYZ. X, Y and Z each are entitled to one-third of the partnership's items of income, gain, loss, deduction, and credit. Each partner has an outside basis of $0 and a capital account of $0. The partnership owns six identical assets, with each asset being an unrealized receivable having a current fair market value of $30, an inside basis of $0, and a book value of $0. None of the gain in any of the partnership's assets is described in section 704(c).

If the partnership distributes all of its assets in complete liquidation of the interests of all of its partners, the analysis should go as follows. First, the partnership must revalue each of its assets to current fair market value (that is, to $30), allocating one-third of the revaluation gain (that is $60) to each of the partners. After this step, each partner has a capital account of $60 constructed by allocating $10 of book gain from each asset to each partner.

The partnership then distributes two of its assets to each partner. In this step, each partner receives assets worth $60, the final value of each partner's capital account. Prior to the distribution, each partner's share of the partnership's ordinary income equaled $60, composed of $10 of ordinary income from each of the partnership's six assets. After the distribution, each partner's share of the partnership's ordinary income again equals $60, although it now is composed for each partner of $30 of ordinary income from each of the two assets distributed to that partner. There is no taxation under section 751(b) resulting from the distribution under the Proposed Regulations because no partner's share of the partnership's ordinary income is reduced by reason of the distribution. The Proposed Regulations—quite properly, we believe—focus on each partner's share of the partnership's ordinary income and not on the assets that generate those shares before or after the distribution.

Reconsider this example but assume that instead of distributing all of its assets in complete liquidation of all partnership interests, the partnership distributes one asset to each of its partners in a nonliquidating distribution. Under the Proposed Regulations, the partnership is required to revalue all of its assets and restate capital accounts, again bringing each partner's capital account to $60 immediately prior to the distribution. And again, as before, each partner's capital account has been increased by a $10 share of ordinary income from each of the partnership's six assets.

This distribution does not trigger taxation under section 751(b) because it does not reduce any partner's share of the partnership's ordinary income. Prior to the distribution, each partner had a $60 share of the partnership's ordinary income composed of $10 from each asset. After the distribution, each partner has a $60 share of the partnership's ordinary income composed of $10 from each of the three undistributed assets as well as $30 from the single asset distributed to that partner. In effect, each partner has given up a $10 share of ordinary income in each of the two assets distributed to the other partners in exchange for an additional $20 share of ordinary income from the asset received in the distribution. Because there is no net reduction in shares of ordinary income, there is no taxation under section 751(b). As before, application of section 751(b) is indifferent to the composition of each partner's share of ordinary income, focusing instead only on each partner's share of the ordinary income.

Finally, consider this partnership a third time, but assume that only a single asset is distributed to one partner (partner X) in a nonliquidating distribution. The Proposed Regulations again require that the partnership revalue its assets immediately prior to the distribution, and if each partner is again allocated one-third of the unrealized book gain in each asset, each partner again will have a $60 capital account balance immediately prior to the distribution. Immediately after the distribution, X's capital account balance will stand at $30 while the other two partners will continue to have capital account balances of $60.

This distribution presumably will trigger immediate taxation to Y and to Z because each will see her share of the partnership's ordinary income decline from $60 to $50. X will see an increase in her share of ordinary income because X continues to have a one-third share of the ordinary income of each of the five undistributed assets (that is, $10 per asset) as well as a 100% share of the ordinary income of $30 in the distributed asset, for a total post-distribution share of $80.

From the analysis presented above, both Y and Z will be taxed under section 751(b) on $10 of ordinary income. This ordinary income recognition will then increase the adjusted basis of the asset distributed to X, preventing X from taking a carryover basis in the asset unless X recognizes gain (capital gain under the Proposed Regulations) of $20 solely for the purpose of increasing X's pre-distribution outside basis so that X can take a $20 basis in the distributed asset. Thus, the distribution triggers immediate taxation to all of the partners even though not only is no partner receiving more than her share of the partnership's ordinary income assets but X in fact is receiving only half of her share. Recall that if X received not one asset but two assets (in a liquidating distribution), there would be no immediate taxation to any partner. Further, X is forced to recognize capital gain of $20 even though the partnership owns no capital assets, making it difficult to justify immediate recognition imposed on each of the partners and impossible to determine the appropriate capital gain rate that should apply to such capital gain.

There is a much more natural way to analyze the transaction, a way that resolves all of the problems described above. When an asset is distributed to a partner, the shares of the nondistributee partners in the unrealized appreciation in the distributed asset necessarily drop to zero because the asset once distributed is no longer owned by the partnership. When that asset is sold, it will be the distributee partner who sells it and thus the distributee partner who recognizes whatever gain was built into the asset when it was distributed by the partnership. Accordingly, if tax and book allocations should correspond,[35] then when the asset is booked to fair market value immediately prior to its distribution, all of the unrealized book appreciation in the asset should be allocated to the distributee partner because it is only the distributee partner who will recognize the corresponding tax gain when the asset is sold. On the facts of the example above, that means all $30 of unrealized appreciation in the distributed unrealized receivable should be allocated to X.

To maintain the proper economic relationship among the partners, the extra book income allocated to the distributee partner with respect to the distributed asset should be offset by a reduced share of the unrealized appreciation in other partnership assets. In our example, this means that instead of X being allocated $10 of book gain from each of the six assets, X should be allocated $30 of book income from the distributed asset and only $6 of book income from each of the undistributed five assets. Similarly, Y and Z should each be allocated $0 from the asset distributed to X and $12 of book gain from the five undistributed assets. This set of allocations increases each partner's capital account by $60, yet ensures that the distribution does not trigger the application of section 751(b).[36] Note further that, because application of section 751(b) is avoided, not only do Y and Z avoid the immediate recognition of ordinary income, but X also avoids the immediate recognition of capital gain. With elimination of that capital gain, we avoid the need for determining what capital gain rate to use.

It is at least arguable that this eminently sensible set of allocations is in fact invalid under the current regulations defining "substantial economic effect." Current regulations provide that a set of allocations is invalid if there is a strong likelihood that:

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[35] Reg. § 1.704-1(b)(2)(ii)(a).

[36] Prior to the distribution, each partner has a $60 share of the partnership's ordinary income. Immediately after the distribution, X's share of the partnership's ordinary income equals $30 from the distributed asset and $30 (five assets times $6 per asset) from the undistributed assets. For Y and Z, each partner's share immediately after the distribution equals $60 (five assets times $12 per asset).

> (1) The net increases and decreases that will be recorded in the partners' respective capital account for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and
>
> (2) The total tax liability of the partners . . . will be less than if the allocations were not contained in the partnership agreement . . . .[37]

As discussed above, because the set of allocations proposed above are intended to preserve the agreed upon economic interests of the partners, they have no net effect on the capital account balances as compared with a simple splitting of all unrealized appreciation equally among the three partners. Further, because the proposed set of allocations eliminates the application of section 751(b) to the distribution, it thereby reduces the total tax liability of each of the partners. Thus, according to the literal language of the regulations quoted above, the proposed allocations arguably fail the substantiality test. If this is true, then presumably the partners must allocate all of the unrealized appreciation in the partnership's assets equally among the partners.

The proposed set of allocations should be permitted because it—rather than the simple-minded allocation of book appreciation equally among the partners without regard to the tax implications that follow from a distribution of property—best ensures that allocations of tax items correspond with the allocations of book (economic) items, the "fundamental principle" of the requirement of economic effect.[38] To be sure, allocations made as proposed above must not violate the requirement of substantial economic effect in any other way, but the allocation of unrealized book appreciation in distributed property to the distributee partner should not, standing alone, be considered abusive or invalid. Accordingly, we propose that the final regulations include the following statement: "An allocation of unrealized book appreciation in distributed unrealized receivables or an item of substantially appreciated inventory to a distributee partner will not be invalid for want of substantiality if the only net reduction to total tax liability of the partners arises from the reduction (including the elimination) of the applicability of section 751(b) to the distribution."

5. *Capital Gain Recognition*

a. *Background.* Notice 2006-14[39] and the public comments submitted regarding Notice 2006-14, identified situations in which the operation of regulations under section 751(b) would benefit from provisions providing for

[37] Reg. § 1.704-1(b)(2)(iii)(b).
[38] Reg. § 1.704-1(b)(2)(ii)(a).
[39] 2006-1 C.B. 498.

capital gain recognition.[40] Under current rules, limitations on basis adjustments can result in distortions in gain recognition results. For instance (as described in more detail below), depending on whether the partnership has a section 754 election in effect, because a distributee's basis in distributed assets cannot exceed the distributee's outside basis in its partnership interest immediately prior to the distribution, either section 734(b) adjustments made to remaining hot assets can reduce the amount of unrealized ordinary income in the partnership or the distributee's unrealized ordinary income can be increased as a result of this limitation. In either case, the shares of unrealized ordinary and capital gain income attributable to the distributee and non-distributee partners have been altered from the base case (*i.e.*, a distribution by the partnership of cash proceeds from the sale of the same asset). These results can be avoided if the distributee recognizes capital gain, which increases his outside basis and thereby eliminates the need for an adjustment under section 734(b).

The situations addressed by the capital gain recognition provisions in the Proposed Regulations generally involve basis adjustments in connection with the partnership's distribution of property. In particular, a distributing partnership is required to increase or decrease the adjusted basis of its non-distributed assets if an election is in effect under section 754 or if there is a "substantial basis reduction."[41] Under section 734(b)(1), a distributing partnership increases the adjusted basis of its retained assets by the sum of (i) the amount of gain recognized by the distributee partner with respect to the distribution and (ii) any downward basis adjustment made to the distributed property. Alternatively, under section 734(b)(2), a distributing partnership reduces the tax basis of its retained assets by the sum of (i) the amount of loss recognized by the distributee partner with respect to the distribution, and (ii) any upward basis adjustment with respect to the distributed property. Unlike section 743(b) basis adjustments, which solely relate to a single partner, section 734(b) basis adjustments apply to the common basis of partnership assets. As a result, section 734(b) benefits (or burdens) all of the partners remaining in the partnership.

Section 755 and the regulations thereunder prescribe how a section 734 adjustment is to be allocated among the partnership's assets. Specifically, a section 734 basis adjustment must be allocated to retained partnership property of a character similar to that of the distributed property.[42] When an adjustment to the adjusted basis of the partnership's retained assets cannot

[40] *See* Comm. On Partnerships & LLCs, *ABA Tax Sec., ABA Members Comment on Partnership Distribution Guidance*, 2007 Tax Notes Today 82-22 (Apr. 27, 2007) [hereinafter "ABA Report"]; *NYSBA Tax Section Comments on Partnership Distribution Guidance*, 2006 Tax Notes Today 230-8 (Nov. 28, 2006) [hereinafter "NYSBA Report"].

[41] A "substantial basis reduction" exists with respect to a distribution if the sum of (i) the loss recognized by the distributee partner with respect to the distribution and (ii) the upward basis adjustment applicable to the distributed property exceeds $250,000. I.R.C. § 734(d).

[42] Reg. § 1.755-1(c)(1)(i).

be made because the partnership does not hold any assets of a similar class or because the basis of all the property of a like character has been reduced to zero when a downward adjustment is required, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.[43]

b. *Elective Recognition of Capital Gain*. The Proposed Regulations provide that distributee partners may elect to recognize capital gain to avoid decreases to the basis of distributed section 751 property—specifically, to eliminate a negative section 732(a)(2) or (b) basis adjustment to the asset(s) received in the distribution if the partner's net section 751 unrealized gain would otherwise be greater immediately *after* the distribution than it was immediately *before* the distribution (or would cause the partner's net section 751 unrealized loss to be less immediately after the distribution than it was immediately before the distribution). For example, the preamble to the Proposed Regulations suggests that gain recognition would be appropriate if a partner with zero basis in its partnership interest receives a distribution of section 751 property with basis in the hands of the partnership equal to its value, and the distribution otherwise increases the distributee partner's net section 751 unrealized gain. That is, the goal of this new rule in the Proposed Regulations is to avoid the effect of converting what would have been capital gain to the distributee into ordinary income as a result of section 751(b).

Consider an example using facts similar to those of Example 7 of the Proposed Regulations. A, B, and C are each 1/3 partners in a partnership, ABC, that holds Unrealized Receivable 1 with a fair market value of $90, Unrealized Receivable 2 with a fair market value of $30, and nondepreciable real property with a fair market value of $180. The partnership does not have a section 754 election in effect. Each of the partners has an adjusted basis in its partnership interest of $0 with a fair market value of $100. None of the partners has a capital loss carryforward. ABC distributes to C Unrealized Receivable 1 in a current distribution. Before the distribution, ABC's balance sheet is as follows:[44]

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	0	90	A	0	100
Unrealized Receivable 2	0	30	B	0	100
Real Property	0	180	C	0	100
Totals	0	300		0	300

[43] Reg. § 1.755-1(c)(4).

[44] The left two columns in the grids represent partnership accounts by asset, and the right two columns represent partner accounts.

Before the distribution, the net section 751 unrealized gain of each of the partners is $40 in the case of A, $40 in the case of B, and $40 in the case of C (each has a 1/3 share of the aggregate built-in gain of $120 with respect to the two hot assets). After the distribution, the net section 751 unrealized gain of each of the partners is $10 in the case of A, $10 in the case of B, and $100 in the case of C (each partner's 1/3 share of the remaining $30 built-in gain, with respect to the remaining hot asset, plus C's ownership of the $90 built-in gain with respect to Unrealized Receivable 1).

As a result of this shift, the distribution is a section 751(b) distribution, and each of A and B has a section 751(b) amount of $30 (the difference between the predistribution amount of $40 and the postdistribution amount of $10). The $30 of ordinary income recognized by each of A and B immediately prior to the distribution is deemed to be its respective share of ABC's ordinary income in Unrealized Receivable 1, and A and B each increases its outside basis in its ABC partnership interests by $30. ABC increases its basis in unrealized receivable 1 by $60. The balance sheet of ABC immediately prior to the distribution thus reads as follows as a result of the operation of section 751(b):

	Tax	Book	Capital	Tax	Book
	60	90	A	30	100
Unrealized Receivable 2	0	30	B	30	100
Real Property	0	180	C	0	100
Totals	60	300		60	300

After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1			A	30	100
Unrealized Receivable 2	0	30	B	30	100
Real Property	0	180	C	0	10
Totals	0	210		60	210

Regarding the tax consequences to C, the distributee partner, C's outside basis is $0, so C receives Unrealized Receivable 1 with a $0 basis—that is, the $60 of basis in Unrealized Receivable 1 will be "lost." C will therefore recognize a full $90 of ordinary income when C disposes of Unrealized Receivable 1, and $60 of this ordinary income "duplicates" ordinary income previously picked up by A and B.[45] More importantly, this result puts C in a worse position than if he had received cash proceeds from the sale of Unrealized Receivable 1—recall that in that case, there would have been $60 *capital gain* under section 731.

This situation permits an illustration of the new elective capital gain recognition regime. Under the Proposed Regulations, C may avoid the increase of $60 of ordinary income by electing to recognize $60 of capital gain (effectively C's share of the gain in the real property). Example 7 of the Proposed Regulations would dictate that ABC increases under section 734(b) its basis in the real property by $60 (thereby eliminating C's reverse section 704(c) gain in the real property).[46] Thus, C's outside basis increases by $60, and C receives Unrealized Receivable 1 with a basis of $60—as a result, C will recognize only $30 of ordinary income upon its disposition of that asset. A modified ABC predistribution balance sheet that takes into account this additional gain recognition would read as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	60	90	A	30	100
Unrealized Receivable 2	0	30	B	30	100
Real Property	60	180	C	60	100
Totals	120	300		120	300

After the distribution, the balance sheet would read as follows:

	Tax	Book	Capital	Tax	Book
			A	30	100
Unrealized Receivable 2	0	30	B	30	100
Real Property	60	180	C	0	10
Totals	60	210		60	210

[45] Further, C retains its $10 share of built-in gain in the remaining hot asset, Unrealized Receivable 2, and its 1/3 share of the $180 gain built in to the remaining cold asset ($60). Thus, if ABC sold its remaining assets for cash and liquidated, the sale would generate a $60 built-in loss in C's partnership interest, which now has a $10 fair market value.

[46] Prop. Reg. § 1.751-1(g), Ex. (7) at (iii). The Proposed Regulations reach this conclusion notwithstanding no section 754 election and notwithstanding the general rule that section 734(b) adjustments affect common partnership basis rather than being attributable to a specific partner.

Under Proposed Regulation section 1.751-1(b)(3)(B), a distributee partner elects to recognize capital gain by providing the partnership with written notification of its intent to make the election and reporting the capital gain on the return. The Proposed Regulations do not provide any potential extension period for this partner-level election. We believe Treasury should consider whether an extension of time in which to make the election may be appropriate in certain circumstances.

The results of the new elective gain recognition rule in the Proposed Regulations permit recipients of distributed hot assets to replicate the results of a partnership sale of the same hot assets and distribution of the cash proceeds. We believe that taxpayers should be able to replicate those results and therefore agree with the elective regime permitted by the Proposed Regulations.

c. *Mandatory Recognition of Capital Gain*. The recognition of capital gain is required under the Proposed Regulations where a section 754 election is in effect and recognition is necessary to prevent the distribution from triggering a basis adjustment under section 734(b) that would reduce other partners' shares of net unrealized section 751 gain or loss.[47] In particular, this gain recognition would be necessary where a section 734(b) adjustment arising from a distributee partner's low outside basis was not taken into account in determining the partners' net section 751 unrealized gain or loss immediately after the distribution.

The effect of the new proposed rule can be illustrated using Example 3 of Notice 2006-14. In the example, because A's basis in its partnership interest is $0, the basis of the distributed hot asset would be reduced under section 732(b) to $0 in A's hands. If the partnership had a section 754 election in effect, the partnership would increase the basis of the retained hot asset under section 734(b) by $50. As the ABA Report notes,[48] absent a special rule, the section 734(b) basis adjustment given to the partnership for the extraordinary income ultimately recognized by the distributee partner reduces the ordinary income shares of the other partners. It should be noted that, if taxpayers were permitted to allocate the section 734(b) basis adjustment solely to the distributee partner rather than to common partnership basis, the other partners' ordinary income shares would not be reduced.

Under Proposed Regulation section 1.751-1(b)(3)(ii)(A), if an adjustment to the basis of the distributed section 751 property (here, the downward adjustment to $0 under section 732(b)) results in a section 734(b) basis adjustment (the upward adjustment by $50 under section 734(b)), and that basis adjustment would have altered the amount of net section 751 unrealized gain or loss if the section 734(b) adjustment had been included immediately prior to the distribution, then the distributee partner (A) must recognize

[47] Recognized gain is usually capital but may be ordinary (or dividend) if an election under Regulation section 1.755-1(c)(2)(ii) is in effect (Example 9 in Proposed Regulation section 1.751-1(g)).

[48] *See supra* note 40.

capital gain immediately prior to the distribution in an amount sufficient to eliminate that section 734(b) basis adjustment ($50). The effect of the new rule provides a way to prevent the reduction of non-distributee partners' shares of ordinary income remaining "in the system" without changing the operation of section 734(b).

Consider a second example using facts similar to those of Example 5 of the Proposed Regulations. A, B, and C are each 1/3 partners in a partnership, ABC, that holds Unrealized Receivable 1 with a fair market value of $90, Unrealized Receivable 2 with a fair market value of $30, and nondepreciable real property with a fair market value of $180. The partnership has a section 754 election in effect. Each of the partners has an adjusted basis in its partnership interest of $0 with a fair market value of $100. None of the partners has a capital loss carryforward. ABC distributes to C Unrealized Receivable 1 in a current distribution. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	0	90	A	0	100
Unrealized Receivable 2	0	30	B	0	100
Real Property	0	180	C	0	100
Totals	0	300		0	300

Before the distribution, the net section 751 unrealized gain of each of the partners is $40 in the case of A, $40 in the case of B, and $40 in the case of C (each has a 1/3 share of the aggregate built-in gain of $120 with respect to the two hot assets). After the distribution, the net section 751 unrealized gain of each of the partners is $10 in the case of A, $10 in the case of B, and $100 in the case of C (each partner's 1/3 share of the remaining $30 built-in gain, with respect to the remaining hot asset, plus C's ownership of the $90 built-in gain with respect to Unrealized Receivable 1).

As a result of this shift, the distribution is a section 751(b) distribution, and each of A and B has a section 751(b) amount of $30 (the difference between the predistribution amount of $40 and the postdistribution amount of $10). The $30 of ordinary income recognized by each of A and B immediately prior to the distribution is deemed to be its respective share of ABC's ordinary income in Unrealized Receivable 1, and A and B each increases its outside basis in its ABC partnership interests by $30. ABC increases its basis in Unrealized Receivable 1 by $60. The balance sheet of ABC immediately prior to the distribution thus reads as follows as a result of the operation of section 751(b):

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	60	90	A	30	100
Unrealized Receivable 2	0	30	B	30	100
Real Property	0	180	C	0	100
Totals	60	300		60	300

Under the current rules, following the distribution to C, C's basis in Unrealized Receivable 1 is $0 under section 732(a)(2). Because ABC has made an election under section 754, the distribution of Unrealized Receivable 1 to C would result in a $60 section 734(b) adjustment to Unrealized Receivable 2 (an asset of the same class as the distributed asset).[49] Under the current rules, that basis adjustment would alter the amount of ordinary income immediately prior to the distribution. Thus, absent the new gain recognition rule, immediately prior to the distribution, ABC's balance sheet would read as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	60	90	A	30	100
Unrealized Receivable 2	60	30	B	30	100
Real Property	0	180	C	0	100
Totals	120	300		60	300

The remaining amount of unrealized ordinary income "in the system" has dropped from $60 (the difference between book and tax for both of Unrealized Receivables 1 and 2 together) to $0. A's and B's shares of the remaining unrealized ordinary income would remain unchanged, but C's share would be reduced as a result of the basis adjustment—which makes sense, because C takes the distributed asset with a $0 basis (as a result of the operation of section 732) and therefore holds the asset tainted with the full $90 of unrealized ordinary income inherent in the asset. Thus, if the section

[49] Regarding the tax consequences to C, the distributee partner, C's outside basis is $0, so C receives Unrealized Receivable 1 with a $0 basis. Consider the consequences if the section 734(b) adjustment were not made by ABC - C would therefore recognize a full $90 of ordinary income when C disposes of Unrealized Receivable 1, *and $60 of this ordinary income would duplicate ordinary income previously picked up by A and B*. This result indicates the reason for the Proposed Regulations offering both mandatory and elective capital gain recognition. The mandatory capital gain recognition is necessary to tax the full amount of gain in the system, but the elective capital gain recognition, discussed previously, is offered in order to avoid duplicative taxation where a section 754 election is not made.

734(b) adjustment could be allocated solely to C, the basis increase would not benefit the nondistributee partners, but rather would result in the correct economic result. Instead, under the Proposed Regulations, C must recognize $60 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to Proposed Regulation section 1.751-1(b)(3)(ii)(A). This gain recognition increases C's basis in its ABC partnership interest by $60 immediately before the distribution to C, which eliminates the section 734(b) adjustment.[50]

d. *Basis Adjustments.*

i. *Allocation of a Section 734(b) Adjustment Among the Partners.* Both the mandatory and the optional capital gain recognition provisions respond to the same basic problem: if there is a step-down in basis to a distributed ordinary income asset that triggers an inside basis adjustment under section 734(b), that adjustment as generally understood reduces the ordinary income shares of all of the remaining partners and so represents a shifting of ordinary income from the nondistributee partners to the distributee partner. Recognition of capital gain by the distributee increases the distributee's outside basis, an increase that then avoids the basis step down and so precludes the need for an inside basis adjustment under section 734(b).

While recognition of capital gain by the distributee does solve the basis shifting problem caused by an inside basis adjustment under section 734(b), there is a more direct way to solve this problem without triggering immediate income recognition: If the distributee remains in the partnership after the distribution, all that is necessary is that the section 734(b) basis adjustment be allocated exclusively to the distributee.[51] That is, the section 734(b) basis adjustment should squeeze out some (or all) of the distributee's share of ordinary income in the partnership's remaining ordinary income assets but leave the ordinary income shares of the nondistributee partners unchanged.

If the distributee does not remain a partner after the distribution—that is, if the distribution is a liquidating distribution—then section 734(b) works fine without any change because squeezing out ordinary income from the remaining partners is appropriate when those remaining partners otherwise would acquire the distributee's ordinary income share. Of course, when a partner exits the venture via a liquidating distribution, the exiting partner's share of appreciation and loss in partnership assets necessarily shifts to the remaining partners except to the extent an inside basis adjustment under section 734(b) eliminates the gain or loss. In this case the section 734(b) basis adjustment to the common basis of the assets ensures that the remaining partners see no change in their ordinary income shares.

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[50] In addition, the partnership would increase its basis in Real Property by $60 pursuant to Proposed Regulation section 1.751-1(b)(3)(iii), and would treat C's gain recognized as reducing C's $60 reverse section 704(c) amount in the Real Property. C receives Unrealized Receivable 1 with a basis of $60.

[51] *See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (2004).

While it certainly seems to be the conventional wisdom that section 734(b) basis adjustments are made to the partnership's common basis in its property (and so affect all partners) rather than made on a partner-specific basis, there is in fact no direct authority for either approach. The statute itself says only that "[t]he basis of partnership property shall not be adjusted,"[52] without any specification as to whom the adjustment should benefit. The regulations promulgated under section 734 also shine no light on this question. And while the regulations include four examples of section 734(b) basis adjustments,[53] each of the examples involves only a liquidating distribution as to which, as discussed above, an adjustment to the partnership's common asset basis in favor of all remaining partners is appropriate under either theory. As a result, we recommend that final regulations require distributing partnerships to allocate these section 734(b) adjustments specifically to distributee partners and not require mandatory capital gain recognition (which otherwise would be required if a section 754 election is made).

In both Example 5 and Example 7 of the Proposed Regulations, capital gain recognized by the distributee partner results in a step-up to the basis of the remaining cold asset in the partnership (Real Property) that is allocated solely to the distributee partner and reduces the reverse section 704(c) amount in the cold asset.[54] This conclusion effectively reflects a position that the basis adjustment affects solely the distributee partner. While this result makes logical sense, the Proposed Regulations neither mandate this result nor provide authority for this partner-specific allocation other than under Proposed Regulation section 1.751-1(b)(3)(iii), which contains language that supports this partner-specific allocation, but could be made more specific. We recommend that the final regulations explicitly provide for the allocation of the basis adjustment arising from a distributee partner's capital gain recognition (as mandated or permitted by Proposed Regulation section 1.751-1(b)(3)(ii)(A) or (B)) specifically to the distributee partner.

ii. *Allocation of a Section 734(b) Adjustment in the Absence of Capital Gain Assets.* An additional open issue relates to partnerships that have no remaining capital gain assets to which the basis adjustment arising from the capital gain recognition can be attached. For example, suppose A, B and C are each 1/3 partners in a partnership, ABC, that holds Unrealized Receivable 1 with a fair market value of $250 and Unrealized Receivable 2 with a fair market value of $50. The partnership has a section 754 election in effect. Each of the partners has an adjusted basis in its partnership interest of $0 with a fair market value of $100. None of the partners has a capital loss carryforward. ABC distributes to A Unrealized Receivable 2 in a current distribution. Before the distribution, ABC's balance sheet is as follows:

[52] I.R.C. § 734(a).
[53] *See* Reg. § 1.734-1(b)(1)-(2).
[54] *See supra* note 46.

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	0	250	A	0	100
Unrealized Receivable 2	0	50	B	0	100
			C	0	100
Totals	0	300		0	300

Before the distribution, the net section 751 unrealized gain of each of the partners is \$100 in the case of A, \$100 in the case of B, and \$100 in the case of C (each has a 1/3 share of the aggregate built-in gain of \$300 with respect to the two hot assets). After the distribution, the net section 751 unrealized gain of each of the partners is \$133.33 in the case of A, \$83.33 in the case of B, and \$83.33 in the case of C (each partner's 1/3 share of the remaining \$250 built-in gain, with respect to the remaining hot asset, plus A's ownership of the \$50 built-in gain with respect to Unrealized Receivable 2).[55]

As a result of this reduction in the net section 751(b) unrealized gain (or increase in loss), the distribution is a section 751(b) distribution,[56] and each of B and C has a section 751(b) amount of \$16.67 (the difference between the predistribution amount of \$100 and the postdistribution amount of \$83.33). Under the deemed gain approach, \$16.67 of ordinary income is recognized by each of B and C immediately prior to the distribution, and B and C each increases its outside basis in its ABC partnership interests by \$16.67. ABC increases its basis in Unrealized Receivable 2 by \$33.34. The balance sheet of ABC immediately prior to the distribution thus reads as follows as a result of the operation of section 751(b):

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	0	250	A	0	100
Unrealized Receivable 2	33.34	50	B	16.67	100
			C	16.67	100
Totals	33.34	300		33.34	300

[55] If the partnership had sold Unrealized Receivable 2 for cash and then distributed the proceeds to A, each of the three partners would have realized \$16.67 of ordinary income, and A would have recognized \$33.33 of capital gain under section 731.

[56] The NYSBA Report suggests that treatment of this distribution as a section 751 distribution is inappropriate, as the partners have not exchanged an interest in a hot asset for an interest in a cold asset (because the partnership owns no cold assets).

After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	0	250	A	0	50
			B	16.67	100
			C	16.67	100
Totals	0	250		33.34[57]	250

Following the distribution to A, A's basis in Unrealized Receivable 2 is $0 under section 732(a)(2), a $33.34 basis step-down. Because ABC has elected under section 754, the distribution of Unrealized Receivable 2 to A would result under current law in a $33.34 section 734(b) adjustment to Unrealized Receivable 1 (an asset of the same class as the distributed asset).[58] Absent the gain recognition rule in the Proposed Regulations, that basis adjustment would alter the amount of net section 751 unrealized gain or loss of the partners immediately prior to the distribution.

Instead, under the Proposed Regulations, A must recognize $33.34 of *capital gain* prior to the distribution of Unrealized Receivable 2 pursuant to Proposed Regulation section 1.751-1(b)(3)(ii)(A). This gain recognition increases A's basis in its ABC partnership interest by $33.34 immediately before the distribution to A, which eliminates the step-down and the associated section 734(b) adjustment. However, Proposed Regulation section 1.751-1(b)(3)(iii) does not clarify which asset would be affected by the basis adjustment associated with the capital gain recognition. Each of the Examples in the Proposed Regulations contains a remaining capital gain asset, the basis of which is stepped up in connection with the distributee partner's capital gain recognition. Here, the Proposed Regulations would seem to require a step-up to the basis of Unrealized Receivable 1, because it is the sole remaining asset in the partnership. However, this step up would mean that the distributee partner recognized capital gain and yet also will benefit from a basis increase affecting an ordinary-income asset. In this situation, we recommend that final regulations clarify that the basis adjustment associated with the

[57] After the distribution but before the tax consequences of the Proposed Regulations, both B and C would have tax capital accounts of zero.

[58] Regarding the tax consequences to A, the distributee partner, A's outside basis is $0, so A receives Unrealized Receivable 1 with a $0 basis. Consider the consequences if the section 734(b) adjustment were not made by ABC – A would therefore recognize a full $50 of ordinary income when A disposes of Unrealized Receivable 1, *and $33.34 of this ordinary income would duplicate ordinary income previously picked up by B and C.* This result indicates the reason for the Proposed Regulations offering both mandatory and elective capital gain recognition. The mandatory capital gain recognition is necessary to prevent the reduction of ordinary income in the system, but the elective capital gain recognition is offered in order to avoid this "duplicative" taxation (which impacts A as a conversion of capital gain to ordinary income).

distributee partner's capital gain recognition attaches to a capital asset. A partnership with no remaining capital gain assets should suspend the basis adjustment until additional capital property is acquired (similar to the rule in Regulation section 1.755-1(c)(4)).

The new capital gain recognition rules in the Proposed Regulations eliminate the reduction of unrealized ordinary income attributable to non-distributee partners. However, we note that providing for partner-specific section 734(b) basis adjustments to remaining partnership property can accomplish the same end. As a result, we recommend that the final regulations require partner-specific section 734(b) adjustments that accomplish this purpose. Further, in a situation involving a partnership with no remaining cold assets, we recommend that final regulations clarify that the section 734(b) basis adjustment arising from the distributee partner's capital gain recognition may affect only capital property.

e. *The Capital Gain Rate*. Regarding mandatory capital gain recognition, Proposed Regulation section 1.751-1(b)(3)(ii)(A) states, "the distributee partner must recognize capital gain . . . ." Likewise, regarding elective capital gain recognition, Proposed Regulation section 1.751-1(b)(3)(ii)(B) states, "A distributee partner may elect to recognize capital gain . . . ." However, the Proposed Regulations do not specify whether this capital gain is long-term or short-term nor which of the several capital gain rates apply.

In some circumstances, the mandatory or optional capital gain arises in connection with the distribution of a capital asset from the partnership, and in such circumstances it might be reasonable to treat the mandatory or optional capital gain as attributable to the distributed asset. But it seems equally appropriate to treat the mandatory or optional capital gain as arising from unrealized capital assets continuing to be held by the partnership immediately after the distribution, suggesting that a look-thru rule might be appropriate. However, the mandatory and optional capital gain could be triggered by a distribution of high-basis inventory from a partnership that owns only ordinary income assets, a situation that would require its own separate rule.

We believe this is an area that calls for simplicity, and we propose that the mandatory and optional capital gain be treated as gain from the sale or exchange of a capital asset other than a collectible. We also recommend that the capital gain not be treated to any extent as unrecaptured section 1250 gain. Further, we propose that the gain be treated as long-term or short-term based on the distributee partner's holding period in his partnership interest.[59] In support of this proposal beyond its simplicity, we note that capital gain triggered under section 731(a)(1) by a partnership distribution of cash is not subject to a look-thru rule for determining the appropriate capital gain rate.[60]

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[59] See Reg. § 1.1(h)-1(f), Ex. (5) for the possibility that a partner has a mixed holding period in his partnership interest.

[60] Reg. § 1.1(h)-1(b)(ii) (final sentence).

B. *Reporting Requirement for Tiered Partnerships*

An upper-tier partnership subject to section 751(b) that owns an interest in a lower-tier partnership should account for the lower-tier partnership's ordinary income assets in applying section 751(b), but that can be difficult because the upper-tier partnership often will not have sufficient information about its share of the lower-tier partnership's assets.[61] This problem is exacerbated if the upper-tier partnership distributes its interest in the lower-tier partnership, because in that case the distribution effectively shifts ordinary income assets indirectly owned by all the partners of the upper-tier partnership to the distributee partner.

We believe it is unrealistic to ask every lower-tier partnership to revalue its assets every time a distribution is made by an upper-tier partnership. However, it also seems inappropriate to permit an upper-tier partnership to ignore the ordinary income aspects of every lower-tier partnership interest that it owns. We believe a reasonable accommodation is to require every partnership in which there is a partner that is a partnership to report to its partners the partners' shares of the partnership's ordinary income assets at the end of each partnership year as well as whenever the reporting partnership (that is, the lower-tier partnership) revalues its assets. For this purpose, the reporting partnership should be permitted to use the book value of its assets or the actual fair market value of its assets. While book value is not a perfect substitute for fair market value, it can be a reasonable approximation and should impose no additional cost on the reporting partnership to determine. We assume that in a particular reporting cycle, a partnership could use book value or fair market value but would be required to be consistent in its choice across both its assets and its partners.

C. *Interaction with Other Code Provisions*

1. *Coordination with Sections 1245 and Similar Provisions*

Under the final flush language of section 751(c), the depreciation recapture component described in section 1245 of an asset otherwise not captured by section 751 is treated as an "unrealized receivable." As a result, a capital asset can contain within it an unrealized receivable to the extent that the disposition of the asset for current fair market value would yield ordinary income under section 1245. Proposed Regulation section 1.755-1(c)(2)(iii) ensures that basis adjustments allocable to the class of capital assets (including assets described in section 1231) be made in a way that ensures the adjustment reduces capital gain (including gain described in section 1231) but does not reduce ordinary income within the partnership's assets.

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[61] While section 741 generally treats a partnership interest as a capital asset, it expressly provides that this characterization is subject to the exceptions provided in sections 751(a) and 751(b).

We believe there are two ambiguities in these rules that should be clarified in the final regulations. First, the Proposed Regulations provide that "[a]ny increase in basis allocated to capital gain property" is allocable to the non-ordinary income component of an asset that includes both ordinary and non-ordinary income components.[62] This result is achieved in the Proposed Regulations by providing that such a basis increase is not taken into account in computing recomputed basis or adjusted basis for purposes of section 1245(a)(1). By ignoring basis increases in computing recomputed basis and adjusted basis, the amount of depreciation recapture is unaffected by the basis increase.

We believe there should be a companion provision providing that any increase in basis allocated to ordinary income property *is* taken into account in computing recomputed basis and adjusted basis for purposes of section 1245(1). While a technical reading of the language of the Proposed Regulations arguably leads to this conclusion, we believe that clarity of the regulations would be significantly improved if an express rule were included applicable to basis increases attributable to ordinary income assets.

In addition, we believe that the Proposed Regulations inappropriately deflect non-ordinary income basis adjustments away from section 1231 property. Proposed Regulation section 1.755-1(c)(2)(iv) provides:

> Any increase in basis allocated to capital gain property pursuant to the second sentence in paragraph (c)(2)(i) of this section *is not taken into account in determining section 1231 gain and loss*, as defined in section 1231(a)(3). Any basis adjustment to an asset not taken into account pursuant to this paragraph (c)(2)(iv) shall be treated as gain from the sale or exchange of a capital asset with the same holding period as the underlying asset. (emphasis added)

We see no statutory basis for the language italicized in the quotation above. First, section 751 carefully distinguishes between a partnership's ordinary income assets and its other assets, but it draws no distinction within the class of non-ordinary income assets. Consequently, we see no basis for the regulations drawing a distinction that does not appear in the statute. Second, a basis adjustment provided by section 1.755-1(c)(2)(i) of the Proposed Regulations can be triggered by the distribution of an asset described in section 1231, and it seems particularly inappropriate in such circumstances to deny section 1231 treatment to such a basis adjustment.

Consider, for example, a partner who has a $1,000 outside basis and receives in a distribution certain non-depreciable real estate used by the partnership in its trade or business and with a holding period in the hands of the partnership in excess of one year. Such an asset is described in section

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[62] Prop. Reg. § 1.755-1(c)(2)(iii). A similar rule is applied to property described in sections 617, 855, 1248, 1250, 1252, and 1254, other classes of property that can contain an ordinary income component (captured by the final flush language of section 751(c)) within an asset that is otherwise not described in section 751(c).

1231, and, if the partnership's adjusted basis in the real estate equals $1,200, then the distributee partner must step-down the basis to $1,000 pursuant to section 732(a)(2). That basis step-down triggers a positive basis adjustment to the remaining non-ordinary income assets of the partnership pursuant to section 734(b)(1)(B), and that basis adjustment is described as "allocated to capital gain property pursuant to the second sentence in paragraph (c)(2)(i)."

The step-down in basis to the distributed real estate will increase the amount of gain or decrease the amount of loss recognized upon the taxable disposition of the real estate. The basis adjustment provided by section 734(b)(1)(B) will decrease the amount of gain or increase the amount of loss in undistributed assets of the partnership, precisely offsetting the effect of the basis step-down in the distributed real estate triggered by section 732(a)(2). But while the basis step-up provided by section 734(b)(1)(B) ensures an offsetting *amount* of gain or loss, it does not by its terms require that the character of the offsetting gain or loss matches. Section 755 provides that a basis step-down in distributed ordinary income assets is offset by a basis adjustment to undistributed ordinary income assets and that a basis step-down in distributed non-ordinary income assets is offset by a basis adjustment to non-ordinary income assets. However, nothing in the statute ensures that the distribution of an asset described in section 1231 triggering a basis adjustment under section 734(b)(1)(B) will yield an offsetting basis adjustment *to an undistributed asset described in section 1231*.

The Proposed Regulations provide precisely the opposite of the correct rule: as quoted above, the inside basis adjustment triggered by the distribution of an asset described in section 1231 will give rise to an adjustment that "is not taken into account in determining section 1231 gain and loss." We believe that the final regulations should either (a) omit Proposed Regulation section 1.755-1(c)(2)(iv) in its entirety or (b) provide that a basis adjustment provided by section 734(b)(1)(B) triggered by the distribution of an asset described in section 1231 should be made to undistributed assets of the partnership described in section 1231 to the extent the partnership owns such assets.

A second issue arises in connection with section 751(b) when property subject to an allowance for depletion is contributed to a partnership. The preamble to the Proposed Regulations states, in part, that "[a] partner's net section 751 unrealized gain or loss includes any remedial allocations under §1.704-3(d),"[63] a result generally consistent with Regulation section 1.1245-1(e)(2)(ii)(C)(3). However, section 1254(a)(1)(A)(ii) provides that potential recapture amounts only include "deductions for depletion under section 611 *which reduced the adjusted basis of such property*" (emphasis added), and Regulation section 1.704-3(d)(4)(i) provides, in part, that "[r]emedial items…do not affect the partnership's adjusted tax basis in partnership property."

[63] *See* 79 Fed. Reg. 65,151, 65,155 (Summary of Comments and Explanation of Provisions (General Principle)).

A remedial deduction is not treated as depletion for purposes of potential ordinary income recapture treatment under section 1254 and is not depletion under section 611 or for purposes of section 705(a)(3) because the partner receiving the remedial deduction cannot have a corresponding depletable basis allocation under section 613A(c)(7)(D). Under Regulation section 1.1254-5(c)(1), the contributing partner of depletable mineral property retains all of its precontribution section 1254 recapture potential for those contributed properties. Further, upon the disposition of section 1254 property by a partnership, the amount treated as ordinary income is determined at the partner level based on the partner's section 1254 costs with respect to the depletable mineral property being disposed of.

For example, section 1245 depreciation recapture potential on a section 721 contribution of depreciable property is transferred to the partnership. The amount of precontribution depreciation recapture potential allocable to the recipient of the remedial deductions is determinable at the partnership level and will be calculated by the partnership in accordance with (and so as not to exceed the amount provided under) the regulations (*e.g.*, total depreciation recapture potential limited to depreciation reducing the basis of the asset).[64]

However, as noted, in the event of a disposition of natural resource recapture property by a partnership, the amount treated as ordinary income under section 1254 generally is determined at the partner level.[65] Thus, section 1254 recapture potential is not transferred to the partnership on a section 721 contribution of depletable mineral property and the partnership may not have the information needed to determine the amount of precontribution section 1254 recapture potential to be allocated to the recipient of the remedial deductions.

We recommend that an example be provided that includes the interaction of sections 751(b), 1245, and 1254 when a partnership uses the remedial allocation method for property contributed to the partnership that is subject to an allowance for depletion.

2. *Coordination with Section 1248*

a. *Section 1248 Stock Owned by a Domestic Partnership with Domestic Partners*. Section 751(c) states that unrealized receivables include "stock in certain foreign corporations (as described in section 1248)," *i.e.*, foreign corporation stock that meets certain United States person (a "U.S. person")

[64] *See* Reg. § 1.1245-1(e)(2)(ii)(C)(3)-(4).

[65] *See* Reg. § 1.1254-5(b). Section 1254 recapture is composed of oil and gas depletion (not in excess of tax basis) and intangible drilling and development costs (IDC). For example, under section 613A(c)(7)(D) the depletable tax basis in an oil and gas property is allocated to the partners and reported on Schedule K-1 of Form 1065 and each non-passthrough partner computes and reports depletion on its own return. Each non-passthrough partner may currently deduct all of its share of IDC or elect to capitalize and amortize any dollar amount of its IDC share under section 59(e).

ownership tests that is sold for a gain, and which gain, pursuant to section 1248(a), generally is included in the income of the US person as a dividend to the extent of the foreign corporation's earnings and profits.[66] More specifically, section 1248(a) provides that if a United States person sells or exchanges stock in a foreign corporation and such person owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), ten percent or more of the total voting power of all classes of voting stock of the foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation as defined in section 957 (a "CFC"), then the gain recognized upon the sale or exchange is included in the gross income of the person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the stock. For this purpose, a domestic partnership is considered to be a U.S. person and, if the partnership meets the 10 percent voting power threshold, domestic partners in the partnership are subject to section 1248 on gain from a sale or exchange of the stock by the partnership.

Regulation section 1.751-1(c)(4)(iv) clarifies that the term unrealized receivables includes "the amount that would be treated as gain to which section 1248(a) would apply if [at the time of the distribution] the stock were sold by the partnership at its fair market value (referred to as the "section 1248 amount)." Because the section 1248 amount is included as section 751 property, each partner's pre- and post-distribution share of the section 1248 amount is considered in determining whether a partner has a section 751(b) amount and thus whether a section 751(b) distribution has occurred.

Section 751(b), the current regulations thereunder[67] and under section 731,[68] and the Proposed Regulations[69] each treat section 751(b) as giving rise to a deemed sale or exchange between the partnership and the relevant partners(s). Whether that applies for all purposes of the Code is not expressly stated, though section 1.751-1(b)(1) carves out section 707 and not other provisions.

Examples 8 and 9 of the Proposed Regulations[70] illustrate the impact of a distribution of section 1248 stock by a domestic partnership to one of three

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[66] For purposes of section 1248, a U.S. person is treated as having sold or exchanged any stock if the person is treated as realizing gain from the sale or exchange of the stock under any income tax provision of the Code. Under section 1248(g)(2)(B), section 1248 does not apply to any amount to the extent such amount is, under any other provision of this title, treated as ordinary income.

[67] Reg. § 1.751-1(b)(1).

[68] Reg. § 1.731-1(b).

[69] Prop. Reg. § 1.751-1(b)(1), -1(b)(3)(ii)(A), -1(g), Ex. (8)(v) and (vii), Ex. (9)(ii).

[70] Prop. Reg. § 1.751-1(g), Ex. (8)-(9).

domestic partners.[71] In Example 8, a domestic partnership is owned in equal shares by three domestic corporations, A, B, and C.[72] The partnership owns all of the stock of two CFC's, X and Y, and because the partnership meets the ownership requirements of section 1248 with respect to the stock of X and Y, the stock of X and the stock of Y constitute section 1248 stock. The section 1248 amount associated with the stock of X is $135 ($45 allocable to each of A, B. and C), and the section 1248 amount associated with the stock of Y is $27 ($9 allocable to each of A, B and C.)

In Example 8, all of the stock of Y (having a fair market value of $30 and an adjusted basis of $3) is distributed to A in a non-liquidating distribution at a time when A's partnership interest has a fair market value of $60 and an adjusted basis of $6. The distribution increases A's section 1248 amount by $18 and reduces B and C's section 1248 amount (and thus each of B's and C's net section 751 unrealized gain) by half of that amount each. Because the distribution reduces the amount of net section 751 unrealized gain that would be allocated to B and C from a sale of Y stock by the partnership, B and C each have a section 751(b) amount, and the distribution of the Y stock results in a section 751(b) distribution. Example 8 analyzes the tax consequences of the section 751(b) distribution using two approaches.

In the portion of Example 8 in which the partnership is assumed to use the deemed gain approach, B and C are each deemed to recognize $9 of gain, includible as a dividend with respect to the distribution of Y stock. The example states that the gain recognition "is treated as a sale or exchange for purposes of section 1248," invoking section 1248(a) and the recognition of ordinary dividend income by B and C, but do not explicitly describe the deemed seller or deemed purchaser.

In the portion of Example 8 in which the partnership is assumed to use the hot asset sale approach, immediately before the section 751(b) distribution, each of B and C is deemed (1) to receive a distribution of a portion of the partnership's Y stock with a fair market value of $9 and an adjusted basis of $0, (2) to sell the Y stock back to the partnership for $9, recognizing $9 of gain includible as a dividend under section 1248(a), and then (3) to contribute the $9 to ABC.

Example 8 concludes that both the deemed gain approach and the hot asset sale approach are reasonable (provided that the partnership applies the approach consistently) because in each case, B and C recognize ordinary income equal to their section 751(b) amounts (*i.e.*, the amount by which their share of ordinary income is reduced).[73]

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[71] This statement is true to the extent it is limited by the cap on ordinary income recapture provided in section 1245(a)(1) because remedial allocations can shift section 1245 recapture potential among partners but cannot create additional recapture potential. Reg. § 1.1245-1(e)(2)(ii)(C)(4), (iv)(B).

[72] The example does not indicate whether A, B and C are related.

[73] Prop. Reg. § 1.751-1(b)(3)(i).

Because Proposed Regulation section 1.751-1(b)(3)(i) does not specify a particular approach under which each partner with a section 751(b) amount recognizes ordinary income, there is both flexibility *and uncertainty* regarding the overall tax consequences associated with the selection of an approach. Apparently, any transaction under which any partner with a section 751(b) amount recognizes ordinary income equal to the section 751(b) amount could be considered.[74]

For example, if deemed gain recognized under the deemed gain approach is considered to arise from a sale or exchange of the section 1248 stock by the ABC partnership to A[75] in exchange for consideration, and if A and one or more other partners of ABC are in a section 304 control group, the transaction could be recast under section 304. Under section 304, if one or more persons are in control of two corporations and in return for property one of the corporations acquires stock in the other corporation from the person so in control, then the consideration received is treated as a distribution in redemption of the stock of the corporation acquiring the stock. If the distribution of consideration to the redeemed transferor is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated as if the transferor had transferred the stock so acquired to the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation redeemed the stock of the acquiring corporation.

If ABC partnership is considered to be in control of A (a corporation) at the time of the sale due to one or more affiliated partners,[76] a sale of the stock of Y by the partnership may be recast as a contribution by the partnership of the stock of Y to A in exchange for A stock in a transaction governed by section 351(a) followed by a redemption of the newly issued A stock by A in a transaction subject to section 301 (*i.e.*, potentially in a dividend equivalent redemption).

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[74] The additional requirement that the method be "consistent with the purpose" of section 751(b) does not appear to add any restrictions. *See* 79 Fed. Reg. 65,151, 65,155 (Summary of Comments and Explanation of Provisions (General Principle)). ("The purpose of section 751 is to prevent a partner from converting its share of potential ordinary income into capital gain.").

[75] *See* notes 66-68 *supra* and accompanying text. *But see, e.g.*, I.R.C. § 311(b)(1) (providing that if a corporation distributes property to a shareholder in a distribution to which subpart A applies, and the property's fair market value exceeds the corporation's adjusted basis in the property, then the corporation recognizes gain as though the property had been sold *to the distributee* at its fair market value).

[76] The ABC partnership may be considered to constructively own the stock of A under section 318. Control for purposes of section 304 is determined considering the attribution rules of section 318(a) relating to constructive ownership of stock. Under the modified version of the attribution rules provided by section 304(c)(3), ABC partnership may be attributed ownership of the A stock in certain circumstances, causing the partnership to be treated as being in control of both Y and A. For example, if A, B, and C were all wholly owned by parent corporation P, P's stock in A may be treated as owned by B and C under section 318(a)(3)(C) and in turn, A stock considered as owned by B and C may be attributed to the ABC partnership under section 318(a)(3)(A).

Such a transaction may also give rise to ordinary income that is recognized by B and C, but the ordinary income is not necessarily attributable to the earnings and profits of Y, nor is it attributable to section 1248 as section 1248 does not apply to a transaction in which gain is not recognized.[77] Further, under section 304(b), the determination of an amount constituting a dividend to the partnership would be made by reference to the earnings and profits of A (and not Y) to the extent of its earnings and profits and only thereafter by reference to the earnings and profits of Y.[78]

Because the nature of the transaction that underlies the recognition of deemed gain is not specified, the deemed gain approach seems to be intended not to attract these collateral issues. We recommend that, when finalized, the Regulations clarify that the deemed gain approach will not be given effect for any other purpose as a partnership-level sale of the assets.

b. *Indirect Foreign Tax Credit Issue*. Another collateral consideration is generation and allocation of foreign income tax credits. If the deemed gain is considered to have arisen from an actual sale of the section 1248 stock, foreign taxes related to that income may be available as a credit to B and C under section 902(a).[79] If a partner or a partnership recognizes ordinary income as a result of a distribution taxable under section 751(b), then, subject to the possible application of section 1248(g), the appropriate approach would be to allow the partner or partnership to treat the ordinary income recognized as a deemed dividend that carries the possibility of a section 902 deemed-paid credit to the extent it relates to a section 1248(a) amount, regardless of which approach the partnership adopts for purposes of applying section 751(b). As discussed below, by referring to the ordinary income recognized with respect to the CFC stock in Examples 8 and 9 of the Proposed Regulations as a "dividend," the IRS and Treasury may have concluded that the ordinary income recognized with respect to the CFC stock carries the possibility of a section 902 deemed-paid credit. In our view, however, the Service and the Treasury should provide clarity by specifically providing for this result in the final Regulations.

As discussed above, Example 8 analyzes the tax consequences of the section 751(b) distribution considering both the hot assets sale approach and the deemed gain approach. In both cases, the example refers to the ordinary income recognized with respect to the CFC stock as a "dividend." Similarly, ordinary income recognized with respect to a distribution of CFC stock is referred to in Example 9 as a "dividend."

Consistently with the deemed sale or exchange treatment provided under section 751(b) generally as well as in the last sentence of section 1248(a), by

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[77] Reg. § 1.1248-1(c).

[78] A similar issue may arise in the event of a deemed sale or exchange involving loss property. If the recognition transaction is considered to involve a sale to a related party, the loss may be deferred under section 267 or section 707(b).

[79] I.R.C. § 902(a).

referring to the ordinary income recognized with respect to the CFC stock as a dividend, these examples at least imply that the ordinary income recognized with respect to the CFC stock is the same "dividend" type that would be recognized on an actual sale of the CFC stock under section 1248. Thus, the party treated as selling or exchanging the CFC stock seems to have satisfied the first requirement for a section 902 deemed paid credit (*i.e.*, there has been a sale or exchange of CFC stock). Whether the partnership is treated as selling the stock (deemed gain approach) or the partner is treated as selling the stock (hot asset sale approach), if the partner is a domestic corporation owning at least 10 percent of the voting power of the CFC shares, the deemed sale may permit a deemed-paid section 902 credit.

Section 1248(g) displaces the applicability of section 1248 in any case in which, in so far as relevant here, another provision of the Code provides for ordinary income treatment. In assessing the potential applicability of section 1248(g) in the context of section 751(b), relevant considerations include that there would be no sale or exchange and hence section 1248 would not apply, but for the deemed sale or exchange treatment provided under section 751(b). On the other hand, section 751 provides for ordinary income treatment only because that treatment is provided under section 1248 and thus, but for section 1248, section 751 would have no application. We recommend that final regulations resolve any ambiguities regarding the interaction of sections 1248(a) and 902 with section 751(b).

As noted above, Examples 8 and 9 refer to "dividends" under section 1248, but the Proposed Regulations do not refer to section 1248(g) or discuss why it does not apply. We note that the preamble to the section 1248 regulations finalized in 2007[80] indicated that Treasury and the Service were at that point of the view that section 1248(g) did apply to the sale of an interest in a foreign partnership, and specifically narrowed the wording of Regulation section 1.1248-1(a)(4) to be consistent with that view. The Proposed Regulations create two alternative constructs under section 751(b) and, if either were the actual transaction, it would be governed by section 1248 and not by section 751; those constructs, however, are created under section 751. Accordingly, we believe the guidance should be clear on this point.

In this regard, we would note that, in the case of both a domestic partnership and a foreign partnership, the fact is that dividend treatment or any other ordinary income treatment would not result from a distribution within the aegis of section 751(b) *but for* section 1248. On that basis, we believe it to be appropriate for the Treasury and the Service to conclude that section 1248(g) is not an obstacle to treating the income included under section 751(b) that results from section 1248 stock as eligible for section 902 credits in the case of a domestic corporate partner satisfying the 10 percent voting power threshold, and we so recommend. A clear statement with respect

[80] T.D. 9345 (2007).

to both the deemed gain approach and the hot asset sale approach would be helpful.

In Example 9, the facts are the same as Example 8, except that the partnership is assumed to make an election under Proposed Regulation section 1.755-1(c)(2)(vi) not to apply Proposed Regulation section 1.755-1(c)(2)(v) and Proposed Regulation section 1.732-1(c)(2)(v). Those sections provide (in the context of Example 9) that (i) any decrease in the basis of the distributed Y stock is not taken into account in determining the amount of gain recognized on a sale or exchange of the stock for purposes of section 1248, and (ii) any increase in basis under section 734(b) allocated to stock of a foreign corporation is not taken into account in determining the amount of gain recognized on the sale or exchange of the stock for purposes of section 1248(a). Because of the election, the rules that turn off consideration of basis adjustments arising from the distribution are themselves turned off, and the amount of A's post distribution section 1248 amount in the stock of Y is determined by reference to any adjustment in the basis of distributed stock made under Regulation section 1.732-1(c)(i) or (ii). Because these adjustments would affect the amount of section 1248 gain allocable to ABC (*i.e.*, a decrease in the adjusted basis of Y stock under section 732(a)(2) would result in an increase in the adjusted basis of X stock under section 734(b)(1)(B) that would be taken into account in determining the amount of section 1248 gain recognized by ABC), A is required to recognize gain immediately prior to the distribution in an amount equal to the basis reduction. This gain recognition increases A's basis in its partnership interest, eliminating any reduction in the basis of the distributed Y stock, and in A's share of the retained X stock.

Example 9 indicates that the gain recognition by A is "with respect to the X share pursuant to [Proposed Regulation section 1.751-1(b)(3)(ii)(A).]"[81] Example 9 indicates that the partnership treats the $15 of dividend income recognized by A as reducing A's reverse section 704(c) amount in the X stock created upon the revaluation of partnership property in advance of the distribution. As a result of this transaction, A has preserved its pre-distribution share of section 1248 gain in the Y stock and recognized currently ordinary income with respect to A's portion of the X share retained in order not to decrease the amount of section 751(b) income of B and C. By forcing A to recognize gain, A is unable to shift the amount of A's ordinary income in the X stock to the Y stock on a tax free basis. The Proposed Regulations might have permitted A to increase A's share of ordinary income associated with the Y stock had the section 734(b)(1)(B) basis adjustment arising from the distribution been allocated solely to Y's share of the basis of the retained X

[81] Proposed Regulation section 1.751-1(b)(3)(ii)(A) generally provides for the mandatory recognition of capital gain, but in the case where the partnership has made the election under Proposed Regulation section 1.755-1(c)(2)(vi) to have the basis adjustments affect the amount of section 1248 gain, the partner must characterize all or a portion of the gain recognized as ordinary income or as a dividend.

stock. As discussed above, we recommend such an approach to the allocation of section 734(b) adjustments.

c. *Section 1248 Stock Owned by a Domestic Partnership with Foreign Partners*. As Examples 8 and 9 of the Proposed Regulations indicate, stock constituting section 1248 stock in the hands of a distributing partnership for purposes of allocating income to partners generally[82] also constitutes section 1248 stock in the hands of a distributee partner that is a U.S. person and meets the 10% voting power threshold under section 1248.[83] However, stock constituting section 1248 stock in the hands of a distributing partnership may not constitute section 1248 stock in the hands of, *e.g.*, a foreign distributee partner (other than a CFC meeting the 10 percent voting power requirement).[84] This is because the amount of any gain from the sale of the stock by a foreign distributee to which section 1248 would apply would be zero in the case where the foreign distributee is not a U.S. shareholder (or such a CFC).[85]

Though not expressly articulated, the Proposed Regulations appear to apply to a distribution of section 1248 stock by a domestic partnership having both U.S. and non-U.S. partners. All else being equal, the net section 751 unrealized gain or loss of a U.S. distributee meeting the 10 percent voting threshold following the distribution would tend to increase on account of a distribution of section 1248 stock by the excess of the section 1248 amount attributable to the shares received over the distributee's distributive share of the total section 1248 amount. Correspondingly, the net section 751 unrealized gain or loss of the non-distributee partner or partners, including any foreign partners, would be reduced, giving rise to section 751(b) amounts. Under Proposed Regulation section 1.751-1(b)(2)(iii), the amount of a non-distributee partner's net section 751(b) unrealized gain or loss on a post distribution basis is measured by reference to the amount of section 1248 income that would be allocated to the partner if the partnership disposed of all of the partnership's assets. The fact that the foreign non-distributee partners would not be subject to U.S. tax on gain from a sale of the stock (assuming it is not an effectively

[82] Assuming section 1248 earnings and profits, a sale or exchange by the partnership would result in a deemed dividend under section 1248 even to a U.S. partner that is considered to own (including under section 958) less than 10% of the voting power in the underlying controlled foreign corporation.

[83] If tested immediately following the distribution, the stock apparently would cease to be section 1248 stock in the hands of a U.S. person not meeting the 10 percent voting threshold (even though a sale or exchange by *the partnership* prior to the distribution could result in a deemed dividend under section 1248 for such a partner). The five-year rule would not seem applicable to such a partner.

[84] If the foreign distributee partner is itself a CFC and would be subject to section 1248 on a sale or exchange of the stock if a U.S. person, then the stock generally would constitute section 1248 stock, by reason of section 964(e)(1). A deemed sale is treated as an actual sale for such purpose. I.R.C. § 964(e)(3).

[85] For simplicity, the references to a foreign partner in the discussion below assumes such partner is not such a CFC.

connected asset of the partnership) apparently is irrelevant to the operation of section 751(b). A reduction in the amount allocated to a foreign partner would still be a section 751(b) amount under Proposed Regulation section 1.751-1(b)(3)(i), though the foreign partners generally would not be taxable on the amount allocable under section 751(b).[86]

If stock constituting section 1248 stock in the hands of a domestic partnership is distributed to a foreign partner, the net section 751 unrealized gain or loss of both the non-distributee partner or partners and the distributee foreign partner is reduced. Pursuant to Proposed Regulation section 1.751-1(b)(3)(i), the partners would be required to recognize ordinary income (which generally would be taxable only to U.S. partners). This appears to be the correct result from a section 751(b) perspective as the amount of ordinary income otherwise allocable to U.S. partners and subject to U.S. income tax is departing the U.S. tax base.

If the deemed gain approach is adopted, immediately before a distribution of section 1248 stock by a domestic partnership to a non-U.S. partner, each U.S. partner (regardless of such partner's share of voting power in the corporation) would be deemed to recognize ordinary income equal to such partner's reduction in net section 751(b) unrealized gain or loss,[87] and the partnership would be deemed to distribute the stock to the non-U.S. partner. Because the non-U.S. distributee is not subject to U.S. tax on gain from the stock (under section 1248 or otherwise), the section 755 election is irrelevant to it. An election to take any basis adjustment into account and any resulting required gain recognition by the non-U.S. distributee may be meaningless in terms of U.S. income tax liability to the non-U.S. distributee, but may benefit non-distributee CFC partners (if for example, the resulting basis adjustment to retained partnership property were to reduce subpart F income), as well as non-distributee U.S. partners.

If the hot asset sale approach is adopted, the partnership would be deemed to distribute to each non-distributee partner the portion of such partner's share of the section 1248 stock corresponding to a section 751(b) inclusion in respect thereof, which each such partner would be deemed to sell back to the partnership for cash, followed by a deemed contribution of the cash to the partnership.

As suggested above, if one or more of the non-distributee partners of the domestic partnership is not a U.S. person owning at least 10% of the voting power of the CFC, a deemed gain approach, but not a hot asset sale approach may result in "ordinary income" with respect to the such non-distributees (but generally would be nontaxable foreign source gain in the case

[86] *See* I.R.C. §§ 871, 872, 881, 882.

[87] It is unlikely that the distributive share of ordinary income from the deemed gain approach would be subject to withholding by the partnership to the extent allocable to the non-U.S. partner under section 1411 or section 1446 as generally the amounts would not be US fixed or determinable annual or periodical income (FDAP) and only rarely would the deemed gain be considered U.S. source income or effectively connected income to the non-U.S. partners.

of non-U.S. persons). More specifically, because the person selling the stock in the deemed gain approach is the partnership and the partnership is a US person, the deemed gain will result in the recognition of ordinary income by the partnership and its allocation to the partners who have section 751(b) amounts. On the other hand, if, pursuant to a hot asset sale approach, the section 1248 stock is deemed distributed to the non-distributee partners, in the case of any such partner that is not a U.S. person owning at least 10% of the voting power of the CFC, the stock would not constitute section 1248 stock in its hands and hence a disposition of the stock by such distributee partner would not give rise to a section 1248 amount. Although this distinction would exist, and thus the hot asset method may be more advantageous for small U.S. non-distributee partners, we do not think that the absence of ordinary income treatment for such partners in this context should cause that method to be unavailable.

d. *Distribution of Section 1248 Stock by a Foreign Partnership*. In general, a partnership is treated as an entity for purposes of applying section 741. On that basis, stock owned by a foreign partnership, regardless of the residence, citizenship or place of incorporation of its partners, generally would not constitute section 1248 stock in the hands of the foreign partnership because section 1248 applies only if the stock is sold by a U.S. person. Thus, stock owned by a foreign partnership generally would not constitute section 751 property within the meaning of Proposed Regulation section 1.751-1(e). While a distribution of foreign corporation stock to a U.S. partner may increase the distributee partner's net section 751 unrealized gain or loss (since the stock may constitute section 1248 stock in the hands of the U.S. distributee partner), and conversely, a distribution to a non-U.S. partner may result decrease a U.S. non-distributee partner's net unrealized section 751 gain or loss,, an increase or decrease in the amount of net section 751 unrealized gain or loss apparently would not give rise to a section 751(b) amount for a partner.[88]

However, Regulation section 1.1248-1(a)(4) states that if a foreign partnership sells or exchanges stock of a corporation, then for purposes of section 1.1248-1(a)(1), the partners in such foreign partnership are treated as

[88] Elective capital gain recognition may be appropriate in the case of a distribution by a foreign partnership of property that would constitute section 1248 stock in the hands of a distributee partner and that increases the amount of section 1248 gain to the partner, even if no section 751(b) amount is generated. Under Proposed Regulation section 1.751-1(b)(3)(ii)(B), such election can only be made to eliminate section 732(a)(2) or (b) basis adjustments to the asset or assets received in distribution if, and to the extent that, the basis adjustments required by paragraph (b)(3)(iii) of such section would otherwise cause the distributee partner's net section 751 unrealized gain to be greater immediately after the distribution than it was immediately before the distribution or would cause the distributee partner's net section 751 unrealized loss to be less immediately after the distribution than it was immediately before the distribution. A distribution of section 1248 stock by a foreign partnership to a U.S. partner that did not result in a basis adjustment would not trigger a right to elect to recognize capital gain. However, elective recognition may be appropriate in these cases.

selling or exchanging their proportionate share of the stock of such corporation.[89] More generally, the legislative history of subchapter K provides that, for purposes of interpreting Code provisions outside of that subchapter, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular Code section under consideration.[90]

The purpose of section 1248 is to ensure that earnings and profits of CFCs (or former CFCs) are taxed as a dividend when certain U.S. persons recognize gain on the sale or exchange of stock in such corporations. In cases in which a U.S. person is a partner in a foreign partnership that holds a CFC and the U.S. person meets the ten percent voting stock ownership threshold, if such U.S. person recognizes income on the sale of stock of the CFC by such foreign partnership, the purpose of section 1248 is fulfilled only if the partnership is treated as an aggregate for section 1248 purposes. Treatment of a foreign partnership as an entity, in contrast, could result in such partners in the partnership not receiving dividend treatment to the extent of allocable section 1248 amounts on the sale by the partnership of stock of the foreign corporation. Thus, under Regulation section 1.1248-1(a)(4), a foreign partnership is treated as an aggregate of its partners for purposes of applying section 1248(a) to a sale by the partnership of stock in the CFC.[91]

This aggregate notion, however, does not currently extend to section 751(b) in the context of a foreign partnership. The Proposed Regulations as drafted also do not appear to apply aggregate notions to the section 1248 stock held by a foreign partnership. Proposed Regulation section 1.751-1(b)(2)(ii) provides that a partner's net section 751(b) unrealized gain or loss immediately before a distribution equals the amount of net income or loss from section 751 property *that would be allocated to the partner* if the partnership disposed of all of its property in a fully taxable transaction (emphasis added). But under Regulation section 1.1248-1(a)(4), for section 1248 purposes, each partner is treated as directly selling the partner's proportionate share of such

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[89] Apparently considering this Regulation to be an exception, the Preamble to the proposed section 1248 regulations stated that 1248 and the existing regulations do not address specifically sales or exchanges of stock by foreign partnerships with United States persons as partners. Reg. 135866-02, 71 Fed. Reg. 31,985 (Preamble to the Proposed Section 1248 Regulations).

[90] H.R. Rep. No. 83-2543, at 59 (Conf. Rep.) (1954).

[91] The language of this regulation had been narrowed from the proposed form and the Treasury and the Service believe that section 1248(g) prevents a deemed dividend and indirect foreign tax credit on the sale of an interest in a foreign partnership by a domestic corporation, contrary to the view taken by certain practitioners under the proposed regulation. As discussed above, however, we understand the reference to "dividends" in Examples 8 and 9 to indicate that the dividend character under section 1248 is intended to be applicable both under the deemed gain approach and the hot asset sale approach even taking into account section 1248(g). Note also that a domestic corporate partner that meets the 10 percent voting threshold with respect to CFC stock held by a foreign partnership clearly may obtain indirect foreign tax credits under section 902 upon an actual distribution.

stock and so none of the stock is treated as sold by the partnership for such purposes. Accordingly, there does not appear to be any "allocation" from the partnership of gain from appreciated section 1248 property on the deemed sale by the partnership of its assets. If that is true, then under the Proposed Regulation, each partner's pre-distribution share of section 1248 gain—and thus each partner's share of net section 751(b) unrealized gain or loss—would be zero.

We recommend that Proposed Regulation section 1.751-1(b)(2)(ii) be changed to provide that a foreign partnership is treated as an aggregate of its partners for purposes of section 751(b). Specifically, we recommend that it be made clear in Regulations section 1.751-1(b)(2)(ii) that an "allocation" includes each partner's share of gain from the deemed sale by the partnership of section 1248 stock, and that this be without regard to the otherwise applicable recharacterization in Regulation section 1.1248-1(a)(4).[92] We believe that this result would better comport with the purposes of sections 751(b) and 1248 where some or all of the partners are U.S. persons.

D. *Anti-Abuse Rules*

1. *Scope of the Proposed Anti-Abuse Rules*

The Proposed Regulations contain a series of anti-abuse rules in Proposed Regulation section 1.751-1(b)(4) largely based on an anti-abuse principle identified in the first sentence of the provision reading: "The purpose of section 751 is to prevent a partner from converting its rights to ordinary income into capital gain, including by relying on the rules of section 704(c) to defer ordinary income while monetizing most of the value of the partnership interest."[93] That principle is applicable to section 751(a) but it has no application to section 751(b). There appears to be no authority that this accurately reflects the purpose of section 751(b). In fact, the purpose underlying section 751(b) is well known and has never been subject to dispute.

From the words of the statute, the legislative history of the statute, and the regulations that were promulgated almost contemporaneously with enactment of section 751, the purpose of section 751(b) is to prevent the use of partnership distributions to shift ordinary income shares among the partners. We can find no source that suggests any other understanding of the purpose underlying the enactment of section 751(b). Indeed, even the very first substantive paragraph of the preamble to these Proposed Regulations recognizes that "section 751(b) overrides the nonrecognition provisions of section 731 to the extent a partner receives a distribution from the partnership that causes a shift between the partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items (collectively, the partnership's

[92] Regulation section 1.1248-1(a)(4) could have particular relevance under the deemed gain approach, as that involves a deemed sale by a partnership.

[93] Prop. Reg. § 1.751-1(b)(4)(i).

"section 751 property") and the partner's interest in the partnership's other property."

The statute itself seems clear: section 751(b) speaks to those distributions of unrealized receivables and substantially appreciated inventory "in exchange for all or a part of" the distributee's share of other property (or vice versa). If there is no such exchange, the statute simply does not apply to the distribution. Nowhere is there any suggestion that section 751(b) can reach a distribution that does not work such an exchange but instead "monetize[s] most of the value of the partnership interest."

In what most consider to be as authoritative as a law review article can be, four giants of the tax bar wrote immediately after enactment of section 751(b) that "[s]ection 751 inhibits tax avoidance by applying special rules to prevent the shifting of potential ordinary income attributable to substantially appreciated inventory and unrealized receivables owned by the partnership."[94] The legislative history confirms this understanding of section 751(b).

It is clear that the Treasury and the Service are concerned about the following type of transaction.

> Example: The XYZ partnership has an unrealized receivable with fair market value of $120 and adjusted basis of $0. The partnership borrows $35 from a third party, with the debt entirely allocable to Z. The borrowed funds are then distributed to Z, reducing the value of Z's interest from $40 to $5. This distribution does not reduce Z's share of the partnership's ordinary income because, assuming the property is revalued immediately prior to the distribution, Z's share remains at $40. Thus, the distribution has largely monetized the value of Z's partnership interest without triggering any immediate taxation. Further, if the distribution of cash had been in complete liquidation of Z's interest, it would have triggered application of section 751(b), resulting in the recognition of $40 of ordinary income to Z.

In this example, the concern is that the partner will never recognize the ordinary income that is captured in the partner's remaining capital account in circumstances where there is no economic incentive to be treated as a partner. We understand that concern and appreciate that the Proposed Regulations are an attempt to limit the situations when taxpayers will be required to engage in the complexity of applying section 751(b) without allowing wholesale avoidance of the provision. However, in the example above, the distribution of $35 in cash to Z does not work a shift in Z's share of ordinary income because the partnership's ordinary income asset remains held by the partnership and Z will be taxed on his share exactly as Z would be if there had been no distribution.

Nevertheless, we are concerned that this anti-abuse rule in the Proposed Regulations suggests a principle that some distributions that are nonliquidating in form should be treated as liquidating in substance without full consideration of the implications or authority to do so in these Proposed

[94] Jackson, Johnson, et al., *supra* note 21, at 1214 (1954).

Regulations. As an example of application of this principle to another situation, assume that the partnership's asset is a zero-basis capital asset rather than an unrealized receivable. If the partnership borrows $35 (entirely allocable to Z) and then distributes the cash to Z, the transaction is tax-free. But if the partnership were to distribute $40 to Z in a liquidating distribution, it would be taxable in full. If the monetization of a $40 partnership interest by a $35 cash distribution is a problem, it is immaterial whether the distribution defers recognition of ordinary income or capital gain. As described below, we recommend an approach that avoids reliance on reasoning that treats a nonliquidating distribution as though it had liquidated the partner's interest but allows consideration of the remaining interest in the partnership as a factor to be considered in terms of whether the transaction violates the anti-abuse rules.

2. *Technical Analysis of the Proposed Anti-Abuse Rules*

According to the Preamble and the Proposed Regulations, the purpose of section 751 is "to prevent a partner from converting its rights to ordinary income into capital gain, *including by relying on the rules of section 704(c) to defer ordinary income while monetizing most of the value of the partnership interest*." Proposed Regulation section 1.751-1(b)(4) (emphasis added). The Proposed Regulations contain an anti-abuse rule that requires a partnership and its partners to apply section 751 and the Proposed Regulations consistent with this purpose and expressly authorizes the Service to recast a transaction based on all the facts and circumstances to effectuate the purpose of section 751 if a principal purpose of the transaction is to achieve tax results inconsistent with its purpose. The Proposed Regulations then enumerate six situations in which a transaction will be presumed to be inconsistent with the purposes of section 751 and require a partner to file Form 8275-R, Regulation Disclosure Statement, if the partner does not recognize and report ordinary income in such a situation.

The first five presumptions involve situations in which the application of section 704(c) ostensibly has preserved a partner's share of the partnership's unrealized ordinary income but the attendant facts or subsequent events cast doubt as to whether the partner would have to satisfy the future tax liability.[95] For example, the first three presumptions target transactions in which the tax liability associated with the deferred ordinary income likely would exceed the economic value to be realized such that there may be little or no incentive to realize the remaining value of the partner's interest. The fourth and fifth presumptions involve subsequent nonrecognition transfers in which the partner would escape recognizing the deferred income, which is shifted to the transferee.

The sixth presumption appears targeted at the failure to apply section 704(c). The presumption applies if a partner's net section 751 unrealized gain is reduced as a result of modifications to a partnership agreement that change the manner in which the partners share partnership items. One example would be a recapitalization where the partnership does not elect to revalue capital accounts as would be permitted by Proposed Regulation section 1.704-1(b)(2)(iv)(f)(5)(v). To the extent this presumption prevents the shifting of ordinary income among partners, we agree that it promotes the purposes of section 751 and we recommend that the scope of the regulation be narrowed to apply only in this situation. As currently drafted, the Proposed Regulation could apply whether or not there is an actual or deemed distribution that otherwise would trigger section 751(b). Finally, we recommend that the anti-abuse rule be modified to eliminate the list of presumptively abusive circumstances, in favor of a list of factors the IRS will consider in applying the facts and circumstances test set forth in the general rule or provide examples of transactions or circumstances that the Service may find abusive. If the presumptions are retained, the Proposed Regulations should provide that taxpayers may rebut the presumptions by establishing there is no abuse, based on facts and circumstances.

Furthermore, in that regard, we also recommend that the disclosure rules be modified to require disclosure on Form 8275, rather than Form 8275-R. The required disclosure should be limited to the factual basis for rebutting the applicable presumption and should not require a taxpayer to report that their position is in conflict with a regulation the terms of which are uncertain.

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[95] These situations include circumstances in which a partner receives a distribution to which section 751(b) would apply but for the application of the principles of section 704(c) and one or more of the following conditions exist: (i) the partner's interest in net section 751 unrealized gain is at least four times greater than the partner's capital account immediately after the distribution; (ii) going forward, the partner is substantially protected from losses and has little or no participation in the profits of the partnership other than a preferred return for the use of capital; (iii) after the transaction, the net worth of the partner's interest is less than the tax liability that would result from a sale of its partnership interest, (iv) the partner transfers a portion of its partnership interest within five years after the distribution to a tax-neutral person in a manner that does not trigger ordinary income recognition; or (v) the partnership transfers section 751 property to a corporation in a nonrecognition transaction other than in connection with a transfer of materially all property used in a trade or business. Prop. Reg. § 1.751-1(b)(4)(i)(A)(1)-(5).