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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE PROPOSED REGULATIONS ON PARTNERSHIP BUILT-IN LOSSES

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REPORT ON THE PROPOSED REGULATIONS ON PARTNERSHIP BUILT-IN LOSSES

This report (this "Report")[1] comments on the proposed regulations under sections 704, 732, 734, 737, 743 and 755 of the Internal Revenue Code of 1986, as amended (the "Code"),[2] published in the federal register on January 16, 2014 (the "Proposed Regulations").[3] The Proposed Regulations primarily address the amendments made to sections 704(c), 734 and 743 under the American Jobs Creation Act of 2004 (the "Jobs Act"),[4] all of which are intended to limit the ability of taxpayers to transfer losses among partners in a partnership.[5]

The principal features of the Proposed Regulations include: (1) the provision of basic rules of application for section 704(c)(1)(C), which governs the treatment of property that is contributed to a partnership with a "built-in loss" (that is, with a fair market value that is less than the contributor's adjusted basis in the property); (2) guidance on the "substantial basis reduction" and "substantial built-in loss" thresholds under sections 734 and 743, which, if exceeded, give rise to "mandatory step-downs" of the basis of partnership assets; (3) guidance on

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[1] The principal drafters of this Report were Stuart L. Rosow and Malcom S. Hochenberg. Substantial contributions were made by Amanda H. Nussbaum, Eric B. Sloan, Philip Gall and Amy M. Zelcer. Helpful comments were received from David H. Schnabel, Michael L. Schler, Andrew W. Needham, Marcy G. Geller, Matthew W. Lay and Stephen B. Land. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless otherwise indicated, all references in this Report to "section" and "sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" (or "Prop. Treas. Reg. §") are to regulations (or proposed regulations) issued thereunder. References to the "IRS" are to the Internal Revenue Service, and references to the "Treasury" are to the United States Department of the Treasury.

[3] Disallowance of Partnership Loss Transfers, Mandatory Basis Adjustments, Basis Reduction in Stock of a Corporate Partner, Modification of Basis Allocation Rules for Substituted Basis Transactions, Miscellaneous Provisions, 79 Fed. Reg. 3042 (proposed Jan. 16, 2014) .

[4] American Jobs Creation Act of 2004, Pub. L. No. 108-357 § 833, 118 Stat. 1589 (2004).

[5] H.R. Rep. No. 108-755 (2004).

the exception to the mandatory step-down rules of section 743 for "electing investment partnerships" ("EIPs"); (4) the clarification of certain issues of more general application under sections 734, 743 and 755 regarding adjustments to the basis of partnership property, including the application of the basis adjustment rules to tiered partnerships and substituted basis transactions; and (5) the provision of a general rule under the section 704(c) regulations that requires partnerships to use separate "layers" of allocations to account for each instance in which differences between the adjusted basis and fair market value of partnership property arise, whether upon the contribution of property to a partnership or upon permitted revaluations of partnership capital accounts,[6] rather than to "net" those layers against one another.

We generally agree with the approach of the framework of rules set forth in the Proposed Regulations. Our comments are primarily directed at aspects that could be clarified in the final regulations (the "Final Regulations").

The Proposed Regulations also touch upon a number of issues that have a broader application and which have been generally well-understood for many years, including: (1) potential incongruities arising out of the elective nature of section 754 elections (where a failure to make the election can result in a disparity between the partner's "outside" basis in its interest in the partnership and the partner's share of inside basis);[7] (2) challenges of accounting for tiered partnerships, in determining whether the upper-tier partnership ("UTP") should be

[6] Treas. Reg. § 1.704-3(a) already provides that such allocations must be separately tracked for each item of partnership property and for each partner.

[7] The elective nature of section 754 elections can contribute to a difference between inside and outside basis for a partner and create the equivalent of a built-in loss situation. Consider the following example: Partnership ABC with three equal partners owns an asset with a value of $120 and a basis of $30. If A sells its partnership interest to D, the transferee will have a $40 outside basis (D's purchase price) but a share of inside basis of only $10 if no section 754 election is made. If the partnership thereafter sells the asset for $120, D will be allocated $30 of gain, increasing its outside basis to $70, and creating a potential loss asset for D in the form of its partnership interest.

regarded as owning a separate item of property in the form of an interest in the lower-tier partnership ("LTP") or whether the UTP should be viewed as owning an interest, consisting of its allocable share, in each of the assets owned by the LTP; and (3) the impact of section 704(c) and section 743 on the fungibility among partnership interests (which is relevant particularly in the case of publicly traded partnership ("PTP") interests).

The Proposed Regulations generally address these broader issues only to the extent they are relevant to one of the amendments effected under the Jobs Act, but they do not attempt to resolve such issues on a more general basis. We support this approach and have taken a similar approach to these issues in the Report.

This Report is divided into eight parts. Part I lists our principal recommendations. Part II provides background on section 704(c) and the relevant provisions of the Jobs Act, in particular, the enactment of section 704(c)(1)(C). Part III describes the Proposed Regulations to sections 704 and 732 (including the basic rules of application for section 704(c)(1)(C)) and our recommendations to those portions of the Proposed Regulations. Parts IV and V describe the Proposed Regulations to sections 734 and 743 and our recommendations to those portions of the Proposed Regulations. Parts VI and VII describe the Proposed Regulations to the EIP exception and to section 755 and our recommendations to those portions of the Proposed Regulations. Part VIII discusses the use of separate layers of allocations.

I. Summary of Principal Recommendations.

Below is a list of the principal recommendations of this Report. Additional technical recommendations are contained in the body of this Report.

1. We support the decision not to extend the Proposed Regulations' special basis regime for built-in loss property to reverse section 704(c) adjustments. However, since this leaves open some opportunity to structure transactions that circumvent the special basis regime, we suggest that the regulations make clear that the general anti-abuse rules (such as that of section 704(c)) remain applicable.

2. We recommend that the Final Regulations provide additional guidance as to what portion of a partner's share of built-in losses is eliminated or transferred upon the transfer of a portion of a partnership interest.

3. In the case of a gift of a partnership interest, we recommend that the donee keep the portion of the donor's built-in loss in an item of partnership property as is needed to ensure the donee is not placed in a built-in gain position with respect to that item.

4. We recommend further coordination between the rules of sections 362 and 704(c)(1)(C). For example, consistent with the election under section 362(e)(2)(C), we recommend that Final Regulations allow an election to reduce the basis of corporate stock rather than the basis of built-in loss property when either the property or an interest in partnership holding built in loss property is contributed to a corporation.

5. In the case of a partnership's transfer of built-in loss property in which gain is recognized only in part (such as a section 351 contribution with boot), we recommend that the Final Regulations consider addressing the extent to which the partner who contributed the built-in loss property should recognize gain.

6. Where a partnership sells built-in loss property in an installment sale, we recommend that a partner be permitted to currently apply the entire amount of the special basis adjustment with respect to the contributed property where that partner would, taking into account all payments (fixed and contingent) to be received under the installment term, have an overall loss.

7. In the case of a distribution of property contributed with a built-in loss, we recommend that the Final Regulations maximize the portion of any reallocated special basis adjustment that is allocated to property of a "like" character (for example, built-in loss from a capital asset should be reallocated to capital assets and not ordinary income property). Further, we recommend that the Final Regulations clarify that, where built-in loss property is distributed to the contributing partner but the partner's outside basis has been reduced below the sum of the partnership's basis in the property and any remaining built-in loss, the partner be permitted to reallocate any remaining special basis adjustment to other partnership property, taking into account appropriate adjustments under section 734. We also recommend that the special basis adjustment to property for built-in loss not be taken into account for the purposes of section 732(f) on distributions of that property to a non-contributing partner.

8. In the case of a partnership merger or division, we recommend that, to the extent possible, property retain its pre-merger/division special basis adjustment.

9. We recommend that the Final Regulations expressly state that the substantial basis reduction threshold under section 734(d) is measured on a partner-by-partner and distribution-by-distribution basis. We also recommend that the Final

Regulations provide guidance on what constitutes a single "distribution," with the goal of prohibiting techniques to bypass the $250,000 threshold but otherwise not combining separate distributions.

10. In calculating whether the substantial built-in loss threshold of section 743(d) has been exceeded, we recommend that the Final Regulations (A) make clear that the determination is based upon the fair market value of partnership assets rather than a derived value based upon the sales price or other value of the partnership interest being transferred and (B) determine the value of an interest in a lower-tier partnership based on the amount for which the attributable portion of the lower-tier assets would be sold.

11. We do not recommend the adoption of any new de minimis exceptions to the mandatory basis step-down rules. However, we do recommend that the Final Regulations address the practical issue faced by partners who hold "small" interests in partnerships, by allowing such partners to rely on information provided to them by the partnership as to asset value and, in certain cases, requiring partnerships to provide such information.

12. We recommend that the Final Regulations provide additional guidance on the scope of "relatedness" for the purposes of the "substantial built-in loss anti-abuse rule" of the Proposed Regulations, which among other things, would aggregate the losses of certain "related" partnerships for purposes of calculating whether the $250,000 loss threshold has been exceeded.

13. We generally agree with the approach of the Proposed Regulations in requiring section 734(b) and section 743(b) basis adjustments at an upper-tier partnership to "tier down" to lower-tier partnerships where each partnership has a section 754 election in effect or where the top-tier partnership has a substantial basis reduction (in the case of section 734(b) adjustments) or a substantial built-in loss (in the case of section 743(b) adjustments). However, we recommend that, where a tier-down of a section 743 adjustment would result in a net basis increase at a lower tier partnership, the tier down to such partnership be required only where the partnership has a section 754 election in effect or the upper tier partnership owns 50% or more of the capital and profits of the lower tier partnership.

14. For the purposes of the eligibility test for electing investment partnership status, in determining whether an upper-tier partnership is treated as engaged in the trade or business of a lower-tier partnership and thus ineligible, we recommend that the Final Regulations provide a rule that, if the sum of the contributions to the capital of the lower-tier partnership and the recourse liabilities allocated to the putative EIP are less than 25% of the total capital required to be contributed to the putative EIP, then the lower-tier partnership is disregarded (rather than measure against adjusted basis in the lower-tier partnership interest, as the Proposed Regulations do). We also recommend that the Final Regulations provide limited relief for inadvertent terminations of EIP status, but we do not recommend that the Final Regulations allow a partnership that has willingly revoked its EIP status to re-elect such status.

15. Where section 755(c) applies to disallow a basis step-down to stock owned by a partnership, we recommend that the basis step-down be allocated among eligible partnership property under the regular principles of Treas. Reg. § 1.755-1(c). To the extent gain is recognized under section 755(c)(2), we recommend that the gain be allocated to the partners in a similar manner to that in which basis adjustments provided for under section 734(b) are reflected in the partners' capital accounts for purposes of section 704(b).

16. We agree with the general position of the Proposed Regulations to require the separate tracking of each "layer" of section 704(c) allocations, as opposed to the netting of those allocations. We recommend, however, that the Final Regulations allow netting in the case of certain "small partnership," "small asset" and "small adjustment" situations. We also recommend that the Final Regulations allow taxpayers reasonable latitude in choosing how to allocate gain and loss across layers where the "ceiling rule" applies.

II. Background.

Section 704(c) provides a series of rules that are intended to ensure that partners that contribute property with an adjusted basis different from its fair market value on the date of contribution (also known as "built-in" gain or loss property or "Section 704(c) Property") retain the tax attributes associated with that difference. Section 704(c)(1)(A) provides that items of income, gain, loss and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. Section 704(c)(1)(C) was added by Section 833(a) of the Jobs Act and is effective for

contributions of property to a partnership after October 22, 2004.[8] Section 704(c)(1)(C) was enacted to compel particular tax results under section 704(c) to property that is contributed to a partnership with a built-in loss ("Section 704(c)(1)(C) Property") and, in particular, to prevent the transfer of built-in losses to partners other than the partner to which the loss was attributable as an economic matter.[9] The general rule of section 704(c)(1)(A) was perceived as not being sufficient to prevent such transfers due to the application of the "ceiling rule," which precludes partnerships that use the "traditional method" of making section 704(c) allocations from allocating to a partner gain or loss in respect of a particular item of partnership property to the extent the partnership lacks a current overall item of tax gain or loss in respect of that item.[10] The below example illustrates the issue.

> Pre-Jobs Act Example. Partner A[11] contributes property to partnership AB with a basis of $190,000 and a value of $100,000 for a 50% partnership interest, and B contributes $100,000 of cash for a 50% partnership interest. AB uses the traditional allocation method under section 704(c)(1)(A). Subsequent to contribution, the property increases in value to $160,000, at which time AB sells the property for $160,000—an economic gain of $30,000 for B. Because the overall result of the transactions is a $30,000 tax loss, however, the ceiling rule applies to prevent an allocation of tax gain to B. $30,000 of loss is allocated to and reported by A, and no gain (or loss is allocated to or reported by B. The result is, in effect, a shift to B of $30,000 of A's $60,000 economic loss ($90,000 built-in loss, $30,000 share of post-contribution appreciation).

Section 704(c)(1)(C)(i) provides that if property contributed to a partnership has a built-in loss, such built-in loss shall be taken into account only in determining the amount of items

[8] Jobs Act § 833(a).

[9] H.R. Rep. No. 108-548, at 282 (2004); H.R. Rep. No. 108-755, at 622 (2004).

[10] Treas. Reg. § 1.704-3(b)(1).

[11] Unless otherwise specified, the parties mentioned in each example in this Report are not the same as in any preceding or subsequent examples, even if identified with the same letter or number.

allocated to the contributing partner.[12] For this purpose, section 704(c)(1)(C)(i) defines "built-in loss" to be equal to the excess of the adjusted basis of the property over the fair market value of the property at the time of contribution. Section 704(c)(1)(C)(ii) provides that except as provided in regulations, in determining the amount of items allocated to other partners, the basis of contributed built-in loss property in the hands of a partnership shall be treated as being equal to its fair market value at the time it was contributed to the partnership. In effect, the statute provides for separate basis computations with respect to the contributed property. For the contributing partner, the basis for the contributed property is a carryover basis.[13] For the non-contributing partner(s), the basis of the contributed property is its fair market value, which corresponds to its section 704(b) book value for purposes of partnership allocations generally.[14] The intended operation can be illustrated by the following example, which uses the same contribution basis and contribution value figures as the immediately preceding Pre-Jobs Act Example.

> Example A. Partner A contributes property with a fair market value of $100,000 and a basis of $190,000 to partnership AB and Partner B contributes $100,000 cash. Upon a sale of the property for $100,000, A will recognize a $90,000 loss and B will be allocated no gain or loss. If instead the property appreciates in value and is then sold by AB for $160,000 (the same as in the Pre-Jobs Act Example), under section 704(c)(1)(C), AB is considered to recognize a gain of $60,000, an amount consistent with its gain for book purposes under section 704(b).[15] B would be allocated $30,000 of gain because under section 704(c)(1)(C), the basis of the property is $100,000 with respect to B. A would recognize a loss of $60,000 on the sale, reflecting that with respect to A the property had an additional $90,000 in basis.

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[12] Section 704(c)(1)(C).

[13] Section 723. This result is consistent with the contributing partner having an outside basis for its partnership interest that is equal to its share of inside basis with respect to the contributed property.

[14] Section 704(c)(1)(C)(ii); Treas. Reg. § 1.704-3(a)(3)(i).

[15] Section 704(c)(1)(C).

As these examples demonstrate, section 704(c)(1)(C) expands the application of section 704(c)(1)(A) to prevent all loss shifting with respect to contributed property. In effect, the Jobs Act eliminates the ceiling rule with respect to built-in loss property (but does so differently than simply mandating curative or remedial allocations).

Partnerships also have to account for post-contribution (but pre-disposition) fluctuations in the value of property, which raise issues similar to those directly addressed by section 704(c) and illustrated in the above examples. Although not addressed by the Jobs Act, a set of rules (explained in greater detail later in Part VIII of this Report) require partnerships to account for the disparities between adjusted basis and fair market value of property that arise when a partnership is permitted to revalue capital accounts under the section 704 regulations.

The Jobs Act also introduced the so-called "mandatory basis adjustment" provisions of sections 734 and 743.[16] These provisions were enacted in light of Congress's belief that the "electivity of partnership basis adjustments upon transfers and distributions leads to anomalous tax results, causes inaccurate income measurement, and gives rise to opportunities for tax sheltering."[17] Specifically, Congress was concerned that the optional basis adjustment regime permitted partners to duplicate losses and inappropriately transfer losses among partners.[18] The

[16] Jobs Act § 833(b).

[17] S. Rep. 108-192, at 189 (2003).

[18] *Id*. For example, partnership PRS's sole asset is an item of property with a basis of $2 million and a fair market value of $1.6 million. Partner A and Partner B had each contributed $1 million cash in exchange for 50% interests in PRS, and PRS then bought the property. PRS does not have a section 754 election in effect. A sells its 50% interest to C for $800,000. A recognizes a $200,000 loss on the sale ($1 million basis in PRS interest, $800,000 proceeds). PRS has an unrealized loss in the property of $400,000. As explained later, this amount of loss would, under current law, require a step-down of C's share of PRS's basis in its assets, to $800,000. But, pre-Jobs Act, C would succeed to A's $1 million share of the basis in the PRS property. Accordingly, if PRS were to then sell the property, each of B and C would be allocated a $200,000 loss. This result is appropriate for B but is non-economic and not appropriate for C. The loss would reduce C's basis in its PRS interest to $600,000 ($800,000 purchase price, less $200,000 allocated loss). C's interest in the assets of PRS is worth $800,000. If this amount was distributed to C in liquidation, C would recognize a $200,000 gain to offset the non-economic loss. *See* Santa

goal of these provisions was to prevent inappropriate loss transfers among partners, while simultaneously keeping the more simple features of the existing partnership rules for transactions involving smaller loss amounts.[19]

As amended by section 833(c) of the Jobs Act, section 734(b) requires, upon a distribution of partnership property with respect to which there is a "substantial basis reduction" ("SBR"), a downward basis adjustment with respect to remaining partnership property equal to the amount of loss recognized by the distributee or the excess of the adjusted basis of the distributed property to the distributee over the property's pre-distribution adjusted basis to the partnership. There is a SBR with respect to a distribution where a distributee either recognizes gain in excess of $250,000 or takes distributed property with a basis more than $250,000 greater than the pre-distribution adjusted basis of such property to the partnership.[20] Prior to the Jobs Act, section 734(a) did not require a partnership to make a basis adjustment with respect to partnership property upon a distribution unless the partnership had made an election under section 754.[21]

Monica Pictures, LLC v. Commissioner, T.C. Memo 2005-104 (2005); *see also* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005).

[19] H.R. Rep. No. 108-548, at 282 (2004).

[20] Section 734(d).

[21] Sections 734(e) and 743(f), added by Section 833(b) and (c) of the Jobs Act, provides an exception to the section 734 and section 743 mandatory basis adjustment provisions, respectively, for "securitization partnerships." Section 743(f)(2) defines a "securitization partnership" as "any partnership the sole business activity of which is to issue securities which provide for a fixed principal (or similar) amount and which are primarily serviced by the cash flows of a discrete pool (either fixed or revolving) of receivables or other financial assets that by their terms convert into cash in a finite period, but only if the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired so as to be disposed of." The reason for the exemption is that the assets of a securitization partnership are not expected to significantly fluctuate in value. *See* H.R. Rep. No. 108-755 at 626-7.

As amended by section 833(b) of the Jobs Act, section 743(a) requires upon a "sale or exchange" of a partnership interest in a partnership with a "substantial built-in loss" ("SBIL"), a downward basis adjustment in the transferee's share of the partnership's basis in its property ("inside basis") equal to the excess of the transferee's share of the inside basis over the transferee's basis in the acquired partnership interest.[22] As described in further detail later in Part VI of this Report, there is a SBIL if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.[23] Prior to the Jobs Act, section 743(a) did not require a partnership to make a basis adjustment with respect to a sale or exchange unless the partnership had made an election under section 754. The Jobs Act included an exception to the section 743 mandatory basis adjustment rules for "electing investment partnerships," which are instead subject to a partner-level loss limitation rule described in Part VI of this Report.[24]

The allocation of basis adjustments to partnership property under sections 734 and 743 is governed by section 755. The Jobs Act did not address the basic rules of section 755 but did enact section 755(c) to curtail certain techniques that made use of the interaction of sections 332, 734, and 1032 to achieve the tax result of allocating a basis step-down to stock the disposition of which would not give rise to gain.[25] Part VII of this Report provides further detail on section

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[22] Section 743(a); Section 743(b). For these purposes, a "sale or exchange" generally includes any transfer other than a contribution or a gift.

[23] Section 743(d)(1).

[24] This exception stemmed from Congress's awareness that certain types of investment partnerships would incur administrative difficulties in making partnership-level basis adjustments in the event of a transfer of a partnership interest (H.R. Rep. No. 108-548, at 282 (2004)).

[25] Section 1032 provides that a corporation cannot recognize gain or loss on the receipt of money or property for its stock. Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, JCS-3-03 (February 2003) (*hereinafter* JCT Report).

755(c). Aspects of the basis allocation rules more generally are also discussed throughout this Report.

III. Proposed Regulations to Sections 704 and 732.

A. Scope of Application of Proposed Regulations to Section 704.

As an initial matter, we note that the Proposed Regulations do not extend the section 704(c)(1)(C) basis adjustment rules to "reverse section 704(c) allocations" (that is, the items of unrealized gain or loss in property that arise when partnership capital accounts are revalued under Treas. Reg. § 1.704-1(b)(2)(iv)(f) after property is contributed to the partnership). The Preamble states that "applying the Proposed Regulations to reverse section 704(c) allocations would be difficult for taxpayers to comply with and for the IRS to administer."[26] In addition, the statute applies only to contributions of built-in loss property, and the legislative history does not mention reverse section 704(c) allocations.

We agree that extending section 704(c)(1)(C) principles to reverse section 704(c) allocations would raise material compliance and administrability issues. In particular, for a partnership with numerous assets and frequent admissions or redemptions, tracking the reverse section 704(c) allocations is already a substantial administrative undertaking. Adding to the burden by requiring special tracking of section 704(c)(1)(C)-like basis adjustments could be significant. Further, it may well be that admission and redemption transactions that give rise to reverse section 704(c) allocations occur with much greater frequency than transactions giving rise to forward section 704(c) allocation. Moreover, the ability to use existing partnerships with built-in losses as a vehicle to transfer those losses would frequently be mitigated by non-tax

[26] 79 Fed. Reg. at 3047.

considerations about becoming a partner in an existing entity which may have additional disclosed or undisclosed liabilities.

We have some concern, however, that the failure to apply the section 704(c)(1)(C) rules to reverse section 704(c) allocations could allow some taxpayers to engage in transactions at odds with the statute's purpose. As a basic example, consider a situation in which Partnership AB owns an asset with a basis equal to its fair market value upon contribution or purchase that subsequently declined in value, and C wishes to acquire an interest in that asset. If Partnership AB and C were to form a new partnership, ABC, with AB contributing its asset and C contributing cash, the section 704(c)(1)(C) rules would apply and only AB and its partners would have the benefit of the basis in excess of value.[27] If, however, C were to contribute the cash to AB in exchange for an interest in AB identical to the interest it would have had in ABC, the rules would not apply.[28] Accordingly, we recommend that the Final Regulations contain an express reference to the anti-abuse rule of Treas. Reg. § 1.704-3(a)(10)[29] so as to demonstrate that this

[27] If the loss were substantial, and C were to purchase an interest in AB from one of the other partners, the mandatory basis step-down rules under section 743 would apply.

[28] Consider a promoter that takes offsetting long and short positions on an underlying asset, with the long position held through Partnership 1 and the short position held through Partnership 2. Each partnership uses the traditional allocation method. When the value of the underlying asset has changed, investors contribute cash to the partnership that has an unrealized loss. The loss partnership could allocate gain and loss so as to shift the pre-existing losses to the investors. In contrast, a hedge fund has an onshore feeder (through which U.S. taxable persons invest) and an offshore feeder (through which foreigners and tax-exempts invest). The fund uses the traditional allocation method. The assets held by the fund decline in value. More U.S. taxable persons invest through the onshore feeder. The assets recover their value and are sold, with no overall gain or loss. The tax losses of the foreign-feeder investors have, in effect, been shifted to the U.S. taxable investors.

[29] Treas. Reg. § 1.704-3(a)(10) generally provides that an allocation method is not reasonable (and may not be respected) if the method results in shifting the tax consequences of built-in gain or built-in loss (and such gain or loss considered to arise by reverse section 704(c) allocations) among partners in a fashion that substantially reduces the present value of the partners' aggregate tax liability. This rule would apply in addition to the generally applicable anti-abuse rule of Treas. Reg. § 1.701-2.

rule could be utilized to counteract engineered loss-shifting that arises through not applying the section 704(c)(1)(C) basis adjustment rules to reverse allocations.[30]

B. General Description of Proposed Regulations to Section 704

The Proposed Regulations to section 704(c)(1)(C) generally implement the statutory provisions by treating the excess of the adjusted tax basis of a contributed property over its fair market value as a special basis adjustment with respect to the contributing partner. In adopting this approach, the Proposed Regulations introduce rules similar to those of section 743(b) for the purpose of accounting for Section 704(c)(1)(C) Property (which, as described above, is property contributed to a partnership with an adjusted basis to the transferor that is greater than the property's fair market value, also known as a "built-in" loss).

Section 704(c)(1)(C) Property will, at contribution, have a basis adjustment equal to the amount of built-in loss (such basis adjustment, the "Section 704(c)(1)(C) Basis Adjustment").[31] The Section 704(c)(1)(C) Basis Adjustment is an adjustment to the basis of partnership property, but the basis adjustment applies *only* to the partner that contributed the Section 704(c)(1)(C) Property (such partner, the "Section 704(c)(1)(C) Partner").[32]

Consistent with the statutory intent, a Section 704(c)(1)(C) Basis Adjustment amount does not affect the partnership's computation of any items under section 703 with respect to the non-contributing partners. Stated another way, for purposes of calculating income, deduction, gain and loss, (1) the initial basis of the 704(c)(1)(C) Property to the partnership will equal the

[30] We also believe that the alternative of applying section 704(c)(1)(C) only when there is an actual revaluation is also incorrect. Such a rule would only encourage taxpayers not to revalue partnership assets, even in those circumstances in which revaluation is clearly appropriate to reflect the business transaction.

[31] Prop. Treas. Reg. § 1.704-3(f)(2)(ii).

[32] Prop. Treas. Reg. §§ 1.704-3(f)(1)(i) and 1.704-3(f)(3)(ii).

fair market value of the Section 704(c)(1)(C) Property upon contribution, and all partners will, in effect, share in this basis in accordance with their partnership interests and (2) the Section 704(c)(1)(C) Partner will have an additional special basis in the Section 704(c)(1)(C) Property equal to the Section 704(c)(1)(C) Basis Adjustment (which, as described above, is, on contribution, the difference between the partner's pre-contribution adjusted basis in the property and the fair market value of such property).[33] Subsequent to the contribution of the underlying Section 704(c)(1)(C) Property, the Section 704(c)(1)(C) Basis Adjustment may be decreased by depreciation, amortization or other cost recovery deductions, or other losses or adjustments in a manner similar to reductions made with respect to positive section 743(b) basis adjustments. The following example illustrates the operation of the basic rules:

> Example B. Partner C contributes property with an adjusted basis of $12,000 and a fair market value of $5,000 on January 1 of the year of contribution, and Partner D contributes $5,000 to CD, a partnership. Prior to the contribution, C was depreciating the property under section 168 over a 10-year recovery period using the straight-line method of depreciation and the half-year convention. On the contribution date, the property has 7.5 years remaining in its recovery period. The property is Section 704(c)(1)(C) Property, and C's Section 704(c)(1)(C) Basis Adjustment is $7,000. CD's common basis in the property is $5,000 (fair market value) and, in accordance with section 168(i)(7), the depreciation is $667 per year ($5,000 divided by 7.5 years), which is shared equally between and C and D. C's $7,000 Section 704(c)(1)(C) Basis Adjustment is subject to depreciation of $933 per year in accordance with Section 168(i)(7) ($7,000 divided by 7.5 years), which is taken into account by C. After three more years, CD sells the property for $7,000. CD recognizes $4,000 of gain on sale [$7,000-($5,000-(3*$667))], half of which is allocated to C and half to D. D recognizes a $2,000 gain on the sale. C's Section 704(c)(1)(C) Basis Adjustment has been reduced to $4,200 [$7,000-(3*$933)] by the intervening depreciation. Accordingly, C recognizes a $2,200 loss ($2,000 gain minus the $4,200 remaining 704(c)(1)(C) Basis Adjustment) on the sale.

[33] Using the facts of Example A, AB would have a fair market value ($100,000) basis in the property, which would be shared equally by A and B. Where the property is sold for $160,000, A would have a Section 704(c)(1)(C) Basis Adjustment of $90,000. When the property is sold for $160,000, AB has a gain of $60,000 ($160,000 sales price less $100,000 basis), half of which is allocated to each of A and B. B recognizes $30,000 of gain. A offsets its share of the $30,000 gain with its $90,000 Section 704(c)(1)(C) Basis Adjustment and recognizes a $60,000 loss.

The Proposed Regulations contain rules detailing the treatment of the Section 704(c)(1)(C) Basis Adjustment upon sales or other taxable and nontaxable dispositions of the Section 704(c)(1)(C) Property, transfers of partnership interests by the Section 704(c)(1)(C) Partner as well as distributions of partnership property to such partner and distributions of the Section 704(c)(1)(C) Property to other partners. Further, the Proposed Regulations provide for the coordination of the section 704(c)(1)(C) rules with the mandatory basis adjustments required under sections 734 and 743.

C. Response to Proposed Regulations to Section 704.

We support the decision to apply to Section 704(c)(1)(C) Property a set of rules similar to those applicable under section 743(b). In general, this approach relies upon a set of rules that are well developed and with which many taxpayers have some familiarity, and that have over time worked well to prevent taxpayers from shifting tax attributes among partners.

Our comments to the Proposed Regulations under section 704 relate primarily to clarifying the framework set up by the Proposed Regulations and the interaction with existing rules under sections 743, 734 and 755. We also have more technical suggestions intended to make the language of the Proposed Regulations easier to understand and more consistent with other related provisions in the regulations.

An important issue that needs clarification under the Proposed Regulations is the timing and amount of recovery of the Section 704(c)(1)(C) Basis Adjustment. Although the issue is straightforward when a Section 704(c)(1)(C) Partner disposes of its entire interest in a partnership or the partnership disposes of the entire interest in Section 704(c)(1)(C) Property in a fully taxable transfer, the results are more complicated when there is a disposition of less than all

of an interest or partnership in which gain or loss is recognized only in part. The Proposed Regulations either fail to address the results, or reach results that are inconsistent with each other and with the results that would arise if the partner owned a direct undivided interest in the subject property. The Proposed Regulations also do not address the effect on Section 704(c)(1)(C) Basis Adjustments when, upon a non-liquidating distribution of cash or non-Section 704(c)(1)(C) Property to a Section 704(c)(1)(C) Partner, the partner recovers (or could be considered to have recovered) its outside basis attributable to its built-in loss in Section 704(c)(1)(C) Property.

Our substantive recommendations follow, in most cases after summaries of the relevant provisions of the Proposed Regulations.

1. Transfer of Section 704(c)(1)(C) Partner's Partnership Interest.

Prop. Treas. Reg. § 1.704-3(f)(3)(iii) provides specific rules intending to limit the benefit of the special Section 704(c)(1)(C) Basis Adjustment to the original contributing partner in the event of the transfer of a partnership interest by that partner. In general, if the transfer is a taxable transfer, the portion of the Section 704(c)(1)(C) Basis Adjustment "attributable to" the transferred interest is eliminated.[34] The 704(c)(1)(C) Partner would retain any remaining Section 704(c)(1)(C) Basis Adjustment. In nonrecognition transfers, the transferee succeeds to the Section 704(c)(1)(C) Basis Adjustment, reduced by any negative section 743 basis

[34] Prop. Treas. Reg. § 1.704-3(f)(3)(iii)(A). We note that Treas. Reg. § 1.704-3(a)(7) provides that in the case of a contributing partner's transfer of an interest with an associated built-in gain, the portion of the built-in gain that must be allocated to the transferee is "proportionate" to the interest transferred. We believe that the rules for built-in loss and built-in gain should be consistent and that the standard of "attributable to" is more appropriate than "in proportion to." The "attributable to" approach is more consistent with the construct that a transferee has acquired the allocable portion of the assets of the partnership. For example, if a section 754 election was in effect upon a cash sale of a partnership interest, the transferee would receive a step-up only to the extent necessary to eliminate any gain that would be allocated to the transferee if, immediately after the cash sale, the partnership sold all of its assets. *See, e.g.,* Section 743(b)(1); Treas. Reg. § 1.755-1(b)(1)(ii).

adjustment that "would be allocated to the Section 704(c)(1)(C) Property pursuant to the provisions of § 1.755-1 if the partnership had a section 754 election in effect upon the transfer."[35] In the case of a gift, however, the donee does not receive a carryover Section 704(c)(1)(C) Basis Adjustment.[36]

Recommendation – Clarify Meaning of "Attributable To." We recommend that the Final Regulations provide additional guidance as to how to determine the portion of the Section 704(c)(1)(C) Basis Adjustment "attributable to the transferred interest" and the portion attributable to the retained interest in a case in which a portion of the transferor's partnership is transferred. The Proposed Regulations provide limited guidance, in that Example 2 under Prop. Treas. Reg. § 1.704-3(f)(3)(iii), which illustrates the application of the rule, is ambiguous. In that example, A contributed property with a basis of $11,000 and a fair market value of $5,000 and a Section 704(c)(1)(C) Basis Adjustment of $6,000, for a one-third interest in a partnership, with B and C each having contributed $5,000 for their respective one-third interests. Upon sale of 50% of A's interest at a time that the property has not changed in value, A's Section 704(c)(1)(C) Basis Adjustment is reduced to $3,000, without an explanation as to the method of the computation.

We think that in many cases (particularly where there is a transfer of a "vertical slice"), it would be appropriate for the reduction in the Section 704(c)(1)(C) Basis Adjustment that results from a partial transfer to correspond to the recovery of outside basis. However, in other cases

[35] Prop. Treas. Reg. § 1.704-3(f)(iii)(B). This wording (the reference to making the adjustment only to the Section 704(c)(1)(C) Property) suggests that, even where there is no built-in gain property (that may reduce the amount of the overall section 743 adjustment), less than all of the Section 704(c)(1)(C) Basis Adjustment may be reversed out (as, if the partnership holds property other than Section 704(c)(1)(C) Property, some of the negative section 743 basis adjustment could be allocated to such other property).

[36] Prop. Treas. Reg. § 1.704-3(f)(3)(iii)(B)(2); H.R. Rep. No. 108-755, at 622 (2004), n. 546.

this may not be appropriate, such as where the transferor retains its entire (pre-transfer) share of partnership liabilities or the transfer involves a partnership interest with a disproportionally large (or small) interest in the underlying Section 704(c)(1)(C) property. Depending upon the policy at issue, it may be appropriate to tie the reduction in the Section 704(c)(1)(C) Basis Adjustment to the extent to which (i) there has been a transfer of the underlying Section 704(c)(1)(C) Property, (ii) there would have been a transfer of the underlying 704(c) loss in the absence of Section 704(c)(1)(C) or (iii) there is a recovery of the outside tax basis associated with that property.

> Example C. Partner E has a basis of $110 in non-depreciable property, which has a fair market value of $50. E contributes the property to Partnership EF for a 50% capital interest, and Partner F contributes $50 to EF for a 50% capital interest. E has a $60 Section 704(c)(1)(C) Basis Adjustment in the property. At the time of the contributions by both partners, E also receives a profits interest for services to be rendered. Upon grant, the profits interest has a liquidation value of $0. For the purposes of simplifying this example, assume that the profits interest will be allocated the first $100 of income earned by the partnership and that the grant of the profits interest is not subject to tax. At a time when $30 of income has been allocated to the profits interest (and no other income or loss has been allocated to any other interest in EF) and the fair market value of the property remains at $50, E sells two thirds of its profits interest for $20. E's overall basis in its partnership interest would equal $140 ($110 basis of contributed property plus $30 income allocated to E via the profits interest).
>
> The proper method of allocation of basis to the sold partnership interest is not entirely clear. Many taxpayers would calculate E's adjusted basis of the sold profits interest by apportioning basis to it based on the value of the sold interest relative to the value of the retained interest.[37] Here, the value of the sold interest is $20 and the value of the retained interest is $60 – accordingly, applying the principles of Rev. Rul. 84-53, the reporting position would be for E to apply $35 of its outside basis against the $20 sales proceeds and recognize a loss of $15. If E were to allocate basis in this manner, E should be required to reduce its Section 704(c)(1)(C) Basis Adjustment by $15, which is proportionate to the amount of outside basis that was taken into account in the sale.[38]

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[37] Rev. Rul. 84-53, 1984-1 C.B. 159, is generally viewed as providing the basis for this position.

[38] If there was no reduction in the $60 Section 704(c)(1)(C) Basis Adjustment, then upon a sale of the property for $50, E would recognize a $60 loss, reducing its basis in EF to $45. Although this loss would

We recommend that the Final Regulations allow taxpayers to use any reasonable method in determining the portion of the Section 704(c)(1)(C) Basis Adjustment that is "attributable to" a transferred interest, subject to an anti-abuse rule. The reasonable-method approach would be consistent with the current uncertainty in the law, addressed in the above example, concerning the determination of the portion of a partner's basis that is used to determine gain or loss when the partner transfers less than all of its partnership interest. It would also be consistent with the current uncertainty in the law as to what portion of any Section 704(c) (or reverse Section 704(c)) gain or loss transfers when the transfer is not a "vertical slice" of the transferor's interest. The antiabuse rule could cover situations in which the transferor seeks to recover some of outside basis that resulted from the Section 704(c)(1)(C) Property while retaining a disproportionate interest in the property.

If the Final Regulations adopt this recommendation, it would be helpful if they also include examples illustrating reasonable.

Recommendation – Gifts. Section 1015 provides that a donee takes gifted property with a basis equal to the lower of the donor's basis upon gift and the fair market value of the gifted property. Given this rule, the elimination of the Section 704(c)(1)(C) Basis Adjustment in the case of a gift seems inappropriate to the extent the elimination results in built-in gain to the donee. A donee of a partnership interest should be in the same position with respect to underlying Section 704(c)(1)(C) Property in which the donee would have been had that property been directly gifted to the donee.

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be reversed if E exited EF is a taxable transaction (either a sale or liquidation), E could be viewed as having received a double benefit from the high basis in the contributed loss property for some period. It is not entirely clear whether Section 704(c)(1)(C) was intended to limit the Section 704(c)(1)(C) Partner's use of the high tax basis in this circumstance or is limited to the the taxation of the non-contributing partners.

Example D. Partner G contributes property to partnership GH for a 50% interest in GH. At the time of contribution, the property has an adjusted basis to G of $100 and a fair market value of $60. The other partners contribute cash of $60. G has a $40 Section 704(c)(1)(C) Basis Adjustment in the property and a $100 basis in its GH partnership interest. At a time when the value of the property has increased to $70 and the value of all other partnership property is unchanged, G transfers its GH interest to Individual J for no consideration (that is, as a gift). Under section 1015, J would take the GH interest with a basis of $65, the fair market value of the GH interest. Under the Proposed Regulations, none of the Section 704(c)(1)(C) Basis Adjustment in the property would transfer. If GH sold the property, J would recognize a $5 capital gain (50% partnership interest * $10 gain to partnership). J could recover only this gain upon liquidation of its GH interest, at which time J would recognize a $5 capital loss (adjusted basis of partnership interest $70 ($65 post-gift basis + $5 gain on sale of the property), liquidation proceeds of $65). Conversely, had J been treated as receiving an undivided interest in the property, J would be treated as having a $5 basis offset in the property and would not recognize gain upon the sale of the property by GH for $70.

Accordingly, we recommend that a donee be permitted to retain the donor's Section 704(c)(1)(C) Basis Adjustment, reduced by the amount of the negative section 743 basis adjustment that would have arisen had the partnership interest been transferred by an arm's length sale with a section 754 election in effect.[39] This would, in substance, put the donee in the same position as if the donor had transferred an undivided interest in the property, and would be in harmony with the aforementioned basis rule of section 1015. This would also make the rule more consistent with the approach of the Proposed Regulations to non-gift nonrecognition transactions. On the facts of the above example, had Partner G sold its GH interest for its value ($65) and had a section 754 election been in effect with respect to GH and the $40 Section 704(c)(1)(C) Basis Adjustment otherwise carried over, the transferee would have had a negative $35 section 743 adjustment, reducing its Section 704(c)(1)(C) Basis Adjustment in the property to $5.

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[39] For this limited purpose, the Section 704(c)(1)(C) Basis Adjustment would be considered to have otherwise carried over (which it normally does not on a taxable sale).

2. Transfer of Section 704(c)(1)(C) Partner's Partnership Interest to a Corporation.

The Proposed Regulations provide an example that illustrates the interaction of sections 704(c)(1)(C) and 362(e) where a Section 704(c)(1)(C) Partner transfers an interest in a partnership to a corporation in a nonrecognition transaction under section 351 (the "704(c)(1)(C)/362(e) Interaction Example"). Under the example, the transferor and transferee did not elect to reduce the basis of the corporate stock and the value of the partnership assets had not changed since contribution. Therefore, under section 362(e)(2)(A), the basis of the contributed partnership interest was reduced to its fair market value. As a result, there would be a negative section 743 adjustment if the partnership had made a section 754 election. The example further provides that this negative adjustment will be allocated among the partnership's assets "in accordance with section 755 and the regulations thereunder."

Recommendation – Further Develop the 704(c)(1)(C)/362(e) Interaction Example. The 704(c)(1)(C)/362(e) Interaction Example presents two questions that the Final Regulations should address. First, the Final Regulations should address the situation in which an election to reduce the basis of the stock of the corporation under section 362(e)(2)(C) is made. In that case, the rules under section 362(e) should control, and the Final Regulations should provide that the corporation retains the Section 704(c)(1)(C) Basis Adjustment as adjusted under section 362(e) and the regulations thereunder. Second, once the basis of the partnership interest transferred has

been determined, the rules under section 743 can be applied to further adjust the basis of the property held by the partnership with respect to the corporation.[40]

3. Transfer of Section 704(c)(1)(C) Property by Partnership.

Similar to the rules governing section 743 adjustments, Section 704(c)(1)(C) Basis Adjustments are generally taken into account in determining the Section 704(c)(1)(C) Partner's income, gain, loss or deduction from the sale or exchange of Section 704(c)(1)(C) Property. Special rules apply to a variety of nonrecognition or partial recognition transfers, described below.

As mentioned earlier, the Proposed Regulations generally do not address transfers of built-in loss property in which there is a partial recognition of gain (for example, a section 351 contribution with boot). Implicitly, the Proposed Regulations provide that the entire Section 704(c)(1)(C) Basis Adjustment may be applied to reduce the Section 704(c)(1)(C) Partner's income or loss. This would lead to a result that is arguably inconsistent with the book allocations of income or loss, as illustrated by the analysis of the section 1031 example below. A different result would apply if the paradigm was a sale by the Section 704(c)(1)(C) Partner of the appropriate portion of the property directly. In such a case, if the property had appreciated so that the contributing partner's share of the post-contribution appreciation exceeded the partner's Section 704(c)(1)(C) Basis Adjustment, the contributing partner would have recognized some amount of gain.[41]

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[40] To the extent that the partnership interest transferred was itself an asset that was subject to a Section 704(c)(1)(C) Basis Adjustment, (such as an interest in a LTP) there would need to be a corresponding adjustment to the Section 704(c)(1)(C) Basis Adjustment to reflect the reduction in the basis of the corporate stock under section 362.

[41] As a general illustration: Partner A has an adjusted basis of $100 in property, which has a fair market value of $90. Partner A contributes property to ABC, for a 50% interest in ABC. A has a $10 Section 704(c)(1)(C) Basis

Recommendation – Limit Recovery of Basis Adjustment where Partial Gain Recognized. We believe that Treasury and the IRS should consider adopting a rule that would allocate the contributing partner's Section 704(c)(1)(C) Basis Adjustment between the portion of the property transferred and the portion retained, rather than apply the basis adjustment first to offset any gain recognized.

This issue is not directly considered in the treatment of section 743 basis adjustments. Treas. Reg. § 1.743-1(h)(2)(ii) provides that, in the case of a section 351 contribution of partnership property, the partnership recognizes gain as if any section 743 basis adjustments in the property did not exist and that "[t]he amount of gain, if any, recognized by the partnership on the transfer that is allocated to a partner with a basis adjustment in the transferred property is adjusted to reflect the partner's basis adjustment in the transferred property." This rule suggests that a basis adjustment should be applied against any gain that would otherwise be recognized but does not explicitly address the partial gain recognition case. An example intended to illustrate the rule[42] provides no further guidance because the example appears to address a situation in which the property with the section 743 basis adjustment does not change in value from the time in which the adjustment was calculated. Consider the following example, where property with a Section 704(c)(1)(C) Basis Adjustment appreciates in value subsequent to contribution to a partnership.

> Example E. Partner K contributes Section 704(c)(1)(C) property with a value of $10 and basis to Partner K of $100 in exchange for a 50% KL interest. Partner K

Adjustment. The property subsequently increases in value to $115, at which time it is sold by ABC. A has a gain of $2.50 ($12.50 allocable share of ABC's gain less $10 Section 704(c)(1)(C) Basis Adjustment). If the partnership transferred the property in a transaction in which only $15 of gain is recognized by the partnership (of which A's share is $7.50), the question is what portion of the special basis adjustment may be applied to reduce the gain.

[42] Treas. Reg. § 1.743-1(h)(2)(iv).

> has a $90 Section 704(c)(1)(C) Basis Adjustment in the property. The property appreciates in value to $310. In a transaction that qualifies under section 351, partnership KL contributes the property to Corporation A in exchange for $210 of Corporation A stock and $100 cash. KL realizes $300 of gain, of which $100 is recognized and $50 is allocated to each partner (before applying the Section 704(c)(1)(C) Basis Adjustment).[43]

The issue is how much of the Section 704(c)(1)(C) Basis Adjustment should be applied to reduce the gain allocated to the contributing partner. The Proposed Regulations do not address this issue and there are multiple possible approaches. The entire amount of the Section 704(c)(1)(C) Basis Adjustment could be applied to reduce the gain recognized.[44] This approach would result, in the example above, in Partner K recognizing no gain even though there was an economic profit. Alternatively, the basis adjustment could be allocated either in proportion to the recognized gain and realized but unrecognized gain or in proportion to the fair market value of the consideration received (i.e., in proportion to the value of the boot received as compared to the value of the property received without recognition of gain).[45]

a. Section 1031 Exchange.

If Section 704(c)(1)(C) Property is transferred in a section 1031 ("like-kind") exchange, the replacement property takes on the same Section 704(c)(1)(C) Basis Adjustment, adjusted for gain or loss recognized, and again only with respect to the Section 704(c)(1)(C) Partner. The

[43] Prior to enactment of section 704(c)(1)(C), KL would have realized a gain of $210, of which $100 would be recognized. Partner K would have been allocated $50 of that recognized gain.

[44] In such a situation, the application of the basis adjustment should not be applied to permit recognition of a loss.

[45] Another alternative would be to permit the Section 704(c)(1)(C) Partner to apply as much of the Section 704(c)(1)(C) Basis Adjustment to put the partner in the same economic position as if the partner had disposed of its proportionate share of the property not through a partnership. We are concerned that Section 704(c)(1)(C) Basis Adjustments would be applied in a fashion that would defer taxable gain on the partial disposition of an asset, where there is economic gain on the disposition. Compare to the general rules of, for example, Sections 351, 356 and 1031, which require the recognition of gain to the extent of boot.

Proposed Regulations contain an example (the "1031 Example")[46] in which a 50% partner contributes property with a $12,000 basis and a $10,000 fair market value to a partnership, and the property subsequently appreciates in value to $13,000, at which time the partnership engages in a like-kind exchange with respect to the property in which $12,000 of qualifying property and $1,000 of cash is received. The example provides that the partner "must use" $500 of its $2,000 Section 704(c)(1)(C) Basis Adjustment to offset the partner's share of the gain that would otherwise arise from the cash boot.

Recommendation – Potentially Recognize Net Built-in Gain on 1031 Exchange. We note that the 1031 Example suggests that a Section 704(c)(1)(C) Partner must utilize its basis adjustment against any gain that would otherwise be recognized on a section 1031 exchange, irrespective of whether the partner has a built-in gain (after taking into account any Section 704(c)(1)(C) Basis Adjustments) in the subject property. We suggest that the Final Regulations follow our general recommendation with respect to transactions in which gain is recognized in part and consider addressing how much of the basis adjustment must be utilized.

Recommendation – 1031 Exchange With Multiple Replacement Properties. The Proposed Regulations do not address how to allocate the Section 704(c)(1)(C) Basis Adjustment among multiple replacement properties. We recommend that the Final Regulations address how to allocate the adjustment among multiple replacement properties. Options include: (1) to allocate based on relative fair market value, (2) to allocate in a way that reduces disparity between fair market value and basis, or (3) any reasonable method. We believe that the least distortion would, in most cases, occur if the Section 704(c)(1)(C) Basis Adjustment were

[46] Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(2).

allocated on the basis of the relative fair market value of the properties, but we recommend that any reasonable method be allowed.[47]

b. Section 721 Contribution by Partnership.

The Proposed Regulations that address the contribution of Section 704(c)(1)(C) Property by a partnership (the UTP) to another partnership (the LTP) provide only a basic framework.[48] These rules also implicate the general concern about the approach to tiered partnerships. In the case of the contribution of Section 704(c)(1)(C) Property, the issue relates to ensuring that the use of tiered partnerships does not allow for an impermissible shift of the benefit of the excess basis to another partner.

If the property was first contributed to the UTP with a built-in loss and then contributed to the LTP, the interest in the LTP is treated as Section 704(c)(1)(C) Property as to the UTP with the same Section 704(c)(1)(C) Basis Adjustment as the contributed property, with the UTP's basis adjustment allocated solely to the partner that originally contributed the property.[49] Despit this, in such a circumstance, the LTP's common inside basis in the contributed property excludes the Section 704(c)(1)(C) Basis Adjustment.[50] If the property decreased in value from the time of

[47] As with other instances in which we recommend that taxpayers be able to choose any reasonable method, the regulations should make clear that the general section 704(c) anti-abuse rules are applicable.

[48] Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(B).

[49] The treatment of the LTP as Section 704(c)(1)(C) Property will apply even if the value of the property had appreciated by the time the property was contributed to the LTP. In that case the UTP would have both a "forward 704(c) allocation" reflecting the built-in gain upon the contribution of the property to the LTP and a separate Section 704(c)(1)(C) Basis Adjustment. The built-in gain would be allocated to UTP as required by section 704(c) and among the partners of the UTP as required under section 704(b) and the Section 704(c)(1)(C) special basis adjustment would be allocated only to the original contributing partner. In accordance with the approach to layering under the Proposed Regulations (described further at Part VIII of this Report), these adjustments would not be netted either for the UTP or the original contributing partner.

[50] Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(B)(1).

original contribution to the UTP, a Section 704(c)(1)(C) Basis Adjustment will be made in respect of the decrease and allocated to the UTP's partners to reflect each partner's share of the decrease.[51]

Recommendation –Ordering of Tiered Adjustments. In situations in which property that was contributed to the UTP with a built-in loss and then had a further adjustment as a result of either a decrease or increase in value prior to the contribution to the LTP, there are potentially multiple adjustments that would apply. The issue then arises as to whether there is a specific order or priority for applying the different adjustments. Example 3 of Prop. Treas. Reg. § 1.704-3(f)(3)(iv) illustrates the sale by a LTP of property that had a Section 704(c)(1)(C) Basis Adjustment attributable to its contribution to the UTP and another Section 704(c)(1)(C) Basis Adjustment that arose later, when the property was contributed by the UTP to the LTP. The example addresses the later arising Section 704(c)(1)(C) Basis Adjustments first[52]– this could imply an "ordering rule" in which later-arising basis adjustments need to be fully utilized before other basis adjustments can be accessed, which in turn could give rise to basis disparities in tiered partnership situations. We believe, however, that the attributable portion of a Section 704(c)(1)(C) Basis Adjustment should be utilized, regardless of its location in a tiered structure, and we suggest that this point be clarified in the Preamble to the Final Regulations. Another way

[51] Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(B)(2(b).

[52] This example describes a transaction in which A contributes loss property to UTP, which, after a further decline in the fair market value of the property, contributes that same property to LTP. At the time LTP sells the property, its fair market value is equal to its fair market value at the time it was contributed by UTP. Under the Proposed Regulations, LTP recognizes no gain or loss on the sale because its adjusted basis is equal to the sale price; however, the sale triggers both A's Section 704(c)(1)(C) Basis Adjustment, and UTP's Section 704(c)(1)(C) Basis Adjustment. Thus, in this example, the sale of the property by LTP results in recognition of loss to both UTP (which flows through to each of the partners) and to A in an individual capacity.

to express the idea is that the basis rules of the Proposed Regulations should simply be applied, and no special order should be imposed beyond that. The following example illustrates the issue.

> Example F. Partner M contributes property to UTP with a basis of $800 and a fair market value of $300 in exchange for a 50% interest in UTP. N contributes $300 in cash for a 50% interest in UTP. Following the contribution, UTP's basis in the property is $300, and M has a $500 Section 704(c)(1)(C) Basis Adjustment in the property. When the property's fair market value has decreased to $200, UTP contributes the property to LTP. UTP has a $100 Section 704(c)(1)(C) Basis Adjustment, which is allocated 50% to M and 50% to N. Then, LTP sells half of the property for $100. LTP will recognize no gain or loss because its basis was equal to the fair market value of property at the time of sale. However, the result must take into account both Section 704(c)(1)(C) Basis Adjustments. The adjustments that are triggered by this sale should be half of each Section 704(c)(1)(C) Basis Adjustment. This means that M will be entitled to recognize $250 of loss per its Section 704(c)(1)(C) Basis Adjustment plus an additional $25 from the portion of UTP's Section 704(c)(1)(C) Basis Adjustment that is allocated to M (half of the full $100 basis adjustment is $50, half of which is allocated to each partner). No ordering rule should mandate that UTP's Section 704(c)(1)(C) Basis Adjustment be utilized in full before any of M's Section 704(c)(1)(C) Basis Adjustment is accessible.

Similarly, no ordering rule should apply in a case where LTP sells property that has appreciated in value post-contribution by UTP. In the above example, if before LTP sold a 50% interest in property, property had appreciated to $250 (so that ½ of property was sold for $125), LTP would have realized $25 of gain, but UTP and Partner M still would have an overall loss. The result in this case should be that 50% of each of UTP's and Partner M's Section 704(c)(1)(C) Basis Adjustments be taken into account, rather than using an ordering rule to apply one full Section 704(c)(1)(C) Basis Adjustment before the other.

c. Section 351 Contribution by Partnership.

Under Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(C), the contribution of Section 704(c)(1)(C) Property to a corporation severs the 704(c)(1)(C) Partner's basis adjustment in the underlying property from the Section 704(c)(1)(C) Partner. Rather, the Section 704(c)(1)(C) Partner applies

the basis adjustment to the stock of the corporation, reduced by any gain that otherwise would have been recognized by the Section 704(c)(1)(C) Partner on the contribution but for the offsetting of the gain with some or all of the Section 704(c)(1)(C) Basis Adjustment.[53] The Section 704(c)(1)(C) Partner would recognize its built-in loss only upon the sale of the corporate stock by the partnership. This is consistent with a direct contribution by a shareholder of built-in loss property to a corporation under section 351 – because the corporation is not a look-through entity, the shareholder has no basis in the assets of the corporation and takes a substituted basis only in the corporate stock.

In addition, Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(C)(1) provides that a "corporation's adjusted basis in property transferred in a transaction described in section 351 is determined under section 362 (including for purposes of applying section 362(e)) by taking into account any Section 704(c)(1)(C) basis adjustment for the property…." This is consistent with the approach under section 743, in which the corporation's basis for the contributed property includes any section 743(b) adjustment with respect to the property.[54] It is not entirely clear whether the

[53] Under Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(C)(2), a Section 704(c)(1)(C) Partner's allocable share of any gain on a section 351 contribution is reduced by the Section 704(c)(1)(C) Basis Adjustment in the transferred property.

[54] Treas. Reg. § 1.743-1(h)(2)(i). So as to avoid loss duplication (recognition of built-in loss at the corporate level and shareholder-level loss recognition upon the sale of corporate stock), section 362(e) limits the application of section 362(a) carryover basis rule through two provisions, at sections 362(e)(1) and 362(e)(2). Section 362(e)(2) is the rule of more general application. It limits a transferee corporation's total basis for property transferred to it by any single transferor to the total fair market value of the transferred property. Thus, if the aggregate adjusted bases of transferred property in the hands of a transferee corporation exceed their aggregate fair market value, the bases of the assets will be stepped down to their aggregate fair market value. The basis reduction is allocated among the transferred property in proportion to the built-in loss in each item of property. However, under section 362(e)(2)(C) the transferor and transferee may jointly elect to apply the basis reduction rule of section 362(e)(2) to the transferor's stock instead of the property in the hands of the corporate transferee.

Section 362(e)(1) (which trumps section 362(e)(2) when both apply) restricts importation of built-in losses on certain transfers to corporations (generally from non-taxable persons to taxable corporations), if the aggregate adjusted bases of the assets transferred in the transaction (that are taxable in the hands of the transferee) exceed their fair market value at the time of the transfer. In such a case, each asset transferred (that is taxable in the hands of the transferee) takes a fair market value basis in the hands of the transferee.

basis of the transferred property includes the amount of the Section 704(c)(1)(C) Basis Adjustment for all purposes. For example, if the property has not changed in value, its basis in the hands of the corporation will be determined by reference to whether it is the only property transferred, in which case there would be a basis reduction under section 362(e)(2), or whether it was transferred with other property, in which case there may or may not be a basis reduction. In contrast, if the property has appreciated its value since its contribution to the partnership, then no basis reduction under section 362 may be applied. Finally, it is not clear under the Proposed Regulations whether the transferor and transferee may elect to apply any basis step-down against the corporate stock rather than the property contributed to the corporation.[55]

We believe the Final Regulations need clarification. First, the regulations should explicitly address whether the Section 704(c)(1)(C) Basic Adjustment is included in the corporation's basis, as would be the case with a section 743(b) adjustment. Second, to the extent that the Section 704(c)(1)(C) Basis Adjustment is included in the corporation's basis, the Final Regulations should explicitly provide that the specific election under section 362(e)(2)(C) is available. In that case, the corporation and the partnership would import the built-in loss to the corporation in exchange for the cancellation of the Section 704(c)(1)(C) Basis Adjustment that would otherwise arise in the stock of the corporation.[56] In that event, the Final Regulations should specify the portion of any adjustment that is required to be made to the stock that is attributable to the Section 704(c)(1)(C) Basis Adjustment.

d. Installment Sales.

[55] See the prior footnote for a description of the basis reduction rules of section 362(e) and the election provided at section 362(e)(2)(C).

[56] In that case, there would also be a corresponding basis adjustment to the contributing partner's interest in the partnership.

Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(E) provides that when a partnership disposes of Section 704(c)(1)(C) Property in an installment sale, the installment obligation assumes the Section 704(c)(1)(C) Basis Adjustment, with "appropriate" adjustments for gain recognized on the installment sale.[57] Presumably this means that the Section 704(c)(1)(C) Partner must recognize gain in a fashion consistent with the other partners (that is, without taking into account the Section 704(c)(1)(C) Basis Adjustment) and would offset this gain by applying portions of the Section 704(c)(1)(C) Basis Adjustment in the same fashion in which common partnership basis is recovered under the installment sale. This could give rise to the recognition of loss over time to the Section 704(c)(1)(C) Partner.

> Example G. Partner O contributes property to Partnership OP for a 50% interest in OP. At contribution, O has a $100,000 adjusted basis in the property, which has a fair market value of $50,000. O has a $50,000 Section 704(c)(1)(C) Basis Adjustment in the property. OP subsequently sells the property for $120,000, to be paid in equal installments of $40,000 over three years. Assume the sale is eligible for the installment method. The gain to OP ($70,000) is recognized in equal portions ($23,333) over the three years and is allocated to each partner $11,667 per year. Under the Proposed Regulations, O would appear to be required to apply its Section 704(c)(1)(C) Basis Adjustment in the property in equal portions ($16,667) against each installment payment, such that O would recognize a taxable loss of $5,000 ($11,667 minus $16,667) each year.

Recommendation – Allow for Current Recognition of Net Loss. The installment sale rule of the Proposed Regulations appears to preserve built-in loss, to be recognized over the term of the installment obligation. This rule is in seeming conflict with the position of Revenue Ruling 79-92,[58] which held that a partner should recognize its entire loss on an installment sale, even where each of the other partners recognized gain. (In the ruling, the partner's loss was attributable to positive section 743 basis adjustments). Further, losses are not reported on the

[57] This approach is similar to that of Treas. Reg. § 1.704-3(a)(8)(ii).

[58] Rev. Rul. 79-92, 1979-1 C.B. 180.

installment method. We suggest that the Final Regulations replace the installment sale rule of the Proposed Regulations.

Where, taking into account all allocable fixed and contingent installment payments that could be received, the Section 704(c)(1)(C) Partner would have a net loss, the Section 704(c)(1)(C) Partner should be required to currently apply its entire Section 704(c)(1)(C) Basis Adjustment against the partner's share of "partnership level" gain from the sale. For this purpose, such gain would be calculated by reference to fixed payments to be received in the current taxable year and in future taxable years, where the application of the Section 704(c)(1)(C) Basis Adjustment against the partner's share of partnership-level gain would yield an overall loss. For example, on the facts of Example G, Partner O should be required to recognize a $15,000 loss in year 1, with no further consequences from the sale.

Where there is or could be a net gain to the Section 704(c)(1)(C) Partner, we recommend that the basis adjustment not be fully utilized currently, so as to avoid a gain recapture situation (i.e., recognition of loss in one year followed by recognition of gain). Instead, the regular installment rules should generally be followed, with the Section 704(c)(1)(C) Basis Adjustment recovered in the same fashion as common partnership basis. We recognize that the allocation of the basis adjustment to each of the payments received may result in the recognition of gain in one or more years followed by a loss in the final year of payment.[59] However, this situation is similar to many others that could arise under the installment sale rules where the maximum selling price is uncertain.

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[59] When an installment sale provides for payments over a fixed period of time but does not provide for a maximum stated selling price, basis is normally allocated in equal annual increments over the payment period. Where payments for a year are less than the basis allocable to the year, the "loss" is not allowed and instead the excess basis is carried forward. Temp. Treas. Reg. §§ 15A.453-1(c)(3)(i) and 15A.453-1 (c)(4).

4. Distributions Involving Section 704(c)(1)(C) Property or Section 704(c)(1)(C) Partner.

The Preamble states that the Proposed Regulations generally provide rules similar to those for section 743(b) adjustments. In addition to the recommendations in the below three subsections, we also recommend in Section VI below that the Final Regulations contain rules and examples that explain and illustrate how Section 704(c)(1)(C) Basis Adjustments are affected by mergers and divisions, with the objective of keeping an entire Section 704(c)(1)(C) Basis Adjustment with the original Section 704(c)(1)(C) Property to which the adjustment relates.

a. Distribution of Section 704(c)(1)(C) Property to Section 704(c)(1)(C) Partner.

Section 732(a) provides that in the case of a non-liquidating distribution by a partnership to a partner, the property received by the distributee partner is equal to the basis of the distributed property to the partnership. This is subject to the limitation that if the partner's outside basis (that is, its basis in its partnership interest) is less than the basis to the partnership of the distributed property, the distributed property will take an aggregate basis equal to the partner's pre-distribution outside basis in the partnership less the amount of money distributed.[60] The Proposed Regulations provide that the basis of Section 704(c)(1)(C) Property includes its Section 704(c)(1)(C) Basis Adjustment when that property is distributed to the Section 704(c)(1)(C) Partner that contributed it.[61]

[60] Section 732(a)(2).

[61] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A); Prop. Treas. Reg. § 1.704-3(f)(3)(v)(D), Example 1. This approach is similar to that of Treas. Reg. § 1.743-1(g)(1)(i).

Recommendation – Address Situation in which Basis Capped Under Section 732. The Final Regulations should address the situation in which the basis of distributed Section 704(c)(1)(C) Property is reduced due to a lower outside basis. As in the case of distributions in complete liquidation of a partner's interest or distributions of Section 704(c)(1)(C) Property to a non-Section 704(c)(1)(C) Partner (discussed below), any unused Section 704(c)(1)(C) Basis Adjustment should be allocated to other (undistributed) assets of the partnership, in accordance with the rules of Treas. Reg. § 1.755-1(c). In such a situation, the Final Regulations would also need to distinguish between adjustments with respect to the Section 704(c)(1)(C) Basis Adjustment and any additional adjustments that would be required under section 734 (that is, decide which adjustments come first).

> Example H. For a 50% interest in Partnership QR, Partner Q contributes two nondepreciable capital assets, property 1 with a basis of $100 and a fair market value of $80 and property 2 with a basis of $0 and a fair market value of $70. Q has a $20 Section 704(c)(1)(C) Basis Adjustment in property 1 and a $100 basis in its QR interest. $25 of operating losses are allocated to Q, reducing Q's basis in QR to $75. QR then distributes property 1 to Q. Under section 732(a)(2), A takes property 1 with a $75 basis. Q should be allowed to reallocate its $20 Section 704(c)(1)(C) Basis Adjustment among the remaining property of QR. If QR does not have a section 754 election in effect, no further basis adjustments are made. If QR has a section 754 election in effect, under section 734(b)(1)(B), a $5 upward basis adjustment should be allocated among the remaining property of QR, in accordance with Treas. Reg. § 1.755-1(c).

b. Distribution of Section 704(c)(1)(C) Property to Another Partner.

Prop. Treas. Reg. § 1.704-3(f)(3)(v)(B) sets forth the rules that govern the distribution of Section 704(c)(1)(C) Property to another partner. The distributee partner does not take the distributed Section 704(c)(1)(C) Property with the Section 704(c)(1)(C) Basis Adjustment—rather, the distributee inherits the partnership's basis in the property, subject to the basis

limitation rules of section 732.[62] If Section 704(c)(1)(B)[63] causes the Section 704(c)(1)(C) Partner to recognize loss on the distribution, then the 704(c)(1)(C) Partner takes into account the Section 704(c)(1)(C) Basis Adjustment in determining the amount of the loss.[64] Presumably under this circumstance, a Section 704(c)(1)(C) Partner can recover a portion of its Section 704(c)(1)(C) Basis Adjustment if less than a complete interest in the Section 704(c)(1)(C) Property is distributed to another partner. In addition, if the entire Section 704(c)(1)(C) Basis Adjustment is not recovered in the distribution, then the remaining portion of the adjustment is reallocated among the remaining property of the partnership in accordance with the basis allocation rules of Treas. Reg. § 1.755-1(c) (which govern the allocation of section 734(b) basis adjustments).

Recommendation – Allocation of Unrecovered Basis Adjustment. The Preamble requested comments on whether reallocations of Section 704(c)(1)(C) Basis Adjustments upon the distribution of Section 704(c)(1)(C) Property to another partner should occur as provided for under the rules applicable to section 734 adjustments, or instead "under the principles of Prop. Treas. Reg. § 1.755-1(b)(5)(iii) to take into account the partner's allocable share of income, gain, or loss from each partnership asset."[65]

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[62] This approach is similar to that of Treas. Reg. § 1.743-1(g)(2)(i).

[63] Section 704(c)(1)(B) generally provides that where contributed property is distributed to a non-contributing partner within seven years of contribution, the contributing partner will recognize gain or loss as if the distributed property had been sold for its fair market value at the time of the distribution.

[64] As an aside, this section of the Proposed Regulations refers to where section 704(c)(1)(B) applies to treat the Section 704(c)(1)(C) Partner as recognizing "loss on the sale of the distributed property." Because the distributed property has not been sold, we suggest that the provision be changed to "loss as if the distributed property had been sold."

[65] 79 Fed. Reg. at 3048.

If the section 734 rules are used, basis adjustments would be allocated only to property of "like character." That is, if a section 734 adjustment arises from the distribution of a capital asset, the corresponding allocation can be made only to capital assets, with the same concept for ordinary income property.[66] If this rule is used for section 704(c)(1)(C), upward adjustments would then be apportioned among like character property in proportion to and to the extent of the total unrealized appreciation in that property (and not just the Section 704(c)(1)(C) Partner's share of unrealized appreciation), with any remaining adjustment apportioned among all like character property in proportion to the relative fair market values of each item of like character property.[67]

The Prop. Treas. Reg. § 1.755-1(b)(5)(iii) approach is not explained under the Preamble. We believe that the intent is to treat all partnership property as deemed sold and then allocate positive adjustments to the same class of property as the distributed Section 704(c)(1)(C) Property in proportion to the gross gain that the Section 704(c)(1)(C) Partner would recognize upon the deemed sale of each item of such class of partnership property, with any remaining adjustment apportioned among all property of that class in proportion to the relative fair market values of each item of property. If there is no like character property to which the upward adjustment can be reallocated, when and how any remaining positive adjustments would be reallocated is unclear.[68]

We prefer the Prop Treas. Reg. § 1.755-1(b)(5)(iii) approach to the section 734 approach. The Treas. Reg. § 1.755-1(b)(5)(iii) approach would look to the Section 704(c)(1)(C) Partner's

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[66] Section 734(c); Treas. Reg. § 1.755-1(c).

[67] Treas. Reg. §§ 1.755-1(c)(1) and 1.755-1(c)(2).

[68] Prop Treas. Reg. § 1.755-1(b)(5)(iii)(1) contains a rule for allocating leftover decrease, but not increase.

share of gain or loss in each item of partnership property (and not all partners' shares), and so is more likely to reduce the amount of unrealized gain that the applicable partner would have in items of partnership property.[69] We also believe that the rules should maximize the portion of the Section 704(c)(1)(C) Basis Adjustment that is reallocated to property of the same character as the distributed property, and so our preference for the Prop. Treas. Reg. § 1.755-1(b)(5)(iii) approach is based in part on our interpretation of how the approach would apply.

Recommendation – Do Not Apply Basis Adjustment for Purposes of Section 732(f). The Preamble requested comments on whether a Section 704(c)(1)(C) Basis Adjustment to distributed stock should be taken into account for purposes of section 732(f), notwithstanding the general rule that distributees that receive Section 704(c)(1)(C) Property that they themselves did not contribute do not take into account the Section 704(c)(1)(C) Basis Adjustment under section 732.[70] We believe that the basis adjustment should not be taken into account under section 732(f).

Neither the operation nor policy of section 732(f) would require that any Section 704(c)(1)(C) Basis Adjustment be taken into account. The Proposed Regulations generally provide that a Section 704(c)(1)(C) Basis Adjustment generally is not basis to a distributee that did not contribute the distributed property, and so, accounting for the adjustment differently under section 732(f) would often result in an adjustment in the basis of the assets of the

[69] As shown above, the Section 734 approach would more readily allocate a Section 704(c)(1)(C) Basis Adjustment to partnership property the sale of which would not give rise to gain to the Section 704(c)(1)(C) Partner (for example, property contributed with a built-in gain by another partner), even where there is other partnership property the sale of which would give rise to gain to the Section 704(c)(1)(C) Partner (for example, property in which the partnership has a $100 basis declines in value to $70, at which time the Section 704(c)(1)(C) Partner enters the partnership and which then increases in value to less than $100). The section 734 approach may be sensible when dealing with section 734 adjustments, which are shared by all partners. The more individualized Prop. Treas. Reg. § 1.755-1(b)(5)(iii) approach (as we understand it) is more suited towards reallocating Section 704(c)(1)(C) Basis Adjustments, given that only the Section 704(c)(1)(C) Partner is impacted.

[70] 79 Fed. Reg. at 3048.

underlying corporation where that corporation is controlled by the distributee (because an amount equal to the adjustment would always be included in the partnership's basis against which the transferee corporation's basis is compared). We believe that the contribution of corporate stock with a built-in loss does not implicate the anti-subcorporation stuffing transactions that were the object of section 732(f).[71]

c. Distribution in Complete Liquidation of Section 704(c)(1)(C) Partner's Interest.

In the case of a distribution in complete liquidation, Prop. Treas. Reg. § 1.704-3(f)(3)(v)(C) provides that the adjusted basis of the distributed property includes the Section 704(c)(1)(C) Basis Adjustment, whether or not the basis adjustment relates to the distributed property.[72] The partnership reallocates any Section 704(c)(1)(C) Basis Adjustment from retained Section 704(c)(1)(C) Property of the liquidated partner to the distributed property in accordance with the basis allocation rules of Treas. Reg. § 1.755-1(c)(i) (after taking into account the anti-mixing bowl rules of sections 704(c)(1)(B) and 737).[73] If the entire basis adjustment cannot be

[71] As background, Section 732(f) generally provides for a reduction in the basis of corporate property when corporate stock is distributed to the corporate partner or a related party and the partner controls the distributed corporation. The Tax Relief Extension Act of 1999 amended section 732(f) to address a perceived abuse in which a corporate partner would achieve an tax-free increase in the basis of assets received in distributions from a partnership. For example: Corporation X is a partner in partnership XYZ, with a basis of $0 in its partnership interest, and the partnership has an asset with a basis and value of $100. The partnership plans to distribute the asset to X. X would take a $0 basis in the property under section 732 and recognize $100 of gain on a subsequent disposition of the property for $100. To avoid this, XYZ contributes the asset to a newly formed corporation (Newco) and then distributes 100% of Newco's stock to X. Under section 732, X will take the Newco stock with a basis of $0. However, because X owns 100% of Newco stock, it can liquidate Newco tax-free under Section 332. Under section 334(b), Newco's basis in the asset it distributes in liquidation would carry over to X, so that X would eliminate $100 of built-in gain from the partnership distribution. To prevent this result, section 732(f) provides that the basis of property held by a corporation whose stock is distributed by a partnership to a corporate partner is reduced when the corporate partner controls the subsidiary corporation after the distribution. Tax Relief Extension Act, Pub. L. No. 106-170, 113 Stat. 1860 (1999).

[72] This approach is similar to that of Treas. Reg. § 1.743-1(g)(3).

[73] As a clarification, the Final Regulations should also reference section 707.

reallocated to distributed property because the Section 704(c)(1)(C) Partner does not receive property of a like character to the Section 704(c)(1)(C) Property, as required under Treas. Reg. § 1.755-1(c) in order to allocate the basis, then the remaining basis adjustment is treated as a positive section 734(b) adjustment.[74] This positive section 734(b) adjustment is netted against any negative section 734(b) adjustment that arises on the liquidation.[75] On the liquidation of a Section 704(c)(1)(C) Partner's interest, the partnership will be treated as having a section 754 election in effect for the purposes of determining the negative section 734(b) adjustment that would arise on the distribution. This rule reduces the possibility that the liquidation will cause a section 734(b) basis reduction to the remaining partners. We believe this approach is sound.

5. Other Provisions Under Treasury Regulation § 1.704-3.

a. Proposed Treasury Regulation § 1.704-3(a)(7).

The Proposed Regulations introduce Prop. Treas. Reg. § 1.704-3(f) by modifying Treas. Reg. § 1.704-3(a)(7) to add a cross-reference to Prop. Treas. Reg. § 1.704-3(f). Prop. Treas. Reg. § 1.704-3(a)(7) states that "if the contributing partner transfers a portion of the partnership interest, the share of built-in gain proportionate to the interest transferred must be allocated to the transferee partner." We recommend that "proportionate to" be changed to "attributable to," so as to conform to the wording used elsewhere in the Proposed Regulations (such as Prop. Treas. Reg. § 1.704-3(f)(3)(iii)(A)), which we believe is a more appropriate phrasing.

b. Treasury Regulation § 1.704-3(a)(9).

[74] Treas. Reg. § 1.734-2(c).

[75] We note that this netting approach could cause an adjustment to "jump" from ordinary property to capital assets, or vice versa. *See* Prop. Treas. Reg. § 1.734-2(c)(3) Example 4 for an illustration (partner contributed capital asset with built-in loss, received ordinary property in liquidating distribution and so could not use Section 704(c)(1)(C) Basis Adjustment; partnership had negative section 734 basis adjustment to ordinary property, but adjustment offset by reallocated Section 704(c)(1)(C) Basis Adjustment originally attributable to capital asset).

The Proposed Regulations do not modify Treas. Reg. § 1.704-3(a)(9), which provides that, in a tiered partnership situation in which the LTP holds Section 704(c) Property of a UTP partner, the UTP must allocate its distributive share of LTP items with respect to the property in a manner that takes into account the UTP partner's remaining built-in gain or loss. Now that the Proposed Regulations provide rules governing such allocations for built-in loss property, we recommend that, at a new Prop. Treas. Reg. § 1.704-3(a)(9), the Final Regulations cross reference Prop. Treas. Reg. § 1.704-3(f).

6. Further Recommendations.

We have four further recommendations to the Proposed Regulations to section 704(c)(1)(C), as follow below.

Recommendation – Address Impact on Section 704(c)(1)(C) Basis Adjustment of Non-liquidating Distributions of Non-Section 704(c)(1)(C) Property and Loss Allocations. The Proposed Regulations do not address what happens to Section 704(c)(1)(C) Basis Adjustments when a Section 704(c)(1)(C) Partner receives a non-liquidating distribution of non-Section 704(c)(1)(C) Property (most notably, cash) or is allocated partnership losses. This is similar to the situation in which a Section 704(c)(1)(C) Partner sells a portion of a partnership interest in that the Section 704(c)(1)(C) Partner has received the benefit of the high basis by reducing or eliminating the amount of gain that would otherwise have been recognized or by using the higher basis to claim losses. However, unlike a transfer, the distribution may or may not change the Section 704(c)(1)(C) Partner's interest in the underlying Section 704(c)(1)(C) Property. Moreover, there is no "shift" of Section 704(c) gain (or loss) upon a distribution.

Depending on the policy at issue, it may be appropriate for the Final Regulation to provide that, if the partner's outside basis is reduced below the amount of the partner's Section 704(c)(1)(C) Basis Adjustment, there will be a reduction in the corresponding portion of the partner's Section 704(c)(1)(C) Basis Adjustment.[76] It would also be possible to provide that transactions designed to exploit the high outside basis while preserving the Section 704(c)(1)(C) Basis Adjustment may be subject to the general partnership anti-abuse rules in Treas. Reg. §1.704-2.[77]

Recommendation – Address Allocation Rules in Context of Mergers and Divisions. The application of the proposed distribution rules under Prop. Treas. Reg. § 1.704-3(f)(3)(v) in the context of partnership mergers and divisions is uncertain. The Proposed Regulations could be interpreted in a manner that results in a Section 704(c)(1)(C) Basis Adjustment's moving (in part) to property other than Section 704(c)(1)(C) Property, which we believe is contrary to the general objectives of the Proposed Regulations.[78] We recommend that the Final Regulations

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[76] If the Final Regulations provide for the reduction of a Section 704(c)(1)(C) Partner's basis adjustment upon a non-liquidating distribution, it could be argued that there should also be an offsetting upward section 734 adjustment (which would be shared by all partners). One argument for this is that the reduction of the Section 704(c)(1)(C) Basis Adjustment is akin to the recognition of gain, and that Prop. Treas. Reg. § 1.734-2(c)(2) provides for a similar adjustment when a Section 704(c)(1)(C) Partner receives a liquidating distribution to which the partner cannot allocate its Section 704(c)(1)(C) Basis Adjustment. The liquidation rule, however, appears to be designed to prevent anomalous results to the other partners under section 734, including the creation or exacerbation of an inside/outside basis disparity. For example, absent the liquidation rule, where a Section 704(c)(1)(C) Partner contributes built-in loss property and recognizes loss on a liquidating distribution of cash, that loss would give rise to a net downward section 734 adjustment attributable to pre-contribution losses. In contrast, in the non-liquidating distribution context, section 734 will not have been triggered (given that, under Prop. Treas. Reg. § 1.734-2(c)(1), Section 704(c)(1)(C) Basis Adjustments are to be taken into account in determining the basis adjustment under section 734(b)). Further, the Section 704(c)(1)(C) Partner may still have the opportunity to recognize the remaining built-in loss. Alternatively, it may be appropriate to provide that Section 734 will applied without regard to any outside basis attributed to the loss inherent in Section 704(c)(1)(C) Property.

[77] However, as noted above, it is not entirely clear whether Section 704(c)(1)(C) was intended to limit the Section 704(c)(1)(C) Partner's use of the high tax basis in this circumstance or is limited to the taxation of the non-contributing partners.

[78] In a sense, similar issues can arise with respect to the treatment of section 743(b) adjustments under Treas. Reg. § 1.743-1(g) and (h).

address this issue despite the presence of similar uncertainties with respect to section 743 basis adjustments. We recommend that the Final Regulations clarify that, to the extent possible, Section 704(c)(1)(C) Basis Adjustments should not move to other property as a result of a partnership merger or division. The examples below illustrate these issues in assets-up divisions and mergers and assets-over divisions and mergers and contain our recommendations based on the following base case.

Base Case. Partner A contributes property with an adjusted basis of $11,000 and a fair market value of $5,000, and Partner B contributes land with an adjusted basis and fair market value of $5,000 to AB1, a partnership.[79] A has a $6,000 Section 704(c)(1)(C) Basis Adjustment in the property.

Assets-up Division**.** More than seven years after the formation of AB1, when property and land are each worth $5,000, AB1 distributes half of property to A and half of property to B.[80] A and B contribute their interests in property to AB2, a newly formed partnership. As a general matter, if Section 704(c)(1)(C) Property is distributed to a partner other than the Section 704(c)(1)(C) Partner, the Section 704(c)(1)(C) Basis Adjustment is reallocated among the remaining items of partnership property under Treas. Reg. § 1.755-1(c).[81] However, the

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[79] Partner B is generally unaffected by the choice of allocation method and so is not addressed in the below discussion.

[80] The anti-mixing bowl rules do not apply to the distributions because the distributions occur more than seven years after the formation of AB1. Therefore, it is unnecessary to determine whether those rules would apply to the distributions if they had occurred within seven years of the contribution of property to AB1. See also T.D. 8925, 66 Fed. Reg. 715, 718 (Jan. 4, 2001) ("To the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the IRS and Treasury agree that a partnership division should not create new Section 704(c) Property or section 737 net pre-contribution gain.").

[81] Under Prop. Treas. Reg. § 1.704-3(f)(3)(v)(B), if section 704(c)(1)(B) applies to treat the Section 704(c)(1)(C) Partner as recognizing loss on the sale of the distributed property, the Section 704(c)(1)(C) Basis Adjustment is taken into account in determining the amount of the loss.

Proposed Regulations do not provide clear guidance regarding whether any portion of A's Section 704(c)(1)(C) Basis Adjustment is attributable to the portion of the property distributed to B, and, if so, whether that portion of the adjustment should be reallocated to AB1's remaining property (i.e., Land) or to the portion of the property that was distributed to A. Two general approaches could be taken.

Under the first approach, A's entire Section 704(c)(1)(C) Basis Adjustment is attributable to the portion of property that is distributed to A. A would take that adjustment into account in determining A's adjusted basis in that portion of the property.[82] A's adjusted basis in that portion of property would be $8,500 (i.e., $2,500 (half of AB1's $5,000 common basis in the property) plus $6,000 (the entire Section 704(c)(1)(C) Basis Adjustment)). Accordingly, A's outside basis in AB2 would be $8,500, and A would have a $6,000 Section 704(c)(1)(C) Basis Adjustment in the property.[83]

Under the second approach, only half of A's Section 704(c)(1)(C) Basis Adjustment is attributable to the portion of the property that was distributed to A. A would take only that part of the adjustment into account in determining A's adjusted basis in that portion of the property.[84] A's adjusted basis in that portion of property would be $5,500 (i.e., $2,500 (half of AB1's common basis in the property) plus $3,000 (half of the Section 704(c)(1)(C) Basis Adjustment)). A would have an outside basis in AB2 of $5,500 and a $3,000 Section 704(c)(1)(C) Basis

[82] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A).

[83] This result would be similar to the operation of Prop. Treas. Reg. § 1.704-3(f)(3)(v)(C), but that paragraph does not apply because the distribution to A is not in liquidation of A's interest in AB1.

[84] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A).

Adjustment in the property. The balance of A's Section 704(c)(1)(C) Basis Adjustment in the property, or $3,000, would be reallocated to land.[85]

We believe the first approach is preferable, because this approach would prevent any part of the Section 704(c)(1)(C) Basis Adjustment from being transferred to property other than that to which the adjustment originally relates. We recommend that the Final Regulations clarify that this approach should be used.

Assets-up Merger. The issues here are similar to those of assets-up divisions.[86]

Assets-over Division. More than seven years after the formation of AB1, when property and land are still each worth $5,000, AB1 contributes property to AB2, a newly formed partnership, and distributes an interest in AB2 to A ("A's AB2 interest") and an interest in AB2 to B ("B's AB2 interest").[87]

In the "nanosecond" after the contribution by AB1 to AB2, but before the distribution of the interests in AB2 to A and B, AB1's outside basis in AB2 is $5,000; AB2's common basis in the property is $5,000; and A has a Section 704(c)(1)(C) Basis Adjustment of $6,000 in AB1's interest in AB2.[88] AB1 also has a Section 704(c)(1)(C) Basis Adjustment of $6,000 in the property that must be segregated and allocated to A (the "tiered Section 704(c)(1)(C)

[85] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(B).

[86] Although in a simple case, A would end up in the same position irrespective of allocation method, A's ultimate position would be less clear on more complicated facts, such as if AB1 owned other assets and a portion of the property were distributed to B.

[87] The anti-mixing bowl rules do not apply to the distributions because the distributions occur more than seven years after the formation of AB1. Therefore, it is unnecessary to determine whether those rules would apply to this distribution.

[88] Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(B).

adjustment").[89] In determining its basis in the distributed AB2 interest, whether A ultimately takes into account A's entire Section 704(c)(1)(C) Basis Adjustment can depend on which of two approaches is applied.

Under the first approach, A's Section 704(c)(1)(C) Basis Adjustment is attributable solely to A's AB2 interest. In this case, A would take the entire Section 704(c)(1)(C) Basis Adjustment (i.e., $6,000) into account when determining its basis in A's AB2 interest and would have an $8,500 outside basis in its AB2 interest and a $2,500 outside basis in its AB1 interest.[90]

Under the second approach, A's Section 704(c)(1)(C) Basis Adjustment is attributable partly to A's AB2 interests and partly to B's AB2 interests. In this case, A would take only the Section 704(c)(1)(C) Basis Adjustment attributable to A's AB2 interest (i.e., $3,000) into account in applying section 732 to the distribution of A's AB2 interest.[91] The part of A's Section 704(c)(1)(C) Basis Adjustment attributable to B's AB2 interest (i.e., $3,000) would be reallocated to AB1's remaining property of a like character property (i.e., land).[92] This would cause A to have a $5,500 outside basis in AB1 and a $5,500 outside basis in AB2. Thus, A's outside bases in the two partnerships would be different depending on which approach is chosen.

Similar to our position for assets-up transactions, we believe that the first approach is preferable because this approach would prevent any part of the Section 704(c)(1)(C) Basis Adjustment from being transferred to property other than that to which the adjustment originally

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[89] *Id.*

[90] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A).

[91] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A).

[92] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(B).

relates. We recommend that the Final Regulations clarify that this approach should be used.[93] We also note that it could be argued that the Proposed Regulations already require the first approach because AB2 would be treated as a disregarded entity during the "nanosecond" before the AB2 interests are distributed by AB1. We believe, however, that further clarification is appropriate.[94]

Assets-over Merger. When the value and basis of both property and land are still $5,000, AB1 merges into AB2, an existing partnership, with AB2 surviving for state law and tax purposes. AB1 is deemed to contribute property and land to AB2 and then to distribute an interest in AB2 to A ("A's AB2 interest") and an interest in AB2 to B ("B's AB2 interest") in liquidation of AB1.[95]

In the "nanosecond" after the contribution by AB1 to AB2, but before the liquidation of AB1, AB1's common basis in AB2 is $10,000, and AB2's common basis in each of property and land is $5,000. A has a Section 704(c)(1)(C) Basis Adjustment of $6,000 in AB1's interest in AB2.[96] AB1 also has a Section 704(c)(1)(C) Basis Adjustment of $6,000 in the property that must be segregated and allocated to A (the "tiered Section 704(c)(1)(C) adjustment").[97]

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[93] We also suggest that the Final Regulations clarify that, if AB1 were to contribute built-in loss property in an assets-over division (that is, property that declined in value after its transfer to AB1), A and B would receive a corresponding Section 704(c)(1)(C) Basis Adjustment even though, as a technical matter, A and B did not contribute the property with the built-in loss.

[94] Similar issues can arise with respect to the treatment of section 743(b) adjustments under Treas. Reg. §§ 1.743-1(g) and (h).

[95] Treas. Reg. § 1.708-1(c)(3)(i). Even if the distribution were within seven years of the contribution, the anti-mixing bowl rules would not apply to the distributions because of the exceptions for transfers of all of a partnership's property to another partnership, followed by a distribution of interests in that partnership. *See* Treas. Reg. §§ 1.704-4(c)(4) and 1.737-2(b)(1)(i).

[96] Prop. Treas. Reg. § 1.704-3(f)(3)(iv)(B).

[97] *Id.*

In determining its basis in the distributed AB2 interest, A could, under the Proposed Regulations, take into account the entire basis adjustment under either of two approaches. Under the first approach, A's Section 704(c)(1)(C) Basis Adjustment is attributable solely to A's AB2 interest, and A takes that adjustment into account in determining its basis in the distributed interest.[98]

Under the second approach, A's Section 704(c)(1)(C) Basis Adjustment is attributable partly to A's AB2 interest and partly to B's AB2 interest. In this case, the Section 704(c)(1)(C) Basis Adjustment attributable to the AB2 interest distributed to B would be reallocated to the AB2 interest distributed to A.[99] Thus, in applying section 732 to the distribution to A, A takes into account both the Section 704(c)(1)(C) Basis Adjustment attributable to the AB2 interest distributed to it and the reallocated Section 704(c)(1)(C) Basis Adjustment.[100] Therefore, A's outside basis in AB2 is $11,000 under either approach.[101]

The Final Regulations should clarify, whether by text and example or solely by example, that (i) the tiered Section 704(c)(1)(C) Basis Adjustment in AB2's assets (i.e., property in this example) continues to be segregated and allocated to A after the liquidation of AB1, and (ii) B does not step into the shoes of AB1 with respect to any part of the tiered adjustment under Prop. Treas. Reg. § 1.704-3(f)(3)(iii)(B).

Recommendation – Place Proposed Regulations to Section 704 in Own Section. Strictly for organizational reasons, we suggest that the Proposed Regulations to section 704 (that is,

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[98] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A).

[99] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(C).

[100] Prop. Treas. Reg. § 1.704-3(f)(3)(v)(A) and (C).

[101] Section 732(b).

Prop. Treas. Reg. § 1.704-3(f)) be placed in a new Treas. Reg. § 1.704-5 (as existing Treas. Reg. § 1.704-3 addresses general principles and allocation methods).

Recommendation – Use of Reasonable Method. Because the Proposed Regulations do not address all issues or circumstances that could arise due to Section 704(c)(1)(C) Basis Adjustments, we recommend that Treasury *and* the IRS consider having the Final Regulations provide that taxpayers may use any reasonable method for addressing Section 704(c)(1)(C) Basis Adjustments where no specific method is set forth in regulations or other applicable guidance.

IV. Proposed Regulations to Section 734.

A. Background on Section 734.

When a partnership distributes property to a partner, section 734 applies to adjust the basis of the property retained by the partnership where either (1) a section 754 election is in effect with respect to the partnership or (2) even if no section 754 election is in effect, the distribution gives rise to a SBR (the threshold for which is described below). Where a section 754 election is in effect, a distribution gives rise to a basis step-up to the extent the distributee recognizes gain on the distribution or takes the distributed property with a lower basis than that at which the partnership held the property, and a basis step-down to the extent the distributee recognizes loss on the distribution or takes the distributed property with a higher basis than that at which the partnership held the property.[102] If the amount of the basis reduction exceeds $250,000, there is a SBR and the distribution gives rise to a mandatory basis step-down in an amount equal to the basis step-down that would have occurred had a section 754 election been in effect.

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[102] Section 734(b)(2)(B); Treas. Reg. § 1.734-1(b).

B. Proposed Regulations to Section 734.

The Proposed Regulations to section 734 provide guidance as to (1) what constitutes a SBR, (2) the circumstances under which a LTP must adjust the basis of its assets under section 734 when a UTP that directly or indirectly holds an interest in the LTP makes a section 734(b) adjustment and (3) the impact of section 734 on liquidating distributions to Section 704(c)(1)(C) Partners. The remainder of this section of this Report discusses our views of items (1) and (2).[103] We also discuss below an issue not addressed by the Proposed Regulations: that section 734(b) adjustments, under certain circumstances, perpetuate inside/outside basis disparities (though we recommend that no measure be taken to counteract this).

1. Substantial Basis Reduction ("SBR").

Section 734(b)(2) provides that, with respect to a distribution by a partnership with a section 754 election in effect or a distribution with respect to which there is a SBR, the partnership shall decrease the adjusted basis of its remaining assets by (A) the amount of any loss recognized by "the distributee" under section 731(a)(2)[104] or (B) the amount of the basis increase with respect to which the distributee takes the property under section 732.[105] Section 734(d) provides that there is a SBR with respect to a distribution "if the sum of the amounts described in subparagraphs (A) **and** (B) of subsection (b)(2) exceeds $250,000" (emphasis added). Because one partner cannot both recognize a loss as described in Section 734(b)(2)(A) and have an increase in basis of distributed property under section 734(b)(2)(B) in a single

[103] Item (3) was discussed in Part III of this Report.

[104] Section 731(a)(2). This can apply only in the case of a liquidation of the distributee for cash and other limited classes of property.

[105] Section 734(b)(2). This can apply only in the case of a liquidating distribution not described under section 731(a)(2).

distribution, there was a question as to whether a SBR should be determined by reference to a partnership's aggregate distributions (to all partners) for a taxable year (an "aggregate approach") or by reference only to properties distributed to the partner-distributee (a "partner-by-partner" approach).

The Preamble suggests that the partner-by-partner approach is the proper method and further provides that the $250,000 threshold is determined by reference to all properties distributed to the partner-distributee "as part of the same distribution."[106] The conclusion is based upon the statutory language referring to a distribution to "a partner" and the reference to the "distributee partner" or "distributee." Thus, under this approach, there would be no SBR if there were distributions to multiple partners as long as no single distributee had a reduction in basis (or loss) exceeding the $250,000 threshold, even if, in the aggregate the threshold is exceeded.

Recommendation – Clarify Rule in Final Regulations. We agree with the partner-by-partner approach set forth in the Preamble but have two recommendations to further clarify the SBR rule. First, we recommend that the Final Regulations expressly state that the partner-by-partner approach is the general rule (and explain that the SBR threshold is judged only with respect to properties distributed as a part of the "same distribution"). Similarly, the Final Regulations should modify Prop. Treas. Reg. § 1.734-1(a)(2) to read "there is a substantial basis reduction with respect to a distribution of property or properties to a partner if the sum of the amounts described in section 734(b)(2)(A) **or** (b)(2)(B) exceeds $250,000" (emphasis added to show the changed word from the Proposed Regulations).

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[106] 79 Fed. Reg. at 3052.

Second, we suggest that the Final Regulations (under section 734) clarify how a Section 704(c)(1)(C) Basis Adjustment is accounted for in calculating whether the $250,000 threshold has been met. Where Section 704(c)(1)(C) Property is distributed to the partner that contributed the property, the basis of the property to the partnership immediately before the distribution (that is, the adjusted partnership basis against which the SBR is measured) should take into account the Section 704(c)(1)(C) Basis Adjustment. Prop. Treas. Reg. §§ 1.732-2(c)(1) and Prop. Treas. Reg. §§ 1.704-3(f)(3)(v)(D), Example 1 indicates that this is the rule, but the Final Regulations should be explicit. Where Section 704(c)(1)(C) Property is distributed to a non-contributing partner, the adjusted partnership basis should exclude the Section 704(c)(1)(C) Basis Adjustment that was associated with the property prior to its distribution.[107]

2. Tiered Partnerships.

The Proposed Regulations add a new § 1.734-1(f), which specifies two circumstances under which section 734(b) adjustments by a UTP can give rise to basis adjustments by LTPs.

First, if a UTP makes a section 734 basis adjustment to the basis of an interest in a LTP that has a Section 754 election in effect, the LTP must make section 734(b) adjustments with respect to the UTP's share of the LTP's assets. The overall adjustment must equal the adjustment made to the basis of the UTP's interest in the LTP. This result is consistent with that of Situation 1 in Revenue Ruling 92-15, which Prop. Treas. Reg. § 1.734-1(f)(1) cites to as containing additional examples of the application of the principles of Prop. Treas. Reg. § 1.734-1(f)(1).

[107] This result is consistent with the transfer of the Section 704(c)(1)(C) Basis Adjustment to other partnership property. In such circumstance, the special basis adjustment continues only with respect to the Section 704(c)(1)(C) Partner. *See* Prop. Treas. Reg. § 1.704-3(f)(3)(v)(B).

Second, if there is a SBR with respect to a distribution by a UTP, then each direct or indirect LTP (through other partnerships) of the UTP will be treated as having made a section 754 election, but solely with respect to the distribution.[108] The Preamble noted the administrative difficulties in tiering down where a LTP does not have a section 754 election in effect and requested comments on the scope of the section 734 tier-down rule.[109] The following example illustrates the section 734 tier-down rule:

> Example I. U, V, and W are equal partners in UTP, a partnership. Each partner's interest in UTP has an adjusted basis and fair market value of $2 million. UTP owns two capital assets (property 1 with an adjusted basis of $1.2 million and a fair market value of $2 million; property 2 with an adjusted basis of $1.8 million and a fair market value of $2 million). UTP also owns a 50% interest in LTP, a partnership. UTP's interest in LTP has an adjusted basis of $3 million and a fair market value of $2 million. LTP owns one asset, property 3, a capital asset with an adjusted basis of $6 million and a fair market value of $4 million. Neither UTP nor LTP has an election under section 754 in effect. In a liquidating distribution to U of property 1, the adjusted basis of property 1 to U is $2 million under section 732(b). Therefore, there is a SBR with respect to the distribution to U because the amount described in section 734(b)(2)(B) (the excess of $2 million over $1.2 million, or $800,000) exceeds $250,000. UTP must decrease the basis of its property by $800,000. Under Treas. Reg. § 1.755-1(c), UTP must decrease the adjusted basis of its 50% interest in LTP by $800,000. (The step-down applies to the LTP because property 2 is appreciated). Under Prop. Treas. Reg. § 1.734-1(f)(1) and Treas. Reg. § 1.755-1(c), LTP must decrease its basis in UTP's share of property by $800,000.

Recommendation – Scope of Tiering Down under Section 734. We agree with the general approach of Prop. Treas. Reg. § 1.734-1(f). We believe that it is appropriate for a LTP to adjust the basis of its assets when there is any basis reduction with respect to the interest in the LTP.[110] Requiring the tier-down in this circumstance reduces the instances in which inside/outside basis

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[108] Prop. Treas. Reg. § 1.734-1(f)(1).

[109] Comments were also requested to the scope of the section 743 tier-down rule; this is addressed in Part V of this Report.

[110] We believe it is not necessary that there be a SBR with respect to the LTP. For these purposes, the interest in the LTP should be treated as any other item of property of the UTP.

disparities at lower-tier levels may arise. Further, the Proposed Regulations require tiering down only where the LTP has a section 754 election in effect or would have to reduce the basis of its assets (as a result of a SBR at a UTP level). This conclusion is implicit in the regulations, as there would be no LTP asset basis reduction if all UTP asset basis adjustments were allocated to property other than the LTP interest under Treas. Reg. § 1.755-1(c).

We considered whether to propose a de minimis rule under which tiering down would not be required (for example, not requiring a section 734 adjustment at the LTP level if the adjustment would be less than $50,000). Though tiering down poses administrative difficulties, we do not propose such a de minimis rule at this time.[111] We believe consistency is important (and in some respects more administrable) and that UTPs should be treated as owning a direct share of the assets of LTPs.

3. Perpetuation of Inside/Outside Basis Disparities.

Somewhat incongruous with the broad tier-down approach of the Proposed Regulations to section 734 (which curtails the creation or increase of inside/outside basis disparities) is the fact (already fairly well understood) that mandatory section 734 step-down adjustments can create (or increase) inside/outside basis disparities to nondistributee partners.

> Example J. Partnership ABCD has four partners, A, B, C and D. A, B and C each own a 20% interest and have an outside basis of $0, and D owns a 40% interest with an outside basis of $0. ABCD owns one item of property, Capital Asset 1, with a basis of $0 and a value of $1 million. ABCD does not have a section 754 election in effect. D sells its ABCD interest to E for $400,000, and so E has an outside basis of $400,000 and an inside basis of $0. Later, ABCD sells the Capital Asset 1 for $1 million. E recognizes $400,000 of gain, increasing its outside basis to $800,000, and each of A, B and C recognizes $200,000 of gain, increasing their outside bases to $200,000 each. With the $1 million sales

[111] We also note that the Proposed Regulations do not appear to require UTPs to notify LTPs of transactions that may give rise to tier-down adjustments. Such notice should be required.

> proceeds, ABCD buys two capital assets, Capital Asset 2 for $400,000 and Capital Asset 3 for $600,000. ABCD later distributes Capital Asset 2 to E in liquidation of E's interest. Under section 732, E has a basis of $800,000 in Capital Asset 2. Accordingly, ABCD must step down the basis of its remaining property (Capital Asset 3) by $400,000. As a result, A, B and C each have an outside basis of $200,000 and an inside basis of $67,000 ($600,000 purchase price of Capital Asset 3 less $400,000 basis step-down, divided by 3) – had there been no mandatory step-down, each would have had an outside basis and an inside basis of $200,000.

We considered whether to recommend a rule that would limit the amount of a mandatory section 734 step-down to the amount (if any) by which the remaining partners' inside bases in the assets of the partnership exceeded their outside bases. On balance, however, we believe that taxpayers should be held to their decision to make or not make a section 754 election[112]– otherwise those partnerships that do not make section 754 elections would derive an advantage (that is, enjoy a deemed section 754 election that applies to prior transactions) in distributions that would otherwise trigger the full effect of the mandatory step-down rule.

V. Proposed Regulations to Section 743.

A. Background on Section 743.

Upon a "sale or exchange" (generally, any transfer other than a contribution or a gift) of a partnership interest, the transferee adjusts its basis in the partnership's assets under section 743, where either (1) a section 754 election is in effect with respect to the partnership or (2) there is a SBIL immediately after the transfer. Section 743(d)(1) provides that a partnership has a SBIL with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property-

[112] Had a section 754 election been in place at ABCD upon the sale of D's ABCD interest to E, E would have received a basis step-up in Capital Asset 1, would not have recognized gain upon the sale of Capital Asset 1 and would have taken Capital Asset 2 (received in the liquidation) with a $400,000 basis – in other words, there would not have been a mandatory section 734 step-down upon the liquidation of E.

accordingly, a sale or exchange that occurs when there is a SBIL generally gives rise to a mandatory step-down.[113]

B. Proposed Regulations to Section 743.

The Proposed Regulations to section 743 provide guidance as to (1) how to measure whether a partnership has a SBIL after a transfer, (2) the circumstances in which a transferee inherits any section 743 adjustments of the transferor and (3) how to apply section 743 in tiered partnership situations. The Proposed Regulations also introduce an anti-abuse rule that would specifically target efforts to make an end-run around the SBIL mandatory step-down rule.

In some ways, the Proposed Regulations to section 743 parallel those to section 734, as both sets of proposed rules address the mandatory step-down thresholds and the circumstances in which basis adjustments must be tiered down through layers of partnerships. Due to the different contexts in which section 734 and section 743 basis adjustments arise and the manner in which they are allocated, however, the effect of the Proposed Regulations to each Code section is different – in particular, the tier-down rules of the Proposed Regulations to section 743 could impose mandatory basis step-ups on LTPs that do not have a section 754 election in effect and do not have a SBIL, whereas the section 734 tier-down rules would not impose mandatory step-ups. That stated, as described below, we generally support the section 743 tier-down approach of the Proposed Regulations. The remainder of this section of this Report discusses our views of these provisions of the Proposed Regulations.

[113] The net effect would generally be a step-down; however, both (a) step-ups and (b) a mix of step-ups and step-downs can occur under section 755.

1. Substantial Built-in Loss ("SBIL").

The Proposed Regulations provide general rules to determine whether a partnership has a SBIL with respect to a transfer. We believe that the Final Regulations should clarify the manner in which the existence of a SBIL is determined. We have three principal points on this topic.

The first point concerns the determination of the value of partnership property and the basis of the partnership property in connection with the transfer. The statutory provision refers to the "fair market value" of partnership property. There is a question as to how that amount should be determined. The following example illustrates the issue.

> Example K. Partnership XY holds readily traded assets with a fair market value and tax basis of $100 million. X holds a 5% interest in the partnership, which is sold to Z for $4.5 million, reflecting a discount from the value of the partnership's assets, attributable to the lack of control. The question is whether there is a SBIL. If the fair market value of the partnership's assets governs, there would be no built-in loss in this example. If the determination is made by reference to an implied value for the assets derived from the sales price of the partnership interest (the "derived value approach"), then the partnership would be treated as having a SBIL.

We believe that the Proposed Regulations should make clear that the threshold is determined by looking to the fair market value of the partnership's assets rather than a derived value based upon the value of the partnership interest. This approach is more consistent with the statutory language and would be easier to apply in all situations, particularly those in which the fair market value of the partnership interest may not be readily ascertainable through an arm's-length sale, such as upon the death of the partner. We recognize that this approach may create certain inconsistencies between the values used for purposes of determining whether there is a SBIL and the residual values that must be used in determining the amount of any section 743

adjustment[114] (whether the adjustment arises because a section 754 election is in effect or because there is a SBIL). Thus, in the example above, no negative section 743 adjustment would be made in the absence of a Section 754 election even though Z's share of the partnership's inside basis would exceed the amount paid by Z for the transferred interest. Under this recommended approach, Z would no taxable gain gain upon the sale of assets by the partnership (but would have taxable gain under Section 731 upon a distribution of the proceeds). In contrast, if a section 754 election were made (or a SBIL was computed based on the derived value), there would be a basis reduction under the rules of section 743. Under this latter approach, if the partnership sold its assets immediately after the transfer, Z would have a taxable gain on the sale by the partnership (and no gain upon a distribution of the proceeds)Thus, although the partnership does not in fact have a loss in its assets, the failure to apply the derived value approach would present situations in which the timing benefit of the higher inside basis is transferred to the purchaser.[115] Nevertheless, the statutory change did not make section 743 mandatory in all circumstances and did not requires a mandatory adjustment in all situatios in which an adjustment would be made of there were a section 754 election in effect. Rather, the focus of Congress appears to have been narrower and this shift of excess basis to the purchasing partner may be viewed as beyond the scope of what Congress intended. We believe that the treatment of tiered arrangements should also be clarified. Prop. Treas. Reg. § 1.743-1(a)(2)(iii) provides that a UTP's fair market value in a LTP is equal to the sum of (A) the amount of cash the UTP would receive on a liquidation of the LTP by arm's-length sales of LTP property (net of

[114] See Treas. Reg. § 1.755-1(b)(1)(ii).

[115] Consider if in Example K, the partnership were to sell its marketable assets for $100 million. In such circumstance, if there were no built-in loss, the transferee would be allocated no gain, but its share of the cash proceeds from the sale would be $5 million, even though its outside basis would only be $4,500,000. In substance, the transferee has avoided or deferred recognition of $500,000 of gain.

liabilities and a payment to a third party to assume the LTP's contingent liabilities) and (B) the UTP's share of the LTP's liabilities (determined under section 752). Using the facts of the Example K above and treating the partnership in the example as the LTP and X as the UTP, the control discount would not be taken into account in determining whether UTP has a SBIL, under the Proposed Regulations.

Recommendation –Method for Calculating Fair Market Value in LTP. The rule of the Proposed Regulations sets forth a "fair market value of assets" approach, treating the UTP as having an attributable share of the underlying assets. This rule would appear to be consistent with the approach generally under section 743(d), even though the LTP interest might sell at a discount and therefore we generally agree with the approach taken in the regulations. Merely holding assets through a lower tier partnership should not yield a different result than holding those assets.[116]

The second point concerns the provision in Prop. Treas. Reg. § 1.743-1(a)(2)(ii), which provides that, for purposes of calculating whether the $250,000 SBIL threshold has been met, "any section 743 or Section 704(c)(1)(C) Basis Adjustments…(other than the transferee's section 743(b) basis adjustments or Section 704(c)(1)(C) Basis Adjustments) to partnership property are disregarded." We believe that this rule reaches the correct result in less than all cases. We believe the rule is correct to ignore basis adjustments in the cases of (1) a cash purchase of a partnership interest by a person with no pre-existing inside basis adjustments (since the

[116] An alternative method could be to have the Final Regulations provide that – similar to the valuation method of Prop. Treas. Reg. § 1.362-3(c)(4)(ii)– a UTP's fair market value in a LTP is equal to what a willing third-party buyer would pay for the LTP interest, plus the share of non-contingent liabilities allocable to UTP. In this circumstance, contingent liabilities would have been accounted for in the purchase price. We suspect that this approach would tend to produce a lower value for the partnership interest since discounts may be more prevalent than premiums for minority interests, and therefore believe that the result would be inconsistent with the general approach of determining the applicability of section 743 based upon the fair market value of the assets.

transferee will not get the benefit or detriment of any basis adjustments, the transferee should not have to step-down its share of inside basis on account of any Section 704(c)(1)(C) Basis Adjustments with respect to the partnership assets) and (2) nonrecognition transfers of partnership interests (because not accounting for the basis adjustments generally avoids the creation of inside/outside basis disparities).

On the other hand, we believe that the Proposed Regulations are incorrect in not disregarding the transferee's basis adjustments, at least in the case of a taxable purchase. When a Section 704(c)(1)(C) Partner or a partner with a pre-existing positive section 743 basis adjustment purchases a partnership interest, the purchaser's pre-existing basis adjustments would contribute to the $250,000 threshold and potentially be (in substance) reversed out by the mandatory step-down provision.[117] We do not view a transferee's pre-existing basis adjustments as a reason to depart from the general approach of disregarding basis adjustments in calculating whether there is a SBIL.

Recommendation – Disregard Transferee's Pre-existing Special Basis Adjustments. The Final Regulations should provide that a transferee's pre-existing special basis adjustments are disregarded for the purposes of determining whether there is a SBIL. The below example provides an illustration of the merits of this approach.

> Example L. A contributes property 1 with a value of $100,000 and basis of $160,000 for a 20% interest in partnership ABC, and B and C contribute property 2 and property 3 respectively, each with a value and basis of $200,000, for 40% interests in partnership ABC. A has a Section 704(c)(1)(C) Basis Adjustment of $60,000. The values of property 2 and property 3 each decline by $100,000 and the value of property 1 remains constant. A buys C's interest for $120,000. The Proposed Regulations count A's Section 704(c)(1)(C) Basis Adjustment towards

[117] Under the same rule, pre-existing negative section 743 basis adjustments of the transferee would count against the $250,000 threshold, which we also believe is incorrect.

the SBIL threshold, and so there is a SBIL (2*$100,000 + $60,000 >$250,000), meaning that A would step-down its inside basis in the assets of ABC by $80,000 (C's inside basis of $200,000 less A's $120,000 purchase price). The result would be different if B (the other partner) or Z (that is, a third party who previously was not a partner), purchased C's interest for $120,000 – in that case, there would be no SBIL (because A's $60,000 Section 704(c)(1)(C) Basis Adjustment would be ignored) and B or Z would inherit C's inside basis of $200,000 in respect of the transferred interest.

The third point concerns whether there should be a new de minimis exception to mandatory section 743 step-downs. The Preamble cited a comment to Notice 2005-32,[118] in which the commenter suggested that the Treasury and the IRS provide a de minimis exception for the SBIL provisions for transfers of "small interests" in a partnership (subject to an annual limit on aggregate transfers).[119] The Preamble explained that this comment was rejected but, in turn, solicited further comments as to whether a rule is warranted that excludes de minimis basis adjustments from the mandatory adjustment provisions.[120]

Recommendation – No New De Minimis Rule to Mandatory Step-Down at Top Tier. We believe that the size of a transferred top-tier partnership interest should not impact whether there is a mandatory step-down – in other words, we believe that the $250,000 threshold for a SBIL is a sufficient limitation, though perhaps this threshold (and the SBR threshold) should be indexed for inflation. Additionally, we recommend that the Final Regulations address the practical issue faced by partners who hold "small" interests in partnerships with regard to obtaining detailed information about the value of the assets of the partnership. The Final Regulations could permit

[118] In relevant part, Notice 2005-32 imposed reporting requirements (normally applicable only to partnerships with a section 754 election in effect) on partnerships in respect of the assets of which there was a mandatory section 743 step-down. 79 Fed. Reg. at 3051.

[119] 79 Fed. Reg. at 3051.

[120] *Id.*

partners to rely on information provided by a partnership (and require partnerships to provide such information) upon written request.

2. Retention of Section 743 Basis Adjustment by Transferee.

Treas. Reg. § 1.743-1(f) sets forth the general rule that where there has been more than one transfer of a partnership interest, a transferee's section 743 basis adjustment is determined without regard to any prior transferee's basis adjustment.[121]

The Proposed Regulations introduce a special rule, at Prop. Treas. Reg. § 1.743-1(f)(2), for "substituted basis transactions" (that is, transactions in which the transferee's outside basis is determined in whole or in part by reference to the transferor's outside basis or other property held by the transferee).[122] The rule states that, in a substituted basis transaction in which the transferor partner has a section 743 basis adjustment attributable to a non-substituted basis transaction, the transferee succeeds to (that is, "retains") the portion of the transferor's basis adjustment that is attributable to the transferred partnership interest (less any basis reduction attributable to other rules under the Code).[123] This retained basis adjustment is taken into account for purposes of determining whether further basis adjustments need to be made under section 743. An example illustrating this rule is below.

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[121] Treas. Reg. § 1.743-1(f) also provides that in the case of a gift of a partnership interest, the donee takes the portion of the donor's Section 743(b) basis adjustment that is attributable to the transferred interest.

[122] Because of the addition of the special rule under Prop. Treas. Reg. § 1.743-1(f)(2), we recommend that the Final Regulations amend paragraph (f)(1) to commence by stating, "Except as otherwise provided in paragraph (f)(2)…."

[123] Prop. Treas. Reg. § 1.743-1(f)(2). Presumably the transferee steps into the shoes of the transferor with respect to the retained adjustments in all respects. So as to make the Final Regulations to section 743 more consistent with the Prop. Treas. Reg. § 1.704-3(f)(3)(ii)(D) (which provides rules to account for depreciation and amortization of a Section 704(c)(1)(C) Basis Adjustment), we recommend that the Final Regulations expressly provide a rule that addresses amortization and depreciation of a retained section 743 basis adjustment.

Example M: UTP acquired for $100 a 50% interest in LTP, the sole assets of which are two capital assets, and has a $40 section 743 basis adjustment in respect of this interest, divided evenly among the two capital assets, each of which has a fair market value of $100 (and in respect of which UTP has an inside basis of $50 each, counting the section 743 basis adjustment). UTP distributes its LTP interest to Partner B, a partner in UTP who has an adjusted basis of $70 in his UTP interest. UTP and LTP have section 754 elections in effect. B takes the LTP interest with the $40 section 743(b) adjustment but, since the adjustment is taken into account for the purpose of determining whether section 743 basis adjustments are required on the transfer, B must make a negative $30 section 743 basis adjustment ($70 outside basis less $100 share of inside basis) and allocate that adjustment among the two capital assets under Treas. Reg. § 1.755-1(b)(5).

Recommendation – Clarify that Section 743 Basis Adjustment Retained through Multiple Substituted Basis Transactions. We note that the substituted basis transaction retention rule of Prop. Treas. Reg. § 1.743-1(f)(2) provides for the carryover of the basis adjustment even where the partnership does not have a section 754 election in effect and there is no SBIL on transfer. We agree with this approach. However, because the first sentence of Prop. Treas. Reg. § 1.743-1(f)(2) refers only to a basis adjustment that arises from a non-substituted basis transaction, Prop. Treas. Reg. § 1.743-1(f)(2) could be read to imply that the retention of the section 743 basis adjustment stops after the first substituted basis transaction. Accordingly, we recommend that the Final Regulations clarify that a transferee of a partnership interest in a substituted basis transaction always takes the attributable portion of the section 743 basis adjustment of the transferor, even if all or a portion of the transferor's adjustment was received in a substituted basis transaction.

Recommendation – Address Transfer of Less than Entire Partnership Interest. We believe that the Final Regulations should address what portion of a section 743 basis adjustment should be carried over to the transferee in a substituted basis transaction in which the transferor does not transfer its entire partnership interest. We recommend that the Final Regulations take an approach similar to the approach this Report recommends for determining the portion of a

Section 704(c)(1)(C) Basis Adjustment that is transferred in a nonrecognition transaction – that is, any reasonable method would suffice.

3. Tiered Partnerships.

The Proposed Regulations add a new § 1.743-1(l), which, similar to the Proposed Regulations to section 734, describes two circumstances under which a LTP would be required to make basis adjustments as a result of a transaction at the UTP level.

First, if an interest in a UTP that holds a LTP interest is transferred by sale or exchange, and each of the UTP and LTP have section 754 elections in effect, then for the purposes of sections 743(b) and 754, an interest in the LTP will be deemed similarly transferred in an amount equal to the portion of the UTP's interest in the LTP that is attributable to the interest in the UTP being transferred. In this case, the LTP must make section 743(b) adjustments on the portion of the interest in the LTP that was deemed transferred. This result is the same as that of Situation 1 in Revenue Ruling 87-115, which the Proposed Regulations cite to as containing examples of the application of the principles of Prop. Treas. Reg. § 1.743-1(l).[124]

Second, if the UTP has a SBIL with respect to the transfer, each direct or indirect LTP of the UTP will be treated as having made a section 754 election, but solely with respect to the transfer. Apparently, the LTP would be required to make basis adjustments as if the attributable portion of the LTP was deemed transferred, even if the LTP did not itself have any built-in loss. This result does not reconcile with that of Situation 2 in Revenue Ruling 87-115, in which a LTP that had not made a section 754 election was not required to make section 743 basis adjustments

[124] Rev. Rul. 87-115, 1987-2 C.B. 163; Prop. Treas. Reg. § 1.743-1(l)(1).

where an interest in a UTP that held a direct interest in the LTP and had made a section 754 election was transferred.

The issue involved includes balancing the complexity and potential difficulty in making the adjustments required by a section 754 election with the potential for inconsistent tax results if no election is made. The Preamble to the Prop. Treas. Reg. § 1.743-1(1) tier-down rules notes the administrative difficulties in tiering down where LTPs had not made section 754 elections and requested comments on the proper scope of the section 743 tier-down rule. The concern is the situation in which the UTP may have only a small interest in the LTP and the compliance burden, particularly obtaining the necessary information, may be high. However, potential for abuse arises in the mismatch between outside and inside basis that will arise if no tier-down rule is adopted. Consider the following example:

> Example N: Partner C has a basis of $4.2 million for its 40% interest in UTP. UTP holds a capital asset with a basis of $10 million and a value of $7 million; UTP also holds a 10% interest in LTP with a basis of $500,000 and value of $1 million. LTP has a capital asset with a value of $10 million and a basis of $5 million. Neither partnership has made a section 754 election. Assume C sells its interest in UTP to Individual D for $3.2 million. Because UTP has a SBIL, there will be a mandatory reduction in the basis of UTP's capital asset with respect to D in the amount of $1.2 million. (The aggregate step-down is $1 million, but the step-down to the capital asset is $1.2 million because the step-up to the LTP interest is $200,000). If (contrary to the rule of the Proposed Regulations) LTP is not treated as making a section 754 election with respect to the transfer, there would be no basis increase to UTP (and through UTP to D) with respect to LTP's capital asset. Such a result would seem to be unfair to D and may not be remedied by having LTP make an election under section 754 if UTP has not made one.[125] Moreover, such a result would create an inside-outside basis disparity with respect to UTP, in that UTP's basis in LTP would be increased, while its share of the basis of LTP's assets would not be adjusted. Upon LTP's sale of its asset, there would be additional gain allocated to UTP that would be offset only by a disposition of the LTP interest.

[125] The Proposed Regulations do not explicitly provide that an interest in a LTP is considered sold or exchanged to make it eligible to make a section 754 election if the basis of assets of a UTP are being adjusted as a result of a SBIL.

Recommendation – Scope of Tiering Down Under Section 743. On balance, we believe that the potential inside-outside basis disparity and potential ability to create an artificial loss generally outweighs the potential difficulties in obtaining the necessary information or the administrative burden on the partnership. Therefore, we generally support the rule of the Proposed Regulations because tiering-down limits inside/outside basis disparities.

We also recommend that the Final Regulations provide that electing investment partnerships (which are generally exempt from the mandatory step-down rules of section 743) are exempt from having to adjust the basis of their assets under the section 743 tier-down rule.[126]

We do, however, recommend that, where the effect of a tier-down to a LTP would be to cause an overall basis step-up in the assets of the LTP, the tier-down not be required unless the LTP has a section 754 election in effect or the UTP owns 50% or more of the capital or profits interests in the LTP. We believe that the mandatory step-up would be a particularly surprising result to partnerships that have not made a section 754 election and so, in part due to administrative concerns, we think the scope of the mandatory step-up rule should be constrained to related party situations. In this regard, we believe that limiting the scope of mandatory step-ups to the assets of a LTP presents less of an opportunity for abuse than does not stepping down the basis of the assets of a LTP – where the step-up does not occur, the UTP could sell the partnership interest and be removed from the LTP, whereas where the step-down does not occur, the LTP can sell assets and allocate non-economic losses to the UTP (losses that generally would be reversed out only upon exit from the LTP). Regardless of what approach is taken by the Final

[126] For a further discussion of electing investment partnerships, see Part VI.

Regulations, we recommend that the Final Regulations clarify the status of Revenue Ruling 87-115.[127]

Note on Publicly Traded Partnerships. We also note that the tier-down rule impacts PTPs that own interests in LTPs that do not have section 754 elections in effect. The mandatory tier-down rule could, as a technical matter, force PTPs to apply the "look-through" approach of Treas. Reg. § 1.704-3(a)(9) in order to ensure that PTP interests are fungible.[128] The below example illustrates the issue.

> Example O: Partner E and Partner F each contribute $60 to UTP for 50% interest in UTP. Assume that neither UTP nor LTP has a section 754 election in effect, and further assume that UTP has a SBIL. UTP contributes $120 to LTP. When the value of UTP's LTP interest is $90, G contributes $45 to UTP for a 33.33% interest, and UTP's LTP interest is booked down to $90.

At a later time when values are the same, E sells its interest to Individual A for $45 and G sells its interest to B for $45. (Ignore the technical termination of UTP). A will have a negative $15 basis adjustment in UTP's LTP interest. B will not have a basis adjustment; although there is a SBIL in UTP, B does not have a difference between outside basis and its share of inside basis. The future allocations to A and B need to be the same in order for the interests in UTP to be considered fungible.

To test for fungibility, consider what the allocations to A and B would be from LTP's recognition of its $30 loss in the following four cases: (I) look-through approach followed and

[127] We would also urge that the section 743 anti-abuse rule include situations in which the partnership engages in transactions intended to avoid the impact of the tier-down rule, such as where the upper tier partnership reduces its interest below 50% before a transfer of an interest in the upper tier partnership.

[128] Treas. Reg. § 1.704-3(a)(9) provides that if a partnership contributes Section 704(c) Property to a second partnership (the LTP), or if a partner that has contributed Section 704(c) Property to a partnership contributes that partnership interest to a second partnership (the UTP), the UTP must allocate its distributive share of LTP items with respect to that Section 704(c) Property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Such allocations are considered "look-through" allocations and so Treas. Reg. § 1.704-3(a)(9) is known as a "look-through" rule or approach.

basis adjustments tier down, (II) look-through approach followed and basis adjustments do not tier down, (III) look-through approach not followed and basis adjustments tier down, and (IV) look-through approach followed and basis adjustments do not tier down.

> CASE I. When LTP allocates $30 of loss to UTP, it is offset by the negative $15 basis adjustment for A, and because the look-through approach is followed the remaining $15 of loss is allocated solely to F. Neither A nor B will be allocated any loss, so their interests will be fungible.
>
> CASE II. When LTP allocates $30 of loss to UTP, because the look-through approach is followed the $30 of loss is allocated equally between A (as E's transferee under Treas. Reg. § 1.704-3(a)(7)) and F. Thus, A will be allocated $15 of loss (since its basis adjustment in the LTP interest would not be used) and B will be allocated no loss. Their interests will not be fungible.
>
> CASE III. When LTP allocates $30 of loss to UTP, it is offset by the negative $15 basis adjustment for A, and because the look-through approach is not followed, it is allocated equally among A, F, and B. Thus, A has $5 of income and B has a $10 loss. Their interests will not be fungible.
>
> CASE IV. When LTP allocates $30 of loss to UTP, because the look-through approach is not followed, it is allocated equally among A, F, and B. Thus, A will be allocated $10 of loss (since its basis adjustment in the LTP interest would not be used) and B will be allocated $10 of loss. Their interests will be fungible.

The following chart summarizes the cases in which fungibility exists and where it does not exist. In effect, a full aggregate (upper left box) or a full entity (lower right box) approach is required for fungibility.

	Tier-Down	No Tier-Down
Look-through Approach Followed	Case I: Fungible	Case II: Not Fungible
Look-through Approach Not Followed	Case III: Not Fungible	Case IV: Fungible

4. Anti-Abuse Rule with Respect to SBIL Provisions.

The Proposed Regulations add an anti-abuse rule that provides that the provisions of the regulations relating to SBIL transactions (including with respect to the reporting requirements of

Treas. Reg. and Prop. Treas. Reg. § 1.743-1(k))[129] "must be applied in a manner consistent with the purposes of these [provisions] and the substance of the transaction." The Proposed Regulations provide two general examples of how the anti-abuse rule could be applied: (1) aggregating the property of "related" partnerships (what constituted "relatedness" is not explained); and (2) disregarding contributions (presumably of built-in gain property) to a partnership.

Recommendation – Clarify "Related." We recommend that the Final Regulations provide additional guidance on the scope of "relatedness" for the purposes of the SBIL anti-abuse rule. We believe that the anti-abuse rule should generally apply only where (1) separate partnerships have substantially identical or complementary businesses, (2) there is no non-tax business purpose to having organized separate partnerships and (3) the same taxpayer (or a combination of the taxpayer and a related person) (A) acquires interests in each partnership within a short period (e.g., six months) and (B) one or more of the partnerships sells the loss assets within a short period of the entry of the subject taxpayer. While we do not recommend that the anti-abuse rule be removed, we recommend that the IRS be restrained in its application of the anti-abuse rule because we believe that this anti-abuse rule serves a narrow purpose.[130]

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[129] Treas. Reg. § 1.743-1(k)(1) requires that a partnership with a section 754 election in effect attach a statement of section 743(b) adjustments to its partnership return, setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated. Under Treas. Reg. § 1.743-1(k)(2), transferees of interests in such a partnership are required to notify the partnership of the transfer, within 30 days.

Prop. Treas. Reg. § 1.743-1(k)(1)(iii) provides that when partnerships are required to reduce the bases of partnership properties under the SBIL provisions in Section 743, they must comply with Prop. Treas. Reg. § 1.743-1(k)(1) and other reporting provisions as if an election under section 754 were in effect at the time of the relevant transfer. Additionally, a transferee of a partnership interest where the partnership is required to reduce the bases of partnership properties under the SBIL provisions of section 743, must comply with Prop. Treas. Reg. § 1.743-1(k)(2) as if an election under section 754 were in effect at the time of that transfer. Prop. Treas. Reg. § 1.734-1(d) imposes somewhat comparable reporting requirements for mandatory section 734 basis adjustments.

[130] Also, we are not aware of significant use of multiple partnerships to avoid the $250,000 threshold.

VI. Electing Investment Partnerships.

A. Overview of Proposed Regulations on Electing Investment Partnerships.

The Proposed Regulations also implement rules that govern the circumstances under which certain partnerships may elect to become "electing investment partnerships. Section 743(e) sets forth a regime for the special treatment of EIPs under section 743. An EIP is not treated as having a SBIL (making transfers of EIP interests exempt from the "regular" mandatory basis adjustment rules discussed in Part V of this Report).[131] Instead, the distributive share of losses (without regard to gains) from the sale or exchange of partnership property is not allowed to a transferee of an interest in an EIP except to the extent that it is established that those losses exceed the loss (if any) recognized by the transferor (or any prior transferor to the extent not fully offset by a prior disallowance) on the transfer of the partnership interest.[132] Disallowed losses do not reduce a transferee's basis in the EIP.[133] Where the basis of property distributed to a partner by an EIP is reduced under section 732(a)(2), the amount of loss recognized by the transferor is treated as having been reduced by the amount of the basis reduction (that is, to the extent the transferee has to step down its basis in distributed assets due to an outside basis limitation, the loss disallowance threshold is lowered by an equal amount).[134]

The special EIP regime was enacted largely to limit the expected administrative burden of the section 743 mandatory basis adjustment regime on certain partnerships.[135] Generally

[131] Section 743(e)(1).

[132] Section 743(e)(2).

[133] Section 743(e)(3).

[134] Section 743(e)(5).

[135] H.R. Rep. No. 108-755, at 283.

speaking, the EIP election often should not have a significant impact on substantive tax liability, except where the step-down would have otherwise been made to depreciable assets.

B. Definitional Prerequisites.

There is a series of prerequisites to EIP status for a partnership. They are (1) the partnership makes an election to have section 743(e) apply, (2) the partnership would be an investment company under the Investment Company Act of 1940 but for certain exemptions, (3) the partnership has never been engaged in a trade or business, (4) substantially all the assets of the partnership are held for investment, (5) at least 95% of the assets contributed to the partnership consist of money, (6) no assets contributed to the partnership had an adjusted basis in excess of fair market value at the time of contribution, (7) all partnership interests of the partnership are issued by the partnership pursuant to a private offering before the date which is 24 months after the date of the first capital contribution to such partnership, (8) the partnership agreement of the partnership has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and (9) the partnership agreement of the partnership provides for a term that is not in excess of 15 years.[136] These requirements are applied without regard to any technical termination of the partnership under section 708(b)(1)(B) (that is, the successor to an EIP that technically terminates is not retested for EIP eligibility).

Notice 2005-32 sets forth a variety of interim guidance and reporting requirements relating to the EIP election, including an articulation of the "25% test" described below (used to determine whether a putative EIP is engaged in the trade or business of a LTP).

[136] Section 743(e)(6).

The Proposed Regulations generally adopt the statutory prerequisites. The Proposed Regulations also address in further detail requirements (1), (3) and (8).[137] Our recommendations related to the prerequisites follow below, with descriptions of the relevant portions of the Proposed Regulations.

1. Trade or Business.

In addition to restating the statutory requirement, the Proposed Regulations provide two safe harbors under which a EIP will not be treated as engaged in a trade or business. The Preamble states that the Treasury and the IRS believe that the two safe harbors provide appropriate guidance as to the no trade or business requirement, and therefore, the proposed regulations do not provide any additional safe harbors.[138]

The first safe harbor provides that a partnership will not be treated as engaged in a trade or business if, based on all the facts and circumstances, the partnership is not engaged in a trade or business under the rules in Treas. Reg. § 1.731-2(e)(3).[139]

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[137] As did Notice 2005-32, the Proposed Regulations extend the limit of requirement (9) to 20 years for partnerships in existence on June 4, 2004 and also exempt such partnerships from requirement (8).

[138] 79 Fed. Reg. at 3052.

[139] Treas. Reg. § 1.731-2(e)(3) provides in part that, for the purposes of determining whether a partnership is an investment partnership and thus eligible to not treat distributions of marketable securities as distributions of cash, a partnership is not treated as engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in any asset described in Section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets. The list of assets described in Section 731(c)(3)(C)(i) consists of: money; stock in a corporation; notes, bonds debentures or other evidence of indebtedness; interest rate, currency or equity notional principal contracts; foreign currencies; interests in or derivative financial instruments; other assets specified in the regulations, such as reasonable and customary management services; or any combination of the foregoing. Under section 731, the distribution of marketable securities by an "investing partnership" is not treated as a cash distribution (which is the general rule—the primary issue being that a cash distribution in excess of outside basis gives rise to gain from the sale of a partnership interest). Section 731(c)(3)(B). Among other requirements for investment partnership status, a partnership cannot be engaged in a trade or business under Treas. Reg. § 1.731-2(e)(3).

The second safe harbor provides that, in the case of a tiered partnership arrangement, a UTP will not be treated as engaged in a trade or business of a LTP if the UTP can establish that, at all times during the period in which the UTP owns an interest in the LTP, the adjusted basis of the UTP's interest in the LTP is less than 25% of the total capital that is required to be contributed to the UTP by its partners during the entire term of the UTP (the "25% test").[140] The 25% test, in addition to being a safe-harbor, is a bright-line rule in that a failure to meet the 25% test at any time will mean that the partnership is treated as engaged in a trade or business and, therefore, fails to qualify as an EIP.[141] The Preamble solicited comments as to whether borrowing (which can increase basis)[142] should be taken into account for purposes of the 25% test.

Recommendation – Borrowing. We believe that the Final Regulations should not account for non-recourse borrowing but should account for recourse borrowing. Recourse borrowing is more akin to contributed capital and so we believe merits inclusion. Excluding non-recourse borrowing from consideration would reduce uncertainty over EIP eligibility – non-recourse borrowing can be a particular wild-card if the putative EIP is not involved in LTP borrowing decisions.

Recommendation – 25% Basis Test Should Be Measured at the Time of the Initial Investment. Consistent with our recommendation on borrowing, we believe that the Final Regulations should replace the adjusted basis portion of the 25% test with the sum of the capital

[140] The Treasury Department and the IRS should consider clarifying this safe harbor by having the Final Regulations expressly state that, if a partnership is not considered engaged in a trade or business through its ownership of a LTP under the 25% test (the "intermediate LTP"), a partnership (the UTP) that holds an interest in the intermediate LTP also will not be treated as engaged in the trade or business under the 25% test.

[141] Prop. Treas. Reg. § 1.743-1(n)(7)(ii) (final sentence).

[142] 79 Fed. Reg. at 3051; Section 752(a); Treas. Reg. § 1.752-1.

contributed to a LTP by the putative EIP and the borrowing of the LTP that is recourse to the putative EIP. Setting aside the borrowing aspects of the 25% test, we believe contributed capital is a better measure than looking to some post-contribution characteristic (such as adjusted basis) because looking to contributed capital minimizes the impact of basis fluctuations. For example, an adjusted basis approach could render a partnership ineligible for EIP status because an investment generates taxable income (increasing basis in the LTP interest).[143]

2. Assets.

Prop. Treas. Reg. § 1.743-1(n)(6)(v) restates the statutory requirement that at least 95% of the assets contributed to a putative EIP consist of money (the "95% money test").

Recommendation – Exceptions for mergers and divisions. In the absence of further guidance, certain partnership will be unable to meet the 95% money test due to matters of practical necessity that, in our view, do not bear on whether the partnership merits EIP status. Some of the shortcomings of the 95% money test arise where (1) a partnership transfers an existing investment to an alternative investment vehicle (an "AIV," which in this scenario is the putative EIP), and the investment was not initially made by the AIV either because of timing[144] or because the regulatory, tax or other reasons necessitating the creation of the AIV were not determined until after the investment was made or (2) a feeder vehicle (the putative EIP) is formed after an investor has made an investment in a partnership, and the investor transfers its interest in the partnership to the feeder vehicle (for example, for tax or regulatory reasons).

[143] We note that the 25% basis test can appear generous is some circumstances. For example, consider a situation in which the putative EIP makes four equal investments in LTPs and each LTP makes a section 754 election. In this circumstance, arguably the putative EIP should be subject to the mandatory step-down rules.

[144] For example, the AIV could not be set up prior to the investment date.

We believe that the Final Regulations should provide exceptions for these scenarios, in the form of a rule that provides that a partnership merger or division does not cause the resulting entities to be ineligible for EIP status if the constituent entities were themselves eligible and further provided that the transactions do not have the effect of increasing the term of any partnership beyond the 15-year limit for the term of an EIP.

3. Substantive Restrictions.

Prop. Treas. Reg. § 1.743-1(n)(6)(viii) restates the statutory requirement that the partnership agreement of the putative EIP have substantive restrictions on each partner's ability to cause a redemption of the partner's interest. Prop. Treas. Reg. § 1.743-1(n)(8) further provides that "substantive restrictions include cases in which a redemption is permitted under a partnership agreement only if the redemption is necessary to avoid a violation of state, federal or local laws (such as ERISA or the Bank Holding Company Act) or the imposition of a federal excise tax on, or a change in the federal tax-exempt status of a tax-exempt partner." Prop. Treas. Reg. § 1.743-1(n)(9) exempts from this requirement partnerships in existence on June 4, 2004.

Recommendation – Add Further Examples of Substantive Restrictions. We note that the Proposed Regulations do not provide an exclusive list of what constitutes a substantive restriction on redemption rights. That stated, we suggest that the Treasury and the IRS further consider whether to expressly grant latitude for where a redemption is necessary to prevent a foreign governmental investor from being treated as engaged in a commercial activity for purposes of section 892.

4. Partnership Term.

Prop. Treas. Reg. § 1.743-1(n)(6)(ix) restates the statutory requirement that the partnership agreement of the putative EIP provide for a term that is not in excess of 15 years, and Prop. Treas. Reg. § 1.743-1(n)(9) provides a longer 20-year term for partnerships in existence on or before June 4, 2004.

Recommendation – Add Guidance on Extension Features. We recommend that the Final Regulations clarify that where a partnership agreement provides for the potential extension of a partnership's term, the potential extension will not be taken into account if the decision to extend is subject to a bona fide vote, and requires the approval of the majority of the limited partners or a limited partner advisory committee. If the partnership indeed extends its term past the 15-year limit, the partnership should no longer qualify as an EIP (though prior qualification should not be impacted).

C. Inadvertent Failure to Qualify as an EIP.

The Preamble solicited comments on appropriate rules for situations in which a partnership that has elected to be an EIP fails to qualify in a particular year, but then qualifies again in a future year.[145] (Under the Code and the Proposed Regulations, it appears that failure renders the partnership permanently ineligible for EIP status).

Recommendation – Allow Reinstatement for Inadvertent Failures That Are Timely Corrected. We recommend that the Final Regulations provide that relief is available where the failure to qualify as an EIP was inadvertent, and where, a reasonable time after the discovery of that failure, steps are taken so that the partnership once again meets the EIP requirements.[146] In

[145] 79 Fed. Reg. at 3052.

[146] *See* Section 7704(e) (provides a comparable relief mechanism for the failure of a PTP to meet the qualifying income test).

addition, to obtain such relief, any losses that were allocated to a transferee partner in a year in which the election was not effective (including a transferee that became a partner in such year) must be disallowed in accordance with the general loss disallowance rules under section 743(e)(2).

D. Revocation of EIP Election.

The Preamble solicited comments on the circumstances in which a qualifying partnership that has revoked an EIP election[147] should be permitted to reelect and the rules and procedures that should apply to the reelection.[148]

Recommendation – No Ability to Reelect. We generally believe that reelection need not be permitted. Presumably, an EIP would revoke its election if it was believed that the administrative burden of the mandatory step-down regime was not significant.

VII. Proposed Regulations to Section 755.

Background and Proposed Regulations.

Treas. Reg. § 1.755-1(b)(5) governs the allocation of section 743 basis adjustments that arise from substituted basis transactions. Treas. Reg. § 1.755-1(b)(5)(ii) imposes a significant limitation on the ability of a partnership to make upward or downward basis adjustments – namely, basis can be increased only where the applicable transferee partner would recognize a net gain upon a hypothetical sale of the partnership's assets, and decreased only where the partner would recognize a net loss upon the hypothetical sale. Treas. Reg. § 1.755-1(b)(5)(ii)

[147] Treas. Reg. § 1.754-1(c).

[148] 79 Fed. Reg. at 3052.

also provides that if the net adjustment is $0 under section 743, then no adjustment to the partnership assets is made.

The Proposed Regulations retain the $0 net adjustment rule but remove the limitations on "net gain" or "net loss." Instead, under Prop. Treas. Reg. § 1.755-1(b)(5)(ii), basis increases (or decreases) are to be allocated between capital gain and ordinary income property in proportion to and to the extent of the gross gain (or loss) that the transferee would have on the hypothetical sale, with the remaining increase (or decrease) to be allocated between the capital and ordinary classes in proportion to their relative fair market values.

Basis increases (or decreases) within a class of property are to be allocated to property so as to reduce the transferee partner's share of unrealized gain (or loss), with the remaining increase (or decrease) to be allocated among property in proportion to their relative fair market values (in the case of an increase) or relative adjusted bases (in the case of a decrease). The Proposed Regulations prohibit a negative basis result, but they do permit a negative adjustment to be applied against more property than the current regulations (which limit the negative adjustments to the amount of the transferee's share of the bases of depreciated partnership property).[149]

The Proposed Regulations contain two examples to illustrate these principles.[150] Unlike the rest of the Proposed Regulations, which become effective on the date Final Regulations are published, the Proposed Regulations under Prop. Treas. Reg. § 1.755-1(b) are effective from January 15, 2014.

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[149] Prop. Treas. Reg. § 1.755-1(b)(5)(iii).

[150] Prop. Treas. Reg. § 1.755-1(b)(5)(iv), Examples 3 and 4.

The Proposed Regulations also introduce regulations to section 755(c), at Prop. Treas. Reg. § 1.755-1(e). Section 755(c) provides that a basis decrease under section 734(b) cannot be allocated "to stock in a corporation (or any person related (within the meaning of sections 267(b) **and** 707(b)(1)) to such corporation) which is a partner in the partnership" (emphasis added). The basis decrease is instead to be allocated to other partnership property. The Proposed Regulations first correct what the Preamble implies was a drafting error in section 755(c) – the use of the word "and" in the relatedness condition referenced in the prior sentence – by changing "and" to "or."[151]

Recommendation – Address to what Other Property Section 755(c)/734(b) Basis Step-down Allocated, and to whom Gain Allocated. Neither the Code nor the Proposed Regulations address how the basis step-down that would otherwise apply to stock of the corporate partner (or related person) should be allocated to the remaining property of the partnership. (The Proposed Regulations contain an example illustrating the general principles of section 755(c),[152] but, in this example, it appears that the partnership owns only two items of property, with one being stock in a disqualified related corporation). We recommend that the Final Regulations provide that the negative adjustment be allocated among eligible property under the regular principles of Treas. Reg. § 1.755-1(c).

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[151] Setting aside the and/or issue, we note that the language of the Code is difficult to understand and that the Proposed Regulations retain this language. We suggest that the Final Regulations further rephrase the wording to make more clear the actual rules, as follows:

Old Language – "No allocation may be made to stock in a corporation (or any person related (within the meaning of sections 267(b) or 707(b)(1)) to such corporation) that is a partner in the partnership."

Recommended Language – "No allocation may be made to stock in a corporation that is a partner in the partnership or is related (within the meaning of sections 267(b) or 707(b)(1)) to a corporation that is a partner in the partnership."

[152] Prop. Treas. Reg. § 1.755-1(e)(3).

Under section 755(c), the partnership must recognize gain to the extent that the basis of the eligible property of the partnership is less than the amount that must be reallocated under the general rule. Neither the Code nor the Proposed Regulations address to which partner such gain should be allocated. We believe that the Final Regulations should provide guidance as to the manner in which such gain should be allocated. In general, basis adjustments provided for under section 734(b) are reflected in the partners' capital accounts for purposes of section 704(b). It is not clear under the regulations that the income recognized under section 755 would also be required to be reflected in the partners' capital accounts. We believe that this is the appropriate result and believe the Final Regulations should make this clear.

VIII. Layering.

A. Background on Layering.

Section 704(c) only provides rules to account for the differences between a contributing partner's adjusted basis in contributed property and the fair market value of that property upon contribution. Differences between adjusted basis and fair market value also arise based on changes in the value of partnership property post-contribution, in which case the differences are between the adjusted basis of the property to the partnership and the fair market value of the property upon revaluation. Treas. Reg. § 1.704-3(a)(6)(i) provides that the principles of section 704(c) apply in circumstances in which a partnership revalues capital accounts as permitted under Treas. Reg. § 1.704-1(b)(2)(iv)(f).[153] Any partnership allocations attributable to

[153] Treas. Reg. § 1.704-1(b)(2)(iv)(f) permits such revaluations in the case of (i) a contribution of money or other property (other than a de minimis amount) to the partnership as consideration for an interest in the partnership, (ii) the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, (iii) the grant of an interest in the partnership (other than a de minimis interest) as consideration for the performance of services to or for the benefit of the partnership by a new or existing partner acting in that capacity, (iv) certain issuances by a partnership of a noncompensatory option and (v) periodic re-bookings consistent with generally accepted industry accounting

unrealized gains or losses resulting from such revaluations are called "reverse 704(c) allocations," since they apply to non-contributing partners (in contrast to the aforementioned allocations that arise on the contribution of Section 704(c) Property, which are known as "forward 704(c) allocations").

Partnerships are not required to use the same allocation method to account for forward and reverse 704(c) allocations, nor are partnerships required to use the same method to account for each instance of reverse section 704(c) allocations – the general requirement is that the allocation methods be "reasonable."[154] All allocation methods under section 704(c) are, however, subject to anti-abuse rules.[155] Under Treas. Reg. § 1.704-3(a)(10), an allocation method is not considered reasonable if the contribution of property (or event resulting in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made in an effort to shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[156]

B. <u>The Proposed Regulations on Accounting for Forward and Reverse 704(c) Allocations</u>.

In addition to setting up a framework of rules that specifically address Section 704(c)(1)(C) Property, the Proposed Regulations to section 704 contain an important rule that

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practices for partnerships substantially all of the property (excluding money) of which consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. These events are known as "book up" or "book down" events because the capital accounts of the partners are "booked" to their current value.

[154] Treas. Reg. §§ 1.704-3(a)(1) and (a)(2).

[155] Treas. Reg. § 1.704-3(a)(6)(i).

[156] Treas. Reg. § 1.704-3(a)(10).

applies to all partnership property. Prop. Treas. Reg. § 1.704-3(a)(6)(i) provides that, with respect to an item of partnership property, each and any reverse 704(c) allocation must be tracked separately from each and any other reverse 704(c) allocation and any forward 704(c) allocation. When such allocations are separately tracked, they are referred to as "layers" or "section 704(c) layers," and so the approach adopted by the Proposed Regulations is generally known as the "layering approach." The alternative would have been to, for each partner, net any positive or negative 704(c) allocations, a so-called "netting approach."

The Preamble approvingly cited to practitioner comments that the netting approach could lead to distortions when the traditional method is used and the ceiling rule is implicated (such distortions are illustrated in an example below) and that the layering approach better maintains the economic expectations of partners.[157] The Preamble then stated that the Proposed Regulations do not permit the netting approach because the netting approach could lead to distortions.[158] The Preamble noted, however, that the layering approach could result in additional administrative burdens on taxpayers.[159] Accordingly, the Preamble solicited comments on the circumstances in which it would be appropriate for partnerships to use the netting approach.

The Preamble also stated that the Treasury and the IRS agree that partnerships should be able to use any reasonable method in allocating tax items across layers.[160] Methods cited by the Preamble, though not expressly approved therein, included (1) allocate tax items to the oldest

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[157] 79 Fed. Reg. at 3054.

[158] 79 Fed. Reg. at 3054.

[159] *Id.*

[160] *Id.*

layer first (the "first-in first-out approach"), (2) allocate tax items to the newest layer first (the "last-in first-out approach") and (3) allocate tax items pro-rata across layers based on the amount of each layer.[161] The Preamble noted that partnerships have already been granted flexibility under Treas. Reg. § 1.704-3(a)(2), which provides that a partnership may use different allocation methods with respect to different items of contributed property (so long as the partnership and the partners consistently apply a single reasonable method for each item of contributed property and the overall method or combination of methods is reasonable based on the facts and circumstances and is consistent with the purpose of section 704(c)).[162]

The Tax Section previously advocated the layering approach in a January 2010 report (the "Layering Report")[163] issued in response to Notice 2009-70, which sought public comments regarding the impact on partnerships of multiple layers of section 704(c) gain and loss. The Tax Section's overall position is unchanged from that of the Layering Report. The remainder of Part VIII of this Report (1) explains why, as a general matter, we continue to recommend the layering approach, (2) sets forth circumstances under which we recommend that the netting approach be allowed and (3) sets forth our recommendations as to what should constitute a reasonable allocation method within the layering approach.

C. Layering Recommendation.

In many situations, the choice between the layering and netting approaches has no meaningful impact. Two factors are of chief importance in determining the significance of

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[161] *Id.* Further variations on the pro-rata approach are possible.

[162] 79 Fed. Reg. at 3054.

[163] New York State Bar Association Section of Taxation, *Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships* (Jan. 22, 2010).

layering versus netting: (1) the section 704(c) allocation method used by a partnership (that is, the traditional allocation method, the traditional method with curative allocations or the remedial allocation method)[164] and (2) the manner in which the subject partnership property fluctuates in value.

As to the section 704(c) allocation method, layering versus netting may lose significance if a partnership consistently uses the remedial allocation method or the traditional method with

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[164] Treas. Reg. § 1.704-3(a)(1) requires a partnership to use a reasonable allocation method and provides that any one of these three methods is generally reasonable. The same allocation method need not be used for each section 704(c) layer. Treas. Reg. § 1.704-3(a)(6)(i).

Under the traditional method, when a partnership has tax items relating to Section 704(c) property, the partnership must make appropriate allocations of those items (as opposed to book items) to its partners in a manner that avoids inappropriate shifting of the tax consequences of the built-in gain or loss to non-contributing partners. For example, if a partnership recognizes gain from the sale of Section 704(c) property, the built-in gain or loss inherent in the property at the time of contribution must be allocated to the contributing partner (to the extent it does not exceed the built-in gain or loss remaining at the time of sale). Treas. Reg. § 1.704-3(b).

Under the "ceiling rule," however, the aggregate amount of tax items allocated to partners of a partnership using the traditional method cannot exceed the aggregate amount of tax items actually realized by the partnership. *See* Treas. Reg. § 1.704-3(b)(1). See the Pre-Jobs Act Example (Section II of this Report) for an illustration of the application of the ceiling rule. *See* Treas. Reg. § 1.704-3(b)(2)(ii).

Under the traditional method with curative allocations, a partnership is permitted to make reasonable "curative" allocations to eliminate the distortions created by the ceiling rule (that is, to eliminate disparities between book and tax items for non-contributing partners). A curative allocation is an allocation of a tax item that differs from the allocation of the corresponding book item and that is used to compensate for a shortfall under the ceiling rule of an allocation (generally with respect to another property) of another tax item. Thus, for example, if as a result of the ceiling rule a non-contributing partner is allocated an amount of tax depreciation that is less than the corresponding book depreciation, the partnership may allocate tax depreciation from another item of property to that partner in order to eliminate the ceiling rule distortion. (*See* Treas. Reg. § 1.704-3(c)(1)). The regulations contain significant restrictions that apply in determining whether curative allocations are reasonable. Treas. Reg. § 1.704-3(c)(3).

As is the case with the other two methods, a partnership using the remedial method first allocates book items and then allocates any tax items using the traditional method. If the ceiling rule causes the book allocation to differ from the tax allocation of an item for a non-contributing partner, the partnership creates a "remedial" item that it allocates to such partner to offset the distortion of the ceiling rule. The partnership also allocates an offsetting remedial item to the contributing partner. The remedial items are notional allocations that exactly offset each other (ensuring that on an aggregate basis, only the total net income or loss of the partnership is allocated) to enable tax allocations to follow book allocations despite the ceiling rule. *See* Treas. Reg. § 1.704-3(d)(4).

The regulations provide an anti-abuse rule. Pursuant to it, an allocation method (or combination of methods) is not reasonable if the contribution of property and the allocation of tax items with respect to the property are made with a view to shifting tax consequences of built-in gain or loss among the partners in a matter that substantially reduces the present value of the partners' aggregate tax liability. *See* Treas. Reg. § 1.704-3(a)(10).

curative allocations. This is so irrespective of the manner in which partnership property fluctuates in value. Under the remedial allocation method, layering versus netting is generally irrelevant because the partnership will merely allocate additional gain or loss to ensure that the economic bargain between the partners is maintained.[165] If the partnership uses the traditional method with curative allocations, layering versus netting will not have an impact provided that other partnership transactions provide sufficient gain or loss to offset any disparities created by netting.

How partnership property fluctuates in value generally matters only where a partnership uses the traditional allocation method. Prior to the Proposed Regulations, it was clear that layering versus netting was irrelevant where property is contributed with (1) a built-in gain and has not decreased in value upon any subsequent valuation event[166] or (2) a built-in loss and has not increased in value upon any subsequent valuation event, the reason being that, since all the layers will have the same "sign" (all positive or all negative), there will be sufficient gain or loss to allocate to all of the partners upon a disposition of the property. This result was not changed by the Proposed Regulations. Because the Proposed Regulations segregate from non-contributing partners the built-in loss of Section 704(c)(1)(C) Property, the Proposed Regulations have also clarified that layering versus netting is irrelevant in situations in which property is contributed with a built-in loss and, upon subsequent valuation events, maintains its value or increases in value.

[165] Issues as to timing of the recognition of depreciation deductions may arise, however, even where the remedial method is used and the property is subject to both forward and reverse section 704(c) allocations and values of the property have changed for each of the layers.

[166] See note 153 for an explanation of "valuation event."

This still leaves an important category of transactions for which layering versus netting matters as an economic matter. Where a partnership uses the traditional allocation method and forward and reverse 704(c) allocations partially or wholly offset one another (except in the case of Section 704(c)(1)(C) Property, where only multiple reverse 704(c) allocations may partially or wholly offset one another), there is a potentially significant economic impact depending on which of the layering or netting approach is followed. The below example illustrates many of these principles.

<u>Layering versus Netting</u>. On January 1, 2014, A and B form a partnership AB with A contributing non-depreciable asset X, with a fair market value of $100 and a tax basis of $120, and B contributing $100 of cash. Partnership AB uses the traditional method of allocation for Section 704(c) items. Asset X is Section 704(c)(1)(C) property because of the built-in loss at the time of its contribution. Partner A is responsible for the initial section 704(c) layer of $20 loss.[167] In no year does partnership AB produce any net income.

Partner A		Partner B		
Capital Account	Outside Basis	Capital Account	Outside Basis	
$100	$120	$100	$100	Jan. 1, 2014

On January 1, 2015, with asset X having declined in value to $50, C is admitted as a new equal partner to the partnership (now named ABC) in exchange for a contribution of $75 to the partnership. Pursuant to Regulation Section 1.704-1(b)(2)(iv)(f), the partnership revalues its assets and reflects the asset depreciation in the partners' capital accounts. Thus, if separate

[167] The Proposed Regulations clearly provide that the $20 built-in loss must be accounted for upon the disposition of the property. *See* Prop. Treas. Reg. § 1.704-3(a)(6)(i). Accordingly, we believe that the forward 704(c) layer for Section 704(c)(1)(C) Property should be segregated from any and all reverse 704(c) layers with the loss reflected by its corresponding Section 704(c)(1)(C) Basis Adjustment allocated solely to the forward layer. It is also possible to conceive of all Section 704(c)(1)(C) Property as having a forward 704(c) layer of $0.

section 704(c) layers are maintained, there is a new reverse layer for the $50 decline in the value of asset X from $100 to $50. The $50 is divided equally between Partners A and B. Partnership ABC continues to apply the traditional allocation method to this layer.

Partner A		Partner B		Partner C		
Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	
$100	$80	$100	$100	--	--	Start of Jan. 1, 2015
($25)	$0	($25)	$0	--	--	Book-Down
$0	$0	$0	$0	$75	$75	Admission of C
$75	$120	$75	$100	$75	$75	End of Jan. 1, 2015

On January 1, 2016, with asset X having increased in value to $80 (and with $175 of cash still remaining in the partnership), D is admitted as a new, equal, partner to the partnership (now named ABCD) in exchange for a contribution of $85 to the partnership. Pursuant to Regulation Section 1.704-1(b)(2)(iv)(f), the partnership once again revalues its assets, this time resulting in a book-up of asset X, and reflects the asset appreciation in the partners' capital accounts. Thus, if separate section 704(c) layers are maintained, there is an additional reverse layer for the $30 increase in value of asset X from $50 to $80. Partnership ABCD applies the traditional allocation method to this layer.

Partner A		Partner B		Partner C		Partner D		
Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	
$75	$120	$175	$100	$75	$75	--	--	Start of Jan. 1, 2016
$10	$0	$10	$0	$10	$0	--	--	Book-Up
$0	$0	$0	$0	$0	$0	$85	$85	Admission of D
$85	$120	$85	$100	$85	$175	$85	$85	End of Jan. 1, 2016

On January 1, 2017, with asset X having decreased in value to $60 (and with $260 of cash still remaining in the partnership), E is admitted as a new, equal, partner to the partnership (now named ABCDE) in exchange for a contribution of $80 to the partnership. Pursuant to Regulation Section 1.704-1(b)(2)(iv)(f), the partnership revalues its assets a third time, resulting in a book-down of asset X, and reflects the asset depreciation in the partners' capital accounts. Thus, if separate section 704(c) layers are maintained, there is an additional reverse layer for the $20 decrease in value of asset X from $80 to $60. Partnership ABCDE applies the traditional allocation method to this layer.

Partner A		Partner B		Partner C		Partner D		Partner E		
Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	
$85	$120	$85	$100	$85	$75	$85	$85	$0	$0	Start of Jan. 1, 2017
($5)	($0	($5)	$0	($5)	$0	($5)	$0	$0	$0	Book-Down
$0	$0	$0	$0	$0	$0	$0	$0	$80	$80	Admission of E
$80	$120	$80	$100	$80	$175	$80	$85	$80	$80	End of Jan. 1, 2017

On January 1, 2018 partnership ABCD sells asset X for $90. Because the partnership's basis in asset X is $100 (under Prop. Treas. Reg. § 1.704-3(f)(1)(ii), the $20 built-in loss is not treated as partnership basis), there is a $10 tax loss. For section 704(b) book purposes, though, asset X was last valued at $60 on January 1, 2017. Therefore, the sale for $90 results in a book gain of $30, allocated equally ($6 gain each) to the five partners.

If the section 704(c) layers are kept separate (that is, the layering approach is followed), they are as follows:

	Partner A	Partner B	Partner C	Partner D	Partner E
Original Section 704(c) Layer (Segregated by 704(c)(1)(C))	($20)	$0	$0	$0	$0
First Reverse Section 704(c) Layer	($25)	($25)	$0	$0	$0

	Partner A	Partner B	Partner C	Partner D	Partner E
Second Reverse Section 704(c) Layer	$10	$10	$10	$0	$0
Third Reverse Section 704(c) Layer	($5)	($5)	($5)	($5)	$0

Here, it is not certain how exactly the $10 of tax loss to partnership ABCDE should be allocated among the three reverse layers.[168] The various possibilities include the first-in-first-out, last-in-first-out, and pro-rata approaches. No matter which allocation approach is used, under the "ceiling rule" of Treas. Reg. § 1.704-3(b)(1), the loss allocated to the partners as a whole cannot be greater than the total tax loss at the partnership level. Under a first-in-first-out approach, Partner A and Partner B could each be allocated $5 of loss (as each has an equal amount of loss in the oldest layer, in excess of the overall $10 tax loss). Under a last-in first-out approach, A, B, C and D could each be allocated $2.50 of loss (as each has an equal amount of loss in the newest layer, in the aggregate in excess of the overall $10 tax loss). Under at least one pro-rata approach, the $10 in loss would be allocated $4.29 {=$10*(($25 + 5)/$70)} to each of A and B, and $0.71 {=$10*(($5)/$70)} to each of C and D.

Whatever approach is used when separate layers are maintained, they all produce a different loss allocation than if the layers were collapsed (that is, if the netting approach is followed). The collapsed layers would be as follows:

	Partner A	Partner B	Partner C	Partner D	Partner E
Collapsed Section 704(c) Layer	($20)	($20)	$5	($5)	$0

[168] The $20 of built-in loss on contribution must be allocated to the forward 704(c) layer and is not considered a loss to partnership ABCDE.

In this scenario, if the netting is respected, $4.44 of loss {=$10*($20/$45)} would be allocated to each of A and B, $1.11 of loss {=$10*$5/$45} would be allocated to D, and no loss would be allocated to E.[169]

The value of separate layers is evident when the partners have a negotiated arrangement (for example, to use the first-in-first-out approach, which yields a very different result than under the netting approach). The partners may or may not have principled reasons for their negotiated arrangement, but in either case they have expectations. Further, partnership anti-abuse rules, including Treas. Reg. § 1.704-3(a)(10), can be utilized to recharacterize an allocation methodology that contravenes the purpose of section 704(c).

Moreover, as we also explained in the Layering Report, we believe that the layering approach not only is the best method for maintaining the economic bargain struck by partners but also best serves the purpose of section 704(c), to assign to contributing partners the tax consequences resulting from the recognition of built-in gains or losses (and prevent the shifting of such gains or losses).[170] Events that require a revaluation of partnership capital accounts and that lead to reverse 704(c) allocations are independent of the original contribution transaction and should not change the tax consequences of the initial contribution transaction. This result is most readily obtained by creating and maintaining separate layers for each event. In the case of a

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[169] If ABCDE used the remedial allocation method, it would allocate additional (remedial) items of gain or loss such that each of the partners would recognize an amount of gain or loss such that the inside basis of each partner would equal the partner's share of book capital ($86). Overall, A would be allocated $14 of loss (or $34 after taking into account A's Section 704(c)(1)(B) Basis Adjustment), B would be allocated $14 of loss, C would be allocated $11 of gain, D would be allocated $1 of gain, and E would be allocated $6 of gain.

If ABCDE followed the traditional method with curative allocations, ABCDE would, to the extent possible, reallocate part or all of the gain or loss from other partnership items of gain or loss to place its partners in the same net gain or loss position as under the remedial allocation method.

[170] *See* Treas. Reg. § 1.704-3(a)(1) (as amended in 2005).

revaluation, the continuing partners in a partnership are, as a conceptual matter, contributing partners with respect to the historic assets of the partnership (even though such assets are not being contributed to a new partnership). The "pre-contribution" (meaning revaluation event) built-in items are appropriately allocated to those partners under the reverse 704(c) rules. To net offsetting layers fails to maintain the distinction among original partners as "contributing" or "non-contributing."

D. Exceptions to Layering.

As the "basic" example above demonstrated, layering is complicated and can require significant record keeping. Accordingly, similar to our position in the Layering Report, we recommend that the Final Regulations allow partnerships to use either layering or netting if the partnership is below certain asset value thresholds. We believe that three value-based thresholds are appropriate.[171]

The first is an overall threshold based on the partnership's gross asset value. If a partnership did not have gross assets with a value meeting the threshold, the partnership would not be required to use the layering approach, although it would be permitted to do so, provided that maintaining layers was not done pursuant to a plan with a principal purpose to avoid taxes. We suggest that this threshold be set initially at $20 million and that the threshold be periodically adjusted to account for inflation. Although not de minimis, we believe that many partnerships with assets below that threshold would be unable to afford the relatively sophisticated tax compliance and accounting functions necessary to maintain section 704(c) layers.

[171] The thresholds this Report recommends are the same as those recommended in the Layering Report.

The second threshold would be applied on an asset-by-asset basis. Under this threshold, section 704(c) layers would not be required to be maintained for any asset with a value less than a certain amount, although a partnership would be permitted to do so subject to a similar anti-abuse rule. We suggest $1 million as the asset-by-asset threshold. We also suggest that these thresholds be adjusted periodically to reflect inflation.[172]

Finally, we suggest that separate section 704(c) layers not be required in the case of adjustments of less than 3% of the partnership's carrying value of its aggregate assets, regardless of the amounts involved, because we do not believe that relatively small changes in the value of assets are likely to implicate the anti-shifting policies of section 704(c).

E. Reasonable Method of Allocating Gain and Loss Between and Among Layers.

Consistent with our position in the Layering Report, we agree with the general flexibility that the Preamble would afford to partners. We believe that it is important for taxpayers to be able to reach a particular economic bargain and tax report in a manner consistent therewith. We acknowledge that a method should be prohibited if its choice is motivated primarily to reduce the aggregate tax liability of the partners. Accordingly, we suggest that the allocation of tax items between and among section 704(c) layers be subject to a general anti-abuse rule. As to a matter of regulatory drafting, we believe that this rule should be embodied in a single broadly drafted section of the regulations, similar to current Treas. Reg. § 1.704-3(a)(10), though we believe that the reasonable-method approach would be more permissive than Treas. Reg. § 1.704-3(a)(10). The rule should govern situations in which the regulations provide electivity to partnerships and partners to choose methods of allocating section 704(c) items.

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[172] *Cf.* Section 1(f) (inflation adjustments for tax brackets); Section 63(c)(4) and (5) (inflation adjustments for personal exemptions).