NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON

REVENUE RULING 99-6

TABLE OF CONTENTS

Page

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS 4

II. BACKGROUND 5

- **A.** The Ruling 5
  - 1. Situation 1 —Partner A sells its interest to Existing Partner B. 6
  - 2. Situation 2. 7
- **B.** McCauslen 8
- **C.** Transaction Forms in Other Partnership Contexts 11
  - 1. Revenue Ruling 84-111 and the Incorporation of a Partnership. 11
  - 2. Checking the Box to Incorporate a Partnership 13
  - 3. Partnership Mergers 14
  - 4. The Sale of a Going Business Doctrine 17
- **D.** Existing Guidance on the Ruling 18
  - 1. Section 1031 Exchanges 18
  - 2. Asset Acquisition Reporting (Section 1060) 19
  - 3. Application of Section 1239 21
  - 4. Consolidated Group Rules 22

III. RATIONALE BEHIND THE INTERESTS OVER RECOMMENDATION. 25

IV. RATIONALE BEHIND OUR RECOMMENDATIONS RELATING TO SITUATION 2 OF THE RULING 28

V. SPECIFIC ISSUES ARISING UNDER THE RULING AND THE INTERESTS OVER RECOMMENDATION 30

- **A.** Which Assets Are Deemed Distributed 31
- **B.** Liabilities 34
- **C.** Property Precontribution Gain (Sections 704(c)(1)(B) and 737) 40
- **D.** Section 197 – Amortization of Goodwill and Certain other Intangibles. 45
- **E.** Distributions of Money and Marketable Securities (Section 731) 47
- **F.** Hot Assets (Section 751) 49
- **G.** Depreciation 51
- **H.** Gain and Loss Deferral Provisions 52
- **I.** Statutory Mergers or Consolidations 54

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON REVENUE RULING 99-6

This Report[1] of the New York State Bar Association Tax Section provides comments on Revenue Ruling 99-6[2] (the "Ruling"). The Ruling provides guidance regarding the Federal income tax treatment when partnership equity is sold in a taxable transaction to a person who then owns all of the partnership equity.

In very general terms, when partnership equity is sold in a taxable transaction to a person (whether an existing partner or third party purchaser) who then owns all of the partnership equity, for Federal income tax purposes, the partnership is treated as terminated and becomes a disregarded entity. In this report, we refer to this type of sale as an "interests over" transaction. In such a case, the Ruling treats the selling partner, in accordance with the form of the transaction, as selling its partnership interest. By contrast, the Ruling provides that, for purposes of determining the tax consequences to the purchaser, (i) the partnership is deemed to make a liquidating distribution of all of its assets to its partners and (ii) following the deemed distribution, the purchaser is treated as acquiring the assets deemed to have been distributed to the selling partner.

The deemed distributions under the Ruling and the asymmetry between the seller's treatment and the purchaser's treatment create a variety of problems, opportunities and uncertainties for taxpayers in connection with an existing partner's purchase of all of the other

[1] The principal authors of this Report are John T. Lutz and David W. Mayo, with substantial assistance from Madeline Chiampou. Significant contributions were made by Matthew Lay, Michael Schler, David H. Schnabel, and Eric Sloan. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] 1999-1 C.B. 432.

interests in the partnership ("Situation 1" in the Ruling).[3] For example, the deemed liquidating distribution in Situation 1 could be viewed as potentially resulting in the recognition of income or gain to the purchasing partner under Section[4] 731, 704(c)(1)(B), 737 or 751(b). Uncertainties, potential problems and opportunities arising under the Ruling include the treatment of partnership liabilities and the application of the holding period rules, the anti-churning rules under Section 197, the consolidated return rules under Section 1502, the depreciation rules under Section 168, the like-kind exchange rules under Section 1031, and the sale of depreciable property to related persons rules under Section 1239.[5] These issues arise primarily as a result of the deemed distribution and bifurcated approach required by Situation 1 of the Ruling, in which the purchasing partner is required to treat partnership assets as having been distributed by the partnership in liquidation and then purchased from the selling partner.

While many of these problems and uncertainties could be addressed by Regulations clarifying whether and how the above Sections apply to the deemed transaction, we believe it would be more efficient to revisit the characterization of the transactions in the Ruling.[6]

---

[3] As discussed further below, we did not identify similar problems and uncertainties arising with respect to the taxable sale of all of the interests in a partnership to an unrelated third party ("Situation 2" in the Ruling).

[4] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Regulations Section" are to the Treasury Regulations promulgated or proposed thereunder ("Regulations").

[5] *See* Matthew Lay, "Treatment of Liabilities in Transactions Governed by Revenue Rulings 99-6 and 99-5," *Journal of Passthrough Entities* (September/October 2008); Don A. Leatherman, "Gimme Fiction: Rev. Rul. 99-6" *Taxes — The Tax Magazine* (March 2008); S. T. Advani, "Asymmetric Acquisitions: Treating Buyer and Seller Differently in the Same Transaction," *Taxes — The Tax Magazine* (March 2008); Howard E. Abrams, "Doing the *McCauslen* Two-Step" *Business Entities* (November/December 1999); Monte A. Jackel, "New Rulings Address One-to-Two and Two-to-One Entity Conversion," *Tax Notes Today* (February 22, 1999); Monte A. Jackel and John J. Rooney, "Comments on Changes in Entity Classification Caused by Change in Number of Members," Letter from American Bar Association Section of Taxation to Commissioner of IRS (September 22, 1998).

[6] Taxpayers who are aware of these uncertainties and potential income or gain recognition events to the purchasing partner in Situation 1 of the Ruling generally can plan around them by ensuring that all of the interests in the partnership are not acquired by the same purchaser. In that case, the partnership does not terminate under Section 708(b)(1)(A), and the asymmetrical treatment of seller and purchaser pursuant to the Ruling does not apply. Rather,

This Report discusses those problems, opportunities and uncertainties and recommends that the IRS[7] and Treasury issue guidance in the form of Regulations governing the treatment of the two situations described in the Ruling.

This Report is divided into five parts. Part I summarizes our principal recommendations. Part II provides background regarding the Ruling and other relevant authorities. Part III describes the rationale for our recommendations that the IRS and Treasury adopt a new approach to interests over transactions. Part IV describes the rationale for our recommendation that the Ruling apply in the context of Situation 2 if an election is made. Part V describes various problems and uncertainties created by the Ruling and the extent to which those problems would arise under our recommended approach to interests over transactions.

---

both the seller and the purchaser are treated as having sold and purchased the same asset – a partnership interest. This could be accomplished in a number of ways, including, for example, acquiring all of the interests in a partnership with one or more affiliates.

[7] All "IRS" references are to the Internal Revenue Service.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

1) The IRS and Treasury should reconsider the Ruling and issue Regulations under Section 708 providing that, in Situation 1 of the Ruling (i.e., where an existing partner purchases the remaining interests in the partnership from the other partners in a taxable purchase) (i) the purchaser is treated as purchasing (and the seller is treated as selling) the acquired partnership interest and (ii) immediately thereafter, the purchaser is treated as receiving all of the assets of the partnership (and as assuming all of the partnership's liabilities) in a liquidation of the partnership in a transaction governed by the rules generally applicable to partnership liquidations (the "Interests Over Recommendation"). If the IRS and Treasury conclude that it is necessary or appropriate to maintain the holding period result under the Ruling, we recommend that the IRS and Treasury adopt the Interests Over Recommendation but prescribe an exception for the determination of the purchaser's holding period.

As discussed below, we believe that somewhat different considerations apply in Situation 2 of the Ruling (i.e., where a person who is not an existing partner purchases all of the outstanding interests in a partnership in a taxable purchase). Approximately one-half of the members of the Executive Committee of the Tax Section believe that in Situation 2 of the Ruling such Regulations should maintain the treatment prescribed by the Ruling and approximately one-half of the members believe that the parties to the transactions (that is, the buyer, the selling partners and the partnership) should be permitted to elect to treat the transaction for all tax purposes as an assets up transaction, an assets over transaction or pursuant to the Interests Over Recommendation.

2) If the Interests Over Recommendation is adopted, the IRS and Treasury should consider issuing guidance providing that similar treatment applies to an interests over transaction governed by Revenue Ruling 84-111, Situation 3.[8]

3) It would be appropriate and helpful for the IRS and Treasury to consider issuing guidance to the effect that the form of a taxable partnership sale will be respected if it is structured as either an assets over transaction (where the partnership in form sells its assets and then liquidates) or an assets up transaction (where the partnership in form distributes its assets to its partners and then the partners sell the assets to the purchaser), similar to the rules applicable in the case of a partnership incorporation under Revenue Ruling 84-111.[9]

4) If our Interests Over Recommendation in 1) above is not adopted, the IRS and Treasury should issue additional guidance with respect to taxable interests over transactions governed by the Ruling, particularly with respect to partnership liabilities, tax-free mergers and reorganizations and the application of Sections 704(c)(1)(B) and 737.

II. BACKGROUND

A. The Ruling

---

[8] 1984-2 C.B. 88. The Treasury and IRS may also consider revisiting the partnership merger and division Regulations if the Interests Over Recommendation is adopted. In making this suggestion, we are also suggesting that the IRS and Treasury reconsider the manner in which the partnership merger or division Regulations determine which partnership is considered to continue, which is governed by the Code.

[9] The history of Revenue Ruling 84-111 indicates that the IRS has previously moved from a regime prescribing the treatment of a transaction for federal tax purposes regardless of form to permitting the form elected by the taxpayer to govern the federal tax consequences of the transaction. Prior to the issuance of Revenue Ruling 84-111, the IRS had issued Revenue Ruling 70-239, 1970-1 C.B. 74. Revenue Ruling 70-239 addressed the same three situations addressed in Revenue Ruling 84-111 (discussed below), but provided that all three situations should be treated as a transfer of the partnership's assets in exchange for all of the stock of the recipient corporation. Revenue Ruling 84-111 later revoked and superseded Revenue 70-239 and provided that the form of a partnership incorporation transaction generally governs the tax consequences of that transaction.

The Ruling generally governs the treatment when partnership interests are sold in a taxable transaction to a person who then own all of the interests in the partnership. More specifically, the Ruling addresses the treatment of the termination of a domestic[10] two person partnership ("AB") upon the taxable sale by one partner ("A") of A's entire interest to the other partner ("B"). It also addresses the treatment of the termination of a partnership ("CD") where both partners ("C" and "D") transfer their partnership interests to an unrelated third party ("E"). Importantly, the Ruling does not address situations in which (i) the partnership owns any Section 751 property; (ii) the partnership has any liabilities or owns assets subject to liabilities; (iii) the partnership has any assets subject to Section 704(c); or (iv) either partner's interest in the partnership is redeemed.

1. Situation 1 —Partner A sells its interest to Existing Partner B.

In Situation 1 of the Ruling, A and B were equal members in AB, a limited liability company classified as a partnership. A sold A's entire interest in AB to B. After the sale, the limited liability company continued its business with B as the sole owner. Citing Regulations Section 1.741-1(b), the Ruling concludes that A must treat the transaction as the sale of a partnership interest and report gain or loss in accordance with Section 741.[11]

For purposes of determining the tax treatment of B, however, the Ruling concludes that, under the analysis in *McCauslen v. Commissioner,*[12] the AB partnership terminates under Section 708(b)(1)(A) and the AB partnership is deemed to make a liquidating distribution of all of its

[10] Our recommendations apply equally to foreign entities classified as partnerships for Federal income tax purposes.

[11] Section 741 generally treats gain or loss resulting from the sale or exchange of a partnership interest as gain or loss from the sale or exchange of a capital asset. However, Section 751(a) may recharacterize a portion of that capital gain or loss as ordinary.

[12] 45 T.C. 588 (1966).

assets to A and B. Following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest. B receives a cost basis in the assets attributable to A's interest in the partnership.[13] Section 735(b)[14] is inapplicable with respect to B's acquisition of these assets, with the result that B's holding period for these assets begins on the day following B's purchase of A's interest.[15] B is considered to receive a distribution from the partnership of those assets of the partnership deemed attributable to B's former interest in AB and must recognize gain or loss on the deemed distribution of these assets to the extent required by Section 731(a).[16] B's basis in the distributed assets is determined under Section 732(b),[17] and B's holding period with respect to these assets includes the partnership's holding period for such assets.[18]

2. Situation 2.

In Situation 2 of the Ruling, C and D are equal members in CD, a limited liability company classified as a partnership. Both C and D sell their entire interests in CD to E, an unrelated person, in exchange for $10,000 each. After the sale, the limited liability company continued its business with E as the sole owner. Consistent with the result in Situation 1, the

---

[13] Section 1012.

[14] Section 735(b) provides that the holding period for property received by a partner in a distribution from a partnership generally includes the holding period of the partnership.

[15] *See* Rev. Rul. 66-7, 1966-1 C.B. 188 (concluding that "the holding period of a capital asset begins to run on the day following the date of acquisition of the asset involved.").

[16] Section 731(a) provides that in the case of a distribution to a partner, the partner will recognize gain only to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. For this purpose, any increase in a partner's share of partnership liabilities is considered as a contribution of money by the partner to the partnership and any decrease in a partner's share of partnership liabilities is considered as a distribution of money by the partnership to the partner. Section 752(a), (b).

[17] Section 732(b) provides that the basis of property (other than money) in the hands of a distributee partner is the same as the adjusted basis of the distributee partner's basis in its partnership interest reduced by any money received in the transaction.

[18] Section 735(b).

Ruling concludes that C and D must report gain or loss, if any, resulting from the transaction as a sale of their partnerships interests and report gain or loss in accordance with Section 741.

For purposes of determining the federal income tax consequences of the acquisition of the CD interests by E, the Ruling holds that the CD partnership terminates under Section 708(b)(1)(A) and is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, by purchase, all of the former partnership's assets. E takes a cost basis in the partnership assets,[19] and E's holding period for the assets begins on the day immediately following the sale date.

The Ruling applies a deemed distribution analysis for some, but not all purposes. The Ruling treats the transaction from the seller's perspective as a transfer of a partnership interest, consistent with Section 741. Thus, the seller is indifferent as to whether it sells the partnership interest to a third party or to its partner, and as to whether the partnership survives the transaction for federal income tax purposes. From the purchaser's perspective, however, the Ruling ignores the form of the sale and treats the transaction as a constructive distribution of partnership assets to the partners followed by a sale of the assets. According to the Ruling, the deemed distribution approach mandated by the Ruling is intended to prevent the legislative purpose of Section 735(b) from being undermined, as explained by the Tax Court in the *McCauslen* case, discussed below.

B. *McCauslen*

In *McCauslen v. Commissioner*,[20] the issue before the Tax Court was whether the purchaser of a deceased partner's partnership interest succeeds to the partnership's holding

[19] Section 1012.

[20] 45 T.C. 588 (1966).

period for the assets attributable to the deceased partner's interest. Under the facts of the case, a partner in an equal, two-member partnership died and the remaining partner purchased the decedent's partnership interest from his estate. Two months later the surviving partner sold certain property that had previously been owned by the partnership (for the long-term holding period) at a gain and reported the gain, in its entirety, as long-term capital gain. Specifically, the court considered whether the taxpayer was entitled to tack on the holding period of the partnership to the portion of the partnership assets he acquired when he purchased the partnership interest of the decedent partner from the estate.

The taxpayer argued that it had received a liquidating distribution of the partnership's assets so that under Section 735(b), which provides that in determining the period for which a partner has held property received in a distribution from a partnership there generally shall be included the holding period of the partnership with respect to such property, he was entitled to the tacked holding period. The Tax Court, perceiving that such an outcome would be tantamount to "purchas[ing] assets belonging to another with a built-in holding period," held that "neither logic nor necessity" calls for such a result:[21]

> The provision for tacking on the partnership's holding period is entirely consistent with the general statutory scheme of postponing recognition of gain or loss until the distributee partner finally disposes of the distributed property. But where, as here, a partner acquires another partner's share by purchase and, as a consequence of the termination of the partnership resulting from such purchase, acquires the partnership assets relating to such purchased interest, the statute has no application.[22]

The court therefore concluded that,

---

[21] At least one commentator has criticized the *McCauslen* decision, noting that "The only authority cited for its willingness to ignore the plain words of the statute is a paragraph from the Mertens treatise." Nothing in Section 735(b) "limits its application to some distributions but not to others." Abrams, *supra*.

[22] 45 T.C. at 592.

> [s]ince petitioner's purchase of the decedent's partnership interest resulted in a termination of the partnership under Section 708(b), . . . petitioner acquired partnership assets relating to such interest by purchase, rather than by any distribution from the partnership, and . . . petitioner's holding period for such assets begins from the date of such purchase.[23]

Revenue Ruling 67-65[24] considered a similar fact pattern and ruled consistently with *McCauslen*. In that ruling, the surviving partner of a two-person partnership purchased the deceased partner's interest from his estate. The ruling concludes that the surviving partner is considered to have received a distribution of his share of partnership assets and to have purchased the assets attributable to the deceased partner's interest. The holding period for the assets attributable to his interest is governed by Section 735(b); thus, he includes the holding period of the partnership. Section 735(b) is not applicable with respect to the assets attributable to the partnership interest purchased from the deceased partner's estate. The acquiring partner's holding period for those assets begins from the date of purchase.

In addition to Revenue Ruling 67-65, the Ruling also cites Revenue Ruling 55-68, which held that the sole remaining partner of a former partnership who purchased the other partner's partnership interest had a holding period for the assets attributable to the purchased partnership interest that began on the date of the sale. In contrast, the purchasing partner's holding period for the assets deemed distributed to him in liquidation of his former partnership interest began on the date he acquired his partnership interest.

McCauslen, Revenue Ruling 67-65 and Revenue Ruling 55-68[25] address the issue of the holding period for partnership assets purchased in connection with a taxable sale of partnership

---

[23] 45 T.C. at 592.

[24] 1967-1 C.B. 168.

[25] 1955-1 C.B. 372

interests to a person who then owns all the interests in the partnership. The Ruling appears to extend the result in *McCauslen*, Revenue Ruling 67-65 and Revenue Ruling 55-68 beyond the taxpayer's holding period to all Federal income tax consequences to the purchaser.

C. Transaction Forms in Other Partnership Contexts

As discussed above, the Ruling rejects the form of the taxable sale of partnership interests in favor of the deemed liquidation approach for purposes of determining the tax consequences to the purchaser. The issue of whether to respect the form of a transaction or to impose an outcome regardless of form (e.g., a deemed liquidation) arises in other partnership transaction contexts.

1. Revenue Ruling 84-111 and the Incorporation of a Partnership.

Revenue Ruling 84-111 addresses partnership incorporation transactions, providing that the incorporation method selected by partners for incorporating a partnership will be respected and will control the tax consequences of the transaction. Three methods for incorporating a partnership are identified: (1) the "assets over" method (where the partnership transfers its assets to a corporation in exchange for its stock and then terminates by distributing the stock to its partners in proportion to their interests in the partnership), (2) the "assets up" method (where the partnership distributes its assets to its partners in proportion to their interests in the partnership in termination of the partnership and the partners, in turn, transfer the assets to a corporation in exchange for all of the outstanding stock of the corporation) and (3) the "interests over" method (where the partners of the partnership transfer their partnership interests to a corporation in exchange for all of its outstanding stock, terminating the partnership in the exchange).

The "interests over" partnership incorporation method, which is analogous to the interests over transaction described in the Ruling, is illustrated by Situation 3 of Revenue Ruling 84-111.

In Situation 3, the partners in a three-member partnership transferred their partnership interests to a newly-formed corporation in exchange for all of its outstanding stock, causing the partnership to terminate under Section 708(b)(1)(A). Upon termination of the partnership, all of the partnership's assets and liabilities became assets and liabilities of the corporation. The ruling concludes that (i) under Section 351(a), gain or loss is not recognized by the partners on the transfer of their partnership interests to the corporation in exchange for stock, (ii) on the transfer of the partnership interests, the partnership terminated under Section 708(b)(1)(A), (iii) under Section 358(a), the initial basis to each partner in the stock it received in exchange for its partnership interest equals the adjusted basis of the partnership interest transferred by it to the corporation (reduced by any partnership liabilities assumed by the corporation), (iv) the corporation's basis for the assets received in the exchange equals the adjusted basis of the partners in their partnership interests allocated in accordance with Section 732(c), (v) the corporation's holding period for the partnership's assets includes the partnership's holding period in the assets, and (vi) the holding period of the stock received by the former partners includes each partner's holding period for the partnership interest transferred, except that the holding period of the stock that was received by the partners in exchange for their interests in Section 751 assets of the partnership that are neither capital assets nor Section 1231 assets begins on the day following the date of the exchange.

However, as discussed below in connection with the partnership merger Regulations, in the case of an interests over transaction governed by Revenue Ruling 84-111, it is not entirely clear whether, in determining the Federal income tax consequences to the transferee corporation (i) the transferee corporation is treated as receiving all of the partnership interests and then receiving a liquidating distribution or (ii) the partnership is deemed to have made a liquidating

distribution to its existing partners and those partners are deemed to have contributed the assets to the partnership.[26]

2. Checking the Box to Incorporate a Partnership

Regulations Section 301.7701-3(g)(1) dictates the transactions that are deemed to occur when a partnership elects to be classified as an association and when an association elects to be classified as a disregarded entity. When a partnership elects to be classified as an association, consistent with the "assets over" method of Revenue Ruling 84-111, described above, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.[27] If an entity classified as an association elects to be disregarded as an entity separate from its owner, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association.[28] In the context of elective conversions, the forms prescribed by these Regulations are necessary because elective conversions inherently have no form.[29]

---

[26] The IRS has indicated it views the "interests over method" in Revenue Ruling 84-111 as consistent with the Ruling. *See e.g.*, Notice of Proposed Rulemaking, Fed. Reg. Vol. 65, No. 7, p. 1572 (January 11, 2000) (finalized by T.D. 8925, January 3, 2001) (indicating that, pursuant to the "interests over" form in Revenue Ruling 84-111, only the transferors' conveyances of partnership interests are respected, and that the transferee corporation should be deemed to have received partnership assets under the theory of *McCauslen*). In addition, in a series of General Counsel Memoranda, Chief Counsel recommended the repeal of Revenue Ruling 70-239, discussed earlier. The memoranda indicated that the asymmetrical result found in *McCauslen* and Revenue Ruling 67-65 applies in the case of an interests over partnership incorporation transaction. GCM 39056 (November 8, 1983); GCM 38144 (October 23, 1979); GCM 37540 (May 18, 1978).

[27] Regulations Section 301.7701-3(g)(1)(i).

[28] Similarly, pursuant to Regulations Section 301.7701-3(g)(1)(ii), if an eligible entity classified as an association elects to be classified as a partnership, the association is deemed to distribute all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

[29] *See* Rev. Rul. 2004-59, 2004-1 C.B. 1050; Rev. Rul. 2009-15, 2009-1 C.B. 1035. In Revenue Ruling 2004-59, an entity that is a partnership for federal tax purposes converts to a state law corporation under a state law formless conversion statute and is classified as a corporation for federal tax purposes as a result. Revenue Ruling 2004-59 rules that, for federal tax purposes, the converting entity is to be treated in the same manner as an entity that makes

Although Regulations Section 301.7701-3 does not prescribe the form for a change in entity classification when an eligible entity classified as a partnership becomes a disregarded entity due to a change in members, the preamble to the Regulations Section 301.7701-3 Regulations indicates that guidance on the federal tax consequences of such a change has already been provided pursuant to the Revenue Ruling 99-6.[30]

3. Partnership Mergers

The question of form also arises in the context of partnership mergers, and is answered differently than the result prescribed in the Ruling. Section 708(b)(2)(A) provides that, in the case of a merger or consolidation of two or more partnerships, the resulting partnership is considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. Regulations issued under this Section explain that the merging or consolidating partnership is considered to have terminated.[31] If the members of none of the merged or consolidated partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.[32]

an election to be treated as an association under Regulations Section 301.7701-3(c)(1)(i). Thus, when an entity that is treated as a partnership for federal tax purposes converts into a corporation under a state law formless conversion statute, Revenue Ruling 2004-59 dictates that the entity is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners (as in Regulations Section 301.7701-3(g)(1)(i)). Situation 2 of Revenue Ruling 2009-15 also applied the principles of Regulations Section 301.7701-3(g) in the formless conversion context in addressing whether an entity taxed as a partnership that becomes a corporation for federal tax purposes is eligible to elect to be taxed as an S corporation effective its first taxable year.

[30] T.D. 8844 (Nov. 29, 1999).

[31] Regulations Section 1.708-1(c)(1).

[32] *Id*.

The Regulations also prescribe the form of the merger or consolidation with respect to the partnership(s) that is deemed to have terminated. They provide that the "assets up" method will be respected if that is the form of the terminating partnership's liquidation. Specifically, the Regulations provide that:

> Despite the partners' transitory ownership of the terminated partnership's assets, the form of a partnership merger or consolidation will be respected for Federal income tax purposes if the merged or consolidated partnership that is considered terminated under [Regulations Section 1.708-1(c)(1)] distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[33]

However, the Regulations provide that if partnerships merge without choosing a form or without using the assets up form described above, the "assets over" form will be applied to the transaction.[34] Pursuant to the "assets over" form, the merged or consolidated partnership that is considered terminated is treated as contributing all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.

Importantly, under the partnership merger Regulations, an interests over transaction is recharacterized as an asset over transaction. The preamble to the proposed partnership merger Regulations explains that:

[33] Regulations Section 1.708-1(c)(3)(ii).

[34] Regulations Section 1.708-1(c)(3)(i).

> In the context of partnership incorporations, Rev. Rul. 84-111 distinguishes among all three forms of incorporation. However, with respect to the Interest-Over Form, the revenue ruling respects only the transferors' conveyances of partnership interests, while treating the receipt of the partnership interests by the transferee corporation as the receipt of the partnership's assets (i.e., the Assets-Up Form). The theory for this result, based largely on McCauslen v. Commissioner, 45 T.C. 588 (1966), is that the transferee corporation can only receive assets since it is not possible, as a sole member, for it to receive and hold interests in a partnership (i.e., a partnership cannot have only one member; so, the entity is never a partnership in the hands of the transferee corporation). Adherence to the approach followed in Rev. Rul. 84-111 creates problems in the context of partnership mergers that are not present with respect to partnership incorporations. Unlike the corporate rules, the partnership rules impose certain tax results on partners based upon a concept that matches a contributed asset to the partner that contributed the asset. Sections 704(c) and 737 are examples of such rules. The operation of these rules breaks down if the partner is treated as contributing an asset that is different from the asset that the partnership is treated as receiving. Given that the hybrid treatment of the Interest-Over Form transactions utilized in Rev. Rul. 84-111 is difficult to apply in the context of partnership mergers, another characterization will be applied to such transactions.[35]

Thus, the Ruling, Revenue Ruling 84-111 and partnership merger Regulations are inconsistent. In determining the tax treatment of an interests over transaction to the transferor, Revenue Ruling 84-111 and the Ruling respect the form of the transaction and treat the transferor as transferring its partnership interest whereas the partnership merger Regulations do not respect the form of the transaction and deem the partnership to have engaged in an assets over transaction.

In determining the tax consequences of an interests over transaction to the transferee, both the Ruling and the partnership merger Regulations recharacterize the transaction but adopt different recharacterizations. The Ruling treats the transaction as an asset up transaction whereas

[35] Notice of Proposed Rulemaking, Fed. Reg. Vol. 65, No. 7, p. 1572 (January 11, 2000) (finalized by T.D. 8925, January 3, 2001).

the merger Regulations treat the transaction as an assets over transaction. While the text of Revenue Ruling 84-111 seems to respect the form of an interests over transaction in determining the tax consequences to the transferee, the preamble quoted above indicates that the IRS (at least at the time the preamble was written) thought that (similar to the Ruling) an interests over transaction governed by Revenue Ruling 84-111 is recharacterized as an assets up transaction from the perspective of the transferee corporation.[36]

4. The Sale of a Going Business Doctrine

Case law developed prior to the issuance of the Ruling and Revenue Ruling 84-111 imposed sale of partnership interest treatment on a sale of the entire business of a partnership. In *Barran v. Commissioner*, for example, the sale of all of the assets of a partnership in an asset purchase was held to constitute a sale of the partners' partnership interests where the operation of the business was to be continued by the purchaser and no business was continued by the historic partnership.[37] The theory underlying *Barran* and the cases preceding it was generally that the sale of an entire business as a going concern is, in substance, a sale of the partnership interests. It would be helpful and appropriate if the IRS and Treasury clarified whether the sale of a going business doctrine has any continued vitality today and if so the scope of the doctrine.[38]

[36] While Revenue Ruling 84-111 and the partnership merger Regulations expressly respect a transaction structured in form as an assets up transaction or an assets over transaction, the Ruling is silent as to whether these forms will be respected.

[37] *La Rue v. Commissioner*, 90 T.C. 465 (1988); *Barran v. Comm.*, 334 F.2d 58 (5th Cir. 1964); *see also Kinney v. United States*, 228 F. Supp. 656 (W.D. La. 1964), *aff'd per curiam*, 358 F.2d 738 (5th Cir. 1966); *Kaiser v. Glenn*, 216 F.2d 551 (6th Cir. 1954) (per curiam); *Est. of Hatch v. Comm.*, 198 F.2d 26 (9th Cir. 1952); *W. Ferd Dahlen*, 24 T.C. 159 (1955) (acq.).

[38] *See* William S. McKee, William F. Nelson, and James P. Whitmire, *Federal Taxation of Partnerships and Partners,* ¶16.03[3] (4th ed. 2007, with updates through February 2011).

D. Existing Guidance on the Ruling

The treatment of the purchase transaction in the Ruling raises a number of potential issues that the Ruling does not address. Some of these have been addressed or clarified in subsequent guidance issued by the IRS.

1. Section 1031 Exchanges

Section 1031(a) provides an exception to the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Pursuant to Section 1031(a), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for "like kind" property which is also to be held either for productive use in a trade or business or for investment. In general, Section 1031(a)(2)(D) specifically excludes any exchange of "interests in a partnership" from Section 1031(a) nonrecognition treatment.

If a single purchaser purchases all of the partnership interests of a partnership from selling partners, consistent with the treatment of the transaction pursuant to the Ruling, the purchaser may be eligible to treat the assets of the partnership as replacement property for purposes of deferring gain on the sale of other assets under Section 1031. If the purchaser is treated as purchasing the partnership assets as opposed to partnership interests under the Ruling, these assets may be like-kind property eligible for a Section 1031 like-kind exchange.

The IRS confirmed this result in Private Letter Ruling 200807005[39] (the "Section 1031 Private Ruling"). Under the facts of the Section 1031 Private Ruling, the taxpayer was a limited partnership engaged in the real estate business. In a typical deferred "like-kind" exchange, the taxpayer transferred property to a qualified intermediary and acquired "replacement property" by

[39] Feb. 15, 2008.

purchasing 100 percent of a limited partnership that owned real property. Citing Situation 2 of the Ruling, the transaction was treated as if the limited partnership was liquidated and taxpayer purchased the distributed property (here, real estate) from the former members. Therefore, the real estate assets deemed to have been purchased qualified the transaction for like-kind exchange treatment under 1031.

If the Interests Over Recommendation were applicable in Situation 2, a third-party purchaser in this context would not be eligible for Section 1031(a) nonrecognition treatment. However, if the treatment prescribed by the Ruling were applicable or if the parties to the transaction were allowed to elect assets up or assets over treatment, Section 1031(a) nonrecognition treatment would be available to the purchaser.

2. Asset Acquisition Reporting (Section 1060)

Because the transactions in the Ruling are treated as a sale of interests to and the purchase of assets by the purchaser, the Ruling raised the question of whether the purchaser is required to file Form 8594 pursuant to Section 1060. Section 1060 provides that, in the case of any applicable asset acquisition, for purposes of determining both (1) the transferee's basis in the acquired assets and (2) the gain or loss of the transferor with respect to such acquisition, the consideration received for the acquired assets is to be allocated among such assets in the same manner as amounts are allocated to assets under Section 338(b)(5).[40] Section 338(b)(5) provides ordering rules for allocating basis to specific classes of assets when a Section 338 election is made. Furthermore, Section 1060 requires the seller and the purchaser in an applicable asset acquisition to report information concerning the amount of consideration in the transaction and

[40] Section 1060(a)(1).

its allocation among the assets transferred.[41] This reporting requirement may be satisfied by the seller and the purchaser each filing asset acquisition statements on Form 8594 (Asset Allocation Statement) with their income tax returns for the taxable year that includes the first date the assets are sold pursuant to an applicable asset acquisition.[42]

Regulations under Section 1060 have answered this question by providing for the application of Section 1060 to asymmetrical transfers. The Regulations provide that a purchaser is subject to Section 1060 if (i) under general principles of tax law, the seller is not treated as transferring the same assets as the purchaser is treated as acquiring; (ii) the assets acquired by the purchaser constitute a trade or business; and (iii) except as specifically provided with respect to certain partial non-recognition exchanges, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.[43]

The Preamble to the proposed Regulations addressing asymmetrical transfers under Section 1060 made clear that the provision was directed to the transactions described in the Ruling:

> This rule clarifies that a purchaser of assets in an applicable asset acquisition is subject to the allocation rules set out in §§1.338-6 and 1.338-7 even if the transferor in the transaction is treated as transferring something different from the assets the transferee is treated as receiving. For example, Rev. Rul. 99-6 (1999-6 I.R.B. 6) concerns the purchase, by one person, of all of the interests in a limited liability company which is classified as a partnership under §301.7701-3. The revenue ruling sets forth two situations and holds that each seller is treated as having transferred its interests in the partnership, while each purchaser is treated as having purchased the assets of the limited liability company. The proposed regulations make it clear that each purchaser described in Rev.

[41] Section 1060(b); Regulations Section 1.1060-1(e).

[42] Regulations Section 1.1060-1(e).

[43] Regulations Section 1.1060-1(b)(4).

> Rul. 99-6 must use the residual method prescribed under §§1.338-6 and 1.338-7 to allocate the consideration paid for the purchased assets (provided that the asset transfer otherwise qualifies as an applicable asset acquisition).[44]

These Regulations were finalized in 2001. Thus, the purchaser in a transaction governed by the Ruling is required to comply with the Section 1060 basis allocation and filing rules.

If our Interests Over Recommendation is adopted, there would be no applicable asset acquisition under Section 1060. The purchaser would be deemed to have acquired partnership interests, as opposed to partnership assets, and Section 1060 would not apply. Accordingly, the IRS may wish to consider whether to repeal Regulations Section 1.1060-1(b)(4).

3. Application of Section 1239

Section 1239(a) treats gain from the sale of assets as ordinary income if such assets are sold to a related taxpayer and are depreciable in the hands of the transferee. In Revenue Ruling 72-172,[45] the IRS addressed the application of this Section in the context of a transaction similar to Situation 2 of the Ruling. The taxpayers in Revenue Ruling 72-172 were husband and wife who owned all of the interests in a partnership owning land and an apartment building. The taxpayers sold all of their interests in this partnership to their wholly-owned corporation, an entity considered related to the taxpayers for purposes of Section 1239. Citing *McCauslen*, the IRS ruled that the transaction had the effect of transferring to the corporation the partnership's assets. Accordingly, Section 1239 applied because the property transferred consisted of assets that were depreciable in the hands of the corporate transferee.

---

[44] Notice of Proposed Rulemaking, Fed. Reg. Vol. 64, No. 153, p. 43461 (August 10, 1999) (finalized by T.D. 8940, February 12, 2001).

[45] 1972-1 C.B. 265.

Application of Section 1239 to an interests over transaction would be slightly more removed under the Interest Over Recommendation than under the Ruling, since under the Interests Over Recommendation the purchaser is treated as purchasing a partnership interest rather than the assets of the partnership and Section 1239 applies to sales of assets that are depreciable in the hands of the transferee. However, the difference seems marginal since the Interests Over Recommendation involves an immediate transfer of the partnership's assets to the purchaser and Section 1239 applies to a sale or exchange of depreciable property "directly or indirectly, between related persons." However, if our Interests Over Recommendation is adopted, it may be appropriate for guidance to be issued providing that, for Section 1239 purposes, an interests over transaction is treated as an indirect transfer of assets, resulting in the application of Section 1239, using principles similar to those of Section 751(a) to the sale of partnership interests.[46]

4. Consolidated Group Rules

The IRS has considered in two private letter rulings[47] the application of the consolidated group matching and acceleration rules in the context of the Ruling. The matching and acceleration rules found in Regulations Section 1.1502-13 govern certain intercompany transactions between two members of a consolidated group of corporations and operate to treat such members as a single entity. Under the matching rule, S, the selling member, and B, the purchasing member, are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions.[48] The acceleration rule provides

[46] Alternatively, the interests over transaction could be treated as an assets over transaction.

[47] PLR 200737006 (Sept. 27, 2006); PLR 200334037 (May 13, 2003).

[48] Regulations Section 1.1502-13(a)(6).

additional rules for taking the items into account if the effect of treating S and B as divisions cannot be achieved (for example, if S or B becomes a nonmember of the group).[49]

When the matching rule applies, S defers gain or loss until B takes its corresponding item into account. At that point, S takes the deferred amount into account to reflect the difference between B's corresponding item and its recomputed corresponding item. The Regulations provide that the "recomputed corresponding item" is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions.[50] An example explains that, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B's corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the property would have if S and B were divisions of a single corporation).[51]

In Private Letter Ruling 200737006, two corporate subsidiaries, one of which ("Sub 1") indirectly owned the other ("Sub 2"), owned all of the interests in a limited partnership ("LP"). LP had been formed to acquire the stock of Sub 3 which, through a series of transactions, became part of the affiliated group that included Sub 1 and Sub 2. Sub 1 and Sub 2 proposed to sell their LP interests to Sub 4, another member of the affiliated group, for cash and relief from certain indebtedness. The consideration received by Sub 1 and Sub 2 was greater than each corporation's basis in its LP interest.

[49] Regulations Section 1.1502-13(a)(6).

[50] Regulations Section 1.1502-13(b)(4).

[51] Regulations Section 1.1502-13(b)(4). It should be noted that neither S nor B actually takes the recomputed corresponding item into account. *Id*.

The IRS ruled that, under the Ruling, LP terminates pursuant to Section 708(b)(1)(A) when Sub 4 purchased all of Sub 1 and Sub 2's interests in LP, because LP then had a single owner. Both Sub 1 and Sub 2 were to treat the transaction as a sale of their partnership interests in LP and would determine income, gain, and/or loss under Sections 741 and 751(a) pursuant to the Ruling. Sub 4 would treat the transaction as an acquisition of the assets (the stock of Sub 3) deemed to have been distributed to Sub 1 and Sub 2 pursuant to the Ruling. The IRS also ruled that the sales by Sub 1 and Sub 2 of their interests in LP to Sub 4 would be intercompany transactions as described in Regulations Section 1.1502-13(b)(1). Thus, the transactions were subject to the acceleration and matching rules.

Private Letter Ruling 200737006 further provided that Sub 1's and Sub 2's intercompany items were the gains recognized from the sales of their partnership interests in LP pursuant to Regulations Section 1.1502-13(b)(2). Those gains (the intercompany items) were accounted for under the matching rule of Regulations Section 1.1502-13(c), and Sub 4's corresponding items were its items with respect to the Sub 3 stock that Sub 4 was treated as acquiring. Sub 4's recomputed corresponding items were based on the respective bases that Sub 1 and Sub 2 had in the Sub 3 stock had that stock been received in a liquidating distribution to which Section 732(b) applied. If Sub 4 disposed of less than all of the shares of Sub 3 stock, it would be considered as having disposed of, pro rata, the Sub 3 shares deemed purchased from Sub 1 and Sub 2.

The relevant facts of Private Letter Ruling 200334037 are substantially the same as those of Private Letter Ruling 200737006. Both rulings indicate that an intercompany transaction exists despite the fact that the selling member's intercompany items are gain or loss from a sale of a partnership interest and the purchasing member's corresponding items are gain or loss from the partnership's assets purchased in the transaction. Because the matching rule applied in this

transaction, the selling member was not required to take the gain or loss on its sale of its partnership interest into account immediately.[52]

III. RATIONALE BEHIND THE INTERESTS OVER RECOMMENDATION.

Several factors underlie our recommendations that the IRS and Treasury adopt the Interest Over Recommendation in Situation 1 of the Ruling.

First, the Interests Over Recommendation would eliminate significant uncertainties and traps for the unwary that exist under Situation 1 of the Ruling that would otherwise require additional guidance in a variety of areas.

As was noted above and is discussed in greater detail in Part V below, under Situation 1 of the Ruling, an existing partner may recognize income or gain upon a purchase of all the other partnership interests under Sections 731, 704(c)(1)(B), 737 or 751(b). By contrast, no such income or gain is triggered if the purchasing partner purchases 99.9% of the partnership interests and an affiliate of the purchaser (including an entity wholly-owned by the purchaser) purchases the remaining 0.1%. Other potential differences can arise (i) under various other provisions under Subchapter K of the Code, including the holding period rules, (ii) under the antichurning rules in Section 197, (ii) under the consolidated return rules under Section 1502, (iv) with respect to the treatment of certain partnership liabilities and (v) under various other provisions, such as Section 168(i)(7) (relating to the placed in service date), Section 1031 (like-kind exchange rules) and Section 1239 (sale of depreciable property to related persons). The potential differences in treatment can create traps for the unwary or ill-advised and permit the well-advised purchaser to

[52] For additional examples of the application of the matching and acceleration rules to consolidated group scenarios under the Ruling, *see* Don A. Leatherman, "Gimme Fiction: Rev. Rul. 99-6" *Taxes — The Tax Magazine* (March 2008).

elect the desired tax treatment by either purchasing 100% of the interests (in which case there is a deemed distribution under the Ruling) or having an affiliate purchase a small interest in the partnership interests (in which case the Ruling does not apply and there is no deemed distribution). Currently, well-advised taxpayers are able to plan around these traps by altering only slightly the form of their transactions. For example, many taxpayers, rather than acquiring all of the interests held by other partners, cause an affiliate to acquire those interests. The Interests Over Recommendation would eliminate the need for this planning.

Second, it is not necessary (or advisable) for all of the tax consequences of a purchase of 100 percent of the interests in a partnership by a single purchaser to be determined by the holding period rule established in *McCauslen*, Revenue Ruling 67-65 and Revenue Ruling 55-68, particularly where those rules create considerable uncertainty. In this regard, we note that the fiction in *McCauslen* was not based on any statutory authority, and the Tax Court provided no reason for distinguishing between the treatment of a liquidating and non-liquidating distribution with respect to the purchasing partner. Moreover, no other court has cited *McCauslen* as authority for this tax treatment. If, however, the IRS and Treasury believe that the holding period rule in *McCauslen,* Revenue Ruling 67-65 and Revenue Ruling 55-68 is correct and should be preserved, we recommend that the Interests Over Recommendation be adopted, but include a special holding period rule that preserves the *McCauslen* holding period result.

Finally, the Interests Over Recommendation would provide for consistent treatment between the seller and the purchaser. By contrast, the approach adopted by the Ruling provides for inconsistent treatment. We think that, in general, the tax rules should treat parties to the same transaction in a consistent manner, absent a strong reason, such as statutory mandate, an abusive

situation, or Treasury and the IRS determining that consistency does not further any rational policy objective and only serves to impose unnecessary burdens (and costs) on taxpayers.

We recommend that guidance be issued in the form of Regulations, particularly if the Interests Over Recommendation is adopted. As discussed at length above, the existing administrative and judicial authority is contrary to the Interests Over Recommendation. Even if the relevant Revenue Rulings were modified or revoked by a new revenue ruling or other non-regulatory guidance, the *McClausen* case would not be overruled. Taxpayers could engage in transactions and report them consistently with the case if it were to their benefit. Such electivity would be eliminated by the issuance of Regulations adopting the Interests Over Recommendation. Even if the Interests Over Recommendation were not adopted, we believe that the Ruling raises enough issues that the proper manner to address them is through relatively comprehensive Regulations rather than other guidance dealing with the issues on an ad hoc basis.

In this regard, we believe that the IRS and Treasury have authority to adopt the Interests Over Recommendation, notwithstanding that the recommendation creates a single member partnership for an instant.[53] The existing Section 708 Regulations recognize the existence of a transitory single person partnership in at least two different situations. In describing the transactions deemed to occur when a partnership is terminated under section 708(b)(1)(B) by a sale or exchange, the Section 708 Regulations provide that the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to

[53] *Cf. Mayo Foundation for Medical Education and Research et. al. v. U.S.,* 131 S.Ct. 704 (2011).

their respective interests in the terminated partnership in liquidation of the terminated partnership.[54] The fact that the new "partnership" has a single member (the terminated partnership) for a moment in time is generally disregarded by the Regulations.[55]

Also, the partnership division rules similarly recognize a transitory single person partnership in the context of an assets over division form. In a division under the assets over form, the divided partnership contributes assets and liabilities to a recipient partnership or partnerships in exchange for interests in such partnership or partnerships; and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership or partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.[56]

In light of the fact that transitory single person partnerships have been incorporated into the partnership Regulations previously, it should be acceptable to do so in connection with the Interests Over Recommendation.

IV. RATIONALE BEHIND OUR RECOMMENDATIONS RELATING TO SITUATION 2 OF THE RULING

The concerns applicable in Situation 2 are somewhat different than the concerns applicable in Situation 1.

First, Situation 2 of the Ruling does not raise the gain-recognition issues under Sections 704(c), 731, 737 and 751(b) that potentially arise in the context of Situation 1.

---

[54] Regulations Section 1.708-1(b)(4).

[55] *See* Regulations Section 1.708-1(b)(4), Example. The Section 704 Regulations provide that the deemed contribution and liquidation with regard to the terminated partnership are disregarded for purposes of determining the capital accounts of the partner and the books of the new partnership. Regulations Section 1.704-1(b)(2)(iv)(l).

[56] Regulations Section 1.704-1(d)(3)(i).

Second, since the purchaser in Situation 2 was never a partner in the partnership, it is sensible to permit the treatment to the purchaser to be governed by the tax rules that generally apply to an asset purchase rather than by Subchapter K of the Code. Thus, if the purchaser is treated as buying assets (either from the partnership in an assets over transaction or from the partners in an assets up transaction), the determination of the purchaser's tax basis and holding period is straightforward, as is the application of the antichurning rules under Section 197. By contrast, if the Interest Over Recommendation applies, the purchaser's tax basis and holding period in the acquired assets would be determined pursuant to the rules applicable under Subchapter K of the Code. The tax basis rules in Section 732 of the Code are complicated, may turn on the application of various other rules applicable under Subchapter K and may result in a different outcome than if the tax basis were determined under Section 1012.[57] Similarly, the application of the Section 197 antichurning rules would be more complicated if the Interest Over Recommendation applied.[58] Where a partner acquires a partnership interest from an unrelated seller and receives a distribution of Section 197 intangibles from a partnership, the Section 197 Regulations generally permit the distributee to amortize the intangible to the extent the basis of the intangible reflects an increase under Section 732(b) or (d) or Section 743(b).[59] Yet in certain situations, the intangible technically remains subject to the anti-churning rules, which could prevent the taxpayer from amortizing a portion of future increases in the basis of the intangible.[60]

---

[57] As a general matter, because of the exchanged (i.e., substituted) basis rule of section 732(b), E's basis in the partnership's assets would, in the aggregate, equal E's purchase price for the partnership interests. Nevertheless, the allocation of that basis would occur under section 732(c), which can differ from the allocation that would occur under section 1012. Moreover, if the partnership held only cash, unrealized receivables, and/or inventory items the aggregate basis of which was less than E's purchase price, E would receive a basis in the partnership's assets equal to its purchase price for the partnership's interests; instead, E would recognize a short-term capital loss. Section 731(a)(2).

[58] *See* Part V.D. et seq. for a more complete discussion of Section 197.

[59] *See* Regulations Section 1.197-2(g)(3), -2(h)(12).

[60] *See* Regulations Section 1.197-2(h)(12)(ii)(C).

Thus, for example, if the Interests Over Recommendation applied, it may not cleanse the antichurning taint applicable to the pre-existing tax basis of the distributed intangible even where the purchaser is not related to the selling partners or the partnership.[61]

Third, if the purchaser is treated as purchasing assets from the partnership or from the existing partners, the transaction could be structured such that the purchaser is eligible for Section 1031 treatment. By contrast, this treatment would not be available if the Interest Over Recommendation applied.

In light of the foregoing, we believe that purchasers should not be required to apply the Interest Over Recommendation in Situation 2. Rather, approximately one-half of the members of the Executive Committee of the Tax Section believe that in Situation 2 of the Ruling such Regulations should maintain the treatment prescribed by the Ruling and approximately one-half of the members believe that the parties to the transactions (that is, the buyer, the selling partners and the partnership) should be permitted to elect to treat the transaction for all tax purposes as an assets up transaction, an assets over transaction or pursuant to the Interests Over Recommendation.

V. SPECIFIC ISSUES ARISING UNDER THE RULING AND THE INTERESTS OVER RECOMMENDATION

In general, the selling partner in the Ruling is indifferent as to the asymmetry created by the Ruling. From the seller's perspective, gain or loss is recognized pursuant to Sections 741 and 751(a) in accordance with the form of the transaction. As discussed below, however, several issues and potential tax consequences may arise with respect to the purchasing partner, B, in

[61] This issue could also be addressed by revising the Section 197 antichurning rules (*e.g.*, to ignore the relationship created by the purchase of the interests in the partnership). *See*, *e.g.*, Treas. Reg. § 1.197-2(h)(6)(iii). A similar issue could arise if the Interests Over Recommendation applied in Situation 1.

Situation 1 of the Ruling as a result of the deemed liquidation of the partnership and B's deemed purchase of assets.

A. Which Assets Are Deemed Distributed

We believe that, if the Ruling remains in place, guidance is necessary in the case of Situation 1 to determine (i) which partnership assets are deemed distributed directly to the purchasing partner (B) and (ii) which partnership assets are deemed distributed to the selling partner (A) and then deemed sold by the selling partner to the purchasing partner.

> **Example 1**. Suppose that in Situation 1 of the Ruling, under the AB partnership agreement, A has 90% of the profits and losses of asset Y and B has 90% of the profits and losses of asset Z. Both assets have equal value and A's and B's partnership interests have equal value.

For purposes of determining the tax consequences to B, are A and B deemed to have been distributed (i) an undivided interest in each asset of the partnership based on the relative value of their partnership interests (that is, 50% of asset Y and 50% of asset Z) or (ii) an undivided interest in the assets of the partnership based on the economic and tax attributes of their respective interests in the partnership (for example, 90% of asset Y and 10% of asset Z to A, and 10% of asset Y and 90% of asset Z to B)? While the first approach has the benefit of being mechanical, it could allow taxpayers (or the IRS) to take advantage of the asymmetric treatment under the Ruling between the seller partner and the purchaser, and it could exacerbate the differences in treatment to a purchaser who purchases 99.9% of the interests in a partnership (and is not governed by the Ruling) and a purchaser who purchases 100% (and is governed by the Ruling). This is because the tax consequences to A (who is treated as selling his partnership interests) will generally be based on the second approach, for example, in applying Section 751(a). Similarly, if B purchased 99.9% of the partnership interests, the tax consequences to B

would generally be based on the second approach, for example, in applying Section 743. However, applying the second approach in Situation 1 of the Ruling could be very complicated, particularly if it takes into account the partner's Section 704(c) and reverse Section 704(c) gain (or loss) in the assets of the partnership as is done under Sections 743 and 751(a).[62]

Two Technical Advice Memoranda (the "TAMs") have suggested, in a somewhat analogous situation to the Ruling, that the potential Section 731 gain recognition to B could be prevented by selecting which assets are distributed to B and which assets are distributed to the selling partner.[63] However, the IRS later reissued these TAMs with the portions of the discussion relating to the ability to identify assets removed.[64] One IRS official has suggested that this is one of several areas relating to the Ruling in which guidance is needed.[65]

The TAMs dealt with a scenario described in Revenue Ruling 99-5,[66] the counterpart revenue ruling to the Ruling, in which a disregarded entity with a single owner becomes a partnership through the addition of a second partner (by purchase in one situation and by contribution in another). The purchase situation in Revenue Ruling 99-5 was applied to the facts of the TAMs to treat one party's purchase of an interest in an entity to be a purchase of a proportionate interest in the entity's assets. The TAMs both noted that "[a]s a caveat, while Rev. Rul. 99-5 treats B as purchasing a 50 percent interest in each of the entity's assets, we do not believe that the analysis of the ruling requires proportionate sales in all cases."

---

[62] Moreover, additional complications would arise where a partner's Section 704(c) or reverse Section 704(c) gain exceeds the value of the partner's interest in the partnership.

[63] TAM 200540010 (Oct. 7, 2005) and TAM 200512020 (Mar. 25, 2005).

[64] TAM 200701032 (Jan. 5, 2007) (revoking and reissuing TAM 200540010);TAM 200650017 (Dec. 15, 2006) (revoking and reissuing TAM 200512020).

[65] *See* Amy S. Elliott, "IRS to Address Illogical Results Caused by LLC Conversion Guidance, Official Says," *Tax Notes Today* (July 14, 2010).

[66] 1999-1 C.B. 434.

In the TAMs, the IRS also relied on the preamble to the final disguised sale Regulations under Section 707 in making the determination that proportionate sales are not always required.[67] That preamble stated that, in response to comments, the final regulations deleted the rule contained in the proposed Section 707 Regulations requiring a partner contributing multiple properties to a partnership to allocate the amount realized among the properties based on their values.[68] The proposed Section 707 Regulations had provided for special rules to prevent a partner from selectively selling certain property (e.g., property with a high basis) and contributing other property to the partnership.[69] The proposed regulations would have required the partner to allocate the amount realized from the disguised sale among all the properties transferred as part of a planned transaction, based on the relative fair market values of each property (reduced by any qualified liability with respect to that property).

The Interests Over Recommendation would eliminate the need for guidance regarding which assets are distributed to each partner. The selling partner would be treated as selling its partnership interest to the purchasing partner, and the purchasing partner would be treated as receiving all of the assets of the partnership on the partnership's liquidation. Furthermore, under the Interests Over Recommendation, the purchasing partner generally would take a basis in the distributed partnership assets equal to its basis in its partnership interest (its historic partnership interest plus the interest acquired from the selling partner) pursuant to Section 732(b) and that basis would be allocated among the assets pursuant to Section 732(c).[70]

---

[67] *See* T.D. 8439, 1992-2 C.B. 126 (Sept. 30, 1992).

[68] *Id*.

[69] *See* Notice of Proposed Rulemaking, Fed. Reg. Vol. 56, No. 80, p. 19055 (April 25, 1991).

[70] But see discussion at note 57, above. We would note that, if a Section 754 election is in effect with respect to the partnership under the Interests Over Recommendation, a Section 743(b) adjustment would be available to the

B. Liabilities

The Ruling states that, "[f]or the sake of simplicity, it is assumed that neither LLC is liable for any indebtedness, nor are the assets of the LLCs subject to any indebtedness."

Consistent with the treatment of partnerships as aggregates of their partners, partnership liabilities create tax attributes for partners. In particular, a partner's basis in its interest in a partnership includes its share of the liabilities of the partnership. Reductions in a partner's share of partnership liabilities are treated as distributions of cash from the partnership and reduce the partner's tax basis in its partnership interest.[71] Increases in a partner's share of partnership liabilities (and the assumption by a partner of a liability) are treated as contributions of cash and increasing the partner's adjusted tax basis in it s partnership interest.[72] A partner's share of a partnership liability is determined under Section 752. Under those rules, recourse liabilities generally are allocated to the partner that bears the economic risk of loss,[73] taking into account all relevant statutory and contractual obligations.[74] If a partner makes a nonrecourse loan to a

---

purchasing partner upon its acquisition of the interests of the selling partner. This basis adjustment would permit the purchasing partner to allocate basis to the assets of the temporary single person partnership pursuant to Section 755. Although the purchasing partner's basis is determined under Section 732 on the liquidation of the partnership, Regulations Section 1.732-2(b) provides that, if a partnership distributes property to a transferee and the transferee has a basis adjustment for the property, the basis adjustment is taken into account under section 732 (other than Section 732(d)), in addition to any adjustments under Section 734(b). *See also* Regulations Section 1.743-1(g). Section 732(d) provides an election for the purchasing partner with respect to a transfer for which the election provided in section 754 was not in effect and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer. This election permits the purchasing partner to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect with respect to the partnership property.

[71] Section 752(b); Section 733. The deemed distribution of cash is disregarded for certain purposes. *See*, *e.g*., Treas. Reg. §§ §1.704-1(b)(2)(iv)(c), 1.1223-3(b)(3).

[72] Section 752(a); Section 722. The deemed contribution of cash is disregarded for certain purposes. *See*, *e.g*., Treas. Reg. §§ §1.704-1(b)(2)(iv)(c), 1.1223-3(b)(3).

[73] *See generally* Regulations Section 1.752-2(a).

[74] Regulations Section 1.752-2(b)(3).

partnership, the partner is deemed to bear the economic risk of loss for that loan.[75] Other nonrecourse liabilities are allocated to the partners under a different set of rules under Section 752 that generally are designed to ensure that partners who are allocated debt financed deductions, receive debt-financed distributions of cash, or contribute encumbered property are allocated the associated debt.[76]

The existence of partnership liabilities creates a variety of difficult issues and uncertainties in applying the Ruling,[77] in particular when the partnership liabilities are allocated disproportionately to the selling or purchasing partners under Section 752.

First, it is not clear how a partnership liability affects the amount of partnership assets deemed to be distributed to a selling partner and whether a selling partner is deemed to assume partnership liabilities. Consider the following example.

Example 2. A and B are equal partners in partnership. Each contributes $5,000 to partnership, which borrows an additional $5,000 on a nonrecourse basis from an unrelated lender and buys land for $15,000. When the land is worth $25,000 and the $5,000 loan is still outstanding, B purchases A's interest for $10,000.

Under the Ruling, A is treated as selling its partnership interest to B. Although not addressed in the Ruling, A's amount realized on the sale should be based on the general tax rules that would apply if A sold its interest in a transaction that did not terminate the partnership. Accordingly, A's amount realized on the sale would equal $12,500 (the $10,000 of cash

---

[75] Regulations Section 1.752-2(c). A nonrecourse liability (or portion of a liability) for this purpose is a liability for which no partners bears the risk of loss. Regulations Section 1.752-1(a)(2).

[76] Regulations Section 1.752-3.

[77] *See* Lay, *supra* note 5, at [].

received, plus $2,500, A's share of partnership liabilities immediately prior to the sale, as provided by Section 752(d)), and A would recognize $5,000 of gain.

Since A's amount realized includes the $2,500 of partnership liabilities, it seems appropriate to include the entire $2,500 of partnership liabilities in determining B's cost basis in the assets that B is deemed to purchase from A under Ruling. This suggests that, in applying the Ruling to B, the partnership should be deemed to have distributed one-half of the land (with a fair market value of $12,500), subject to $2,500 of debt, to each of A and B, and B should be treated as having purchased the $12,500 share of the land deemed distributed to A for $10,000 and the assumption of $2,500 of debt.

If additional factual complications are added to the partnership's liabilities, such as a guarantee of such liabilities by one partner, however, the tax consequences are less clear.

Example 2A. The facts are the same as in Example 2, except that A guarantees repayment of the debt and therefore is allocated all of the debt under Section 752. As in Example 2, when the land is worth $25,000 and the $5,000 loan is still outstanding, B purchases A's interest for $10,000.

Under the Ruling, A is treated as selling its partnership interest to B. Although not addressed in the Ruling, A's amount realized on the sale should be based on the general tax rules that would apply if A sold its interest in a transaction that did not terminate the partnership. Accordingly, A's amount realized on the sale would equal $15,000 (the $10,000 of cash received, plus $5,000, A's share of partnership liabilities immediately prior to the sale, as provided by Section 752(d)), and A would recognize $5,000 of gain.

Since A's amount realized includes the entire $5,000 of partnership liabilities, it seems appropriate to include the entire $5,000 of partnership liabilities in determining B's cost basis in the assets that B is deemed to purchase from A under Ruling.[78] This suggests that, in applying the Ruling to B, (i) the partnership should be deemed to have distributed to B a portion of the land with a fair market value of $10,000, not subject to any of the debt, and (ii) the partnership should be deemed to have distributed to A a portion of the land with a fair market value $15,000, subject to the entire $5,000 of partnership debt, and then B should be treated as having purchased the $15,000 of land deemed distributed to A in exchange for $10,000 of cash and the assumption of $5,000 of debt.[79]

On the other hand, since the values of A's and B's interests in the partnership is equal, it is, in some respects, more logical to deem B to have received 50% of the partnership's gross assets and assume 50% of the partnership's debt.[80] In that event, in applying the Ruling to B, the results should be the same as in Example 2. Specifically, the partnership should be deemed to have distributed one-half of the land (with a fair market value of $12,500), subject to $2,500 of debt, to each of A and B, and B should be treated as having purchased the $12,500 share of the land deemed distributed to A for $10,000 and the assumption of $2,500 of debt.

---

[78] Note that the same issue would arise if A had not guaranteed the debt, but for any reason had been allocated more than 50% of the partnership's liabilities. Similarly, if A were the lender, the same issues would arise. In addition, if B were the lender comparable issues would arise, as well as additional issues arising from the proper treatment of the "disappearing" debt. *See* Monte A. Jackel and Robert J. Crnkovich, "Musings on Partnership Contributions," *Tax Notes Today* (October 8, 2009); H. Grace Kim and Adrienne DeLorme, "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," 50 *Tax Management Memorandum* 107 (March 16, 2009); Matthew Lay, "Can Partners and Partnerships Be Treated as Assuming Notes to Themselves?," *Journal of Passthrough Entities* (May/June 2008).

[79] Note that if this approach is adopted, it may be appropriate for the assets deemed to have been distributed to A as a result of the deemed assumption of partnership liabilities to include a disproportionate share of the partnership's tax basis in its assets.

[80] However, under this approach, it would seem that B's cost basis is based on the assumption of only $2,500 of liabilities even though A's amount realized include $5,000 of liabilities.

It should be noted that the treatment of liabilities under the Ruling does not impact the A, as the selling partner. Thus, because A is treated as selling its partnership interest to B, A's amount realized on the sale should be based on the general tax rules that would apply if A sold its interest in a transaction that did not terminate the partnership. Accordingly, A's amount realized on the sale would equal $15,000 (the $10,000 of cash received, plus $5,000, A's share of partnership liabilities immediately prior to the sale, as provided by Section 752(d)), and A would recognize $5,000 of gain.

While, at least on these facts, B's total basis in the land is the same under both approaches, the amount of assets distributed and the amount of liabilities assumed by each partner is different. These differences can affect the potential application of other rules, as is discussed elsewhere in this Report.

> **Example 3.** B contributed land to a partnership with a value of $199 that is subject to qualified debt of $100 and has a tax basis of $100. The other partner (A) is a general partner (with significant other assets) and contributes $1 of assets to the partnership. Further assume that all of the debt is allocated to A (as the general partner) and (within seven years) B purchases A's interest in the partnership for $1 at a time when the value of the land, the amount of debt and the partnership's tax basis have not changed.

If A is deemed to assume partnership liabilities (and be distributed additional gross assets) based on A's share of those liabilities before the transfer, then A would be deemed to assume $100 of liabilities and be distributed gross assets with a value equal to $101 (the $1 equity value of A's interest plus the amount of liabilities A is deemed to assume). This large deemed distribution of assets to A would potentially trigger approximately $50 of B's Section 704(c) gain in the property contributed by B. In contrast, if A is deemed to be distributed only 1% of the assets and assume only 1% of the liabilities, very little of B's Section 704(c) gain

potentially would be triggered.[81] However, as noted above, treating A as having assumed only $1 of partnership liabilities, as having been distributed only $2 of partnership assets and then as having sold that $2 of assets to B in exchange for B's assumption from A of $1 of partnership debt plus the $1 purchase price seems inconsistent with (i) the fact that A's amount realized will include the entire $100 of partnership liabilities and (ii) how Section 743 would have applied to B in the event that B purchased 99.9% of the partnership interests rather than 100% and caused an affiliate to purchase the remaining .1%.

Second, it is not clear how the Ruling applies if the selling partner or the purchaser partner is a lender to the partnership. This situation raises the issues described above in connection with Examples 2 and 3, as well as additional issues regarding the treatment of the debt.

> **Example 4.** A and B are equal partners and B purchases A's interest for $10,000. The partnership has debt of $5,000 and a single asset with a fair market value of $25,000. A is the lender to the partnership and therefore A is allocated all of the debt under Section 752.

For purposes of determining the tax consequences to B, if A is treated as assuming all or a portion of the $5,000 of debt, then the debt (or the portion) would seem (i) to disappear (*i.e.*, be cancelled) as a result of the deemed assumption by A (because A would for that moment be both the lender and the borrower) and (ii) then reappear (*i.e.*, be reissued) as a result of B's purchase. This raises a variety of issues, including (i) whether the portion of the partnership liability deemed to have been assumed by A is treated as satisfied and reissued for purposes of Sections 108, 163 and 1271-1275, (ii) the possibility that a portion of the assets transferred to A could be

[81] However, in this event the deemed distribution to B could give rise to disguised sale treatment of the liability (*e.g.*, if the liability is not a qualified liability). Issues relating to Section 704(c) are discussed in greater detail below.

treated as having been used to satisfy the indebtedness, and, if so, (iii) whether gain or loss is triggered to the partnership (and therefore to B) in those assets.[82]

In contrast, under the Interests Over Recommendation, the treatment of the liabilities deemed shifted by the sale of partnership interests is clear. The Section 752 rules apply to the sale of A's partnership interest, but the application of those rules and their effect on the partner's basis is not unclear because there is no deemed liquidation of the partnership when A and B are both partners and B is not treated as purchasing assets.

C. Property Precontribution Gain (Sections 704(c)(1)(B) and 737)

Sections 704(c)(1)(B) applies to distributions of built-in gain or built-in loss property ("Section 704(c) property") within seven years of the contribution of the property.[83] Section 737, on the other hand, addresses the distribution of property to a partner that contributed built-in gain Section 704(c) property. In Situation 1 of the Ruling, for the purposes of determining the tax treatment of the purchasing partner, B, the AB partnership is deemed to first make a liquidating distribution of its assets to the existing partners. This deemed liquidating distribution raises the question of whether Sections 704(c)(1)(B) and 737 could cause B, the partner that has acquired A's interest for cash, to recognize gain,[84] as illustrated by the following example.

---

[82] *See* Monte A. Jackel and Robert J. Crnkovich, "Musings on Partnership Contributions," *Tax Notes Today* (October 8, 2009); H. Grace Kim and Adrienne DeLorme, "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," 50 *Tax Management Memorandum* 107 (March 16, 2009); Matthew Lay, "Can Partners and Partnerships Be Treated as Assuming Notes to Themselves?," *Journal of Passthrough Entities* (May/June 2008).

[83] The operation of Section 704(c)(1)(B) since the enactment of Section 704(c)(1)(C) in 2004 has been unclear.

[84] Because (i) Section 704(c)(1)(B) applies before Section 737 and (ii) Section 737(d)(1) provides for a "previously contributed property exception," generally only Section 704(c)(1)(B) should be potentially applicable to a transaction described in Situation 1 of the Ruling. *See* Regulations Section 1.737-1(c)(2)(iv) ("A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and §1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and §1.704-4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the

Example 5. A and B form equal partnership AB. A contributes $100 in cash; B contributes an asset with a fair market value of $100 and an adjusted basis of $60. Three years later, when values and basis have not changed, B buys A's interest for $100 in cash.

Under the Situation 1 of the Ruling, A is treated as selling its interest. A recognizes neither gain nor loss. With respect to B, the partnership is treated as distributing to A $50 in cash and one-half of AB's asset. B would be treated as acquiring the cash and that one-half of the asset for $100. Under Section 704(c)(1)(B), B would recognize $20 of gain. This gain recognition would increase B's basis in its partnership interest to $80.[85] Then, B would be treated as receiving the remaining $50 in cash and one-half of the asset in liquidation of its partnership interest.[86]

Under the Interests Over Recommendation, Sections 704(c)(1)(B) and 737 would not be triggered by a purchase of partnership interests (and it would be helpful if future guidance made this clear by way of an example). In an interests over transaction, the seller would recognize gain or loss on the sale of its partnership interest measured by the difference between its amount realized and the adjusted basis of its partnership interest pursuant to Section 741. The purchaser would take an aggregate basis in the assets of the partnership pursuant to Section 732(b) equal to B's historic outside basis plus B's purchase price for the A interest. Neither Section

---

distributee partner."); Regulations Section 1.704-4(e)(1) (providing for basis adjustments to reflect gain recognized under Section 704(c)(1)(B) for purposes of applying Section 737 to a distribution to a contributing partner that is part of the same distribution that resulted in the contributing partner recognizing gain under Section 704(c)(1)(B)); *see also* Regulations Section 1.731-2(g)(1)(i) ("If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.").

[85] Regulations Section 1.704-4(e)(1). A correlative adjustment would be made to the one-half interest in Asset deemed distributed to A immediately before the deemed distribution. Regulations Section 1.704-4(e)(2).

[86] Section 737 would not be applicable to this distribution because Section 737 does not apply to distributions of cash or of previously contributed property. Sections 737(a)(1) and (d)(1).

704(c)(1)(B) nor Section 737 is relevant because any historic Section 704(c) gain with respect to the buyer will be preserved because a portion of the buyer's basis will consist of its historic outside basis.

If the Interests Over Recommendation is not adopted, however, we recommend that guidance clarify that Section 704(c)(1)(B) and Section 737 are not implicated by the Ruling. The purpose of Section 704(c), according to the Regulations, is to "prevent the shifting of tax consequences among partners with respect to precontribution gain or loss."[87] Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is to 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)(B) targets distributions of this property and provides that if any contributed property is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed, the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under Section 704(c)(1)(A) by reason of the variation described in that Section if the property had been sold at its fair market value at the time of the distribution. If a contributing partner transfers a partnership interest, the transferee is treated as the contributing partner for purposes of Section 704(c)(1)(B) to the extent of the share of built-in gain or loss allocated to the transferee partner.[88]

Section 737 works in conjunction with Section 704(c) to ensure that a partner does not escape precontribution gain on property it contributed by taxing unrecognized gain in such

[87] Regulations Section 1.704-3(a)(1).

[88] Regulations Section 1.704-4(d)(2).

property on the distribution of *other* partnership property to the contributing partner. Section 737(a) provides that in the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or (2) the net precontribution gain of the partner. "Net precontribution gain" is defined as the net gain (if any) which would have been recognized by the distributee partner under Section 704(c)(1)(B) if all property which (1) had been contributed to the partnership by the distributee partner within 7 years of the distribution, and (2) is held by such partnership immediately before the distribution, had been distributed by such partnership to another partner.[89] This rule does not apply to distributions of property that had been contributed by the distributee partner to the partnership.[90]

The Regulations provide exceptions to the application of Sections 704(c)(1)(B) and 737 for certain partnership incorporation transactions. For example, Regulations Section 1.704-4(c)(5) provides that Section 704(c)(1)(B) does not apply to an incorporation of a partnership "by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction." Regulations Section 1.737-2(c) provides a substantively identical rule in the context of Section 737. These exceptions to the application of Sections 704(c)(1)(B) and 737 suggest that interests over partnership incorporation transactions like the transaction described in Situation 3 of Revenue

[89] Section 737(b).

[90] Section 737(a)(2).

Ruling 84-111 would not result in the application of Sections 704(c)(1)(B) and 737. However, these exceptions also suggest that a partnership incorporation transaction involving an actual distribution of partnership property would not escape the application of Sections 704(c)(1)(B) and 737.

We believe that the potential gain recognition by B in Situation 1 of the Ruling pursuant to the application of Sections 704(c)(1)(B) and 737 on a pro rata distribution of partnership property is an inappropriate result because the transaction, taken as a whole, does not result in the shifting of built-in gain property from one partner to the other. In a taxable sale of A's partnership interest, all of the gain inherent in A's interest in the partnership would be realized and recognized on the sale to B. Thus, A should be neutral. B, on the other hand, could recognize gain on what to it should be a neutral transaction—the deemed liquidation of its interest in the assets of the partnership.

Accordingly, if the Interests Over Recommendation is not adopted, we recommend that Regulations provide that Sections 704(c)(1)(B) and 737 not apply to transactions described in the Ruling. Alternatively, in the case of a purchase of interests in a partnership that holds property subject to those Sections, the Regulations could provide that the Section 704(c) property be treated as distributed to the maximum extent possible to the contributing partners in the deemed liquidation so that such Sections typically would not apply. In addition, the Regulations could provide that, if the relevant partnership agreement provides that assets distributed in liquidation

of the partnership will be distributed in a manner so as to minimize the application of the various anti-deferral provisions, this partnership agreement provision should be respected.[91]

D. Section 197 – Amortization of Goodwill and Certain other Intangibles.

The tax treatment of the purchasing partner in the Ruling may cause adverse effects under the anti-churning rules of Section 197. Section 197 was added to the Code in 1993 to permit taxpayers to amortize the cost of most acquired intangibles, such as goodwill, over 15 years. However, special "anti-churning rules" exclude certain Section 197 intangibles from this treatment. The excluded intangibles are defined as intangibles acquired by a taxpayer after August 10, 1993 if: (i) the intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 by the taxpayer or a related person, (ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before August 10, 1993, and, as part of the transaction, the user of such intangible does not change, or (iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before August 10, 1993.[92] Thus, this rule provides that Section 197 amortization is denied for any intangible that was held during the 1991 to 1993 "transition period" by a related person.

Under a special rule for partnerships, the determination as to whether the intangibles meet the tests in (i) through (iii) above is made at the partner level and each partner is treated as having owned and used such partner's proportionate share of the partnership assets, but only with respect to any increase in the basis of partnership property under Sections 732, 734, or

[91] This assumes that the partnership agreement is not modified in connection with the transaction and its provisions should otherwise be respected.

[92] Section 197(f)(9).

743.[93] Sections 732 and 734 apply to certain partnership distributions, and Section 743 applies to transfers of partnership interests. Under Situation 1 of the Ruling, B, the purchasing partner, is deemed to have purchased assets and its basis in those assets is determined by Section 1012, and Sections 732, 734 and 743 do not apply to B's basis in those assets. Thus, to determine whether B acquired the intangibles from a related party that had held them during the transition period, the test is not applied at the partner level. Because B in the ruling owns more than 20% of the partnership, B is related to the partnership[94] and B is subject to the anti-churning rules (assuming the intangibles were used during the relevant time period), and Section 197 amortization would not be available for the prescribed basis in the assets.

In contrast, Section 197 amortization would be available for the intangibles held by the partnership in the Ruling if B were treated (consistent with the form of the transaction) as purchasing partnership interests rather than assets, and B bears no prohibited relationship to A. If, in Situation 1, instead of acquiring all of A's interests directly, B acquired those interests through a regarded affiliate, then, because A and B are not related to each other under the relevant rules, and provided the partnership made a Section 754 election (or B made an election under Section 732(d)), the anti-churning rule would not apply. This difference in the application of the anti-churning rules is, therefore, another example of the variation in tax consequences between a direct purchase of 100% of the partnership's interests and another, very similar, albeit slightly restructured, transaction.

---

[93] Section 197(f)(9)(E).

[94] Section 197(f)(9)(C) provides that a person is related to another person if those persons bear a relationship specified in Section 267(b) or Section 707(b)(1). Pursuant to Section 707(b)(1) and Section 197(f)(9)(C), a partnership and a person owning, directly or indirectly, more than 20 percent of the capital interest, or the profits interest, in such partnership are related persons. Since B owns 50 percent of the partnership in the ruling, B would be related to the partnership under these definitions.

The Interests Over Recommendation, however, would have the same results as the restructured transaction described immediately above. When the assets are distributed in liquidation of the partnership, Section 732(b) would apply to provide that the basis of property (other than money) distributed by the partnership to the partner in liquidation of the partner's interest is equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. Thus, the test to determine whether B acquired the assets it receives in the liquidation from a related person applies at the partner level. If B does not bear a prohibited relationship to A, the anti-churning rules would not apply to the portion of the assets attributable to A's former interest in the partnership.[95]

E. Distributions of Money and Marketable Securities (Section 731)

Section 731(a)(1) provides that gain generally is not recognized on a distribution by a partnership to a partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Marketable securities generally are treated as money for purposes of Section 731(a)(1).[96] In addition, a partner receiving a liquidating distribution could potentially recognize a loss on such distribution if only money or unrealized receivables and inventory are distributed, and the sum of

[95] Regulations Sections 1.197-2(h)(12)(ii), -2(k), *Examples 28 and 29*. See also discussion in Part IV above.

[96] Section 731(c). The term "marketable securities" is defined in Section 731(c)(2) as (1) financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of Section 1092(d)(1)); (2) any interest in (I) a common trust fund, or (II) a regulated investment company which is offering for sale or has outstanding any redeemable security (as defined in section 2(a)(32) of the Investment Company Act of 1940) of which it is the issuer; (3) any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities; (4) any financial instrument the value of which is determined substantially by reference to marketable securities; (5) except to the extent provided in Regulations prescribed by the Secretary, any interest in a precious metal which, as of the date of the distribution, is actively traded (within the meaning of Section 1092(d)(1)) unless such metal was produced, used, or held in the active conduct of a trade or business by the partnership, (6) except as otherwise provided in Regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both, and (7) to the extent provided in Regulations prescribed by the Secretary, any interest in an entity not described in clause (6) but only to the extent of the value of such interest which is attributable to marketable securities, money, or both.

this money and the basis of the receivables and inventory is less than the partner's basis in its partnership interest.[97] Any gain or loss recognized under Section 731 is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner.[98]

The Ruling specifically provides that, in Situation 1, B must recognize gain or loss, if any, on the deemed distribution of the assets to it to the extent required by Section 731(a). Because B could have gain or loss recognition on the liquidating distribution based on the type of assets distributed, it is important to know whether the liquidating distribution to B is deemed to be a distribution of B's proportionate share of each of the partnership's assets (and how that proportion is calculated), or whether the partnership would be permitted to select which assets would be deemed to be distributed to B.

As discussed above, the Ruling leaves open the question of whether the assets of the liquidating partnership are treated as distributed pro rata to B (and, again, what "pro rata" means), or whether B could choose the assets that would be treated as distributed to it. We note that if the parties are allowed to designate which assets are deemed to have been distributed to each partner, it could create a divergence between the assets that B is deemed to purchase and the assets attributable to A's interest for certain purposes, such as Section 751(a). Accordingly, in general, we believe that a pro rata portion of each asset should be treated as having been distributed (and that guidance should be provided regarding how to determine a partner's pro rata share). If, however, the relevant partnership agreement provides that assets distributed in

[97] Section 731(a)(2).

[98] Section 731(a).

liquidation of the partnership will be distributed in a manner so as to minimize the application of the various anti-deferral provisions, this partnership agreement provision should be respected.[99]

If, on the other hand, the Interests Over Recommendation is adopted, the uncertainty and potential problems associated with a deemed distribution of marketable securities to both B and A in the deemed liquidation disappears.

F. Hot Assets (Section 751)

Section 751 operates to prevent shifting of ordinary income property from one partner to another.

Section 751(b) applies to distributions to a partner of certain partnership assets (referred to as "hot assets" or "751 assets") in exchange for all or a part of that partner's interest in other assets (referred to as "cold assets" or "non-751 assets").[100] In very general terms, Section 751(b) prevents taxpayers from converting ordinary income into capital gain by treating any non-pro rata distribution of hot assets as a sale or exchange of such assets by the partnership. Under Section 751(b), hot assets include unrealized receivables (broadly defined under the Code and applicable Regulations to include many assets the sale of which would generate ordinary income)[101] and inventory items that have "substantially appreciated" in value (where the market value of all inventory exceeds 120 percent of the adjusted basis to the partnership of all such property).[102]

---

[99] This assumes that the partnership agreement is not modified in connection with the transaction and its provisions should otherwise be respected.

[100] Section 751(b)(1).

[101] Section 751(c); Regulations Section 1.751-1(c).

[102] Section 751(b)(3)(A).

In a sale of all or part of that partner's interest in the partnership, Section 751(a) governs. Section 751(a) includes as ordinary income items both unrealized receivables and all inventory items. This is in contrast to Section 751(b), which only treats inventory as a hot asset if the partnership's inventory is substantially appreciated.

Neither of the partnerships described in the Ruling holds any unrealized receivables or substantially appreciated inventory for purposes of Section 751(b). Accordingly, the IRS did not need to address the application of Section 751 to the deemed liquidating distribution in Situation 1. It seems clear, however, that if either partnership had held hot assets, the selling partner(s) would have recognized ordinary income under Section 751(a).

What is less clear, however, is whether Section 751(b) applies with respect to the deemed distribution to the selling partner(s).[103] If the partnership is deemed to distribute the assets proportionately to the partners, then Section 751(b) should not apply (because Section 751(b) applies only to disproportionate distributions). Yet this raises the issue of how to measure a partner's "proportionate" share of an asset for purposes of Section 751(b). Moreover, even if it is determined that Section 751(b) should apply, it is not clear how Section 751(b) would apply in this case because Section 751(b) requires a bilateral exchange between the partner and the partnership with any gain or loss recognized by the partnership being allocated to the other partner(s). In Situation 1 of the Ruling, however, the other partner to whom the gain or loss would be allocated under Section 751(b) is treated as selling its partnership interest. Thus, it is not clear whether Section 751(b) applies, or, if it applies, how it applies, to a transaction described in Situation 1 of the Ruling.

---

[103] Assuming that the hot assets deemed to have been distributed to each partner equal the hot assets that will be taxed to the selling partner under Section 751(a), it is hard to understand why the transaction should give rise to a shift of hot assets that necessitates the application of Section 751(b).

Under the Interests Over Recommendation, Sections 751(b) would not be implicated because it applies only to disproportionate distributions of partnership property, and it is impossible for the deemed distribution to the purchaser to be treated as a disproportionate distribution because there is only one partner at the time of the distribution.

G. Depreciation

Section 168 provides a "step in the shoes" rule for depreciation purposes for certain tax-free transfers of property. The rule provides that, in the case of any property transferred in a transaction described in Section 332, 351, 361, 721, or 731 and any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group, the transferee is to be treated as the transferor for purposes of computing the depreciation deduction with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.[104] Where the step in the shoes rule applies, the Regulations provide for allocations of the regular depreciation deduction of the transferor between the transferor and transferee in the year of transfer.[105] However, there is an exception to this "step in the shoes" rule for the deemed Section 721 transfer where a partnership has terminated under Section 708(b)(1)(B).[106] Because the depreciation "step in the shoes" rule only applies in certain nonrecognition transactions where there is no Section 708(b)(1)(B) termination of the partnership, if Section 708(b)(1)(B) applies, partnership property that is depreciable under Section 168 is treated as newly placed in service and depreciation with respect to that property "restarts" upon the termination.

[104] Section 168(i)(7).

[105] *See* Regulations Section 1.168(d)-1(b)(7).

[106] Section 168(i)(7)(B).

In the Ruling, because the purchasing partner is treated as purchasing in a taxable sale at least part of the assets of the partnership from the selling partner in Situation 1 and all of the assets of the partnership in Situation 2, the step in the shoes rule of Section 168(i)(7) does not apply to those assets. Accordingly, depreciation begins anew for those assets with respect to the purchaser. In Situation 1, however, the assets of the partnership attributable to B's former interest in the partnership are deemed distributed, and Section 731 applies. Thus, with respect to the assets deemed distributed to B, the step in the shoes rule of Section 168(i)(7) applies. The result is that B steps into the shoes of the partnership for such assets to the extent that B's basis does not exceed the partnership's basis in those assets and continues depreciating them over their remaining recovery period. As with other issues discussed in this Report, the consequences of Section 168(i)(7) make it important to determine what portion of the partnership's assets is deemed distributed to the seller(s) and what portion to the buyers.

If the Interests Over Recommendation is adopted, in the context of Situation 1, the step in the shoes rule of Section 168(i)(7) would apply to the entire liquidating distribution of assets to B, to the extent that B's basis in those assets does not exceed the partnership's basis provided that the purchase of interests does not give rise to a termination under Section 708(b)(1)(B).

H. Gain and Loss Deferral Provisions

Another issue raised but not addressed by the Ruling is the application of Section 267 to the asymmetrical transaction in the Ruling. Section 267, in simplest terms, provides for the disallowance of a loss on a sale of property to a related person. Section 267(d) further provides that, if the related person later sells the property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain, the recognized gain is reduced by the portion of the formerly disallowed loss allocable to that property.

Pursuant to this rule, if Partners A and B in Situation 1 are related parties under Section 267, and A's basis in its partnership interest exceeds its fair market value, Section 267 would apply to deny A's recognition of this loss. The question that then arises is whether, if at all, this disallowed loss will offset any gain that B potentially recognizes on a subsequent sale of the former partnership assets.

Under the facts of Situation 1 of the Ruling, the selling partner, A, is treated as selling its partnership interests to B. B, on the other hand, is treated as purchasing A's share of the partnership's assets from A. If A and B were related and A incurred a loss on its sale of its partnership interest, the loss would be disallowed to A under Section 267(a). If B later sells the partnership's sole asset at a gain, it is not clear that B can reduce this gain by the loss disallowed to A on its sale of a partnership interest pursuant to the rule in the Regulations stated above, because the loss was incurred on a different asset, the partnership interest, and the basis of the assets in B's hands is determined under Section 1012, not by reference to the basis of the partnership interest in A's hands. Thus, as a textual matter, it appears that Section 267(d) relief may be inapplicable even though as a policy matter relief is warranted.[107] We do not believe that the asymmetric treatment of the transaction should operate to deny what seems quite clearly to be appropriate relief from double taxation. Thus, if the Interests Over Recommendation is not adopted, we recommend that Treasury and the IRS clarify Section 267(d) relief would be available.

If the Interests Over Recommendation is adopted, gain from a later sale of those assets should be eligible for non-recognition treatment pursuant to Section 267(d) and Regulations

[107] For a discussion of this issue, *see* Leatherman, Don A., "Gimme Fiction: Rev. Rul. 99-6," *CCH Journal, Taxes*, March 2008. [conform cite form to earlier cite]

Section 1.267(d)-1(a)(2), both of which provide that Section 267(d) applies when the basis of the property in the taxpayer's hands is determined directly or indirectly by reference to other property acquired by the taxpayer from a transferor through a sale or exchange in which a loss sustained by the transferor was not allowable. Because the former partnership's assets are successor assets to the partnership interest purchased from A, Section 267(d) should apply.

I. Statutory Mergers or Consolidations

In 2006, the Treasury finalized Regulations that permit the merger of a target corporation into a limited liability company that is disregarded as an entity separate from the acquiring corporation for federal income tax purposes to qualify as a statutory merger or consolidation under Section 368(a)(1)(A).[108] In the preamble to these Regulations, the Treasury raised questions relating to the tax consequences of the following situations: (1) the merger of one of two corporate owners of a limited liability company into the limited liability company, and (2) the merger of one of two corporate owners of a limited liability company into the other owner. An example in the final Regulations confirms that the first situation qualifies as a merger pursuant to Section 368(a)(1)(A).[109] The preamble also indicates that the second situation would also qualify as a reorganization pursuant to Section 368(a)(1)(A) because it is simply the merger of two corporations.

However, the preamble recognized that these mergers would cause the limited liability companies at issue to transform from a partnership to a disregarded entity for federal income tax purposes, potentially implicating the Ruling. The Treasury noted that it, along with the IRS, is

---

[108] *See* T.D. 9242 (Jan. 23, 2006). The final Regulations can be found in Regulations Section 1.368-2(b)(1) of the Regulations.

[109] Regulations Section 1.368-2(b)(1)(iii), Ex. 11.

considering the tax consequences of these situations, including the extent to which the principles of the Ruling apply and, if they do apply, their consequences. The Treasury and IRS solicited comments on this issue,[110] but guidance has not yet been issued.

Many of the issues identified in this Report are potentially applicable to the non-merging corporate partner. Would the non-merging corporate partner be required to recognize gain on a deemed liquidating distribution under Section 704(c)(1)(B),[111] 731, 737 or 751(b)? How are the assets deemed to have been distributed to the merging partner versus the merging partner? If the Interests Over Recommendation is not adopted, we recommend that guidance issued by the Treasury clarify that the non-merging partner is not required to recognize gain or loss under these Sections as a result of the deemed distribution to the merging partner. If the Interests Over Recommendation is adopted, as discussed above, many of the issues raised by these mergers would no longer be applicable.

---

[110] *Id.*

[111] While Regulations Section 1.704-4(c)(5) and Regulations Section 1.737-2(c) provide exceptions for the incorporation of a partnership, it is not entirely clear whether these exceptions apply where one corporate partner acquires the interest of another corporate partner in a tax-free reorganization that does not also qualify for treatment under Section 351.