Report No. 1329

**NEW YORK STATE BAR ASSOCIATION**

**TAX SECTION**

# PROPOSED REGULATIONS UNDER SECTION 751(B)

**SEPTEMBER 9, 2015**

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**NEW YORK STATE BAR ASSOCIATION**

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**REPORT ON THE PROPOSED REGULATIONS UNDER SECTION 751(B)**

## INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association provides comments on the regulations proposed on November 3, 2014, primarily concerning partnership distributions under section 751(b) (the "Proposed Regulations").[2] We previously submitted a report (the "Prior Report")[3] concerning the treatment of partnership distributions under section 751(b) in response to Notice 2006-14,[4] which requested comments to assist the Internal Revenue Service (the "Service") and the Treasury Department ("Treasury") in connection with possible revisions to the existing regulations under section 751(b) (the "Existing Regulations").

We commend the Service and Treasury for their extraordinary efforts to revise the Existing Regulations and note that many of the key changes contained in the Proposed Regulations are consistent with the recommendations made in the Prior Report. The Proposed Regulations represent a significant improvement over the Existing Regulations in achieving the purpose of section 751(b). We note, however, that the Proposed Regulations are quite complex[5]

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[1] The principal author of this report is Phillip Gall, with substantial assistance from Kate Kraus and Douglas Longhofer. Significant contributions were made by Matthew Lay, David Sicular, and Eric Sloan. Helpful comments were received from Stephen Foley, Stephen Land, Yaron Reich, and David Schnabel. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-151416-06, 79 Fed. Reg. 65,151 (Nov. 3, 2014), as amended by 80 Fed. Reg. 3926 (Jan. 26, 2015). All "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated under the Code.

[3] NYSBA Tax Section Report No. 1122, "Report Responding to Notice 2006-14 Relating to the Treatment of Partnership Distributions under Section 751(b)" (Nov. 28, 2006).

[4] Notice 2006-14, 2006-1 C.B. 498 (Feb. 2, 2006).

[5] The Proposed Regulations introduce up to four new choices or elections that would need to be evaluated, along with existing choices and elections (*e.g.*, section 704(c) methods and section 754 election), in connection with a

and, as a result, might not provide the "greater simplicity" for section 751(b) to which Notice 2006-14 aspired.

We recognize that the statutory language of section 751(b) may prevent any set of implementing regulations from being simple. We, therefore, believe it would be worthwhile for Congress and Treasury to reevaluate the purpose of section 751(b) and consider the extent to which the stakes involved are worth protecting. As discussed below, we believe the stakes may be worth protecting only to a limited extent. Thus, many of our comments and recommendations emanate from the perspective that simplicity and administrability should take precedence over seeking to provide extensive optionality to taxpayers or attempting to achieve perfection in all possible circumstances.

This report is divided into three parts. Part I provides a summary of our recommendations. Part II provides a summary of current law and the Proposed Regulations. Part III contains a detailed discussion of our recommendations regarding the Proposed Regulations.

## I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

The following are our principal recommendations:

1. We recommend that the regulations create an exception from the mandatory revaluation rule for liquidating distributions that consist solely of money or other cold assets.
2. The regulations should expand the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) to contain an explicit admonition against the selection of a section 704(c) method

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potential section 751(b) distribution. As more fully discussed below, we recommend eliminating some of those choices.

with a view toward avoiding the application of section 751(b) to a distribution while attempting to shift ordinary income among partners in a manner that reduces the present value of the partners' aggregate tax liability.

3. When an upper-tier partnership makes a distribution and is required to revalue its assets under Prop. Treas. Reg. § 1.751-1(b)(2)(iv):

   (a) A lower-tier partnership should not be required to revalue its assets unless the same persons own, directly or indirectly, 80 percent or more, rather than more than 50 percent (as under the Proposed Regulations), of the capital and profits interests in both partnerships. For purposes of determining ownership of the capital and profits interests of a partnership, the regulations should cross reference section 707(b)(3) in order to include ownership held by related parties.

   (b) When the lower-tier partnership does not revalue its assets, the upper-tier partnership should be permitted to adopt any reasonable method for allocating items from the lower-tier partnership in a manner that takes into account each partner's share of the pre-distribution items of the lower-tier partnership; the adoption of the method should explicitly be made subject to the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10). The synthetic revaluation (described in the Proposed Regulations) would be one such method, but its use would not be required.

   (c) If there are multiple tiers of lower-tier partnerships, a revaluation should be required in a particular lower-tier partnership only if the ownership threshold is satisfied with respect to that lower-tier partnership and with respect to each intervening partnership between the distributing partnership and the lower-tier partnership.

4. Regarding the special rules for basis adjustments in Prop. Treas. Reg. § 1.732-1(c)(2)(iii)-(vii) and Prop. Treas. Reg. § 1.755-1(c)(2)(iii)-(vi), the regulations should not treat a basis adjustment allocated to a section 1231 asset under the second sentence of Treas. Reg. § 1.732-1(c)(2)(ii) or of Treas. Reg. § 1.755-1(c)(2)(i) as basis in a capital asset; instead, the regulations should treat such adjustment as basis in a section 1231 asset.

    (a) If recommendation #4 is accepted, the Election Out (defined below) in Prop. Treas. Reg. § 1.755-1(c)(2)(vi) should be eliminated.

    (b) If recommendation #4 is <u>not</u> accepted, the amount of the basis adjustment that is treated as basis in a capital asset should be limited to the lesser of: (i) the amount of the basis adjustment allocated to the asset under the second sentence of Treas. Reg. § 1.732-1(c)(2)(ii) or of Treas. Reg. § 1.755-1(c)(2)(i) and (ii) the amount of ordinary income potential in the asset.

5. A distributee-partner should be required to exchange such partner's reverse section 704(c) amounts in retained hot assets for reverse section 704(c) amounts in distributed hot assets, provided that the distributed hot assets and the retained hot assets produce the same "type" of built-in gain.

6. If the application of the "hypothetical sale" approach results in any partner having a "section 751(b) amount," the final regulations should require the application of the "deemed gain" approach for recognizing the section 751(b) amount.

7. Form 1065 should be amended to require partnerships to indicate whether (i) hot assets are distributed to any partner during the year or (ii) the partnership makes a disproportionate distribution of money or property during the year.

8. The rules for mandatory gain recognition in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A) should be modified:

   (a) to require a distributee-partner to recognize enough gain to avoid any section 734(b) adjustment that would reduce a partner's "net unrealized section 751 gain," and

   (b) to provide that the character of the gain should be based on the character of the distributee-partner's relative share of the built-in gain in the partnership's assets.

9. The rules for elective gain recognition in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B) should be eliminated.

10. The regulations should clarify that the previously contributed property exception under section 751(b)(2)(A) continues to apply with respect to contributed property notwithstanding subsequent adjustments that affect the amount of ordinary income potential in the asset, such as additional depreciation (in the case of depreciable property) and additional earnings and profits (in the case of stock in a controlled foreign corporation).

11. The final regulations should retain the general anti-abuse rule that allows a transaction to be recast to achieve results consistent with the purpose of section 751. The anti-abuse rule should not, however, create presumptions or

disclosure obligations for certain transactions. Instead, transactions that are inconsistent with the purpose of section 751(b) should be illustrated in examples.

12. The Service and Treasury should allow for reasonable applications of the hypothetical sale approach for all prior distributions, not simply those that occur after the issuance of the Proposed Regulations.

13. We encourage Congress and Treasury to reevaluate the purposes of, and stakes involved with, section 751(b) and consider whether the statute should be amended to make section 751(b) operate far more narrowly as an anti-abuse rule.

## II. SUMMARY OF CURRENT LAW AND PROPOSED REGULATIONS

### A. Statutory Scheme

Generally, under section 731(a)(1), no gain is recognized by a partner in connection with a partnership distribution except to the extent the amount of money distributed exceeds the partner's basis in its partnership interest.[6] No loss is recognized by a partner in connection with a partnership distribution except in certain cases involving a distribution in liquidation of the partner's interest in the partnership.[7] Any gain or loss recognized is considered gain or loss from the sale or exchange of the partnership interest of the distributee-partner,[8] thereby giving rise to capital gain or loss.[9]

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[6] A partnership does not recognize gain or loss upon a distribution to a partner. Section 731(b).

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

[8] Section 731(a).

[9] Although a sale of a partnership interest can result in the recognition of ordinary income under section 751(a), Treas. Reg. § 1.731-1(a)(3) makes it clear that gain or loss recognized under section 731(a) is capital gain or loss. *See* McKee, Nelson & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (Thomson Reuters/Tax&Accounting, 4th ed. 2007 with updates through August 2015) ("McKee") ¶ 17.02[1] (stating that section 751(a) is not applicable to amounts received as distributions from a partnership as the "legislative history, the language of § 751(b), and the sense of the overall statutory scheme make it abundantly clear that

Section 751 was enacted to prevent the conversion of ordinary income into capital gain and the shifting of ordinary income among partners.[10] A partner generally recognizes capital gain or loss upon a sale of its partnership interest under section 741. However, section 751(a) provides that the amount of money or fair market value of property received by a transferor-partner in exchange for all or part of its interest in the partnership's "unrealized receivables" or "inventory items" is treated as an amount realized from the sale or exchange of property other than a capital asset, thereby preventing a partner from escaping the ordinary income character of those assets by selling its partnership interest. Similarly, section 751(b) overrides section 731 in the case of certain partnership distributions that alter a partner's interest in "unrealized receivables" and substantially appreciated "inventory items" (collectively, "hot assets" or "section 751 property"; property other than hot assets, "cold assets").[11] Specifically, section 751(b)(1) provides:

> To the extent a partner receives in a distribution
>
> (A) partnership property which is –
>
> > (i) unrealized receivables, or
> >
> > (ii) inventory items which have appreciated substantially in value,
>
> in exchange for all or a part of his interest in other partnership property (including money), or

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§ 751(b), rather than § 751(a), is the controlling provision with respect to both current and liquidating distributions" (footnote omitted)).

10 *See* H.R. REP. NO. 1337 at 70 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4097.

11 Unrealized receivables and inventory items are defined in section 751(c) and (d), respectively. Section 751(b) applies to all unrealized receivables and inventory items that have appreciated substantially in value, whereas section 751(a) applies to all unrealized receivables and all inventory items. Generally, inventory items are considered to have appreciated substantially in value if their fair market value exceeds 120 percent of their adjusted basis to the partnership. Section 751(b)(3)(A).

> (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),
>
> such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

Although the application of section 751(b) depends upon a determination of a partner's interest in partnership property, the statute does not describe how to make that determination.

B. Existing Regulations

The Existing Regulations, which were first issued in 1956 and remain substantially unchanged as they relate to section 751(b), do not define a partner's interest in partnership property. Instead, the examples in the Existing Regulations generally adopt an approach that determines a partner's interest in partnership property by reference to the partner's interest in the gross value of the property (the "gross value approach") rather than by reference to the amount of income or loss the partner would recognize if the property were sold (the "hypothetical sale approach").[12] Under the Existing Regulations, if a distribution results in an exchange of all or a portion of the distributee-partner's interest in one class of assets for assets in the other class, the distributee-partner is deemed to receive a distribution of the relinquished

[12] At the time the Existing Regulations were issued, section 704(c) was not mandatory. Congress amended section 704(c) in 1984 to make its application mandatory. Although regulations under section 751(a) were amended in 1999 to coordinate section 751(a) with the mandatory application of section 704(c), no such changes were made to the regulations under section 751(b).

assets (immediately prior to the actual distribution) and then exchange[13] the relinquished assets with the partnership for the acquired assets (the "asset exchange approach").

The mechanics of the asset exchange approach in the Existing Regulations are typically summarized by a seven-step process.[14] As indicated in the preamble to the Proposed Regulations (the "Preamble"), the use of the gross value approach and the asset exchange approach is extremely complicated and, as discussed below, can be both under-inclusive and over-inclusive in achieving the policy underlying section 751(b).

C. Notice 2006-14 and the Prior Report

Notice 2006-14 announced that the Service and Treasury were studying the Existing Regulations and considering alternative approaches to achieve the purpose of the statute while providing greater simplicity. Specifically, Notice 2006-14 asked for comments on replacing the gross value approach with the hypothetical sale approach for purposes of determining a partner's interest in section 751 property and replacing the asset exchange approach with a "hot asset sale approach" to determine the tax consequences when section 751(b) applies. Under the hot asset sale approach, the partnership is deemed to distribute section 751 property to the partner whose interest in the partnership's section 751 property is reduced, and then the partner is deemed to sell the section 751 property back to the partnership immediately before the actual distribution.

The Prior Report made the following comments regarding the complexity and problems with the Existing Regulations:

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13 The exchange is generally fully taxable to the distributee-partner and the partnership, and the partnership's gain (or loss) is allocable to partners other than the distributee-partner. *See* Treas. Reg. § 1.751-1(b)(2)(ii).

14 *See* McKee ¶ 21.03.

First, the seven-step process is so complicated that applying it to a distribution from even a small partnership requires a substantial amount of time and effort and the assistance of experts in partnership tax generally and section 751(b) in particular.

Second, the Existing Regulations generally focus on the distributee-partner's share of the gross value of the hot and cold assets rather than the distributee-partner's share of the income and gain inherent in those assets. As a result, a distribution may give rise to a taxable exchange under the Existing Regulations even if each partner's share of the hot-asset gain does not change as a result of the distribution. Similarly, a distribution may escape section 751(b) as long as the distribution does not alter any partner's share of the gross value of the hot and cold assets, even if the distribution does alter a partner's share of the built-in gain in hot assets.

Third, nothing in the Existing Regulations (or otherwise) provides meaningful guidance on how to determine a partner's share of the gross value of a partnership asset.[15] While this might be straightforward in a simple partnership with no liabilities, no assets subject to section 704(c) (or reverse section 704(c)), and no special allocations, there can be considerable uncertainty and further complexity in nearly all other cases, including standard commercial partnership arrangements.

Fourth, although there typically is not a readily ascertainable fair market value for most partnership assets, the application of section 751(b) requires knowledge of the fair market value of each partnership asset. As a result, in applying section 751(b), many partnerships seek a third-party valuation, while other partnerships undertake their own valuation. The factual and uncertain nature of these valuations creates additional uncertainty for taxpayers in applying

[15] Monte A. Jackel and Avery I. Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, 98 TAX NOTES 1557, 1559-1560 (March 10, 2003).

section 751(b), as the section 751(b) analysis can be quite sensitive to modest changes in asset valuations.

Fifth, it is not clear whether the deemed distribution of the relinquished assets under the Existing Regulations is treated as an actual distribution for other purposes of the Code, such as sections 704(c)(1)(B), 707, 731(a)(1), and 737.

For the following reasons, the Prior Report endorsed the hypothetical sale approach:

> First, the focus of the Hypothetical Sale Approach on reductions in a partner's share of hot-asset gain (as opposed to reductions in a partner's share of the gross value of the hot assets) furthers the basic purpose behind Section 751.
>
> Second, the Hypothetical Sale Approach's focus on whether there has been a reduction in a partner's share of hot-asset gain provides a working principle that can be used in developing rules under Section 751(b) and in applying Section 751(b) to cases where guidance may be lacking. By contrast, the focus of the Existing Regulations on whether there has been a change in the distributee partner's share of the gross value of the partnership hot assets does not seem to be based on any particular principle that can be extended when working through a Section 751(b) issue.
>
> Third, determining whether there has been a reduction in a partner's share of hot-asset gain (by comparing the amount of gain that would be recognized by the partner upon a deemed sale of assets at fair market value before and after the distribution) is something that practitioners with a general understanding of partnership tax would generally know how to do.
>
> Fourth, we believe that the Hypothetical Asset Sale Approach is significantly less complicated to apply than the Existing Regulations.

In addition, the Prior Report supported the hot asset sale approach over the asset exchange approach but also suggested the "deemed gain approach" as an alternative to the hot asset sale approach:

> [I]n lieu of deeming a distribution, sale and contribution [under the hot asset sale approach, the deemed gain approach would] simply requir[e] that (i) the partnership recognize gain in its hot assets equal to the aggregate reduction in the partners' share of hot-asset gain, (ii) the gain be allocated to the partner(s) whose share of hot asset gain would otherwise be reduced, and (iii) appropriate basis adjustments be made to the partnership's assets to reflect the recognition of the hot asset gain.

The benefits of the deemed gain approach were stated to be that it is "conceptually easier to understand and apply" and eliminates unnecessary steps that are created under the hot asset sale approach (*i.e.*, the deemed distribution, sale, and contribution) and any uncertainty regarding ancillary tax consequences that may arise from those steps.[16]

Finally, the Prior Report suggested that Congress and Treasury consider revising section 751(b) so that it operates as an anti-abuse rule or, short of that, making more modest revisions to section 751(b) that further the Notice's objectives of targeting shifts in hot-asset gain and reducing complexity, including a de minimis rule (discussed below) and a rule that would exclude distributions by partnerships in which all of the partners are domestic C corporations that do not have excess net operating losses.[17]

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[16] The Prior Report indicated that the deemed transactions created under the hot asset sale approach could lead to inappropriate results in a variety of contexts, such as the potential application of the loss disallowance rules under section 707 and the anti-churning rules of section 197.

[17] The Prior Report included a number of other recommendations and suggestions. In addition to those that will be discussed further below, the Prior Report requested guidance on how section 751(b) applies in the context of partnership incorporations and partnership mergers and divisions and on the amortization of reverse section 704(c) amounts. The Preamble states that the Proposed Regulations did not address incorporations or partnership mergers and divisions as the Service and Treasury determined that such guidance would be beyond the scope of the Proposed Regulations.

## D. Proposed Regulations

### 1. Adoption of Hypothetical Sale Approach in General

The Proposed Regulations would replace the gross value approach of the Existing Regulations with the hypothetical sale approach for purposes of determining a partner's interest in partnership property. Under the Proposed Regulations, a partnership is generally required to determine whether any partner's interest in the partnership's section 751 property is reduced by comparing for each partner: (i) the amount of ordinary income (or ordinary loss) that the partner would recognize from hot assets[18] if the partnership sold all of its assets for fair market value immediately before the distribution[19] with (ii) the amount of ordinary income (or ordinary loss) the partner would recognize from hot assets if the partnership sold all of its assets, and, in the case of the distributee-partner, such partner sold the distributed assets, for fair market value immediately after the distribution.[20] If, for any partner, there is a reduction in the amount of ordinary income (or an increase in the amount of ordinary loss, or both) as a result of the distribution (such reduction or increase, a "section 751(b) amount"), the distribution is considered a "section 751(b) distribution" and is subject to section 751(b).[21]

In determining whether a distribution is a section 751(b) distribution, the amount of ordinary income (or ordinary loss) that each partner would recognize from the partnership's

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18 One question to consider is whether Treas. Reg. § 1.752-7 liabilities should explicitly be treated as giving rise to losses from hot assets. *See* NYSBA Tax Section Report No. 1274, "Report on the Allocation of Basis Adjustments Under Section 743(b) to Contingent Liabilities" (Oct. 9, 2012).

19 This amount is referred to in the Proposed Regulations as the partner's "net section 751 unrealized gain or loss immediately before a distribution." Prop. Treas. Reg. § 1.751-1(b)(2)(ii).

20 This amount is referred to in the Proposed Regulations as the partner's "net section 751 unrealized gain or loss immediately after a distribution." Prop. Treas. Reg. § 1.752-1(b)(2)(iii).

21 A partner's section 751(b) amount is determined before taking into account any basis adjustments required by Prop. Treas. Reg. § 1.751-1(b)(3)(iii). *See* Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A).

sale of all of its assets for fair market value includes the amount of gain or loss allocable to the partner under section 704(c), including any remedial allocations under Treas. Reg. § 1.704-3(d).[22] The Proposed Regulations require a revaluation of partnership property under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) in connection with a distribution to a partner in consideration for an interest in the partnership if the partnership owns section 751 property immediately after the distribution, thereby creating a reverse section 704(c) layer in the partnership's assets that preserves the remaining partners' shares of built-in gains and losses in the partnership's assets and, thus, limits the situations in which a distribution will cause a partner to have a section 751(b) amount.[23]

2. Effect of Section 732 and 734 Basis Adjustments

Often in partnership distributions, the basis of a distributed asset is increased under section 732 or the basis of remaining partnership assets is increased under section 734(b). Such an increase in the basis of an asset, particularly a section 1231 asset, could reduce the amount of ordinary income potential in the asset (*e.g.*, under section 1245(a)). Such a reduction could, therefore, result in the application of section 751(b) to the distribution. In an effort to

[22] In addition to taking section 704(c) into account in determining whether a distribution is a section 751(b) distribution, the Proposed Regulations also take into account any section 743 basis adjustment pursuant to Treas. Reg. § 1.743-1(j)(3) and any carryover basis adjustment described in Treas. Reg. §§1.743-1(g)(2)(ii), 1.755-1(b)(5)(iii)(D), or 1.755-1(c)(4) as though the carryover basis adjustment was applied to the basis of new partnership section 751 property with fair market value of zero. The regulations should clarify that such treatment of carryover basis adjustments applies only to carryover basis adjustments allocable to hot assets rather than to *any* carryover basis adjustment.

The Preamble requests comments on whether and how carryover adjustments should be taken into account. While the approach in the Proposed Regulations differs from the approaches suggested in the Prior Report, we believe the approach is reasonable and we support it, as it would produce the same result as the approaches suggested in the Prior Report.

[23] If the partnership does not maintain capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv), it must compute each partner's share of gain or loss in each asset prior to the distribution and make future allocations in a manner that takes these amounts into account (as adjusted for cost recovery and other events affecting the basis of the asset).

minimize the extent to which these types of basis adjustments reduce the amount of ordinary income potential in assets and, thus, minimize the application of section 751(b), the Proposed Regulations contain special rules for such basis adjustments.

(a) *Section 732 Adjustments*

Under Prop. Treas. Reg. § 1.732-1(c)(2)(iii), any basis increase allocated to distributed "capital gain property"[24] pursuant to "the second sentence in paragraph (c)(2)(ii) of this section" is not taken into account in determining the recomputed or adjusted basis in the distributed property for purposes of section 1245(a)(1) and will, thus, not displace the ordinary income potential in the distributed asset.[25] Although depreciation or amortization is allowable with respect to the basis increase, the basis increase is not taken into account in determining section 1231 gain and loss and instead is "treated as gain or loss, as the case may be, from the sale or exchange of a capital asset with the same holding period as the underlying asset."[26]

> ***Example 1***. A partnership distributes a section 1231 asset to one of its partners (X) in liquidation of X's interest in the partnership. The asset has a $10 basis and a $100 fair market value and $60 of potential recapture under section 1245(a). X has a $120 basis in its partnership interest.

For purposes of determining the basis in the distributed asset, the partnership will be treated as distributing two assets: (i) the recapture potential in the distributed asset, which is a zero basis unrealized receivable with a $60 fair market value and (ii) the section 1231 component of the distributed asset, which has a $10 basis and a $40 fair market value. Under Treas. Reg.

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24 The term "capital gain property" should be changed to "property other than unrealized receivables or inventory items" as the term "capital gain property" is not defined in the regulations under section 732.

25 Similar rules are to apply with respect to property subject to section 617(d)(1), 1250(a)(1), 1252(a)(1), or 1254(a)(1).

26 The effect of this rule would be to treat the basis increase as giving rise to a capital loss. *Cf.* Prop. Treas. Reg. § 1.755-1(c)(6) (*Example 2(v)*).

§ 1.732-1(c)(1)(i), X will take a zero basis in the recapture potential in the distributed property. X will initially take a $10 basis in the section 1231 component of the property under Treas. Reg. § 1.732-1(c)(1)(ii). The first $30 of X's remaining $110 of basis in its partnership interest will be allocated to the section 1231 component in the distributed property pursuant to the first sentence of Treas. Reg. § 1.732-1(c)(2)(ii) (*i.e.*, based on the unrealized appreciation in the property). The remaining $80 of basis will be allocated to the property pursuant to the second sentence of Treas. Reg. § 1.732-1(c)(2)(ii). Under the Proposed Regulations, the $80 increase is not taken into account in determining the recomputed or adjusted basis in the distributed property for purposes of section 1245(a)(1). As a result, the $80 basis increase will not displace the ordinary income potential in the distributed asset, thereby preserving the distributee-partner's interest in section 751 property and minimizing the extent to which the distribution creates a section 751(b) amount for the distributee-partner. Under the Proposed Regulations, if X were to sell the distributed asset for $100 following the distribution, X would recognize $60 of ordinary income and $80 of capital loss.

Under Prop. Treas. Reg. § 1.732-1(c)(2)(v), any increase in basis allocated to stock in a foreign corporation pursuant to the second sentence in Treas. Reg. § 1.732-1(c)(2)(ii) or any decrease in basis allocated to stock in a foreign corporation pursuant to the second sentence in Treas. Reg. § 1.732-1(c)(2)(i) is not taken into account in determining the amount of gain recognized on the sale or exchange of stock for purposes of section 1248(a).[27]

[27] In addition, similar rules are to apply with respect to property that is subject to section 995(c).

(b) *Section 734 Adjustments*

The Proposed Regulations also amend Treas. Reg. § 1.755-1(c) to provide that positive section 734(b) basis adjustments allocated to "capital gain property"[28] pursuant to the second sentence in Treas. Reg. § 1.755-1(c)(2)(i)[29] are not taken into account in determining the recomputed or adjusted basis in the property for purposes of section 1245(a).[30] This rule is similar to the special rule for basis increases under section 732 discussed above, except that it prevents section 734(b) basis adjustments from displacing ordinary income potential in the partnership's retained assets, thereby preserving the partners' interest in section 751 property and minimizing the extent to which a distribution creates a section 751(b) amount with respect to the remaining partners. Although depreciation or amortization is allowable with respect to the adjustment, it is not taken into account in determining section 1231 gain and loss and instead is "treated as gain from the sale or exchange of a capital asset with the same holding period as the underlying asset."[31]

Under Prop. Treas. Reg. § 1.755-1(c)(2)(v), any increase in basis allocated to stock in a foreign corporation pursuant to the second sentence in Treas. Reg. § 1.755-1(c)(2)(i) or any decrease in basis allocated to stock in a foreign corporation pursuant to the second sentence

[28] The regulations under section 755, in contrast to the regulations under section 732 (discussed in footnote 24), define "capital gain property" as capital assets and section 1231(b) property. Although the Preamble states that the section 755 regulations do not distinguish between the capital gain and ordinary income potential in the property for allocation purposes, the regulations do treat the ordinary income potential as a separate zero basis asset for allocation purposes.

[29] Thus, for the reasons discussed above, the special treatment applies only to the basis increase in the property in excess of the unrealized appreciation in the section 1231 component in the asset, since that is the only basis increase that has the potential for displacing hot asset gain assuming the property retains its value.

[30] Similar rules are to apply with respect to property subject to section 617(d)(1), 1250(a)(1), 1252(a)(1), or 1254(a)(1).

[31] The above-quoted language in the Proposed Regulations, like the similar language in Prop. Treas. Reg. § 1.732-1(c)(2)(vi), is presumably intended to treat such adjustment as creating a capital loss upon a taxable disposition. *See* Prop. Treas. Reg. § 1.755-1(c)(6) (*Example 2*).

in Treas. Reg. § 1.755-1(c)(2)(ii) is not taken into account in determining the amount of gain recognized on the sale or exchange of stock for purposes of section 1248(a). [32]

#### (c) *Election Out from Special Basis Rules*

Recognizing the additional administrative burden imposed on taxpayers by these rules (*i.e.*, having to separately track such basis increases as separate assets that give rise to a capital loss), the Proposed Regulations allow partnerships to elect not to apply the above rules,[33] and thus allow the basis adjustments to displace ordinary income potential in distributed and retained assets (an "Election Out").[34] The Election Out applies to all property distributions taking place during the taxable year for which the election is made and in all subsequent years, including after a technical termination of the electing partnership under section 708(b)(1)(B). The Election Out is a method of accounting and can be revoked only with the consent of the Commissioner.[35]

### 3. Tiered Partnerships

Under section 751(f), a partnership is treated as owning its proportionate share of property owned by any other partnership in which the partnership is a partner for purposes of determining whether property of the partnership is section 751 property. The Preamble states

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32 *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 8*). (Note that the example cites section 751(b), rather than section 1001, as the provision under which gain is recognized on the partner's sale of the distributed stock.) In addition, similar rules are to apply with respect to property that is subject to section 995(c).

33 Prop. Treas. Reg. § 1.755-1(c)(2)(vi).

34 *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 9*).

35 If an Election Out is made, the mandatory gain recognition rule in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A) (discussed below) requires the distributee-partner to recognize ordinary income rather than capital gain. To adequately apprise taxpayers of that potential consequence of the Election Out, we recommend adding a cross-reference to the mandatory gain recognition rule in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A) in Prop. Treas. Reg. § 1.755-1(c)(2)(vi).

that, because of section 751(f), the Proposed Regulations contain a special revaluation rule for distributing partnerships that own interests in one or more lower-tier partnerships (each, an "LTP"). Specifically, Prop. Treas. Reg. § 1.751-1(b)(2)(iv) provides that if an upper-tier partnership (a "UTP") owns an interest in an LTP, directly or indirectly through one or more other partnerships, and the same persons own, directly or indirectly (through one or more entities), more than 50 percent of the capital and profits interests in both the UTP and the LTP, the LTP must revalue its assets immediately prior to the distribution if the LTP owns[36] section 751 property (a "mandatory revaluation").[37] The Proposed Regulations further provide that if there is a simultaneous revaluation of LTP and UTP assets, the principles of Treas. Reg. § 1.704-3(a)(9)[38] apply with respect to "any reverse section 704(c) allocations" created upon the revaluation.[39] These rules are intended to preserve the partners' interests in hot assets under reverse section 704(c) principles regardless of whether the hot assets are owned directly by the distributing partnership or indirectly through one or more LTPs.

In an effort to also preserve the partners' interests in hot assets in LTPs even in cases in which the ownership threshold is not satisfied, the Proposed Regulations require the UTP to allocate its distributive share of the LTP's items among its partners in a manner that

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36 We do not believe that the LTP's ownership of section 751 property is an appropriate trigger; instead, we believe it would be more consistent with the hypothetical sale approach to require the revaluation in the LTP (assuming the ownership threshold is satisfied) only if the UTP has an interest in the LTP's section 751 property, *i.e.*, if the UTP would recognize ordinary income under section 751(a) from a sale of its LTP interest for fair market value or would be allocated gain from the LTP's hot assets upon a sale of all the LTP's assets for fair market value.

37 Presumably, this requirement applies only if the LTP maintains capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv); if not, we would expect the LTP to be subject to rules similar to those described in footnote 23, *supra*.

38 In limited situations, Treas. Reg. § 1.704-3(a)(9) requires a UTP to allocate its distributive share of LTP items to its partners in a manner that takes into account such partners' remaining share of built-in gain or loss in the LTP's assets.

39 Prop. Treas. Reg. § 1.704-3(a)(9). (The language of the proposed regulation should be modified to refer to reverse section 704(c) *layers* created upon the revaluation rather than reverse section 704(c) *allocations*.)

reflects the allocations that would have been made had the LTP revalued its assets (a "synthetic revaluation"). A synthetic revaluation would seem to apply, therefore, only in situations in which the LTP did not elect to revalue its assets under the Proposed Regulations, which would amend Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) to permit an LTP to revalue its assets any time a UTP revalues its assets.

4. Consequences of a Section 751(b) Distribution

Once it is determined that a distribution is a section 751(b) distribution, the Proposed Regulations require a partnership to use a "reasonable approach" consistent with the purpose of section 751(b) under which, immediately prior to the section 751(b) distribution, each partner with a section 751(b) amount recognizes ordinary income (or eliminates a basis adjustment)[40] equal to the section 751(b) amount. The operative provisions of the Proposed Regulations do not specify methods that are reasonable, although the examples and the Preamble suggest that the hot asset sale approach and the deemed gain approach (described above) are methods that would generally be considered reasonable.[41] Once a partnership has adopted a particular reasonable approach, it is required to apply that approach consistently for all section 751(b) distributions, including a distribution following a technical termination of the partnership under section 708(b)(1)(B). If, however, the adopted approach later produces a result inconsistent with the

[40] *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 4*).

[41] The Preamble states "that a deemed gain approach produces an appropriate outcome in the greatest number of circumstances . . . and that the hot asset sale approach also produced an appropriate outcome in most circumstances." Although the Proposed Regulations do not contain an example or explanation of when either of the two approaches produces an inappropriate result (or even a result different from each other), the Preamble states that "no one approach produced an appropriate outcome in all circumstances." In one of the examples, an approach (other than the deemed gain approach or the hot asset sale approach) was determined not to be reasonable. *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 5*).

purposes of section 751, the partnership must adopt another reasonable approach that achieves the purposes of section 751 for that distribution only.[42]

5. Mandatory and Elective Gain Recognition

In certain circumstances, in connection with a section 751(b) distribution, the distributee-partner may be required or permitted to recognize additional gain. Specifically, to the extent that, as a result of a basis adjustment under Prop. Treas. Reg. § 1.751-1(b)(3)(iii)[43] made with respect to distributed section 751 property, the partnership is required to make a section 734(b) basis adjustment[44] that would reduce any partner's interest in section 751 property if the section 734(b) adjustment had been taken into account immediately prior to the distribution, then the distributee-partner is required to recognize capital gain immediately prior to the distribution and, thus, increase its basis in its partnership interest in an amount sufficient to ensure that no section 734(b) basis adjustment is made.[45] If the partnership has made an Election Out, the distributee-partner is required to characterize all or a portion of the gain to be recognized as

42 Prop. Treas. Reg. § 1.751-1(b)(3)(i).

43 Under Prop. Treas. Reg. § 1.751-1(b)(3)(iii), in connection with a section 751(b) distribution, the partnership and its partners are required to make "appropriate adjustments to the adjusted basis of the partners' interests in the partnership, and of section 751 property and other property held by the partnership or partners, in a manner consistent with the adopted approach to reflect any ordinary income or capital gain recognized upon application of paragraph (b)(3) of this section, and section 704(c) amounts must be adjusted accordingly."

44 The basis adjustment would arise if the basis in the distributed property, after taking into account the basis adjustments made pursuant to Prop. Treas. Reg. § 1.751-1(b)(3)(iii), would be reduced in the distribution under section 732(a)(2) or section 732(b).

45 If the partner's outside basis is increased, the section 734(b) basis adjustment would not be made because the basis in the distributed property would not be reduced under section 732 in the distribution. *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 5* and *Example 6*). (*Example 5* states as one of the facts that none of the partners has a capital loss carryforward; it would be helpful for the example to explain the relevance of that fact.)

ordinary income or a dividend,[46] as appropriate, to match the character of the gain in the asset to which the section 734(b) adjustment would have been made.[47]

In addition, a distributee-partner can elect[48] to recognize capital gain, thereby increasing its basis in its partnership interest, to eliminate reductions in the basis of distributed assets under section 732(a)(2) or (b) "if, and to the extent that, the basis adjustments [under Prop. Treas. Reg. § 1.751-1(b)(3)(iii)] would otherwise cause the distributee partner's net section 751 unrealized gain to be greater immediately after the distribution than it was immediately before the distribution or would cause the distributee partner's net section 751 unrealized loss to be less immediately after the distribution than it was immediately before the distribution." In certain cases, therefore, the Proposed Regulations permit a distributee-partner to recognize capital gain

46 *See* Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A) and § 1.751-1(g) (*Example 9*). The Proposed Regulations should clarify that all the consequences from the recognition of such dividend income under section 1248 would result (*e.g.*, section 960 credits and previously taxed income).

47 The section 1245 regulations should be coordinated with the basis adjustments in the partnership's assets under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) resulting from the partner's recognition of ordinary income under the mandatory gain recognition rule so that the recomputed basis and adjusted basis take such basis adjustments into account so as to not duplicate the ordinary income recognized by the distributee-partner if the adjusted property increases in value. *See* Treas. Reg. § 1.1245-2(c)(6)(ii) (removed by the Proposed Regulations without explanation); *see also* Treas. Reg. § 1.1245-4(f).

The Preamble requests comments on updating Treas. Reg. § 1.1245-1(e)(3), which generally deals with the determination of the share of recapture in a partnership's assets for a transferee of an interest in the partnership. The changes contained in Prop. Treas. Reg. § 1.743-1(f)(2) address some of the concerns with Treas. Reg. § 1.1245-1(e)(3) for transfers in substituted basis transactions; however, other concerns remain, including situations involving purchases of partnership interests at a deep discount and situations where there is a section 754 election in effect but no section 743(b) adjustments are made. While we believe the regulation should be updated to address the concerns, the issues involved are beyond the scope of this report.

48 If the election is retained, the Proposed Regulations should clarify (i) when and how the electing partner is required to give the partnership notice of the election and (ii) whether the election has to be made on the original return or can be made on an amended return. Presumably, the election is required to be made on the original return, since the Proposed Regulations explicitly preclude an extension of time to make the election under Treas. Reg. § 301.9100-3.

at the time of the distribution in lieu of potentially increasing its share of ordinary income in the future.[49]

6. Anti-Abuse Rules

The Proposed Regulations contain an anti-abuse rule[50] that states that the purpose of section 751 is to prevent a partner from converting ordinary income into capital gain, "including by relying on the rules of section 704(c) to defer ordinary income while monetizing most of the value of the partnership interest." The anti-abuse rule authorizes the Commissioner to recast a transaction as appropriate to achieve tax results that are consistent with the purpose of section 751 if a principal purpose of a transaction is, in the determination of the Commissioner, based on all the facts and circumstances, inconsistent with the purpose of section 751.

The Proposed Regulations provide that the existence of one or more of the following situations ("specified transactions") creates both a presumption that a transaction is inconsistent with the purpose of section 751(b) and a disclosure obligation:

- The partner received a distribution that would otherwise be subject to section 751(b), but for the application of the principles of section 704(c), and one or more of the following conditions exist (at such time or later, as appropriate):

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49 *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 7*). The amount of capital gain that is recognized in the example ($60) appears to be inconsistent with the language in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B), which permits the recognition of gain in an amount necessary to eliminate the basis reduction under section 732(a)(2) or (b) but only to the extent that the adjustments under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) would otherwise cause the distributee's net section 751 unrealized gain to increase (or its net unrealized loss to be reduced). Under the facts of the example, only $54, not $60, of the basis reduction results from the adjustments under Prop. Treas. Reg. § 1.751-1(b)(3)(iii). We believe $60 is the appropriate amount of gain that should be recognized; thus, as discussed below, we believe Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B) needs to be modified to permit gain recognition without regard to whether the basis reduction is attributable to the adjustments under Prop. Treas. Reg. § 1.751-1(b)(3)(iii).

50 Prop. Treas. Reg. § 1.751-1(b)(4)(i).

- The partner's interest in net section 751 unrealized gain[51] is at least four times greater than the partner's capital account balance immediately after the distribution.
- The partner is substantially protected from losses from the partnership's activities and has little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital.
- The partner engages in a transaction that, at the time of the transaction, causes the net value of the partner (or its successor) to be less than the tax liability that the partner (or its successor) would incur with respect to its interest in the partnership's section 751 property upon a sale of its partnership interest for its fair market value at the time of the transaction.[52]
- The partner transfers a portion of its partnership interest within five years after the distribution in a manner that does not result in ordinary income recognition, and ordinary income or gain with respect to the partnership interest is subject to Federal income tax in the hands of the transferor partner immediately before the transfer, but any ordinary income or gain

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[51] If the specified transactions are retained in the final regulations, the regulations should clarify that for this purpose the distributee-partner's net section 751 unrealized gain immediately after the distribution includes only amounts attributable to the assets owned by the partnership after the distribution and not to distributed assets, since the concern relates to the amount of hot asset gain associated with the partnership interest in relation to the fair market value of the interest. The distributee-partner's share of hot-asset gain in the distributed assets does not implicate that concern.

[52] For this purpose, the net value of the partner (or its successor) is the fair market value of all assets owned by the partner (or its successor) that may be subject to creditors' claims under local law (including the partner's enforceable right to contributions from its owner or owners) reduced by all obligations of the partner (or its successor) other than the partner's obligation with respect to the tax liability for which the net value is being determined. Prop. Treas. Reg. § 1.751-1(b)(4)(i)(A)(*3*).

with respect to the partnership interest is exempt from, or otherwise not subject to, Federal income tax in the hands of the transferee partner immediately after the transfer.

  - The partnership transfers to a corporation in a nonrecognition transaction section 751 property other than pursuant to a transfer of all property used in a trade or business (excluding assets that are not material to a continuation of the trade or business).

- The partners agree to change (other than a de minimis change) the manner in which the partners share any item or class of items of income, gain, loss, deduction or credit of the partnership under the partnership agreement and that change reduces the partner's net section 751 unrealized gain.

7. <u>Effective Dates</u>

The Proposed Regulations generally provide that a partnership may rely on the Proposed Regulations for purposes of determining a partner's interest in hot assets on or after the date of publication of the Proposed Regulations. Specifically, the Proposed Regulations permit reliance only on Prop. Treas. Reg. § 1.751-1(a)(2) (relating to the clarification of the amount of ordinary income that can be recognized under section 751(a)), -1(b)(2) (relating to the determination of the section 751(b) amount), and -1(b)(4) (relating to the anti-abuse rule). (It is not clear why reliance is limited to these paragraphs.)

To rely on the Proposed Regulations, generally the partnership and its partners must apply the Proposed Regulations consistently for all partnership sales, exchanges, and distributions occurring on or after the date of the publication of the Proposed Regulations.[53]

8. <u>Other Changes</u>[54]

(a) *Clarification to Treas. Reg. § 1.751-1(a)(2)*

Under section 751(a), a transferor-partner is required to treat the amount of money or fair market value of property received in exchange for all or part of its partnership interest attributable to unrealized receivables or inventory items as an amount realized from the sale or exchange of property other than a capital asset. Treas. Reg. § 1.751-1(a)(2), which was amended in 1999 to incorporate section 704(c) principles, provides:

> The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under § 1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest.

53 *See* Prop. Treas. Reg. § 1.751-1(f).

54 In addition to the changes described in the text, the Proposed Regulations make a number of technical changes to account for changes in the law that occurred since the issuance of the Existing Regulations.

As we noted in the Prior Report, it seems fairly clear under the regulations that the amount of ordinary income a partner could recognize upon a sale of its partnership interest is not limited by the selling partner's amount realized from the sale of the partnership interest.[55] Nevertheless, some commentators read section 751(a) and Treas. Reg. § 1.751-1(a)(1) as casting doubt on this result[56] and even question whether the approach is consistent with the statutory language.[57] The Preamble states that "interpreting section 751(a) as limiting ordinary income in this way would contravene Congress's intent to tax partners on their shares of partnership ordinary income as determined by applying section 704(c) principles."[58] Consistent with our suggestion in the Prior Report, the Proposed Regulations clarify Treas. Reg. § 1.751-1(a)(2) to provide that "the amount of money or the fair market value of property received" by the transferor is to take into account the partner's share of income or gain from section 751 property.[59] The Proposed Regulations make this clarification effective for transfers of partnership interests occurring on or after the date the Proposed Regulations were issued.[60]

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55 It is critical to the efficacy of the hypothetical sale approach that the amount of ordinary income that a partner can recognize under section 751(a) not be limited by the amount realized on the sale of the partnership interest: it is appropriate for a distribution not to result in the application of section 751(b) when a distributee-partner would still be subject to tax on its share of ordinary income in the partnership, either under reverse section 704(c) principles if the partnership were to sell its assets or under section 751(a) if the partner were to sell its partnership interest, since the distribution would not permit the partner to convert its share of ordinary income to capital gain or shift its share of ordinary income to another partner. If, however, the amount of ordinary income a partner can recognize under section 751(a) is limited to the amount realized on the sale of the partnership interest, then a distribution could permit a partner to avoid some of its share of ordinary income by receiving a nonliquidating distribution and then selling its partnership interest, thereby undermining the efficacy of the hypothetical sale approach.

56 Jackel & Stok, *supra* footnote 15, at 1581.

57 Monte Jackel, "A Failure of Policy or Just Creative Tax Rulemaking?," 2014 TNT 217-14 (Nov. 10, 2014).

58 The Preamble states that "by mandating the application of section 704(c) principles in 1984, Congress intended that impacted provisions be interpreted consistent with this new emphasis on tax gain or loss. Congress provided a broad delegation of authority to the Treasury Department to address these repercussions of amending section 704(c) on other provisions of subchapter K."

59 The Proposed Regulations contain an example that illustrates that a transferor-partner's ordinary income under section 751(a) is not limited by the amount realized in the sale of the partnership interest. Prop. Treas. Reg.

(b) *Exclusion of Unrealized Receivables from Substantial Appreciation Test*

The Proposed Regulations "clarify"[61] that unrealized receivables are not treated as inventory items for purposes of determining whether the aggregate of all inventory items are substantially appreciated.[62]

(c) *Successor Rules for the Previously Contributed Property Exception*

Section 751(b)(2)(A) provides that a distribution of property contributed to the partnership by the distributee is not subject to section 751(b) (the "PCPE"). Under the Existing Regulations, it is not entirely clear how the PCPE applies when the distributed property is property the partnership received in exchange for the property originally contributed by the distributee or when the distributee is the successor to the original contributor. The Proposed

§ 1.751-1(g) (*Example 1*). The Proposed Regulations also clarify that a transferor's section 743 adjustments are to be taken into account in determining the amount of ordinary income recognized under section 751(a).

60 Since this is a clarification of the section 751(a) regulations issued in 1999, query whether it should be made effective for transfers of partnership interests occurring after the effective date of those regulations, *i.e.*, December 15, 1999.

61 While the Preamble describes this as a clarification, we believe that it is in fact a change, at least with respect to unrealized receivables of a type other than depreciation recapture. *See* McKee ¶ 21.03[1] note 55 ("The statutory provision that treats 'unrealized receivables' as 'inventory items' is § 751(d)(2), which includes as inventory 'any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231.' The recapture rules change the character of the income generated by an asset's sale, not the character of the asset itself.") Nevertheless, we support this change.

62 Prop. Treas. Reg. § 1.751-1(d)(1). The Service and Treasury should consider issuing guidance regarding how inventory items in an LTP are to be taken into account in determining whether inventory items in a UTP are substantially appreciated. *See* section 751(f). For example, if an LTP owns inventory items with a fair market value in excess of tax basis but the income would be allocated to a partner other than the UTP, are the inventory items excluded from the UTP's calculation of whether its inventory items are substantially appreciated, or does the UTP assume a hypothetical distribution of the inventory items to the UTP, or is there a different approach?

Regulations provide successor rules that are generally consistent with successor rules elsewhere in subchapter K.[63]

Under the Proposed Regulations, the transferee in a nonrecognition transaction[64] of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of the PCPE in an amount attributable to the interest transferred. Furthermore, under the Proposed Regulations, if a partnership disposes of contributed section 751 property in a nonrecognition transaction, the substituted basis property (within the meaning of section 7701(a)(42)) received in exchange for the contributed section 751 property is treated as the contributed section 751 property for purposes of the PCPE.[65] Finally, the distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided

[63] Under Treas. Reg. § 1.704-1(b)(2)(iv)(l), a transferee of a partnership interest succeeds to the transferor's capital account attributable to the interest transferred. In addition, Treas. Reg. § 1.704-3(a)(7) effectively treats the transferee of a partnership interest as the contributor of property contributed by the transferor for purposes of section 704(c). Similarly, under Treas. Reg. § 1.704-4(d)(2), the transferee of a contributing-partner's partnership interest will be 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 allocable to the transferee under section 704(c). Moreover, under Treas. Reg. § 1.737-1(c)(2)(iii), for purposes of section 737, a transferee will succeed to the contributor-transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred to the transferee. Regarding successor property, Treas. Reg. § 1.704-3(a)(8)(i) treats property exchanged for section 704(c) property as the section 704(c) property. *See also* Treas. Reg. § 1.704-4(d)(1)(i) and Treas. Reg. § 1.737-2(d)(3)(i).

[64] The other successor rules discussed in footnote 63 do not require the successor to have acquired the partnership interest in a nonrecognition transaction. It is not clear why the successor rule would be limited to nonrecognition transactions in this case. We would suggest not limiting the successor rule to transfers in nonrecognition transactions so as to be consistent with the other successor rules in subchapter K.

[65] If other property is also transferred in the nonrecognition transaction, the substituted basis property is treated as the contributed section 751 property with regard to the contributing partner in the same proportion as the fair market value of the contributed section 751 property bears to the fair market value of the other property transferred at the time of the transfer. *See* Prop. Treas. Reg. § 1.751-1(b)(5)(iii). However, if the transfer was in exchange for an interest in an entity, the interest in the entity will not be treated as the contributed section 751 property to the extent the value of the interest is attributable to other property the partnership contributed to the entity. *See* Prop. Treas. Reg. § 1.751-1(b)(5)(iii). Moreover, an interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent the value of the interest is attributable to property the partnership contributed to the entity after the interest was contributed to the partnership (except to the extent the property contributed to the entity was contributed to the partnership by the partner that also contributed the interest in the entity to the partnership). *See* Prop. Treas. Reg. § 1.751-1(b)(5)(iv).

interest, if any, contributed by the distribute-partner in the same property.[66] We are supportive of these rules as they provide important guidance that is consistent with the guidance under analogous provisions of subchapter K. However, because current law is unclear as to the existence of any successor rules under the PCPE, we suggest allowing taxpayers to rely on the Proposed Regulations.

We would also suggest that a further clarification be made to the PCPE. There is some uncertainty regarding whether post-contribution depreciation causes an item of contributed depreciable property to lose its status, in part or in whole, as previously contributed property.[67] Similar questions arise with other property (*e.g.*, stock of a foreign corporation relating to changes in potential income under section 1248 due to post-contribution earnings and profits in the foreign corporation). In light of the statutory language and with a view toward simplicity, we recommend clarifying that such post-contribution events do not affect the contributed property's status in whole or in part as previously contributed property for purposes of the PCPE.[68]

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[66] Prop. Treas. Reg. § 1.751-1(b)(5)(v). The same exception applies for purposes of sections 704(c)(1)(B) and 737. *See* Treas. Reg. §§ 1.704-4(c)(6) and 1.737-2(d)(4).

In response to the request for comments as to whether certain types of transactions should be excluded from the successor rules, we do not believe any exclusions are necessary. However, the anti-abuse rule should contain a specific reference the use of the PCPE in a manner inconsistent with its purpose as within its scope in order to protect against unanticipated abuses of the exception.

[67] *See* Todd Y. McArthur, PARTNERSHIP TRANSACTIONS–SECTION 751 PROPERTY, BNA TAX MGMT. PORTFOLIO 720-2nd § C.4.a; Treas. Reg. § 1.1245-4(f)(3) (*Example 1*) (treating contributed property as previously contributed property notwithstanding post-contribution depreciation claimed with respect to such property); Alfred D. Youngwood & Christina M. Cerrito, "Tracing Property After Its 'Owner' Changes: Sections 337, 704(c)(1), 737, 751, 382, 384, 1031, and 1374," 51 TAX LAW. 511, 528-31 (1998).

[68] If post-contribution increases in the ordinary income potential in a contributed hot asset could disqualify the asset, in whole or in part, from the PCPE, any increase in value in contributed inventory would disqualify the inventory, in part, from the PCPE. There is no indication that the PCPE is to be applicable only to the extent of the ordinary income potential in the asset at the time of contribution.

(d) *Additional Revaluation Events*

The Proposed Regulations would add several revaluation events to Treas. Reg. § 1.704-1(b)(2)(iv)(*f*): (i) a revaluation is permitted by an LTP upon the revaluation of a UTP's interest in the LTP, (ii), a revaluation is permitted by a UTP upon a revaluation by an LTP of its assets, and (iii) a revaluation is permitted in connection with a change (other than a de minimis change) to the manner in which the partners share any item or class of items of income, gain, loss, deduction or credit of the partnership under the partnership agreement. As discussed above, in the case of tiered partnerships, the principles of Treas. Reg. § 1.704-3(a)(9) apply with respect to any reverse section 704(c) layers created upon the revaluations. We support the addition of these permitted revaluation events, and we recommend that the regulations also permit a revaluation of an LTP's assets upon the contribution of an interest in the LTP to a UTP so that the section 704(c) amount attributable to the UTP's LTP interest can be matched with section 704(c) amounts that could be created in the LTP's assets.

## III. DETAILED DISCUSSION – PROPOSED REGULATIONS

### A. Introduction

The Proposed Regulations represent a substantial improvement over the Existing Regulations in achieving the purpose of section 751(b). The adoption of the hypothetical sale approach, in lieu of the gross value approach, to measure the reduction in a partner's interest in section 751 property in connection with a distribution better ensures that partners are subject to tax when their shares of ordinary income potential in assets have actually been reduced and that partners are not unnecessarily subject to tax when their shares of ordinary income potential in assets have not actually been reduced. By taking into account the now-mandatory principles of section 704(c), the Proposed Regulations not only modernize the Existing Regulations but also coordinate the section 751(b) regulations (dealing with partnership distributions) with the section 751(a) regulations (dealing with sales of partnership interests), which have taken section 704(c) principles into account since 1999. We commend the IRS and Treasury for their exemplary efforts in taking on this challenging task of bringing the section 751(b) regulations up to date.

## B. Section 751(b) Amount

### 1. Limit the Circumstances in which Revaluations Are Required

The section 704(b) regulations permit, but do not require, partnerships to revalue assets in connection with a variety of transactions. The Proposed Regulations would, for the first time, require a partnership to revalue its assets under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) in connection with any distribution to a partner in consideration for an interest in the partnership if the partnership owns section 751 property immediately after the distribution. That requirement is to help ensure that the partners retain their shares of ordinary income potential in the partnership's assets through reverse section 704(c) allocations. However, the Proposed Regulations require partnership revaluations even in cases where the distributee-partner's interest in the partnership is liquidated and the partner recognizes its entire section 751(b) amount in connection with the distribution. We do not believe the regulations should require partnerships to revalue their assets in such situations.

We recommend that the regulations create an exception from the mandatory revaluation rule for distributions of money or other cold assets in complete liquidation of a partner's interest. In those cases, the distributee-partner will recognize its entire 751(b) amount; thus, a revaluation of partnership assets is not necessary to preserve the partners' shares of hot asset gain. We believe this exception would cover a large number of distributions and would, thus, substantially limit the administrative burden of a partnership revaluation where it is unnecessary to carry out the purposes of section 751(b).[69]

2. Expand the Section 704(c) Anti-Abuse Rule to Protect the Hypothetical Sale Approach

At the center of the hypothetical sale approach is a determination of each partner's section 751(b) amount in connection with a distribution. A partner's section 751(b) amount is essentially the reduction (or increase) in the partner's ordinary income (or loss) potential from hot assets as a consequence of the distribution. Each partner is required to recognize ordinary income to the extent of its section 751(b) amount. If the partnership has hot assets, it is required to revalue its assets, creating a reverse section 704(c) layer that preserves the partners' shares of ordinary income in the partnership's hot assets and minimizes the extent to which the distribution will create a section 751(b) amount for a partner. The ability of the reverse section 704(c) layer to preserve a partner's share of ordinary income potential in the partnership's assets is, thus, essential to the efficacy of the hypothetical sale approach.

Depending on the section 704(c) method selected, the ceiling rule may[70] cause a partner's ordinary income potential in hot assets to be shifted to other partners.[71] For example,

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[69] We considered other exceptions to the mandatory revaluation rule, including an exception for liquidating distributions that include hot assets and for non-liquidating distributions if the distributee-partner elected to recognize its entire section 751(b) amount. However, we ultimately did not believe that the additional complexity and optionality was warranted.

[70] Merely because the ceiling rule may shift a partner's ordinary income potential in an asset to another partner does not mean that it will. For example, if a partnership that uses the traditional method sells a zero basis section 1231 asset with section 1245(a) recapture immediately after a revaluation event, none of the ordinary income would shift even though, over time, as the property is depreciated for section 704(b) purposes, the ordinary income potential would shift (as illustrated below). Thus, the potential application of the ceiling rule does not necessarily undermine the rationale of the hypothetical sale approach.

assume a 50 percent partner's interest in a partnership is reduced to a 10 percent interest after a distribution of money to the partner. One of the partnership's assets is a zero basis section 1231 asset that is worth 1000, and all of the built-in gain is section 1245(a) recapture. (Assume no gain was recognized in connection with the distribution because the money did not exceed the partner's basis in its partnership interest.) Upon the distribution, the partnership revalues its assets, preserving the distributee-partner's 500 share of the section 1245(a) recapture in a reverse section 704(c) layer. If the partnership selects the traditional method for making section 704(c) allocations with respect to the asset, due to the ceiling rule, the partner will not recognize additional ordinary income as the partnership depreciates the 1000 booked-up basis in the asset and allocates 90 percent of such depreciation to the other partners, and will have only 100 of ordinary income potential (10 percent) once that booked-up basis has been depreciated to zero (assuming the asset retains its 1000 value). Thus, the selection of the traditional method and the application of the ceiling rule preserved only 100 of the partner's ordinary income potential.

Due to the central role section 704(c) plays in the hypothetical sale approach, notwithstanding the view expressed in the Preamble that the existing anti-abuse rule is adequate to address the issue,[72] we believe the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) should be expanded to contain an explicit admonition against the selection of a section 704(c) method with

71 The Preamble stated: The IRS and the Treasury Department are aware that distortions created under the section 704(c) traditional method may cause ordinary income to shift among partners. However, the regulations under section 704(c) contain an anti-abuse rule that provides that a method is not reasonable if, for example, the event that results in a reverse section 704(c) allocation and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or built-in loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. The IRS and the Treasury Department believe that this anti-abuse provision under section 704(c) properly addresses the possibility that taxpayers would use the traditional method to shift ordinary income.

72 See footnote 71, *supra*.

a view toward avoiding section 751(b) while attempting to shift ordinary income among partners in a manner that reduces the partners' aggregate tax liability.[73]

### 3. Tiered Partnerships

#### (a) *Mandatory Revaluations*

We believe the 50 percent ownership threshold in the Proposed Regulations for mandatory revaluations in LTPs is too low. We recommend that revaluations in LTPs be required after a distribution by a UTP only when the same persons own, directly or indirectly (through one or more entities), 80 percent or more of the capital and profits interests in both the UTP and the LTP. (The Proposed Regulations do not contain any attribution rules for purposes of determining ownership of the capital and profits interests of a partnership. We recommend that the regulations cross reference section 707(b)(3) in order to include partnership interests held by related parties to determine if the ownership threshold has been satisfied.) We believe the 80 percent threshold is a better proxy for whether the UTP has dominance and control over the LTP. For that reason, as discussed below, such a threshold would appropriately limit the cases where an LTP would be subject to the burden of having to revalue its assets and reduces the number of unrelated partners who would be affected by a revaluation at an LTP.[74]

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73 We considered recommending a rule that would require partnerships to select the "remedial allocation method" in Treas. Reg. § 1.704-3(d) or some other method that avoided the application of the ceiling rule in order for the partnership and its partners to rely on the hypothetical sale approach. However, we rejected that approach for a number of reasons, including (i) that it would create a distinction between forward section 704(c) layers and reverse section 704(c) layers as to eligible section 704(c) methods and (ii) that it would either create uncertainty in the application of section 751(b) if the remedial allocation method was not selected or require the creation of a parallel section 751(b) regime to cover situations where the hypothetical sale approach was not available because the remedial allocation method was not selected.

74 *See, e.g.*, section 1504 (80 percent ownership threshold for affiliation); Treas. Reg. § 1.752-4(b) (80 percent ownership threshold for related parties causing a partner to be treated as bearing the "economic risk of loss" for partnership liabilities).

We believe the increase in the ownership threshold is appropriate for a number of reasons. First, revaluations are burdensome and expensive. Although an implied value of the LTP's assets in the aggregate would be set by the revaluation at the UTP, the values of each of the assets of the LTP would need to be determined. Furthermore, there could be differences of opinion of value between the UTP and the other partners in the LTP.

Second, revaluations could have a significant impact on the other, unrelated partners in the LTP. For example, the LTP would be required to select a section 704(c) method, which cannot be changed, with respect to the reverse section 704(c) layer that is created in the revaluation prior to the time that the LTP would otherwise have had to select a method. In addition, the creation of a reverse section 704(c) layer at the LTP could affect the allocation of nonrecourse debt under Treas. Reg. § 1.752-3(a)(2). Before imposing consequences on unrelated partners, we believe further study is warranted to consider all of the potential ramifications on such partners.

Third, although the purpose of the mandatory revaluation at an LTP is to better ensure that a UTP partner's share of hot-asset gain in LTP assets is preserved and cannot be shifted to another partner, the ceiling rule could nevertheless cause such gain to be shifted to another partner in the LTP. Therefore, it would not be appropriate to impose the burden and impact of the revaluation on unrelated partners in the LTP when the revaluation will not even necessarily achieve the objective of preserving the UTP partners' shares of hot-asset gain in the LTP.

Finally, a partner owning more than 50 percent of the capital and profits of a partnership will not necessarily control the partnership. Thus, a 50 percent threshold is not a sufficient proxy to establish that the UTP has such control and dominance over the LTP that actions at the UTP (*e.g.*, distributions) should have an impact at the LTP.

We also recommend that the regulations be clarified to require a revaluation at an LTP only if the ownership threshold is satisfied at each LTP between the distributing UTP and the LTP.

> ***Example 2***. X owns 80 percent of UTP, and unrelated partners own 20 percent of UTP. UTP owns 30 percent of another partnership ("MTP"), and unrelated partners own the remaining 70 percent. MTP owns 10 percent of LTP, and X owns the remaining 90 percent of LTP. Assume UTP makes a non-liquidating distribution to X and LTP owns hot assets.

Under Prop. Treas. Reg. § 1.751-1(b)(2)(iv), it would appear that LTP would be required to revalue its assets even though MTP would not be. If there is no revaluation of MTP's assets, a revaluation of LTP's assets will not create a section 704(c) layer at MTP that matches the section 704(c) layer in LTP. Given that there would be no clear benefit from the revaluation, we recommend the regulations be clarified to require a revaluation at an LTP only if the ownership threshold is satisfied at each intervening partnership between the distributing UTP and the LTP.

(b) *Synthetic Revaluations*

If the ownership threshold is not satisfied and the LTP does not choose to revalue its assets under Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*), the Proposed Regulations still require the UTP to allocate its distributive share of the LTP's items among its partners in a manner that reflects the allocations that would have been made had the LTP revalued its property. We recommend that the requirement for synthetic revaluations be replaced with a more flexible rule.

First, synthetic revaluations would require the UTP to gather the same information and keep track of hypothetical section 704(c) layers in the LTP regardless of the UTP's ownership interest in the LTP. Thus, if the UTP owned 1 percent of the LTP, UTP would be responsible for allocating items from the LTP to its partners on the basis of synthetic revaluation at the LTP.

Second, in many cases, it will be unclear how to implement a synthetic revaluation. For example, does the UTP determine its allocations from the LTP by selecting a hypothetical section 704(c) method for the reverse section 704(c) layer created in the synthetic revaluation at the LTP? If there is a subsequent actual revaluation at the LTP, how does that impact the hypothetical section 704(c) layer created in the synthetic revaluation? If the subsequent actual revaluation at the LTP is at a lower value than the value used in the synthetic revaluation, does the UTP preserve the hypothetical layer and create a new reverse negative layer or does it allow the layer to collapse?[75] What are the consequences if the section 704(c) method selected for a reverse section 704(c) layer created in an actual revaluation at the LTP is different from the section 704(c) method selected for the hypothetical layer created previously in connection with a synthetic revaluation?

Third, synthetic revaluations do not work very well in many common partnership arrangements where the items actually allocated to the UTP do not match the items that would have been allocated had there been an actual revaluation at the LTP.

> ***Example 3***. UTP is the general partner of LTP and is entitled to 20% of LTP's profits after the LTP's limited partners' $100 of

[75] *See* NYSBA Tax Section Report No. 1314, "Report on the Proposed Regulations on Partnership Built-in Losses," 82-94 (Dec. 15, 2014) (discussing layering vs. netting approaches to multiple section 704(c) layers generally).

> capital is returned. UTP makes a distribution to one its partners that results in a mandatory revaluation at UTP. UTP's interest in LTP, which has a zero basis, has a liquidation value of $4. At the time of the distribution, LTP has two assets: a hot asset with a basis of $10 and a value of $30 and a capital asset with a basis and value of $90. The value of the capital asset then declines by $20, to $70.

If LTP revalues its assets at the time of UTP's distribution, LTP would allocate to UTP $4 of its later capital loss from the sale of the capital asset and $4 of ordinary income from its later sale of the hot asset. UTP's share of ordinary income would therefore be preserved. But if LTP does not revalue its assets, it might not allocate any ordinary income to UTP. For example, if the capital asset is sold at a $20 loss, that loss would be allocated to the limited partners. Then, when LTP recognizes $20 of ordinary income from its hot asset, all of that ordinary income would be allocated to the LTP's limited partners, not UTP, in order to reverse the prior allocation of loss. There would be no ordinary income allocated to UTP, so it would not be possible for UTP to allocate its share of LTP's items as if LTP had revalued its assets at the time of the distribution by UTP. The synthetic revaluation does not work properly if the items actually allocated to the UTP do not match the items that would have been allocated had there been an actual revaluation at the LTP.

For the reasons set forth above, we recommend that the Service and Treasury eliminate the requirement for synthetic revaluations. Instead, the section 704(c) regulations should expressly provide that a UTP with a section 704(c) amount reflected in an LTP interest can use any reasonable method for making allocations of items from the LTP if the LTP does not revalue its assets. The regulations should specifically state that there may be many reasonable methods for making such allocations.[76] Whether a method is reasonable would depend on all the facts and circumstances, including the size of UTP's interest in the LTP, the availability of information from the LTP, and the materiality of UTP's section 751 amount associated with its LTP interest. Furthermore, the regulations should expressly provide that it will generally be reasonable to use a synthetic revaluation (notwithstanding its shortcomings noted above) and apply the principles of Treas. Reg. § 1.704-3(a)(9) for purposes of making such allocations. The regulations might also provide that a synthetic revaluation is the only reasonable method where the UTP exceeds a 50 percent ownership threshold in the LTP and none of its shortcomings are implicated (*i.e.*, the UTP has access to information from the LTP and the allocations from the LTP make it possible to achieve the effect of an actual revaluation at the LTP).

Finally, the method selected should be explicitly subject to the section 704(c) anti-abuse rule. Treas. Reg. § 1.704-3(a)(10) should be expanded to provide that a method of allocating items from an LTP after a mandatory revaluation at a UTP is not reasonable if it is selected with a view toward shifting built-in gain in LTP assets from the partners who had a share of that book-up gain in the UTP's LTP interest, with particular sensitivity towards shifts of built-in gain in hot assets, and if it results in a substantial reduction in the present value of the partners' aggregate tax liabilities.[77] Although this approach is not iron-clad, *i.e.*, there could be

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[76] For example, the UTP might choose to treat the first allocations of ordinary income items from LTP following the revaluation at the UTP as section 704(c) items at the UTP up to the UTP's section 751 amount associated with its LTP interest at the time of the revaluation at the UTP. Alternatively, the UTP might simply treat none of the items allocated from the LTP as associated with the reverse section 704(c) layer in the UTP's LTP interest associated with hot assets.

[77] It may be worth considering simplifying the rules further by eliminating mandatory revaluations in all LTPs and simply relying on the requirement to make reasonable allocations, back-stopped by an expanded anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) to ensure taxpayers cannot use an unreasonable method for allocating items in a tiered-partnerships structure to shift hot-asset gain in a manner that achieves a substantial reduction in the present value of the partners' aggregate tax liabilities. While we believe that approach has some merit, we do not support the approach because we believe our recommendation better achieves the goals of the hypothetical sale approach by not imposing an undue burden on the parties and by limiting the impact on unrelated partners.

shifts of hot-asset gain depending on the method selected for making the allocations from the LTP that would not be prevented by the anti-abuse rule, even mandatory revaluations are not iron-clad, since there could be shifts of hot-asset gain caused by the ceiling rule. We believe this approach makes the rules more administrable without sacrificing the purpose of section 751(b).

Whether in connection with a synthetic revaluation required under the Proposed Regulations or under our recommended approach of allowing a UTP to allocate items from an LTP using any reasonable method, the UTP will need information from the LTP. In response to the request for comments on reasonable approaches to address this issue, we believe the regulations could require an LTP to provide any information reasonably requested by the UTP to comply with section 751(b).[78] In addition, we believe the regulations should expressly provide that the UTP may rely in good faith on the information it receives from the LTP.

4. Effect of Basis Adjustments under Sections 732 and 734

In an effort to preserve ordinary income potential in assets and minimize the extent to which distributions are subject to section 751(b), the Proposed Regulations create special rules for basis adjustments under sections 732 and 734 that prevent such adjustments from displacing the ordinary income potential in the adjusted asset.[79] Under these special rules, the basis adjustment is required to be separately maintained and, to the extent not reduced by depreciation, will give rise to a capital loss on the disposition of the adjusted asset. We support

[78] *See, e.g.,* Treas. Reg. § 1.897-2(h) (requiring a domestic corporation to provide to a foreign shareholder, upon request, information about whether the corporate stock constitutes a U.S. real property interest); Treas. Reg. § 1.743-1(k)(2) (requiring a transferee-partner to provide information to the partnership to determine section 743(b) adjustments).

[79] See the discussion of *Example 1* above.

this general approach because it limits the application of section 751(b) and preserves each partner's share of ordinary income. However, we have the following recommendations:

We recommend eliminating the rules in Prop. Treas. Reg. § 1.755-1(c)(2)(iv) and Prop. Treas. Reg. § 1.732-1(c)(2)(iv) that treat the basis adjustment as giving rise to a capital loss. We assume that the purpose of this rule is to avoid creating a section 1231 loss that might be used to offset the ordinary income that the rule was intending to preserve. For the following reasons, we would nevertheless recommend eliminating that rule and allowing the additional basis to be taken into account in determining section 1231 gain and loss, while still preserving the ordinary income potential in the adjusted asset:

First, a section 1231 loss is not a loss from a hot asset. Section 1231 losses are not taken into account in determining a partner's net section 751 unrealized gain or loss. Thus, the fact that a section 1231 loss may be available to offset ordinary income from hot assets does not undermine the purpose of section 751(b), since the net section 751 unrealized gain or loss is still preserved.

Second, depending on a partner's particular circumstances, the partner may or may not be able to use a section 1231 loss to offset the preserved ordinary income. For example, if the partner or the partnership has other section 1231 gains, the section 1231 loss would be used by the partner to offset the section 1231 gain and, thus, have the effect of a capital loss.[80]

Third, even if a partner could use the section 1231 loss to offset ordinary income from hot assets, the partner would be subject to section 1231(c), which would generally

[80] *See* section 1231(a)(1).

recharacterize the partner's section 1231 gains as ordinary income for a five-year period, thereby still largely preserving the potential for ordinary income.

Fourth, many taxpayers would simply choose to Elect Out, allow the basis adjustment to displace the ordinary income potential, thereby accelerating the recognition of ordinary income, rather than risk having an unusable capital loss. That result would undermine the intended benefit of the special basis rules, which was to permit deferral where ordinary income can be preserved.

Finally, creating a unique special basis adjustment that is depreciable yet gives rise to a capital loss that would have to be separately tracked and maintained as a special tax asset would create substantial additional complexity in the tax law. Such additional complexity may be one thing if such rules were limited to section 734 adjustments that remained in the partnership. The partnership will often be better prepared than the distributee-partner (or a subsequent transferee) to handle this complexity. However, where such assets leave partnership solution, for example in connection with a distribution that gives rise to a special basis adjustment or in connection with a transfer of the adjusted asset by the partnership in a nonrecognition transaction (*e.g.*, as a contribution to a corporation in a section 351 exchange), we are concerned that there will be problems maintaining the special basis adjustments.[81] Although the adjustment would still need to be separately maintained for purposes of preserving the ordinary income potential in the asset in such circumstances, taxpayers would not have to apply a special character rule to treat the basis as giving rise to a capital loss even though it is allocable to a section 1231 asset.

[81] For example, we assume these basis adjustments would implicate section 704(c)(1)(C) if the distributee contributes the adjusted property to a different partnership.

For the above reasons, we recommend allowing the basis adjustment to be treated as an adjustment to a section 1231 asset, although we believe it should not be taken into account for purposes of determining the ordinary income potential in the asset.

If the above recommendation is accepted, we would recommend eliminating the Election Out. We generally oppose electivity, and preserving the Election Out allows taxpayers to elect whether or not income is recognized under section 751(b). Furthermore, we believe the administrative burden is lower where the basis adjustment does not need to be separately tracked as giving rise to a capital loss (rather than a section 1231 loss), thereby reducing the need to allow taxpayers to Elect Out to avoid the complexity. Finally, if the basis adjustment is not treated as potentially giving rise to a capital loss, the Election Out would likely be far less important to taxpayers.[82]

As currently drafted, the Proposed Regulations treat any basis adjustment allocated pursuant to the second sentence of Treas. Reg. § 1.755-1(c)(2)(i) or Treas. Reg. § 1.732-1(c)(2)(ii)[83] as giving rise to capital loss, regardless of whether the adjustment would have had the effect of displacing ordinary income.

> ***Example 4.*** A partnership holds a section 1231 asset with a basis of $100 and a fair market value of $100. Thus, there is no section 1245(a) recapture in the asset. The partnership makes a distribution that generates a $5 basis increase to the asset under section 734(b) pursuant to the second sentence of Treas. Reg.

[82] Under Prop. Treas. Reg. § 1.755-1(c)(2)(vi), the Election Out is to be made by the distributing partnership. However, in connection with basis adjustments under section 732, it is the distributee-partner, not the partnership, that would have the administrative burden of maintaining the separate adjustments. If the purpose of the Election Out is to allow taxpayers to avoid that administrative burden, it may be more appropriate to allow distributee-partners to make the Election Out in connection with section 732 adjustments, since they are the ones who would have the burden.

[83] As discussed above, the special treatment is to apply only to the basis increase in excess of the unrealized appreciation in the property.

§ 1.755-1(c)(2)(i). Under Prop. Treas. Reg. § 1.755-1(c)(2)(iv), when the partnership sells the section 1231 asset, the $5 basis adjustment is not taken into account in determining section 1231 gain and loss; instead, it will generate a capital loss.

We assume this result was unintended. Thus, we recommend that if the treatment of the basis adjustment as an adjustment in a capital asset is retained, it apply only to the extent of the lesser of (x) the amount of the basis adjustment allocated to the asset under the second sentence of Treas. Reg. § 1.755-1(c)(2)(i) and (y) the amount of ordinary income potential in the asset.[84] Under that approach, in the example, the $5 basis increase would give rise to a section 1231 loss rather than a capital loss on a sale of the asset.

Finally, the Preamble requests comments on whether these rules should also apply with respect to section 743(b) adjustments in substituted basis transactions. In a substituted basis transaction, the transferor of a partnership interest would not recognize its share of ordinary income from hot assets under section 751(a), yet it is possible that the transferee could be entitled to section 743(b) adjustments that would displace the ordinary income potential in the partnership's hot assets. In certain cases, that result may be appropriate. For example, if a partner sells its partnership interest in a taxable transaction and recognizes ordinary income under section 751(a), but the partnership does not have a section 754 election in effect or a substantial built-in loss, and then the buyer transfers the partnership interest in a substituted basis transaction and the partnership makes a section 754 election, the transferee would be entitled to section 743(b) adjustments in the partnership's hot assets. Arguably, that result is not inappropriate because the original partner recognized the ordinary income in the partnership's assets under section 751(a). Of course, there may be other situations where inside-outside basis

[84] We recommend a similar change be made to Prop. Treas. Reg. § 1.732-1(c)(2)(iv).

disparities exist and the transferee in a substituted basis transaction would be entitled to section 743(b) adjustments in hot assets even though no prior partner recognized ordinary income under section 751(a). Given the complexity involved in identifying the situations in which it would be appropriate to prevent section 743(b) adjustments from being allocated to hot assets, we would recommend not extending the special rules for section 732 and 734(b) basis adjustments to section 743(b) basis adjustments without careful consideration. Moreover, the proposed rules for section 732 and 734(b) basis adjustments are more limited than the rules would need to be for section 743(b) adjustments as the proposed rules relate solely to basis adjustments allocated to capital and section 1231 assets that would otherwise have the effect of displacing ordinary income potential, whereas if a special rule were added in certain cases for section 743(b) adjustments, the rule presumably would apply with respect to all hot assets, since the section 743(b) adjustments could be made to all of the partnership's assets.

5. Swapping of Reverse Section 704(c) Amounts

The Preamble requests comments on whether partners should be permitted to exchange reverse section 704(c) amounts resulting from a distribution in order to narrow the application of section 751(b). In the Prior Report, we stated the following about such an approach (footnote omitted):[85]

> While this approach would require detailed guidance about how to apply reverse 704(c) and would create additional complexity in the case of distributions involving multiple properties or distributions of both hot and cold assets, it has some analytical appeal.
>
> If this approach were adopted, Treasury should consider whether it is appropriate to limit its application so that it applies only in cases where the reverse 704(c) gain in the partnership's retained assets is

[85] *See also* ABA Tax Section Comments Concerning Notice 2006-14 (April 27, 2007).

> of the same character as the inherent gain in the distributed assets. If such a limitation applied, the reverse 704(c) rules would presumably avoid triggering Section 751(b) upon non-liquidating distributions of hot assets only to the extent that the distributee partner's share of the inherent gain in the partnership's retained hot assets were sufficient to absorb the "excess" hot asset gain in the distributed hot asset that was "shifted" to the distributee partner in the distribution.

We continue to believe there is merit to such an approach and recommend that Treas. Reg. § 1.704-3(a)(6) be amended to provide that a distributee-partner's share of reverse section 704(c) gain resulting from the distribution[86] in the hot assets to be distributed should be increased to the full amount of such gain in the distributed assets as limited by the extent to which the distributee's share of reverse section 704(c) gain in the partnership's retained assets can be decreased, provided that the distributed hot assets have the same type of built-in gain that the partnership has in its retained assets.[87]

> ***Example 5:***[88] A, B and C are equal partners in a partnership with two assets (both of which are hot assets that generate income of the same type): Asset 1 has a fair market value of $250 and a tax basis of $0 and Asset 2 has a fair market value of $50 and a tax basis of $0. Assume that there are no section 704(c) amounts in either asset, that the partners have a $0 basis in their partnership interests, and the partnership has a section 754 election in effect. The partnership distributes Asset 2 to A, and A's interest in the partnership is reduced from a 1/3 interest to a 20 percent interest. A receives a $0 tax basis in Asset 2.

Under Prop. Treas. Reg. § 1.751-1(b)(2)(iv), the partnership would be required to revalue its assets, creating a reverse section 704(c) amount of $250 in Asset 1 and of $50 in

[86] Consideration should be given as to whether the rules should require adjustments only with respect to the reverse section 704(c) amount created in the distribution or with respect to any reverse section 704(c) amounts. The rules cannot allow an adjustment to forward section 704(c) amounts without creating issues under section 704(c)(1)(B) and section 737.

[87] Rules similar to the rules in Treas. Reg. § 1.704-3(c)(3)(iii)(A) concerning curative allocations could be applied to determine if the income would be of the same type.

[88] This example is based on Example 2 in the Prior Report.

Asset 2 immediately prior to the distribution. A, B, and C would each have a $83.33 share of the reverse section 704(c) amount in Asset 1 ($250 total) and a $16.67 share of the reverse section 704(c) amount in Asset 2 ($50 total). Under the Proposed Regulations, B and C would have a section 751(b) amount of $16.67 and would, therefore, be required to recognize ordinary income in such amount. The partnership would increase the basis in Asset 2 to $33.33 immediately prior to the distribution to A under Prop. Treas. Reg. § 1.751-1(b)(3)(iii), which would require A to recognize gain under Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A). (The mandatory gain recognition rule applies because, without the recognition of gain and the resulting increase to A's basis in its partnership interest, A would take Asset 2 with a zero basis and the partnership would be entitled to a section 734 adjustment as a result of the basis adjustment made under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) that would reduce the partners' shares of hot asset gain in Asset 1.[89]) Under the mandatory gain recognition rule, A would be required to recognize $33.33 of capital gain, which would prevent the section 734 adjustment, since A's basis in its partnership interest would be increased by such amount prior to the distribution of Asset 2, which would have a basis of $33.33.

We are troubled by this result for two reasons. First, we believe it is inappropriate for A's mandatory income to be capital gain when A has no share of capital gain in the partnership. Second (and a related point), the language of section 751(b) would seem to require some exchange of hot assets for other assets in order for the provision to apply. Although there is a broad delegation of regulatory authority in section 751(b), there is some question as to whether there is authority to apply section 751(b) to cause a partner to recognize capital gain when the partner has no share of the partnership's capital gain.

[89] See the discussion below for our recommended changes to the mandatory gain recognition rule.

If the Proposed Regulations were to require the swapping of reverse section 704(c) amounts (as described above), the distribution to A would not result in the application of section 751(b), which avoids the problem of applying section 751(b) in the context of a hot-asset-only partnership. When the partnership revalues its assets, it would increase A's share of reverse section 704(c) gain in Asset 2 from $16.67 to $50 and reduce A's share of reverse section 704(c) gain in Asset 1 by such amount from $83.33 to $50.[90] Thus, no partner would have a section 751(b) amount in connection with the distribution. Each partner's net unrealized gain from section 751 property before and after the distribution would be $100. While the approach requires different tracking of section 704(c) amounts, section 704(c) amounts already have to be tracked, and we believe tracking different sharing ratios in hot assets would not result in a material increase in the administrative burden on partnerships.

C. Consequences of a Section 751(b) Distribution

1. Selection of Approach

After applying the above rules, if a distribution results in a section 751(b) amount for any partner, the distribution is a section 751(b) distribution and any partner with a section 751(b) amount is required to recognize ordinary income in such amount. The Proposed Regulations do not specify the manner in which the income is to be recognized but require the partnership to adopt a reasonable method "that is consistent with the purpose of section 751(b)" and require appropriate adjustments to basis.[91] Based on the Preamble and the examples in the

[90] Corresponding adjustments to the remaining partners' reverse section 704(c) amounts would be made. Thus, B's and C's shares of reverse section 704(c) gain in Asset 1 would be increased by $16.67 each and in Asset 2 would be decreased by $16.67 each.

[91] Prop. Treas. Reg. § 1.751-1(b)(3)(iii) (requiring appropriate adjustments to basis in connection with a section 751(b) distribution).

Proposed Regulations, the deemed gain approach and hot asset sale approach would generally appear to be reasonable methods. Once a partnership adopts a method, the partnership and its partners are required to apply that method to all subsequent distributions other than those for which the method is unreasonable. The Preamble requests comments as to whether the regulations should specifically describe approaches that are generally reasonable. We believe the regulations should specifically describe the approach for recognizing section 751(b) amounts and further recommend that the deemed gain approach be the only permissible method.

As discussed above, the Prior Report explained why we prefer the deemed gain approach over the hot asset sale approach. The Preamble acknowledged that the deemed gain approach produces the appropriate outcome in the most circumstances, and we are not aware of a circumstance in which it does not produce the appropriate outcome.

In addition, it is the easiest method to apply; the regulations could simply use section 704(c)(1)(B) as a model and clarify that a partner takes into account the character of the ordinary income (*e.g.*, as dividend income under section 1248) because the transaction would be treated as a sale of the asset for all purposes of the Code with any resulting gain (or loss) allocated to the affected partner. The deemed gain approach also resolves other issues, such as how to apply section 751(b) in a liquidation of the partnership,[92] how to apply section 751(f) with respect to LTPs,[93] and reporting and withholding (because the gain would be recognized

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[92] *See* Rev. Rul. 77-412, 1977-2 C.B. 223; McKee ¶ 21.06[2]; Jackel & Stok, *supra* footnote 15, at 1566.

[93] Under the deemed gain approach, there would simply be a deemed sale of UTP's interest in the LTP in which the principles of section 751(a) would apply to determine the amount of income recognize from the LTP interest. The basis adjustments under Prop. Treas. Reg. § 1.755-1(b)(3)(iii) would be made to the LTP interest, which should give rise to corresponding basis adjustments in the LTP's hot assets. These basis adjustments would behave like section 743 adjustments (*i.e.*, they would be solely for the benefit of the UTP). Under the hot asset sale approach, where the partners are treated as receiving a distribution of hot assets and selling them back to the partnership, significant uncertainties would arise in connection with LTPs: Is the deemed distribution of the hot asset "component" of the LTP interest? What is the basis in such interest? Or is there a deemed

and allocated at the partnership level). Furthermore, by permitting only one approach, the complexity that would be involved in testing different methods for each distribution to determine whether the selected method may produce an inappropriate result would be eliminated.

The Preamble requests comments on the disclosures that should be required from partners and partnerships that either recognize gain under section 751(a) or (b) or rely on reverse section 704(c) allocations to defer the gain recognition required by section 751(a) or (b). The deemed gain approach would help resolve disclosure issues when there is a section 751(b) distribution, as the partnership would simply report and allocate the gain from a deemed sale of the asset. In order to help the Service identify distributions that are not treated as section 751(b) distributions under the hypothetical sale approach, we recommend Form 1065 be amended to require partnerships to disclose whether (i) hot assets are distributed to any partner during the year or (ii) the partnership makes a disproportionate distribution of money or property during the year.

2. Elective and Mandatory Gain Recognition Rules

In order to deal with the impact of basis adjustments under section 734 and section 732 arising from the distribution, the Proposed Regulations contain elective and mandatory gain recognition rules to prevent the reduction of hot asset gain from section 734 adjustments (in the case of the mandatory gain recognition rule in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A)) and the increase in hot asset gain from section 732 adjustments (in the case of the elective gain recognition rule in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B)). The gain recognition

distribution of hot assets from the LTP to the UTP and then from the UTP to the partners, who then sell such hot assets back to the UTP, which then contributes such assets back to the LTP? The complexities involved with such an approach would be mitigated with the deemed gain approach.

rules attempt to prevent such adjustments from occurring by causing the distributee-partner to recognize gain and increase its outside basis prior to the distribution. As discussed below, we believe the elective gain recognition rule should be eliminated and the mandatory gain recognition rule should be revised.[94]

(a) *Elective Gain Recognition Rule*

Under the Proposed Regulations, in certain situations, a distributee-partner may elect to recognize capital gain to prevent the reduction in the basis of distributed hot assets under section 732(a)(2) or (b). For the following reasons, we recommend that the elective gain recognition rule in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B) be eliminated.

We generally believe elective gain recognition rules should be avoided. In this case, the elective gain recognition rule essentially provides a second-chance election to allow for gain recognition. The situation in which the distributee-partner would be eligible to make the gain recognition election (*i.e.*, where there would be a reduction under section 732(a)(2) or (b) in the basis of a distributed asset resulting from the section 751(b) adjustments under Prop. Treas. Reg. § 1.751-1(b)(3)(iii)) would usually be avoided if the partnership had a section 754 election in effect at the time of the distribution, which would result in the application of the mandatory gain recognition rule. In addition, if the regulations permitted the exchange of reverse section 704(c) amounts in the manner discussed above, gain recognition would often be unnecessary.

[94] In addition, we recommend that the regulations provide additional guidance as to the allocation of the basis adjustments among the partnership's assets under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) as a result of the partner's recognition of gain under the gain recognition rules. For example, under the Proposed Regulations, in *Example 5*, above, A would be required to recognize $33.33 of capital gain even though it has no share of capital gain in the partnership. It is not clear what basis adjustments the partnership would make under Prop. Treas. Reg. § 1.751-1(b)(3)(iii). Would A be entitled to a hovering basis adjustment under Prop. Treas. Reg. § 1.751-1(b)(3)(iii)? When would A be able to take such adjustment into account? If A did have a share of a capital gain asset in the partnership, but such share was less than the amount of capital gain required to be recognized, would the basis adjustment be allocated entirely to such asset even if it created a built-in loss in such asset?

Under the Proposed Regulations, if the partnership in *Example 5* above did not have a section 754 election in effect, A would be eligible to make the gain recognition election in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B) because, in the absence of such election, the $33.33 basis reduction in Asset 2 under section 732(a)(2) (resulting from the $33.33 basis adjustment in Asset 2 under Prop. Treas. Reg. § 1.751-1(b)(3)(iii)) would cause A's net section 751 unrealized gain to be greater immediately after the distribution ($83.33 from Asset 1 + $50 from Asset 2 = $133.33) than it was immediately before the distribution ($100). Thus, under the Proposed Regulations, A could elect to recognize $33 of capital gain and avoid that result, which is the same result if the partnership had a section 754 election in effect. If the partnership had a section 754 election in effect, as discussed above, the mandatory gain recognition rule would apply, requiring A to recognize $33 of capital gain.

While the distributee-partner may not be able to control whether the partnership has a section 754 election in effect, that election provides the mechanism to prevent the distortion to the distributee-partner. It is not unusual for distortions to arise in the absence of a section 754 election, and partners already often negotiate to have the ability to require section 754 elections to be made to prevent similar distortions. The gain recognition election would provide certain partners with the benefit of the section 754 election without the partnership's having to commit to the section 754 election.[95] We believe the Code and regulations should be designed to encourage partnerships to make section 754 elections.

Finally, a distribution that increases a partner's share of hot asset gain does not violate the purpose of section 751(b) as long as the other partners' shares of hot asset gain do not

[95] The Proposed Regulations also allow different distributee-partners to choose whether or not to make the election and allow the same distributee-partner to choose whether or not to make the election for each distribution.

decrease. Thus, the additional complexity created with a partner-level gain recognition election is not necessary to achieve the purposes of section 751(b).

If, however, the elective gain recognition rule is retained, perhaps an analogous election should be provided for remaining partners to prevent disparate treatment between distributee-partners and remaining partners.

> ***Example 6***: A, B, and C are equal partners in a partnership that has two assets: a section 1231 asset with a tax basis and fair market value of $200, but which was originally purchased for $300, and a capital asset with a tax basis of zero and a fair market value of $100. The $100 of built-in gain in the capital asset is shared equally between A and B under reverse section 704(c). The partnership, which has a section 754 election in effect, distributes the capital asset to C in complete liquidation of its partnership interest. C takes a $100 basis in the capital asset under section 732(b). Consequently, the partnership is required to reduce the basis of the section 1231 asset by $100 under section 734(b).

As result of the negative section 734(b) adjustment in the section 1231 asset, A's and B's net section 751 unrealized gain increased in connection with the distribution, since the partnership would recognize income under section 1245(a) upon a sale of the section 1231 asset after taking into account the negative section 734(b) adjustment; thus, they do not have section 751(b) amounts.[96] C also does not have a section 751(b) amount, since it had no net section 751 unrealized gain or loss before or after the distribution.

It may be appropriate to allow A and B to recognize $50 of capital gain each so that no section 734(b) adjustment will result (since the basis in the capital asset would be increased to $100 prior to the distribution, thereby avoiding a negative section 734 adjustment) and they can avoid having their hot asset gain increase. On the other hand, as we suggested, the

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[96] In this case, the presence of a section 754 election does not prevent A and B from increasing their ordinary income potential.

rules do not need to resolve this situation as increasing a partner's share of hot asset gain (without reducing other partners' shares of hot asset gain) does not implicate section 751(b).

(b) *Mandatory Gain Recognition Rules*

While we generally support the approach of the mandatory gain recognition rules in the Proposed Regulations, as demonstrated by the following examples, we believe the rules can be improved with minor adjustments. We believe the trigger for the application of the mandatory gain recognition rule needs to be expanded. Furthermore, as discussed above relating to *Example 5*, the character of the recognized gain (capital gain unless an Election Out is made, in which case, the gain is ordinary), is not always appropriate.

The following example illustrates why the trigger for the application of the mandatory gain recognition rule is too limited and needs to be expanded.

> ***Example 7***: A, B, and C are equal partners in a partnership that has one asset: a section 1231 asset with a zero basis, a fair market value of $300, and $300 of section 1245(a) recapture. The partnership borrows $60, and A guarantees the loan in a manner that causes A to bear the economic risk of loss for the liability under section 752 and the regulations thereunder. The proceeds are distributed to C in partial redemption of its interest. The partnership has a section 754 election in effect and has made an Election Out. [97] The distribution gives rise to a $60 section 734(b) adjustment allocable to the section 1231 asset.[98]

The mandatory gain recognition rule is not applicable because it applies only when an adjustment to a distributed hot asset under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) results in a section 734(b) adjustment in the partnership that alters a partner's net section 751 unrealized

[97] If the Election Out is eliminated in accordance with our recommendation, that would help limit the situations in which there are problems with the trigger for the application of the mandatory gain recognition rule.

[98] Assume that the value of the asset is at least $0.01 above the amount of section 1245(a) recapture so that it would clearly attract the $50 basis adjustment. For simplicity, such excess value will be ignored.

gain or loss.[99] In the example, there was no distributed hot asset, nor was there an adjustment under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) that would have resulted in a section 734(b) adjustment. The $60 section 734(b) adjustment accordingly reduces the partnership's hot-asset gain by $60, so each partner would appear to have a section 751(b) amount of $20. Thus, the basis in the 1231 asset is increased by $60 under Prop. Treas. Reg. § 1.751-1(b)(3)(iii). Due to the $20 increase in C's outside basis under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) to reflect C's recognition of its $20 section 751(b) amount, the section 734(b) adjustment would now equal $40 (since C's outside basis would have increased by $20 prior to the distribution of $60), leading to iterative calculations to determine the partners' section 751(b) amounts. We do not believe this is intended.[100]

If the trigger for the application of the mandatory gain recognition rule were not limited to situations when an adjustment to a distributed hot asset under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) results in a section 734(b) adjustment in the partnership that alters a partner's net section 751 unrealized gain or loss, but instead applied whenever any distribution results in a section 734(b) adjustment that alters a partner's net section 751 unrealized gain or loss after the distribution, we believe the rule would operate as intended. In the above example, because the distribution results in a section 734(b) adjustment that alters the partners' net section 751 unrealized gain, the mandatory gain recognition rule would apply, and cause C to recognize $60 of ordinary income (because an Election Out was made).

[99] Note that if the mandatory gain recognition rule were applicable, C would be required to recognize ordinary income because of the Election Out. *See* Prop. Treas. Reg. § 1.751-1(g) (*Example 9*).

[100] The result does not occur merely because the section 734(b) adjustment arose in connection with gain recognized under section 731(a)(1). The same result would occur if, instead of distributing cash to C, the partnership were to distribute a full basis capital or section 1231 asset to C.

Similar problems arise under the Proposed Regulations in cases not involving the Election Out. The following example illustrates the problems both with the trigger and with the character of income required to be recognized under the mandatory gain recognition rule.

> ***Example 8***: A, B, and C are equal partners in a partnership that has the following assets: an Unrealized Receivable with a zero basis and $50 fair market value, Inventory Item 1 with a zero basis and $50 fair market value, Inventory Item 2 with a $100 basis and fair market value, and Capital Asset with a zero basis and $100 fair market value. Each partner has a $33.33 basis in its partnership interest. The partnership, which has a section 754 election in effect, distributes Inventory Item 2 to C in complete redemption of its interest in the partnership.[101]

C would receive Inventory Item 2 with a basis of $33.33 under section 732(b). The partnership's basis in the Unrealized Receivable and Inventory Item 1 will increase (in the aggregate) by $66.67 under section 734(b). The mandatory gain recognition rule does not apply to prevent this result because the section 734(b) basis adjustment is not caused by a basis adjustment under Prop. Treas. Reg. § 1.751-1(b)(3)(iii). Therefore, the distribution would reduce A's and B's share of net unrealized section 751 gain by $33.33 each to $16.67 each. Under the Proposed Regulations, A and B would each have a section 751(b) amount of $16.67 and would, thus, have to recognize such amount of ordinary income.[102]

C, on the other hand, does not have a section 751(b) amount because its net section 751 unrealized gain <u>increased</u> from $33.33 to $66.67 in the distribution. C is not eligible

[101] Although Inventory Item 2 has a full basis, it is nevertheless treated as a section 751 asset, since in the aggregate, the partnership's inventory is substantially appreciated. Prop. Treas. Reg. § 1.751-1(d)(1).

[102] Given the fact that the section 734(b) adjustment was already made to the partnership's remaining hot assets, it is not clear what the appropriate basis adjustments under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) would be in this situation. Any additional basis adjustments in the hot assets would further reduce the amount of built-in gain in the partnership's hot assets.

to make the gain recognition election because the increase in C's net unrealized section 751 gain did not arise as a result of basis adjustments under Prop. Treas. Reg. § 1.751-1(b)(3)(iii).

If the trigger for the application of the mandatory gain recognition rule were changed as described above, C would be required to recognize $66.67 of gain, increasing its basis to $100 before the distribution, thereby eliminating the section 734(b) adjustments and preventing A and B from having to recognize gain under section 751(b).

Under the Proposed Regulations, the distributee-partner is required to recognize capital gain unless an Election Out is made, in which case, the gain is ordinary income (or dividend income). Causing C to recognize $66.67 of capital gain seems inappropriate, since C had only a $33.33 share of capital gain in the partnership. Moreover, if C recognized capital gain, no basis adjustments would be made under Prop. Treas. Reg. § 1.751-1(b)(3)(iii) to the partnership's remaining hot assets, which would result in A and B increasing their shares of hot asset gain from $33.33 each to $50 each and decreasing their shares of gain in the capital asset from $33.33 each to $16.67 each. Finally, C would permanently avoid having to recognize its share of hot asset gain in the partnership's assets, since it will take a $100 basis in the distributed inventory.[103] Thus, we believe the character of the gain required to be recognized by the distributee-partner should be prorated based on its share of the built-in gain in the partnership's assets. Under that approach, half of C's $66.67 gain would be capital gain and half would be ordinary income (with appropriate adjustments made to the partnership's assets).[104]

[103] The problem with the character of the gain recognized under the mandatory gain recognition rule was also addressed above in the discussion of *Example 5*.

[104] If swapping of reverse section 704(c) amounts is not permitted or required and this approach is applied in *Example 5*, A would be required to recognize $33.33 of gain, which would all be ordinary. The basis in Asset 1

To summarize, we recommend that the Service and Treasury consider the following two changes to the mandatory gain recognition rule: (i) the distributee-partner is required to recognize gain sufficient to avoid any section 734(b) adjustment that would reduce a partner's net unrealized section 751 gain and (ii) the character of the gain is based on the distributee-partner's relative share of the built-in gain in the partnership's assets.[105]

D. Anti-Abuse Rules

Given the inherent complexity in section 751(b), and the trend in income tax regulations generally, it is not surprising that the Proposed Regulations contain a specific anti-abuse rule. As discussed above, the anti-abuse rule in the Proposed Regulations provides authority to recast a transaction to achieve results consistent with the purpose of section 751 if a taxpayer enters into a transaction with a principal purpose to achieve a tax result inconsistent with such purpose. We support this portion of the anti-abuse rule.[106] The Proposed Regulations, however, go on to set forth six transactions ("specified transactions") the presence of any one of which will create a presumption of a violation of the anti-abuse rule and a disclosure obligation at the partner level.

The Proposed Regulations do not specify what is needed to overcome the presumption. If the specified transactions are retained in the final regulations, we recommend a clarification that the presumption is rebuttable and a statement regarding the standard that would

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would be increased by $33.33 under Prop. Treas. Reg. § 1.751-1(b)(3)(iii), reducing A's reverse section 704(c) gain in Asset 1.

105 If the elective gain recognition rule is retained, similar changes should be made to it as well.

106 As discussed above, we recommend that the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) be strengthened and expanded to address the use of methods under section 704(c) to shift built-in hot asset gain among partners. We believe that expanded anti-abuse rule, the general partnership anti-abuse rule in Treas. Reg. § 1.701-2, and a general anti-abuse rule in the section 751(b) regulations should provide adequate protection against abusive transactions.

need to be satisfied to rebut the presumption.[107] The disclosure obligation is imposed on a partner if the partner participates in one of the specified transactions and "does not recognize and report its share of ordinary income from section 751 property on its tax return for the taxable year of the transaction."[108] The disclosure is required to be filed on Form 8275-R (or any appropriate successor form) disclosing the taxpayer's participation in the transaction for the taxable year in which the transaction occurred. Form 8275-R is the form used to disclose tax positions that are contrary to Treasury regulations. Form 8275, on the other hand, is the form used to disclose tax positions, other than those taken contrary to a regulation, that are not otherwise adequately disclosed. Form 8275 would seem to be the more appropriate form for disclosure, since the taxpayer would be taking a position that it believes is consistent with the regulations.

We believe the specified transactions should be eliminated, since we do not believe that the stakes involved in section 751(b) warrant the creation of presumptions and disclosure obligations for such transactions. Certain specified transactions are not inconsistent with the purpose of section 751, and the others could be addressed in a less onerous fashion through examples.[109]

The presumption and disclosure obligation in the Proposed Regulations impose a significant burden on partners. In order to determine whether a transaction is within one of the

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[107] Notwithstanding the use of the word "presumption" in the Proposed Regulations, some government officials have indicated that the anti-abuse rule is intended to be an outright rule that would require income inclusion. *See* Amy Elliott, "*Gerson Explains Four Times Test in Proposed Hot Asset Regs*," 2015 TNT 84-5 (May 1, 2015). The text of the Proposed Regulations is difficult to reconcile with such an interpretation, and we do not believe it would be appropriate tax policy. If, however, this was the intention, this part of the regulations, when finalized, should be substantially revised and restyled as a substantive rule rather than as an anti-abuse rule.

[108] Prop. Treas. Reg. § 1.751-1(b)(4)(ii).

[109] If the specified transactions are retained, as we stated above, we believe the presumption needs to be clarified and recommend retaining the disclosure obligation, albeit on Form 8275.

first five specified transactions, the partner (not the partnership) would be responsible for initially determining whether the partner "would otherwise be subject to section 751(b), but for the application of the principles of section 704(c)." It is not clear how a partner would be in a position to make this determination. Nor is it clear exactly how the determination would be made. One possible view is that this requires the partner to determine the consequences of the transaction under the gross value approach of the Existing Regulations, since that approach does not take into account the principles of section 704(c). If so, that would place a significant burden on partners solely for the purpose of determining whether a disclosure obligation exists, which is inconsistent with the regulations' stated purpose of reducing complexity. We believe the Service would be adequately apprised of potential abuses under section 751(b) through the general disclosure obligation[110] in the Proposed Regulations where a partnership makes a section 751(b) distribution and through our recommendation, discussed above, that partnerships be required to disclose on Form 1065 whether any hot assets were distributed during the year or whether there were any disproportionate distributions during the year.

While some of the six specified transactions clearly threaten the purpose of section 751(b), with respect to others, it is not quite as clear.

1. <u>Built-In Gain That Exceeds the Economic Interest</u>

The first of the six specified transactions arises when section 704(c) enables a partner to avoid the application of section 751(b) and the partner's interest in net section 751 unrealized gain is at least four times greater than the partner's capital account immediately after the distribution. In the Prior Report we suggested that the best approach for this type of

[110] Prop. Treas. Reg. § 1.751-1(b)(6).

transaction is to clarify the regulations under section 751(a) so that there is no doubt that the amount realized on the sale of a partnership interest is not a limitation on the amount of ordinary income that can be recognized under section 751(a). Because the Proposed Regulations made this clarification, it is not clear that this specified transaction is one that is inconsistent with the purpose of section 751(b). Regardless of the size of the distributee-partner's interest in the partnership, as long as the distributee-partner is still regarded as a partner in the partnership, the ordinary income potential is preserved to be recognized upon the partnership's disposition of the hot assets or upon the partner's sale of its remaining partnership interest.

The anti-abuse rule provides that the purpose of section 751 is to prevent a partner from converting ordinary income into capital gain "including by relying on the rules of section 704(c) to defer ordinary income while monetizing most of the value of the partnership interest." We cannot find support for the quoted language as being part of the purpose of section 751, and it was not previously identified as a purpose of section 751 in Notice 2006-14. In our Prior Report, we stated: "Notably, the legislative history of Section 751(b) does not appear concerned about the deferral of hot-asset gain. Rather, the legislative history is concerned with eliminating hot-asset gain from the tax system altogether and shifting hot-asset gain among partners." Moreover, as a result of the clarification to the regulations under section 751(a), this specified transaction does not allow the distributee-partner to convert ordinary income into capital gain.

In the Prior Report, we did suggest that it may be appropriate to provide a bright-line rule to prevent a distributee-partner from deferring reverse section 704(c) hot-asset gain where it retains an interest smaller than a specified amount. This suggestion was made in the context of the Existing Regulations, which arguably contained some uncertainty as to whether a partner's ordinary income under section 751(a) was limited to the amount realized from the sale of the partnership interest. The concern raised in the Prior Report was premised on an example in which the distributee-partner's reverse section 704(c) hot-asset gain was greater than its remaining interest in the partnership by a 50:1 ratio. Given the clarification to the regulations under section 751(a), we do not believe the transaction described in the first specified transaction is the type of transaction that should be presumed to violate the purpose of section 751(b), particularly not at the 4:1 ratio set forth in the Proposed Regulations.

### 2. Preferred Interest

The second specified situation involves a distribution in which section 704(c) enables a partner to avoid being subject to section 751(b) and at the time of the distribution or at any later date the distributee-partner holds a preferred interest in the partnership that substantially protects the partner from losses and has little to no participation in the profits other than a preferred return for the use of capital.

For the reasons stated above regarding the first specified transaction, we do not believe this specified transaction is inconsistent with the purpose of section 751(b). As a result of the clarification of the regulations under section 751(a), the distributee-partner will be subject to tax on its share of the reverse section 704(c) hot-asset gain even though its interest in the partnership is a preferred partnership interest.

In addition, this specified transaction raises an administrative issue, since it can become relevant at "any later date" when the distributee's interest becomes a preferred interest.[111] This specified transaction can therefore be implicated if the distributee's interest is

[111] This also raises a question about when disclosure would be required. Disclosure is required for the taxable year of the "transaction." If the transaction is the potential section 751(b) distribution, the disclosure couldn't

converted to a preferred interest years after the distribution at issue, perhaps even after the statute of limitations applicable to the year of the distribution has expired.

3. Reduction in Partner Net Value

The third specified situation arises when the hypothetical sale approach enables a partner to avoid being subject to section 751(b) and, at the time of the distribution or at any later time, the partner reduces its net value to less than the partner's tax liability associated with the partnership's section 751 property. This is plainly a situation in which the Service should be authorized to take measures that ensure that the partner's taxes will be paid. We believe this situation could be adequately addressed in an example describing this situation as within the scope of the general anti-abuse rule.

4. Transfer to Tax-Indifferent Party

The fourth specified transaction is when section 704(c) enables a partner to avoid being subject to section 751(b) and, at any time during the five years that follow the distribution, the distributee-partner transfers a portion of its partnership interest in a manner that does not cause ordinary income to be recognized and the transferee is exempt from or otherwise not subject to federal income tax. We agree that this is a potentially abusive situation. However, we believe this should be expanded to section 751 generally, including section 751(a), as the concerns are not limited to situations in which section 751(b) was not applied. As above, we recommend simply including an example describing this situation as within the scope of the general anti-abuse rule.

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possibly be made at such time if it wasn't known at such time whether the transaction was a specified transaction. Each of the other specified transactions that could occur in a later year raises the same concerns.

### 5. Partnership Transfer to a Corporation

The fifth specified transaction occurs when section 704(c) enables a partner to avoid being subject to section 751(b) and, at the time of the distribution or at any later date,[112] the partnership transfers hot assets to a corporation in a nonrecognition transaction other than pursuant to a transfer of all property used in a trade or business (other than assets that are not material to a continuation of the trade or business).[113] While the partnership's transfer to the corporation allows for the potential conversion of the partners' ordinary income into capital gain, the transfer to the corporation also results in an additional level of tax on the hot asset gain. As a result of the transfer of hot assets to the corporation in a nonrecognition exchange, the corporation will be subject to tax on the hot asset gain, and the partnership will be subject to tax (albeit capital gain) with respect to the stock. Thus, except in the limited circumstance where the corporation has net operating losses that would otherwise expire unused, there would not appear to be a loss to the fisc that would justify including this transaction as a specified transaction.

### 6. Recapitalizations

The last specified transaction occurs when the partners agree to change the manner in which they share the partnership's items of income, gain, loss, deduction or credit and that change reduces a partner's net unrealized gain from hot assets. Presumably, this rule would be implicated only if the partnership does not elect to revalue its assets in connection with the

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[112] The specified transaction draws an arbitrary distinction between contributions to corporations that occur prior to the partnership's distribution and contributions to corporations that occur after the partnership's distribution. Removal of the specified transactions would eliminate this arbitrary distinction.

[113] Note that this specified transaction would be implicated in connection with the incorporation of any (or all) the assets of a partnership that is not engaged in a trade or business, even if the incorporation arises in connection with a "check-the-box" election where the contribution would be deemed to be made to the corporation. *See* Treas. Reg. § 301.7701-3(g)(1).

recapitalization under Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(5)(v), since the revaluation would prevent the recapitalization from reducing a partner's net unrealized section 751 gain. Another possible way to address this concern would be to require revaluations in connection with a recapitalization of a partnership that owns hot assets.

If this specified transaction is retained, we would recommend an express exception for service partnerships, which may change partners' shares annually depending on their levels of performance without revaluing their assets. We believe such an exception would be appropriate because the adjustments to the partners' shares of partnership income are a common practice, done for business purposes, and in no way are done with a purpose of achieving a result inconsistent with section 751. Moreover, the partners in such partnerships are likely to all be in the same tax bracket, and as a result, the stakes to the government would likely be negligible.

E. De Minimis Exception

The Preamble states that the Service and Treasury continue to study whether a de minimis exception to section 751(b) should be added and requests comments describing possible parameters of such a rule. Because we believe that the stakes involved in section 751(b) do not justify its complexity in most cases, we believe a de minimis exception would help to limit the application of section 751(b) to situations in which the stakes could be significant. We continue support the suggestion made in the Prior Report to exclude distributions from section 751(b) in cases in which either (i) the distributing partnership has a relatively small amount of hot assets (*e.g.*, less than 10 percent of the gross assets of the partnership, disregarding assets acquired with a principal purpose of qualifying for the de minimis exception) or (ii) the hot assets distributed represent a relatively small amount of the assets being distributed (*e.g.*, less than 10 percent). This would lower the burden significantly on taxpayers and the Service in cases in which the stakes involved would not be significant, at least in relative terms.

There are probably a number of other ways to define whether a transaction should be subject to a de minimis exception. For example, partnerships with total assets that are less than a threshold amount could be exempted from section 751(b). In selecting a metric to be used to define those transactions or partnerships that should be eligible for a de minimis exception to section 751(b), we believe it is important that it be easy to apply. Any metric that would require taxpayers and the Service to go through all or a substantial portion of the mechanics of section 751(b) to determine whether a transaction is within the exception (*e.g.*, if the exception were for distributions that would result in the recognition of less than a threshold amount of income under section 751(b)) would defeat the purpose of the exception.

F. <u>Effective Dates</u>

We believe the Service and Treasury should allow for reasonable applications of the hypothetical sale approach for all prior distributions, not simply those that occur after the issuance of the Proposed Regulations. In the Prior Report, we stated:

> In light of the uncertainty and complexity of the Existing Regulations, it would be appropriate and helpful for implementing regulations to provide that Treasury will generally respect any reasonable, good-faith interpretation of the rules applicable under Section 751(b) for partnership distributions that predate any new regulations. Cf. Notice 2006-79, 2006-43 IRB 763, Section 3.01 (reasonable, good-faith interpretation of Section 409A respected in certain circumstances).

We recommend that the final regulations provide that Treasury and the Service will generally respect, and, thus, not raise on audit, any reasonable, good-faith interpretation of the rules applicable under section 751(b) for all partnership distributions that predate any final regulations, not simply those that occur after the issuance of the Proposed Regulations. Such interpretations would include reasonable applications of the hypothetical sale approach set forth in the Proposed Regulations.

### G. Possible Legislative Change to Section 751(b)

Although the Proposed Regulations are a substantial improvement over the Existing Regulations, the mechanical rules necessary to implement the purpose of section 751(b) are extremely complex: the Existing Regulations are complex, the Proposed Regulations are complex, and the Proposed Regulations would still be complex (albeit somewhat less so) even with our recommended changes. In preparing this report, we devoted considerable thought to whether any set of rules implementing section 751(b) could be simple and concluded that simplicity is not achievable and, as indicated in the Prior Report, it is not clear to us that the stakes at issue in protecting section 751(b) justify the complexity.

Rarely do we see partnership distributions that are designed to shift hot-asset gain among partners. Even if such distributions happen to result in shifts of gain from hot assets among the partners or conversion of ordinary income to capital gain, if there is no revenue loss to the government resulting from the shift, the burden placed on taxpayers to comply with, and the government to enforce, section 751(b) is difficult, if not impossible, to justify.[114] Ironically,

[114] Since the enactment of section 751(b) in 1954, there have been many calls for substantial reform or even outright repeal; however, it remains largely unchanged. *See, e.g.*, William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3, 52-55 (1991); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677, 713–717 (1998); Mark P. Gergen,

large corporations, with teams of internal tax professionals and outside advisors, are the most capable of handling the complexity of section 751(b), and yet they are the same taxpayers who are least likely to be affected by section 751(b), since they do not benefit from a rate difference between capital gains and ordinary income. Moreover, in many cases, all partners in a partnership are in the same tax bracket (either all U.S. individuals or all U.S. corporations). Even in such cases involving partnerships with all U.S. individuals, if a distribution results in a partner converting ordinary income into capital gain, as long as the aggregate amount of ordinary income is not reduced,[115] the application of the Proposed Regulations would produce no net revenue to the government. In the interest of sound tax administration, it would seem that a narrowly crafted anti-abuse rule would suffice to deal with the limited cases in which a distribution causes a shift in ordinary income among partners in a manner that results in a substantial reduction in aggregate tax liabilities (*e.g.*, partnerships between individuals and corporations, partnerships with tax-indifferent partners, and partnerships with C corporations that have expiring capital loss carryforwards).[116] We strongly encourage Congress and Treasury to reevaluate the purposes of, and stakes involved in section 751(b) and consider such an approach.

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*Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173, 200 (1991); Philip F. Postlewaite *et al., A Critique of the ALI's Federal Income Tax Project – Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423, 596–611 (1986). Indeed, in 1999 the Clinton Administration proposed a large, comprehensive modification to the rules governing partnership distributions, including a repeal of section 751(b). In addition, when the Treasury and IRS promulgated regulations under section 1(h) that implement a look-through approach when a partners sells or exchanges an interest in a partnership that has unrecaptured section 1250 gain or collectibles gain, they expressly declined to adopt an analogous regime under section 751(b) that prevents partnership distributions from causing shifts of income subject to higher capital gains rates, finding that "this would not be advisable." *See* section 1(h)(9); Treas. Reg. § 1.1(h)-1; T.D. 8902, 2000-41 C.B. 323, 324.

[115] Under current law, the aggregate amount of ordinary income can be reduced in connection with partnership distributions of capital and section 1231 assets to the extent basis adjustments under section 732 or section 734 displace ordinary income potential in such assets. Thus, we believe it would be important to retain rules in legislation or otherwise that are similar to those contained in Prop. Treas. Reg. § 1.732-1(c)(2)(iii)-(vi) and § 1.755-1(c)(2)(iii)-(vi) in order to prevent the overall reduction in ordinary income.

[116] Implicitly recognizing that there have to be limits on the complexity that can be imposed to protect section 751(b), even the Proposed Regulations relegate certain critical aspects to an anti-abuse rule. Under the

Proposed Regulations, a partner can take into account its share of ordinary income from hot assets under reverse section 704(c) principles to minimize the application of section 751(b) on the basis that such principles ensure that the partner will remain subject to tax on such amount of ordinary income. However, depending upon the section 704(c) method selected for the reverse section 704(c) layer, the partner may not remain subject to tax on that amount of ordinary income. As discussed above, the Preamble stated that the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) could properly address this concern. As the government would already relegate the protection of such a fundamental aspect of the Proposed Regulations to an anti-abuse rule rather than mandate the selection of a different section 704(c) method to prevent shifts of ordinary income among partners, it is at least worth considering whether all of section 751(b) can be relegated to an anti-abuse rule.