

New York State Bar Association Tax Section

Report on Temporary and Proposed Regulations under Section 337(d) and Section 732(f)

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Report on Temporary and Proposed Regulations under Section 337(d) and Section 732(f)

This report¹ (this “**Report**”) of the Tax Section of the New York State Bar Association comments on (i) temporary regulations² and proposed regulations³ under Section 337(d) (the “**337(d) Regulations**”), and (ii) proposed regulations under Section 732(f) (the “**732(f) Regulations**”). The 337(d) Regulations replace proposed regulations that were issued under Section 337(d) in 1992 (the “**Prior Regulations**”)⁴ and apply to transactions occurring on or after June 12, 2015.

This Report is divided into four parts. Part I provides a summary of our principal recommendations. Part II provides a summary of the 337(d) Regulations and the 732(f) Regulations. Part III contains a more detailed analysis of our observations and recommendations on the 337(d) Regulations. Part IV contains a more detailed analysis of our observations and recommendations on the 732(f) Regulations.

I. PRINCIPAL RECOMMENDATIONS

This Report makes the following principal recommendations:⁵

1. In defining the term Stock of the Corporate Partner for purposes of the 337(d) Regulations, an interest in an entity that is not controlled by the Corporate Partner should not be treated as Stock of the Corporate Partner if less than 20 percent of the assets of that entity consists of Stock of the Corporate Partner.
2. In cases where the deemed redemption rule does not apply because of the definition of “control,” the 337(d) Regulations should be clarified to provide that certain subsequent

¹ The principal author of this Report is Amanda Nussbaum. Phillip Gall and Eric Sloan provided significant contributions. Helpful comments were received from Stephen Land and Michael Schler. 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. Unless otherwise indicated, all references to section numbers are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

² T.D. 9722, 2015-26 I.R.B., 80 Fed. Reg. 33402 (June 12, 2015).

³ *Id.* The text of the temporary regulations serves as the text of the proposed regulations.

⁴ Notice of Proposed Rulemaking, REG-208989-90, 1993-1 C.B. 919, 57 Fed. Reg. 59324 (Dec. 15, 1992). The Prior Regulations have been withdrawn.

⁵ Capitalized terms used in this summary are defined in Part III below.

transactions would trigger gain recognition by treating each of those transactions as a Section 337(d) Transaction.

3. The affiliated group exception to the definition of Stock of a Corporate Partner should not be extended to partnerships owned by controlled foreign corporations that are owned entirely by a single affiliated group. However, the 337(d) Regulations should be clarified to provide that the exception applies to lower-tier partnerships that are owned by one or more upper-tier partnerships if the partnerships are ultimately owned entirely by a single affiliated group that includes the Corporate Partner.
4. An example should be included in the 337(d) Regulations of an acquisition by the partnership of Stock of the Corporate Partner that is not treated as a Section 337(d) Transaction.
5. The 337(d) Regulations should include an aggregation rule in which the interests of all members of an affiliated group in corporate stock and appreciated property are taken into account in determining whether the Corporate Partner has exchanged its interest in appreciated property for its stock.
6. The 337(d) Regulations could be coordinated with the provisions of Section 732(f) by providing a rule that reduces the amount of the basis step-down under Section 732(f) by the amount of gain recognized under the 337(d) Regulations.
7. We encourage the Treasury Department and the Internal Revenue Service to study further the special basis rule that applies for purposes of determining the partnership's basis in the Stock of the Corporate Partner distributed to the Corporate Partner in a Section 337(d) distribution and, in particular, whether this rule should apply solely to the Corporate Partner.
8. The inadvertence exception in the 337(d) Regulations should explicitly provide that the conduct does not need to have been inadvertent to satisfy the exception. Additionally, the second requirement of this exception should be retained.
9. Further examples should be added regarding tiered partnerships for purposes of both the 337(d) Regulations and the 732(f) Regulations.
10. The basis aggregation rule under the 732(f) Regulations should be extended to include a distributed corporation (including a controlled foreign corporation) that is owned by members of the distributee partners' consolidated group following the distribution.

II. BACKGROUND

A. The 337(d) Regulations

The purpose of the 337(d) Regulations, like the Prior Regulations, is to ensure that a corporation recognizes gain on the distribution of appreciated property. Since the repeal of the *General Utilities* doctrine,⁶ corporations generally have been required to pay tax on the distribution of appreciated property to shareholders under Section 311(b) and Section 336(a). However, corporations began using transactions involving partnerships to either defer or completely avoid the corporate-level tax on distributions of appreciated property. For example, a corporation could contribute appreciated property to a partnership, with another partner contributing the corporate partner's stock to the partnership. Then, after time had passed, the partnership would make a liquidating distribution of the corporate partner's stock to the corporate partner.⁷ By doing so, in reliance on the provisions of Subchapter K and Section 1032, the corporation would permanently avoid its gain on the appreciated property, since the use of the partnership as an intermediary side-stepped the application of Section 311(b). Section 311(b) would have required recognition of the appreciation had the corporation distributed the appreciated property. Instead, by using the partnership, the corporate partner would never recognize the gain inherent in the appreciated asset because that gain was shifted to the corporate partner's stock and protected against gain recognition under Section 1032.⁸

Variations on transactions like the one described above led to the issuance of Notice 89-37⁹ on March 9, 1989 by the Treasury Department and the Internal Revenue Service, which announced that future regulations under Section 337(d) would address the use of partnerships to avoid the repeal of the *General Utilities* doctrine and would require recognition of gain at the time of the contribution.¹⁰ On December 15, 1992, the Prior Regulations were published, which

⁶ In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), the Supreme Court held that corporations generally could distribute appreciated property to their shareholders without the recognition of any corporate level gain (the "**General Utilities doctrine**").

⁷ The cash contributor would receive the appreciated property in liquidation of its partnership interest, taking that property with a high basis under Section 732(b).

⁸ The targeted transaction is also referred to as the "May Company" transaction after a prominent example involving May Department Stores.

⁹ 1989-1 C.B. 679.

¹⁰ Legislative changes to Subchapter K since the issuance of the Prior Regulations have made these types of transactions more difficult to accomplish (*e.g.*, amendments to Section 704(c)(1)(B), Section 734 and Section 737 and the enactment of Section 731(c), Section 732(f), Section 755(c) and Section 7701(o)), as

addressed partnership transactions involving stock of a corporate partner. The Prior Regulations contained a deemed redemption rule and a distribution rule, as well as a *de minimis* and inadvertence exception to each rule. The deemed redemption rule required a corporate partner to recognize gain at the time of an exchange by the partner of its interest in appreciated property for an interest in its stock or the stock of a member in the corporation's affiliated group. The distribution rule required that a partnership's distribution to a corporate partner of the partner's own stock (or of a member of the partner's affiliated group) be treated as a redemption of the stock for a portion of the partner's interest in the partnership with a value equal to the value of the distributed stock.

The 337(d) Regulations retain the same purpose as the Prior Regulations and some of the same rules. However, the 337(d) Regulations also make some key changes described below. First, the 337(d) Regulations amend the definition of "Stock of a Corporate Partner" to include the stock or other equity interest of any corporation that controls the Corporate Partner within the meaning of Section 304(c) instead of using the Section 337(d) affiliate definition.¹¹ The 337(d) Regulations also introduce an exception for certain partnerships among affiliated partners.

Second, the 337(d) Regulations replace the distribution rule contained in the Prior Regulations with a new rule. The distribution rule had the potential of capturing transactions that did not implicate the repeal of the *General Utilities* doctrine.¹² For example, the distribution rule may have applied when a Corporate Partner exchanges an indirect interest in its own stock for a direct interest in its own stock. The 337(d) Regulations apply only to distributions of stock that have previously been the subject of a Section 337(d) Transaction or would become the subject of a Section 337(d) Transaction as a result of the distribution.¹³ If the distributed stock meets the above criteria, then in addition to any gain recognized under the deemed redemption rule, the

discussed in an earlier NYSBA report. See N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Impact of Legislative Changes to Subchapter K on the Proposed "May Company" Regulations under Section 337(d) and Technical Recommendations Regarding Affiliate Stock* (Rep. No. 1270, Aug. 15, 2012) (the "**2012 NYSBA Report**"). However, we do not believe that these legislative changes obviate the need for the 337(d) Regulations. The Preamble to the 337(d) Regulations similarly addresses this point.

¹¹ The terms "Stock of a Corporate Partner" and "Corporate Partner" are defined in Part III.A below (page 6).

¹² The distribution rule required a Corporate Partner to recognize gain when the partnership distributed Stock of the Corporate Partner to the Corporate Partner. This rule could have caused the Corporate Partner to recognize gain in an amount that exceeded the appreciation in the property effectively exchanged for the stock.

¹³ The term "Section 337(d) Transaction" is defined in Part III.C.1 below (page 10).

Corporate Partner must recognize gain to the extent that the partnership's basis in the distributed stock of the Corporate Partner exceeds the Corporate Partner's basis in its partnership interest (taking into account any cash distributed in the transaction). Furthermore, the 337(d) Regulations include an exception for transactions to which Section 732(f) applies and provide detailed rules with respect to the calculation of the gain to be recognized.

Many of the changes from the Prior Regulations reflect comments that we made prior reports.¹⁴ The Report contains a few additional technical comments and responds to some of the requests for comments that were made in the Preamble.

B. The 732(f) Regulations

Section 732(f) provides that if stock of a corporation is distributed by a partnership to a Corporate Partner, and, after the distribution, the Corporate Partner controls the distributed corporation (*i.e.*, owns stock meeting the requirements of Section 1504(a)(2)), then the basis of the assets of the distributed corporation must be reduced by an amount equal to the excess of (i) the partnership's basis in the stock of the distributed corporation immediately before the distribution, over (ii) the Corporate Partner's basis in the stock of the distributed corporation immediately after the distribution. The Corporate Partner is required to recognize gain to the extent the basis of the distributed corporation's property cannot be reduced. However, under Section 732(f)(3)(A), the amount of this reduction is limited to the excess of the sum of the aggregate adjusted basis of property and the amount of money of the distributed corporation over the Corporate Partner's basis in the stock of the distributed corporation.

Section 732(f) applies if the Corporate Partner either has control of the distributed corporation following the distribution or subsequently acquires control of the distributed corporation at any time afterwards. However, under Section 732(f)(2), this provision does not apply if the Corporate Partner does not have control of the distributed corporation immediately following the distribution and the Corporate Partner demonstrates that the distribution was not part of a plan to acquire control of the distributed corporation. Section 732(f)(8) provides that "the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations to avoid double counting and to prevent the abuse of such purposes."

¹⁴ See 2012 NYSBA Report. See also N.Y. ST. BA. ASS'N, TAX SEC., *Report on Notice 89-37* (Rep. No. 634, Nov. 30, 1989) (the "**1989 NYSBA Report**"); N.Y. ST. BA. ASS'N, TAX SEC., *Report on Proposed Regulations Implementing Notice 89-37* (Rep. No. 752, Mar. 3, 1993) (the "**1993 NYSBA Report**", and collectively with the 2012 NYSBA Report and the 1989 NYSBA Report, the "**Prior NYSBA Reports**").

As described in the Preamble to the 732(f) Regulations, Sections 732(f) and 337(d) share a common purpose of preserving corporate-level gains, and the 732(f) Regulations are intended to carry out the purposes of Sections 337(d) and 732(f). The Preamble notes that the Treasury Department and the Internal Revenue Service believe that, as currently applied, Section 732(f) may be too broad in some circumstances and too narrow in others.

The Preamble notes that, specifically, Section 732(f) may require basis reduction or gain recognition even though that basis reduction or gain recognition does not further the purposes of Section 732(f). In other circumstances, a Corporate Partner may inappropriately avoid the purpose of Section 732(f) by engaging in a transaction that allows the Corporate Partner to receive property held by a distributed corporation without reducing the basis of that property to account for basis reductions under Section 732(b) made when the partnership distributed stock of the distributed corporation to the Corporate Partner. Accordingly, the 732(f) Regulations add new rules to address both issues.

Specifically, these 732(f) Regulations include (i) provisions for the aggregation of bases of consolidated group members in a partnership; (ii) rules providing that, in the event of a gain elimination transaction, Section 732(f) applies as though the Corporate Partner acquired control of the distributing corporation immediately before the gain elimination transaction; and (iii) a requirement that taxpayers apply the 732(f) Regulations to tiered partnerships.

III. DISCUSSION OF THE 337(d) REGULATIONS AND RECOMMENDATIONS

A. Stock of the Corporate Partner

The 337(d) Regulations define “**Corporate Partner**” as a person that is classified as a corporation for U.S. federal income tax purposes and holds or acquires an interest in a partnership.¹⁵ “**Stock of the Corporate Partner**” is defined to include stock or other equity interests, including options, warrants or similar interests, in the Corporate Partner or a corporation that controls (within the meaning of Section 304(c)) the Corporate Partner.¹⁶ We recommend clarifying that this definition includes an equity interest issued by a third party on the stock of a Corporate Partner (*e.g.*, an option issued by a bank on the stock of a Corporate Partner), because

¹⁵ Temp. Reg. § 1.337(d)-3T(c)(1).

¹⁶ Temp. Reg. § 1.337(d)-3T(c)(2)(i).

Section 1032 would apply with respect to the Corporate Partner in the same manner to this type of equity interest.¹⁷

The definition also includes an interest in any entity (whether the entity is a corporation or partnership) to the extent that the value of the interest is attributable to the Stock of the Corporate Partner.¹⁸ This rule would apply regardless of whether the entity is controlled by the Corporate Partner.¹⁹ If the entity is controlled by the Corporate Partner, we agree that the interest in the entity should be treated as Stock of the Corporate Partner to the extent the value of the interest is attributable to Stock of the Corporate Partner. However, if the entity is not controlled, we recommend applying a test similar to the test that is used for purposes of determining whether an interest in an entity that owns marketable securities should be treated as a marketable security for purposes of Section 731(c).²⁰ Under that test, if less than 20 percent of the assets of an entity consist of Stock of the Corporate Partner, an interest in the entity would not be treated as Stock of the Corporate Partner.²¹ However, we do not recommend adopting the portion of that test that would treat the entire interest in an entity as Stock of the Corporate Partner if 90 percent or more of the assets of such entity consisted of Stock of the Corporate Partner.²² If this rule were adopted, it would result in a worse outcome for non-controlled entities than for controlled entities. Instead, we would recommend using the same rule for any entity if 20 percent or more of the assets of the entity consist of Stock of the Corporate Partner, whether or not such entity is controlled.

¹⁷ See Section 1032(a), which provides that a corporation will not recognize gain or loss with respect to its acquisition of an option, and Treas. Reg. § 1.1032-3(d), which provides that the rules under Section 1032 apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules apply to the stock of an issuing corporation. If the option were issued by a third party, this rule would still apply since if the option were distributed to the Corporate Partner, the Corporate Partner would not recognize gain under Section 1032 on either the distribution or sale of the option.

¹⁸ Temp. Reg. § 1.337(d)-3T(c)(2)(i).

¹⁹ For this purpose, control should be defined as (i) in the case of a corporation, at least 80 percent by vote and by value, and (ii) in the case of a partnership, at least 80 percent of the capital or profits interests.

²⁰ Treas. Reg. § 1.731-2(c)(3).

²¹ Treas. Reg. § 1.731-2(c)(3)(ii).

²² Treas. Reg. § 1.731-2(c)(3)(i).

B. “Control”

1. General

The definition of Stock of a Corporate Partner in the Prior Regulations was limited to stock or equity interests issued by the Corporate Partner and its Section 337(d) affiliates.²³ The 337(d) Regulations do not apply to a partnership that owns, acquires or distributes stock of any Section 337(d) affiliate unless the affiliate possesses Section 304(c) control of the Corporate Partner.²⁴ By replacing the affiliated group standard with the control standard in Section 304(c), the 337(d) Regulations lower the ownership threshold from 80 percent to 50 percent. However, in determining Section 304(c) control, the 337(d) Regulations provide that Section 318(a)(1) (attribution among family members) and Section 318(a)(3) (attribution to corporations or other entities) do not apply.²⁵ This effectively limits the definition of Stock of the Corporate Partner to corporations that own an interest directly or indirectly in the Corporate Partner. The Preamble notes that the Treasury Department and the Internal Revenue Service continue to study the application of these provisions and issue additional guidance, as needed, to address further abuses in this area, and solicits comments regarding that guidance.

While we agree that it is appropriate to exclude attribution to corporations or other entities, we are not sure it is appropriate to exclude family attribution. The following example demonstrates this point:

Example 1: Husband owns 90 percent of Corporation A that owns 49 percent of Corporate Partner. Wife owns 90 percent of Corporation B that owns 49 percent of Corporate Partner. Corporate Partner owns an interest in Partnership. Under these facts, because Section 304(c) control is determined without applying Section 318(a)(1) (attribution among family members), neither A nor B control the Corporate Partner. Accordingly, other partners in Partnership would be able to contribute stock of Corpora-

²³ Prior Prop. Reg. § 1.337(d)-3(c). Under the Prior Regulations, a corporation was treated as a Section 337(d) affiliate of the Corporate Partner if the corporation and the Corporate Partner were members of an affiliated group as defined in Section 1504(a), without regard to Section 1504(b).

²⁴ Temp. Reg. § 1.337(d)-3T(c)(2)(i).

²⁵ Temp. Reg. § 1.337(d)-3T(c)(2)(i). The 337(d) Regulations initially did not contain this limitation on the application of the attribution rules. However, a correction was immediately issued that clarified that these attribution rules do not apply for purposes of determining whether a corporation controls the Corporate Partner within the meaning of Section 304(c).

tion A and Corporation B to Partnership in exchange for an interest in Partnership without triggering gain to Corporation A or Corporation B.

We would like to confirm whether this result was intended.

We also believe that in cases where the deemed redemption rule does not apply because of the more limited definition of Stock of the Corporate Partner, the 337(d) Regulations should be clarified to provide that certain subsequent transactions would trigger gain recognition by treating those transactions as a Section 337(d) Transaction.²⁶ For example, suppose Parent contributes an appreciated asset to a partnership that owns or acquires Subsidiary stock. At a later time, Parent contributes the partnership interest to Subsidiary in a Section 351 contribution. We recommend that an example be added to confirm that the deemed redemption rule applies at the time of the contribution of the partnership interest to Subsidiary, with the result that the Parent would recognize gain on the portion of the appreciated asset exchanged at the time of the initial partnership contribution.²⁷ Further, if, after the partnership liquidates, a corporate restructuring results in the elimination of the original built-in-gain in the contributed asset (for example, a Section 332 liquidation eliminates the Subsidiary stock that the Corporate Partner received from the partnership), we believe that the deemed redemption rule should apply to tax the built-in-gain that would otherwise be eliminated as a result of the restructuring, and an example should be added to confirm that result.²⁸

2. Affiliated Group Exception

The 337(d) Regulations provide an exception for certain partnerships. Under this exception, Stock of the Corporate Partner does not include any stock or other equity interest held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group defined in Section 1504(a) that includes the Corporate Partner.²⁹ The Preamble solicits comments on whether this exception should be extended, for example, to partnerships owned by controlled foreign corporations that are owned entirely by a single affiliated group. We do not believe this exception should be extended to partnerships owned by controlled foreign corporations since this type of transaction could effect a repatriation of a built-in-gain

²⁶ See 2012 NYSBA Report, at 33. We note that this is consistent with the analysis in Temp. Reg. § 1.337(d)-3T(h), Example 4.

²⁷ *Id.*

²⁸ *Id.*

²⁹ Temp. Reg. § 1.337(d)-3T(c)(2)(ii).

asset without tax and, therefore, result in gain elimination.³⁰ However, we do believe that the 337(d) Regulations should be clarified to provide that this exception applies to a lower-tier partnership that is owned by one or more upper-tier partnerships if such upper-tier partnerships are owned entirely by a single affiliated group defined in Section 1504(a) that includes the Corporate Partner.³¹

Example 2: Parent owns 100 percent of each of Subsidiary 1 (“**S1**”) and Subsidiary 2 (“**S2**”). S1 and S2 each own 50 percent of upper-tier partnership (“**UTP**”). UTP and Parent each own 50 percent of lower-tier partnership (“**LTP**”). LTP acquires stock of Parent.

The regulations, when finalized, should be clarified to confirm that the exception applies to LTP because UTP is ultimately owned entirely by a single affiliated group that includes the Corporate Partner.

C. Deemed Redemption Rule

1. General

Under the 337(d) Regulations, a “**Section 337(d) Transaction**” occurs if a transaction has the effect of an exchange of appreciated property for Stock of the Corporate Partner.³² The Preamble provides that, in certain limited circumstances, a partnership’s acquisition of Stock of the Corporate Partner does not have such an effect. As an example, the Preamble states that the regulations should not apply if a partnership with an operating business uses the cash generated in that business to purchase Stock of the Corporate Partner because the Corporate Partner’s share in appreciated property has not been reduced (and, accordingly, no exchange of appreciated property for Stock of the Corporate Partner has occurred).

However, the 337(d) Regulations do not contain specific language or an example that provides for this operating cash exception. Accordingly, it is not clear whether the regulations should apply to other acquisitions of the Stock of the Corporate Partner for cash.³³

³⁰ See 2012 Report, at 49.

³¹ See Temp Reg. § 1.337(d)-3T(g) (providing that these regulations should be applied to tiered partnerships in a manner consistent with the regulations’ purpose).

³² Temp. Reg. § 1.337(d)-3T(c)(3).

³³ See Deanna Walton Harris, *Long Awaited Section 337(d) Regulations Leave Some Questions Unanswered*, CORP. TAX’N (WG&L) (Sep.–Oct. 2015).

Example 3: Assume that X, a corporation, transfers cash to a partnership in exchange for a 50 percent interest. A, an individual, contributes property in exchange for the remaining interest in the partnership. If the partnership immediately uses the cash to acquire stock in X from B, an existing shareholder in X, the transaction arguably does not have the effect of an exchange by X of appreciated property in exchange for its own stock. If X had instead redeemed the stock held by B with its own cash, X would not have recognized gain or loss as a result of the redemption.³⁴

We believe that it would be useful if the regulations included examples of transactions that do not have the effect of an exchange of appreciated property for Stock in the Corporate Partner, which would include the operating cash exception from the Preamble, as well as the example above.

2. Aggregation of Interests Owned by Members of an Affiliated Group

As described in Section II.B.2 above, the 337(d) Regulations provide that the Stock of the Corporate Partner does not include any stock or other equity interest held or acquired by a partnership if all of the interests in the partnership are held by members of an affiliated group that includes the Corporate Partner. However, because this exception does not apply to a partnership in which some, but not all, of the interests are owned by members of an affiliated group, the exception would not be available in that case even though there may not be a reason to cause gain recognition.³⁵

Example 4: Parent, Subsidiary, and individual A form a partnership. Parent owns all of the stock of Subsidiary, and Parent and Subsidiary file a consolidated federal income tax return. Parent contributes appreciated property to the partnership. Subsidiary and A each contribute cash to the partnership. In exchange for their contributions, Parent and Subsidiary each receive a 49 percent interest in the partnership and A receives a 2 percent interest. The partnership uses the contributed cash to acquire Parent stock.

As a result of this transaction, Parent has effectively acquired an interest in its stock that the partnership acquired with A's cash in exchange for an interest in the appreciated asset Parent contributed to the partnership. However, unless an exception applied, Parent would also be treat-

³⁴ *Id.* While not relevant to the 337(d) Regulations, we also note that, at the time of the formation of the partnership, X has no interest in the appreciation in the contributed property because all of the pre-contribution gain in the property would be allocated to A under Section 704(c) if the partnership sold the contributed property.

³⁵ *Id.*

ed as acquiring an interest in its stock with cash contributed by Subsidiary.³⁶ We believe that an aggregation rule in which members of an affiliated group are treated as a single taxpayer should apply to determine whether the Corporate Partner has exchanged its interest in appreciated property for its stock.³⁷

3. Corporate Partner's Interest in Partnership Property

The 337(d) Regulations provide that the Corporate Partner's economic interest with respect to both Stock of the Corporate Partner and all other appreciated property of the partnership be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement.³⁸ While the examples addressing non pro rata distributions³⁹ and changes in allocation ratios⁴⁰ are helpful, it might be useful to consider additional examples to provide guidance on how to measure a Corporate Partner's economic interest with respect to partnership property in other than the simplest cases (*e.g.*, where the partnership agreement contains a complex distribution waterfall).⁴¹

4. Amount of Gain Recognized on the Exchange

The 337(d) Regulations provide that the gain under the deemed redemption rule is generally determined by reference to the gain that would be recognized by the Corporate Partner from the appreciated property that is the subject of the exchange if all the partnership's assets were sold for their fair market values, applying the principles of Section 704(c), including any remedial allocations under Treasury Regulations §1.704-3(d) for a partnership that has elected the remedial allocation method.⁴² It would be helpful if the regulations also specifically confirmed

³⁶ *Id.*

³⁷ As described in Section IV.A below (page 17), we note that the 732(f) Regulations contain a rule that aggregates the bases of consolidated group members in a partnership for purposes of applying Section 732(f) under certain circumstances.

³⁸ Temp. Reg. § 1.337(d)-3T(d)(2).

³⁹ Temp. Reg. § 1.337(d)-3T(h), Example 3.

⁴⁰ Temp. Reg. § 1.337(d)-3T(h), Examples 5–7.

⁴¹ *See* 1989 NYSBA Report, at 27–33; 1993 NYSBA Report, at 11.

⁴² Temp. Reg. § 1.337(d)-3T(d)(3).

that any adjustments under Section 743(b) would be taken into account in determining the amount of such gain.⁴³

5. Character of Gain Recognized on the Exchange

The 337(d) Regulations are silent on the character of the gain recognized as a result of the deemed redemption. The regulations should clarify that the character is determined by reference to the property that is the subject of the exchange by the Corporate Partner as if it were sold to an unrelated party for fair market value.⁴⁴

6. Basis Adjustments

The 337(d) Regulations require that the partnership increase its adjusted tax basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction by the amount of gain recognized by the Corporate Partner with respect to that property as a result of the Section 337(d) transaction.⁴⁵ Under the regulations, this basis increase applies whether or not the partnership has a Section 754 election in effect.⁴⁶ It would be helpful if the regulations provided that the basis increase is to be treated as newly purchased property for purposes of determining basis recovery and is to be taken into account in determining the remaining Section 704(c) amounts in the property with respect to the Corporate Partner.⁴⁷

⁴³ We do not believe it is necessary to confirm that any adjustments under Section 734(b) would be included since these adjustments are common basis to the partnership.

⁴⁴ While this rule is different than the character rule under Section 704(c)(1)(B), which provides that the character of the gain or loss generally is determined as if the partnership sold the property to the distributee partner (which could be a related party), we recommend this different approach because the exchange between the Corporate Partner and the other partners under the 337(d) Regulations is only a deemed exchange. Unlike the case of a distribution described in Section 704(c)(1)(B), the property remains inside the partnership.

⁴⁵ Temp. Reg. § 1.337(d)-3T(d)(4)(ii).

⁴⁶ Temp. Reg. § 1.337(d)-3T(d)(4)(ii).

⁴⁷ *See, e.g.*, Prop. Reg. § 1.751-1(b)(iii) (providing that Section 704(c) amounts must be adjusted in the event of any adjustments to basis as a result of a Section 751 distribution).

D. Partnership Distributions of Stock of the Corporate Partner

1. General

Although the 337(d) Regulations have removed the distribution rule of the Prior Regulations, they have replaced that rule with a rule that is an extension of the deemed redemption rule to certain distributions to the Corporate Partner of the Stock of the Corporate Partner.⁴⁸ This rule applies only if the distributed stock has previously been the subject of a Section 337(d) Transaction or becomes the subject of a Section 337(d) Transaction as a result of the distribution.⁴⁹ Significantly, the regulations do not apply to a distribution to the Corporate Partner of the Stock of the Corporate Partner to which Section 732(f) applies at the time of the distribution (the “**Section 732(f) Exception**”).⁵⁰ In light of the definition of “control” in Part III.B.1 for purposes of the definition of Stock of the Corporate Partner, we believe that it would be rare for both the 337(d) Regulations and the Section 732(f) rules to apply to the same distribution.⁵¹

The Preamble notes that while the Section 732(f) Exception generally ensures that gain recognized as a result of the 337(d) Regulations will not be duplicated as a result of Section 732(f), duplication may still result in certain circumstances. For example, if a Corporate Partner recognizes gain under Section 337(d) on a partnership distribution and Section 732(f) does not apply to the distribution because the Section 732(f) control requirement is not satisfied at the time of the distribution, but the control requirement is subsequently satisfied, triggering Section 732(f), then the Corporate Partner could have to reduce the basis of the assets of the distributed corporation even though it already recognized gain under the 337(d) Regulations. The Preamble solicits comments on how these regulations should be coordinated with Section 732(f). We recommend coordinating these provisions by reducing the amount of the basis step-down (or gain recognition) under Section 732(f) by the amount of gain recognized under the 337(d) Regulations.

⁴⁸ This rule could also be viewed as functioning as a “super Section 732(f)” rule.

⁴⁹ Temp. Reg. § 1.337(d)-3T(e)(1).

⁵⁰ Temp. Reg. § 1.337(d)-3T(e)(1).

⁵¹ An example where there would be an overlap is the following:

Parent owns 90 percent of S1, which owns 100 percent of S2. S2 is a partner in Partnership, and Partnership owns the remaining 10 percent of S1. If Partnership distributes the S1 stock to S2, Section 732(f) would apply (because S2 has control of S1 after the distribution within the requirements of Section 1504(a)(2)) even though the distribution would also be treated as Section 337(d) Transaction under Temp. Reg. § 1.337(d)-3T(c)(3)(iv) (distribution to the Corporate Partner of the Stock of the Corporate Partner).

2. Computation of Basis

The 337(d) Regulations set forth two rules under Section 337 and Section 732 to coordinate the effects of the rule requiring gain recognition when the basis of the Stock of the Corporate Partner is stepped down on a Section 337(d) distribution with the existing rules for determining the basis of property upon partnership distributions under Section 732. The first rule applies (i) for purposes of determining the basis of property distributed to the Corporate Partner (other than the basis of the Corporate Partner in its own stock), the basis of the Corporate Partner's remaining partnership interest, and the partnership's basis in the undistributed stock of the Corporate Partner, and (ii) for purposes of computing gain recognized by the Corporate Partner on the distribution.⁵² The second rule applies when a Corporate Partner receives both Stock of the Corporate Partner and other property in a Section 337(d) distribution.⁵³

For purposes of the first rule, the partnership's basis in the Stock of the Corporate Partner distributed to the Corporate Partner is treated as being equal to the greater of: (i) the partnership's actual basis in that distributed stock of the Corporate Partner immediately before the distribution, or (ii) the fair market value of that distributed stock of the Corporate Partner immediately before the distribution less the Corporate Partner's allocable share of gain from all of the Stock of the Corporate Partner if the partnership sold all of its assets 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 before the distribution.⁵⁴ The Preamble notes that this special rule is necessary to prevent basis from shifting away from the distributed Stock of the Corporate Partner to other property.⁵⁵ The Preamble also solicits comments on this rule, including comments on whether its objectives would be better achieved through guidance under Section 732 providing that on a distribution of a partial interest in partnership property, the basis of the distributed property is determined by taking the principles of Section 704(c) into account with respect to the distributee partner.

⁵² Temp. Reg. § 1.337(d)-3T(e)(2)(ii).

⁵³ Temp. Reg. § 1.337(d)-3T(e)(2)(i); Temp. Reg. § 1.732-1T(c)(1)(iii).

⁵⁴ Temp. Reg. § 1.337(d)-3T(e)(2)(ii); Temp. Reg. § 1.337(d)-3T(h), Ex. 2 and 3. The Preamble specifically notes that the issue of whether the Corporate Partner has basis in the stock received in the distribution is beyond the scope of the regulations and no implication is intended from these rules with respect to this issue.

⁵⁵ We note that the effect of this provision is to attract basis to the distributed Stock of the Corporate Partner, which would increase the likelihood of the application of this rule.

In our view, this special basis rule works towards the goal of tracking built-in-gain and, therefore, has meaningful support under current law. Accordingly, we would encourage the Treasury Department and the Internal Revenue Service to further study this rule. As written, it is not clear whether this special rule applies solely to the Corporate Partner or whether it applies for all purposes. For this reason, we would recommend expanding Example 3 to discuss the basis that each of AX partnership and A has in the X stock that is distributed to A.⁵⁶

3. Gain Recognition

If a distribution is a Section 337(d) distribution, then, in addition to any gain recognized under the deemed redemption rule, the 337(d) Regulations also require the Corporate Partner to recognize gain to the extent the partnership's *basis* in the distributed Stock of the Corporate Partner exceeds the Corporate Partner's *basis* in its partnership interest (*as reduced by any cash distributed in the transaction*) immediately *before* the distribution.⁵⁷ We note that the language used in this provision differs from the gain recognition provision in Section 732(f), which evaluates whether the partnership's *adjusted basis* in the distributed stock immediately before the distribution exceeded the Corporate Partner's *adjusted basis* in that stock immediately *after* the distribution.⁵⁸ It would be helpful to understand whether these differences were intentional and, if so, the rationale for the differences.⁵⁹

E. Exceptions to the Deemed Redemption and Distribution Rules

The 337(d) Regulations contain two exceptions: the *de minimis* rule and the inadvertence rule.⁶⁰ In order to meet the inadvertence rule, two requirements need to be satisfied.⁶¹ First, the

⁵⁶ See Temp. Reg. § 1.337(d)-3T(h), Ex. 3, clause (v), which discusses only X's basis in the distributed X stock and in the distributed asset. For example, if the X stock distributed to A would have a basis of \$25 (25% of the X stock's \$100 basis), there would be a replication of basis. Instead, if that X stock would have a basis of \$0, the 337(d) Regulations would have an unintended effect on partners other than the Corporate Partner.

⁵⁷ Temp. Reg. § 1.337(d)-3T(e)(3).

⁵⁸ Section 732(f)(1)(C).

⁵⁹ As described in footnote 47 above (page 13), this distribution rule could be viewed as functioning as a "super Section 732(f)" rule. Accordingly, it is not clear why gain is recognized under this provision under the approach used in the 337(d) Regulations, rather than applying the Section 732(f) approach of reducing the basis in the assets of the distributed corporation.

⁶⁰ Temp. Reg. § 1.337(d)-3T(f).

⁶¹ Temp. Reg. § 1.337(d)-3T(f)(2).

partnership must, by sale or distribution, dispose of the stock of the Corporate Partner before the due date (including extensions) of its federal income tax return for the taxable year in which the partnership acquired the stock (or in which the Corporate Partner joined the partnership, if applicable).⁶² Second, the partnership must not have distributed the Stock of the Corporate Partner to the Corporate Partner or a person possessing control of the Corporate Partner (within the meaning of Section 304(c)).⁶³

While the inadvertence rule does not apply if the Stock of the Corporate Partner was acquired as part of a plan to circumvent the purpose of the 337 Regulations, it does not appear that the conduct needs to have been inadvertent to benefit from this exception. One example that could satisfy this exception where the conduct may not have been inadvertent would be the use of the Stock of the Corporate Partner to compensate employees or to permit the partnership to acquire assets using Stock of the Corporate Partner.⁶⁴ It would be helpful if this could be clarified by either changing the title of this exception or otherwise providing as such in the regulations.

The Preamble solicits comments with respect to removing the second requirement of the inadvertence rule, the prohibition against a distribution of the Stock of the Corporate Partner to the Corporate Partner, in light of Section 737. We do not believe that this requirement should be removed, because the distribution could fall outside the scope of Section 737 if, for example, the Corporate Partner contributed the appreciated asset to the partnership more than seven years before the partnership acquired the stock of the Corporate Partner.⁶⁵ In that case, even if the first requirement of the inadvertence rule is satisfied, if the Stock of the Corporate Partner is distributed to the Corporate Partner, the Corporate Partner could avoid corporate level gain.

F. Tiered Partnerships

The 337(d) Regulations require taxpayers to apply the regulations to tiered partnerships in a manner consistent with the purpose of the regulations.⁶⁶ The regulations provide an example

⁶² Temp. Reg. § 1.337(d)-3T(f)(2)(i).

⁶³ Temp. Reg. § 1.337(d)-3T(f)(2)(ii).

⁶⁴ See Treas. Reg. § 1.1032-3; Rev. Rul. 99-57, 1999-2 CB 678.

⁶⁵ See also 2012 NYSBA Report, at 13–14 (providing more generally that Section 737 does not prevent May Company transactions and that the seven-year waiting period of Section 737 does not obviate the need for the deemed redemption rule under the Prior Regulations).

⁶⁶ Temp. Reg. § 1.337(d)-3T(g).

of the operation of the deemed redemption rule in the context of a tiered partnership.⁶⁷ While we appreciate the inclusion of this example and understand the challenges involved in creating more detailed rules, it would be useful if the regulations could provide more guidance on the operation of the tiered partnership rules, including confirmation that the affiliated group exception discussed above applies to tiered partnerships⁶⁸ and the inclusion of an example of when the deemed redemption or distribution rule would not apply to a tiered partnership.

G. Technical Comment on Example 7

The math in the last sentence of clause (i) of Example 7 does not seem to work correctly (*i.e.*, how can *X* and *A* be equal partners if they started out as 99/1 partners and then both made contributions with a value of \$100).⁶⁹

IV. DISCUSSION OF THE 732(f) REGULATIONS AND RECOMMENDATIONS

A. Aggregation of Basis Adjustments

The 732(f) Regulations provide for the aggregation of basis within the same consolidated group (as defined in Treasury Regulations § 1.1502-1(h)), for purposes of Section 732(f), when two conditions are met.⁷⁰ First, two or more of the corporate partners receive a distribution of stock in a distributed corporation.⁷¹ Second, the distributed corporation is or becomes a member of the distributee partners' consolidated group following the distribution.⁷² Under this basis aggregation rule, Section 732(f) applies only to the extent that the partnership's adjusted basis in the distributed stock immediately before the distribution exceeds the aggregate basis of the distributed stock in the hands of all members of the distributee Corporate Partners' consolidated group immediately after the distribution.

The Preamble notes that requirement that the distributed corporation be a member of the consolidated group is intended to avoid unintended consequences that could result if that corporation was a controlled foreign corporation. The Preamble solicits comments on whether this

⁶⁷ Temp. Reg. § 1.337(d)-3T(h), Ex. 8.

⁶⁸ See Part III.B.2 (page 9).

⁶⁹ Temp. Reg. § 1.337(d)-3T(h), Ex. 7.

⁷⁰ Prop. Reg. § 1.732-3(b).

⁷¹ Prop. Reg. § 1.732-3(b)(1).

⁷² Prop. Reg. § 1.732-3(b)(2).

proposed rule should apply more broadly. We do not believe that there is a reason for the requirement that the distributed corporation be a member of the distributee partners' consolidated group following the distribution. Instead, we would extend the rule to a distributed corporation (including a controlled foreign corporation) that is owned directly or indirectly by members of the distributee partners' consolidated group following the distribution. We do not see any unintended consequences of extending this rule to include a distributed corporation that is a controlled foreign corporation.

Example 5: Parent, and its wholly owned subsidiaries, S1 and S2, are members of a consolidated group. S1 and S2 each own 50 percent of Partnership. S1 has a \$0 basis in its interest in Partnership, which has a \$150 value. S2 has a \$100 basis in its interest in Partnership, which also has a \$150 value. Partnership's only asset is the stock of a wholly-owned controlled foreign corporation ("CFC"). Partnership has a \$100 basis in the stock of CFC and CFC has a \$100 basis in its assets. The stock and assets have a value of \$300. Partnership liquidates, distributing half the CFC stock to S1 and half the CFC stock to S2.

Assuming that none of the exceptions to nonrecognition applies, Section 732(f) would apply to this transaction. S1 and S2 each control CFC because their ownership is combined for purposes of determining control.⁷³ The CFC stock distributed to S1 has a basis in the hands of Partnership of \$50, which is reduced to zero in connection with the distribution under Section 732(b). The basis in the CFC stock distributed to S2, which also has a basis in the hands of Partnership of \$50, is increased to \$100 in connection with the distribution under Section 732(b).

If the basis in the CFC stock is not aggregated, even though the stock was aggregated for purposes of determining control, CFC will have to reduce the basis of its assets by \$50 as a result of the distribution to S1. However, Section 732(f) does not permit CFC to increase the basis of its assets for the increase in the basis of the CFC stock distributed to S2. As a result, unless the exception in the 732(f) Regulations is extended, the CFC would be required to step down the basis of its assets under Section 732(f) even though there has not been a step down in the basis of the CFC stock in the hands of the consolidated group members in the aggregate. In our view, the purpose of Section 732(f) is to ensure that the \$200 of built-in gain in S1's and S2's interests in Partnership is preserved in CFC's assets. It should not, however, increase the built-in gain in CFC's assets to \$250. Therefore, we support the extension of the rule to a distributed corporation

⁷³ Treas. Reg. §1.732-3.

if stock of the distributed corporation constituting control under Section 732(f) is owned by members of the distributee partners' consolidated group following the distribution.

B. Tiered Partnerships

Similar to the 337(d) Regulations, the 732(f) Regulations require taxpayers to apply the regulations to tiered partnerships in a manner consistent with the regulations' purpose.⁷⁴ There are no examples that illustrate the application of this rule. While we understand the challenges involved, it would be useful if the regulations could provide guidance on the operation of the tiered partnership rules, including addressing the following two examples:

Example 6: Parent owns 80 percent of UTP. UTP owns 100 percent of Subsidiary. Subsidiary owns 80 percent of LTP. UTP distributes stock of Subsidiary to Parent and the basis in the stock is reduced under Section 732.

It is not clear whether the step-down in the basis of the Subsidiary's assets under Section 732(f) should apply only to Subsidiary's basis in LTP or whether LTP is also required to step-down its basis in its assets.⁷⁵

Example 7: Parent and S1 own 100 percent of UTP. UTP owns an interest in LTP. LTP owns 100 percent of the stock of S2. LTP distributes all of the S2 stock to UTP.

By its terms, Section 732(f) does not apply to this example because there is no distribution to the Corporate Partner. If the tiered partnership rule was intended to cause Section 732(f) to apply to this example, the 732(f) Regulations should provide accordingly.

⁷⁴ Prop. Reg. § 1.732-3(d).

⁷⁵ If LTP is required to step-down its basis in its assets, the reduction should only be with respect to Subsidiary (and not the other partners in LTP). *Cf.* Rev. Rul. 92-15, 1992-1 CB 215; Prop Reg § 1.734-1(f)(1).