REPORT #634

TAX SECTION

New York State Bar Association

REPORT ON NOTICE 89-37

by the Committee on Corporations and
the Committee on Partnerships

November 14, 1989

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TAX SECTION
New York State Bar Association

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November 14, 1989

The Honorable Kenneth W. Gideon
Assistant Secretary of the
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3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
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Dear Mr. Gideon:

Enclosed is a joint Report by our Committee on Corporations and our Committee on Partnerships on Notice 89-37, dealing with the use of partnerships to avoid the repeal of the General Utilities doctrine. The principal draftsmen of this Report are Michael L. Schler and Steven C. Todrys.

The Report agrees with the theory of the Notice that, following repeal of the General Utilities doctrine, the full amount of gain on an appreciated asset must either be taxed currently or else preserved for future taxation, and it should not be possible to permanently eliminate such gain through transactions involving stock of the corporation owning the appreciated asset. The Report supports the application of the aggregate rather than the entity theory of partnership taxation in determining the appropriate time to tax such gain and the appropriate amount of gain to be taxed.

Consequently, the Report supports, with two modifications, the rule in the Notice under which a corporate partner would have a deemed § 311 redemption of its stock when it exchanges an interest in appreciated property for an interest in its stock. However, because the proposed rule does

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not currently tax or else preserve all appropriate gain on the appreciated asset, the Report suggests modifications to that rule. One would impose a tax currently when the § 732 basis allocation rules result in the shifting of unrealized appreciation to corporate stock where it will never be realized because of § 1032. The other would impose a tax currently when a corporate partner receives from the partnership shares of its stock that were previously attributable to the capital account of other partners and where appreciation on that stock would otherwise escape taxation because of § 1032. Both of these situations would be covered by the broader rule contained in the Notice described below which the Report opposes because of its overbreadth, and these suggestions are intended to be more precisely targeted to the problem.

The Report opposes the second rule in the Notice that would treat any distribution by a partnership of stock of a corporate partner to that partner as a taxable § 311 redemption of the stock with the partnership interest. The Report concludes that the second rule is inconsistent with the first rule described above because (unlike the first rule) it is based on the entity rather than the aggregate theory of partnership taxation, it inappropriately taxes appreciation in stock of the corporate partner that was previously attributable to its own capital account and therefore should be exempt from tax under § 1032, and it is unnecessary in order to tax the correct amount of appreciation required by General Utilities repeal once the proposed modifications suggested above are made to the first rule. The Report does not however, oppose the adoption of the second rule solely as a transition rule to cover partnership distributions occurring after the date of the Notice where the first rule would have applied to a partnership transaction if it had occurred after the date of the Notice.

Sincerely,

Wm. L. Burke
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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON NOTICE 89-37[1/]

by the Committee on Corporations and
the Committee on Partnerships
November 14, 1989

1. Introduction

In March 1989, the Internal Revenue Service issued Notice 89-37, 1989-13 I.R.B. 7 (the "Notice"), dealing with the use of partnerships to avoid the repeal of the General Utilities doctrine. The Notice states that it was issued under the authority of § 337(d) of the Code, which directs the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the 1986 Act's repeal of the General Utilities doctrine. This Report evaluates the rules contained in the Notice and makes suggestions for modifications to, and clarifications of, the Notice. A copy of the Notice is attached at the end of this Report.

[1/] The authors of this report are Michael L. Schler, Co-chairman of the Committee on Corporations, and Steven C. Todrys, Co-chairman of the Committee on Partnerships. William L. Burke and Stephen Millman provided substantial comments. Additional helpful comments were received from Renato Beghe, William B. Brannan, Jay Gayner, Edward D. Kleinbard and James M. Peaslee.

2. The Notice

The Notice contains two separate and independent rules. The first rule discussed in this Report, referred to herein as the "Deemed Redemption Rule", requires that gain be recognized by a corporate partner (referred to herein as "P1") in a partnership (referred to herein as "P") to the extent that any transaction (or series of transactions) has the economic effect of an exchange by P1 in which it gives up an interest in appreciated property and receives an interest in P1 stock owned by P. Among the transactions stated to possibly have this economic effect are (1) a contribution by P1 to P of property and a contribution by another partner (referred to herein as "P2") to P of P1 stock; (2) a contribution by P1 of property and a contribution by P2 of cash where the cash is used by P to purchase P1 stock; (3) disproportionate distributions (presumably involving such situations as a 50-50 partnership that distributes appreciated property to P2, and P1 stock of equal value to P1); and (4) amendments to the partnership agreement. The rule applies to any transaction or series of transactions occurring after March 9, 1989.

The other rule contained in the Notice, referred to herein as the "Distribution Rule", states that when a corporate partner (also referred to herein as "P1") in a partnership (also "P") receives from P a distribution of P1 stock (or stock of an

affiliate of P1), then § 311(b) rather than § 731(a) is applicable. The result is that P1 must recognize gain (but not loss) with respect to its partnership interest. This provisions is effective for distributions of corporate stock after March 9, 1989, including distributions of stock already held by a partnership on that date.

The Notice emphasizes that transactions subject to the Notice may also be recharacterized by the "substance over form" doctrine, or by § 707(a)(2)(B), relating to disguised sales.

The Notice cannot be understood without reference to the well-publicized "May transaction".[2/] Under this approach, P1 contributes appreciated property to P, P2 contributes cash to P, and P uses the cash to purchase P1 stock (perhaps even from P1). After a sufficiently long waiting period to reduce the risk of challenge under the step transaction or disguised sale rules, P1 and P2 will agree to cause P to be liquidated with P1 receiving its own stock and P2 receiving the property contributed by P1. If

[2/] The transaction is named after May Department Stores, which along with a partner entered into the "contribution" part of the transaction prior to the date of the Notice. To the knowledge of the Committees the parties have given no public indication of any further step planned thereafter.

the transaction on its facts successfully avoids the step transaction and disguised sale rules, P1 has effectively used the appreciated property to redeem its stock without recognition of § 311(b) gain (if the P1 stock was purchased on the market) or has effectively received cash for the appreciated property without recognition of § 1001 gain (if the P1 stock was purchased from P1). P2 has effectively purchased the P1 property for cash, and receives a cost basis in the property under § 732(b).

Both the Deemed Redemption Rule and the Distribution Rule would eliminate the benefits of this technique.

The differences between the two rules are:

(1) The Deemed Redemption Rule applies to tax P1 at the time P1 is deemed to receive an economic interest in its own stock in exchange for its interest in appreciated property, and imposes tax based on the value of the appreciated property at that time. In a May transaction, assuming initial pro rata interests in P, the rule would therefore apply in part upon the original contributions to P. On the other hand, the Distribution Rule applies only upon the distribution of P1 stock to P1, applies whether or not the distribution is pro rata and imposes tax based on the value of the appreciated partnership interest at that later time. Moreover, if the Deemed Redemption Rule imposes tax prior to an actual distribution, the Distribution Rule would still apply upon the subsequent distribution based on any appreciation in the partnership interest that had arisen after the prior application of the Deemed Redemption Rule.

(2) If the deemed redemption under the Deemed Redemption Rule occurred before the effective date of the Notice, but the distribution of P1 stock to P1 had not yet occurred by that date, the Deemed Redemption Rule would not apply, but the distribution of P1 stock to P1 would be Picked up by the Distribution Rule.

Thus, transactions where the economic exchange of appreciated property for P1 stock occurred before the date of the Notice are grandfathered in the sense that no tax is considered to arise on previous actions. However, the Distribution Rule would make taxable to P1 any subsequent distribution in accordance with that previous economic exchange. As indicated above, May Department Stores is in this position, and thus subject to the Distribution Rule if it receives its own stock from the partnership in the future.

3. Summary of Conclusions

The Committees believe that the Deemed Redemption Rule is an appropriate exercise of the Secretary's authority under § 337(d) to enforce the repeal of General Utilities. The rule is necessary to prevent a corporation from being able to effectively use appreciated assets to redeem its stock without the application of § 311(b). (Section 4).

The Committees do, however, propose one major extension of the Deemed Redemption Rule and suggest a number of clarifications and modifications to the rule. The proposed extension of the rule would result in immediate taxation to a corporate partner receiving its own stock from a partnership, even where there is no economic exchange of appreciated assets for stock, when such taxation is necessary to avoid permanent avoidance of taxable gain resulting from the basis allocation rules of § 732(c). The suggested clarifications to the Deemed Redemption Rule relate, among other things, to conforming basis adjustments necessary after an application of the rule, successive applications of the rule, contributions to existing

partnerships, the effect of the rule on a partner contributing appreciated stock of the other partner, and transfers to contributing partners. The Committees also suggest that the rule be applied to corporate warrants in addition to corporate stock, that clarifications be made concerning the appropriate treatment of corporate debt distributed to a corporate partner, and that a de minimis exception be adopted. Difficult issues arise in the case of nonpro rata partnerships and nonpro rata partnership liquidations, and the Committees suggest how the rule should be applied to prevent the permanent avoidance of taxable gain in these situations. For example, it is suggested that the Deemed Redemption Rule apply to a partner's receipt of its own stock in lieu of an increase in the partner's interest in post-contribution appreciation in another asset economically allocable to that partner. The “package” of proposals in this section of the Report is designed to assure that no taxable gain on appreciated assets is “lost” because of the special tax rules relating to the receipt by a corporation of its own stock. (Section 5).

Turning now to the Distribution Rule, the Committees believe that rule is not correct and oppose its adoption. On its face, the rule might appear to be a reasonable response to the May transaction. However, upon further examination, that rule

appears to the Committees to be unnecessary and unjustifiable. First, by implicitly adopting an entity rather than aggregate approach of partnership taxation, the rule places a corporate partner in a worse position, by reason of having engaged in activities through a partnership, than if the corporate partner had engaged in the activities directly. Moreover, the entity approach of the rule is fundamentally inconsistent with the Deemed Redemption Rule, which is based on an aggregate approach to partnership taxation. Second, transactions such as the May transaction are fully covered by the Deemed Redemption Rule, in part when the properties are contributed to the partnership and in remaining part when they are distributed from the partnership. To the extent the Distribution Rule goes beyond the Deemed Redemption Rule and the extension of that rule suggested in this Report, aside from effective date considerations (which can be dealt with separately), those transactions are not obvious end runs around General Utilities repeal. Thus, it is not clear why the rule is appropriate under § 337(d). (Section 6).

In any event, if the Distribution Rule is retained, the Report discusses a number of additional technical issues that arise. These issues include the method of calculation of the partner's gain, the application of § 734, and the application of the rule to warrants (as opposed to stock) of a partner. (Section 7).

As to effective date considerations, to the extent the Distribution Rule is designed to cover transactions in which a deemed exchange occurred before March 10, 1989, but a "related" partnership distribution occurs thereafter, the Committees do not oppose the achieving of that purpose by limiting the role of the Distribution Rule to that of a transition rule. The rule would then apply only to distributions by a partnership that had previously engaged in a deemed exchange that would have been subject to the Deemed Redemption Rule but for the effective date of that rule. This limited role for the Distribution Rule would carry out one apparent purpose of the rule and would also avoid the overbreadth inherent in a more general application of the rule. (Section 8).

Finally, the pending Revenue Reconciliation Act of 1989 would adopt a provision that if appreciated property is contributed to a partnership by one partner and distributed to another partner (only if within three years, in the Senate version), upon the distribution the contributing partner is taxed on the original amount of appreciation.

The Committees do not believe that this provision would eliminate the problem dealt with by the Deemed Redemption Rule. Therefore, that rule should be adopted regardless of the pending legislation. (Section 9).

4. Evaluation of the Deemed Redemption Rule

An analysis of the Deemed Redemption Rule must begin with the observation that any time that partners make contributions of different properties to a pro rata partnership, or a pro rata partnership makes distributions of different properties to different partners, there has been an exchange of economic interests in the various properties among the partners. Nevertheless, it is fundamental to the partnership tax rules that, subject to certain narrow exceptions, [3] these economic exchanges do not result in current taxation to the partners. §§ 721, 731. Therefore, unless there is some special consideration relating to stock of a corporate partner, the Deemed Redemption Rule would not be justified.

It is equally fundamental to the partnership tax rules that the taxation of gain on these economic exchanges is deferred, not permanently forgiven. On the contribution of property to a partnership, the property takes a carryover basis, § 723, and the partner's basis in its partnership interest is the

[3] See, e.g., §§ 707(a)(2)(B) (disguised sales) and 751(b).

In a distribution of property to a partner, the partner's aggregate basis in the distributed property and in its remaining partnership interest (if any) remains unchanged, §§ 732, 733. As a result, when the partner's entire interest in the partnership and the underlying assets is converted into cash, all gain (or loss) is recognized.

Moreover, the deferral of gain on these economic exchanges resulting from partnership contributions and distributions is consistent with the repeal of the General Utilities doctrine. That doctrine, while it was in effect, was never the rationale of the gain deferral provisions in the Code such as the partnership rules, § 1031, or the reorganization provisions. Rather, those provisions had their own rationales unrelated to General Utilities. Thus, repeal of General Utilities should have no effect on the continuing operation of such provisions.

Consistent with this analysis, the Deemed Redemption Rule does not attempt to create taxable gain in the innumerable situations where the partnership rules result solely in gain deferral on economic exchanges among the partners. The Committees support this limitation on the Deemed Redemption Rule and believe any extension to those cases would not be authorized by § 337(d).

Consider, however, the case of a partnership acquiring stock of a corporate partner.

> Example 1. P is a 50/50 partnership of P1 and P2. P1 contributes an appreciated asset (referred to herein as asset A) with a basis of $20 and value of $100. P2 contributes P1 stock with a basis and value of $100.

In this case P1 has made an economic exchange of half of its interest in asset A for $50 of its own stock. Moreover, and most significantly, this exchange has the potential for permanent avoidance by P1 (as well as P2) of taxable gain on half of the appreciation in asset A. The reason is that if P is subsequently liquidated (or P1 stock is distributed to P1) without triggering § 707(a)(2)(B), (i) P1's receipt of the P1 stock will be tax-free under § 731, and (ii) the provisions designed to preserve P1's original built-in gain of $80, namely §§ 732 and 733, will not do so. The reason for the latter conclusion is that, regardless of P1's basis under § 732 for the P1 stock distributed to it, under § 1032 P1 will not be taxed on a resale of that stock. Thus, to the extent that the built-in gain in P1's asset becomes (through the partnership mechanism) built-in gain to P1 on its own stock, that gain is permanently exempted from tax under § 1032.

In the example, on a pro rata distribution of the partnership assets when the asset values were unchanged, P1 would presumably have a basis (which would be meaningless) of $16.67 in

the $50 worth of P1 stock, and a basis of $3.3 3 in the $50 worth of asset A.[4] Of P1's original built-in gain of $80, $46.67 is preserved and $33.33 will never be recognized to P1 because of § 1032. P2 would have an aggregate basis of $100 in assets having an aggregate value of $100, and so P2 cannot be said to be bearing the cost of the windfall to P1.

The Deemed Redemption Rule applies in this situation to tax P1 on its initial economic exchange of its interest in asset A for an interest in its own stock. Thus, the rule applies to a situation in which the partnership rules result in permanent gain avoidance, not merely deferral. Such gain avoidance, although consistent with the letter of the partnership rules, is inconsistent with their spirit and with General Utilities repeal. More specifically, such gain avoidance is inconsistent with § 311(b), requiring a corporation to recognize gain if it distributes appreciated property in redemption of its stock.

In every situation of which the Committees are aware, the Deemed Redemption Rule applies only when the partnership rules, combined with § 1032, would have the potential to result

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[4] P1's $20 basis in P would be allocated between the appreciated asset and the P1 stock in proportion to their relative tax bases to P (i.e., $10 in half of asset A and $50 in half the P1 stock). § 732(c).

in permanent avoidance of taxable gain to P1 on what is economically a § 311(b) transaction. The Committees believe such gain avoidance would be inconsistent with General Utilities repeal and thus support the Deemed Redemption Rule.

An alternative to the Deemed Redemption Rule would be to tax P1 not at the time of the deemed exchange, but rather when it received back its own stock from P following a deemed exchange.[5/] Under this approach, the taxable gain to P1 would then be the amount of built-in gain on the P1 stock that was permanently avoided by virtue of § 1032.

The Committees believe, however, that the Deemed Redemption Rule is preferable to this approach. Once the economic exchange of interests has occurred in a manner that will result in permanent avoidance of tax, there appears to be no reason for the taxable event to be delayed.[6/] Moreover, this alternative approach would allow payment of the tax to be delayed

[5/] This rule would differ from the Distribution Rule, since the Distribution Rule applies whether or not there has been a deemed exchange of appreciated property for stock.

[6/] Likewise, for accounting purposes, P1 is apparently treated as redeeming its stock when the stock is acquired by P.

indefinitely, because once the economic exchange has occurred the partners often will be in no hurry to liquidate the partnership.

It is also interesting to note that the Deemed Redemption Rule is somewhat analogous to § 304(a)(2). That section provides that if corporation A controls corporation B, and B acquires A stock from a shareholder of A in exchange for property, then the shareholder is treated as if A had redeemed its own stock from the shareholder. While the analogy is far from exact, in both cases the acquisition of "parent" stock by a "subsidiary" is treated as a "redemption" by the "parent."

5. Technical Issues under the Deemed Redemption Rule

a. Basis. If a partner recognizes gain under the Deemed Redemption Rule, both the partnership's basis in the appreciated asset, and the partner's basis in its partnership interest, should generally be increased by the amount of the gain. For example, in Example 1, P1 would recognize $40 of gain on asset A on the formation of P. P's basis in asset A should be increased by $40, to $60, to reflect this gain.

Consider next P1's basis in P. Under any theory, it should be at least $20, representing P1's contribution of asset A (with a carryover basis) to P. In addition, the Committees believe that P1's basis in P should be increased by the $40 gain

that P1 recognizes, to $60. Likewise, P's basis in the P1 stock should be the usual carryover basis of $100 on the actual contribution from P2.[7/]

b. Disappearing built-in gain: the problem. Consider next the situation in Example 1 if P thereafter engages in a pro rata liquidation while the asset values are unchanged. P2, which had a basis in P of $100, receives back P1 stock (basis to P of $50 and value of $50) and asset A (value of $50). P1, which had a basis in P of $60, receives back P1 stock (basis to P of $50 and value of $50) and asset A (value of $50).

Recall that asset A had a basis to P of $60. When half of asset A is distributed to each of P1 and P2, each partner's basis in its respective share of asset A depends on P's basis in that share of asset A. § 732(c). This in turn depends on how much of P's basis in asset A is to be allocated to the portions of asset A distributed to P1 and P2, respectively. Since P distributes undivided interests in asset A to P1 and P2, P's aggregate basis should logically be divided in proportion to the values of the portions of asset A distributed to each partner. Under this analysis, P's basis of $60 in asset A would be

[7/] § 723.

allocated $30 to P1 and $30 to P2. P1's basis in P of $60 would be allocated $37.50 to the P1 stock and $22.50 to asset A (in proportion to P's respective bases of $50 and $30 in those assets).

The result of this analysis, however, is that a portion of the original unrealized gain in asset A has simply "disappeared". Of the $40 of remaining unrealized gain in asset A, only $27.50 ($50 value distributed to P1 less basis to P1 of $22.50) has been preserved (since P2's aggregate basis of $100 matches the $100 value of assets it receives). The reason for this result is that the basis allocation rules of § 732(c) have "shifted" $12.50 of the unrealized appreciation that was originally in asset A to the P1 stock distributed to P1 (which stock had a basis of $50 to P and receives a basis of $37.50 in the hands of P1). Because of § 1032, that newly created unrealized gain in the P1 stock will never be recognized, resulting in permanent elimination of $12.50 of gain from the tax system.

Two points are particularly significant about this result. First, the shifting of unrealized appreciation from one asset to another has nothing to do with the fact that one of the assets is P1 stock. Exactly the same shifting would have occurred under § 732(c) if any asset were substituted for P1 stock in the foregoing example. If any other asset were involved, however, the result of the shifting would not be a permanent avoidance of

taxation on unrealized gain, but rather a deferral of taxation on such gain. In other words, as long as P1 will be taxed on the disposition of any asset it receives from P, no matter how P1's aggregate basis in P is divided up among the P assets received by P1, the total gain to eventually be recognized by P1 remains unchanged. Only when one of the assets is P1 stock does this result change because of § 1032. Only in the latter case, therefore, is the result inconsistent with General Utilities repeal.

The second significant point about the result in the foregoing example is that it arose on a completely pro rata liquidation of P. While in the example there happens to have been a previous application of the Deemed Redemption Rule, exactly the same result (disappearance of built-in appreciation from the tax system) can arise even when all contributions and distributions are pro rata. [8/] Thus, the problem being addressed is conceptually different than that addressed by the Deemed Redemption Rule.

[8/] For example, assume P1 and P2 each has a 50% undivided interest in asset A, P1's basis is $0, P2's basis is $100, and the value of each 50% interest is $100. P1 and P2 form 50/50 partnership P, each contributing its share of asset A and $100. P takes its $200 of cash and buys P1 stock. At a time when all the assets have unchanged values, P liquidates on a pro rata basis, distributing to each partner $100 worth of asset A and $100 worth of P1 stock. P1's outside basis of $100 is allocated between half of asset A (basis to P of $50, value of $100) and P1 stock (basis to P of $100, value of $100), and so P1 receives a basis of $33 in asset A and $67 in the P1 stock. As a result, of P1's original $100 unrealized gain in asset A, $67 remains in asset A and the remaining $33 has shifted to the P1 stock where it will never be recognized.

c. Disappearing built-in gain: proposed solution. The Committees believe it is essential that the shifting of unrealized appreciation from one asset to another under § 732 not result in the permanent avoidance of taxable gain because P1 stock is the asset to which the unrealized appreciation is shifted. There are a number of possible solutions to prevent this avoidance of gain. First, the Distribution Rule, discussed further below, could be adopted. However, as also discussed below, that rule goes beyond what is appropriate and also goes beyond what is necessary to avoid the permanent avoidance of gain being discussed here.

Second, the basis allocation rules of § 732(c) could be amended to prevent the shifting of unrealized appreciation from one asset to another in all cases, whether or not stock of a corporate partner was involved. Such a modification of the § 732(c) rules would have to be based on § 704(c) principles, providing in effect that if a partner contributes appreciated property to a partnership, the partner's basis in the partnership arising from that contribution is "specially allocable" to that property if that property (or other property) is distributed to the partner. The Committees believe this solution to the problem of the shifting of appreciation among assets merits consideration. However, because such an overhaul of § 732 is not likely in the near future, this Report assumes that another solution is necessary for the time being.

Third, the Treasury could exercise its authority under § 337(d) to override § 732(c) and reallocate basis among distributed assets solely in the case where General Utilities repeal is implicated, namely when P1 stock is distributed to P1. In that situation, the regulations could provide that P1's basis in P will all be available to be allocated to the P1 stock received by P1 from P to the extent of P's tax basis in that stock, and only any remaining basis that P1 has in P will be allocated among other assets received by P1 from P. [9] This rule would prevent a step-down in the basis of the P1 stock upon a distribution of that stock to P1 (which step-down always mirrors a step-up of basis in asset A and consequential elimination of gain on asset A). In the example, P1's basis in P of $60 would first be allocated to the P1 stock distributed to P1 (which had a basis to P of $50), leaving $10 of P1's basis in P to be allocated to asset A and preserving the remaining unrealized gain of $40 in asset A.

Fourth, the Treasury could exercise its authority under § 337(d) to provide immediate gain recognition to P1 if and to the extent that (1) P1 received P1 stock on a liquidation of P, and (2) as a result of the liquidation, P1's basis in the P1 stock under the normal § 732 rules was less than P's tax basis in the P1 stock. [10] In the example, because on the liquidation § 732 reduced the basis in P1 stock from $50 to $37.50, P1 would have immediate taxable income of $12.50. P1's basis in asset A would remain at $22.50, leaving $27.50 of built-in gain in that asset.

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[9] See footnote 10 for a modification of the basis allocation formula if P2 had contributed appreciated P1 stock to P.

[10] As illustrated in Example 5 below, if P2 had contributed appreciated P1 stock to P, the correct amount of taxable gain to P1 on the liquidation is the excess of the value of the P1 stock at the time of P2's contribution (rather than P's tax basis for the stock) over P1's tax basis for the P1 stock following the liquidation.

It should be noted that the third and fourth possible solutions to the disappearing gain problem are similar. The third solution preserves the original built-in gain to be taxed on the disposition of asset A, while the fourth solution taxes the "lost" gain immediately. The difference is in timing, but either solution can be viewed as consistent with General Utilities repeal.

The Committees believe the fourth solution (immediate taxation of the "lost" gain) is appropriate in this situation. The reasons are (1) the Committees' belief that the § 732 basis rules, even though giving inappropriate results in some cases, should be applied uniformly to all assets without a special exception for P1 stock, (2) the fact that the avoidance of "lost" gain requires current taxation in any event in the case of special allocations, as illustrated in Examples 9 and 10 below, (3) the Committees' belief that normal commercial transactions rarely if ever involve a partnership holding stock of a corporate partner, and that it is therefore appropriate to impose an immediate tax on such transactions to the extent the normal tax rules would otherwise result in a permanent loss to the tax system, and (4) the observation that, just as the consequences of § 732(c) can be avoided generally through non-liquidating distributions, immediate taxation of P1 can be avoided (with deferred gain being preserved through basis adjustment) if P, rather than liquidating, first distributes the P1 stock to its partners in a step not considered part of an overall plan of liquidation (thereby preventing the artificial step-down in stock basis that arises on a complete liquidation).

Where indicated, the examples in the remainder of this Report illustrate the mechanics of this rule for the immediate taxation of disappearing built-in gain on a partnership liquidation, and demonstrate that the proposed rule taxes the correct amount of gain. The rule is referred to as the "Modified Distribution Rule" to distinguish it from the Distribution Rule in the Notice discussed below.

d. Successive applications. The Deemed Redemption Rule should be applied separately each time there is a deemed exchange, but only to the assets then involved in the deemed exchange.

> Example 2. Assume the same facts as Example 1, (i.e., P1 contributes asset A with a basis of $20 and value of $100; P2 contributes P1 stock with a basis and value of $100). In addition, asset A appreciates to $200 but the P1 stock remains worth $100, at which time all the P1 stock is distributed to P1, and asset A is distributed 75% to P2 and 25% to P1 (i.e., each partner receives $150 of assets).

Immediately before the liquidation, P1 and P2 were each the economic owner of half of each asset under the terms of the partnership. [11/] As a result of the liquidation, P1 has in effect given up an additional 25% of asset A with an original basis to P1 (and then to P following its contribution to P) of $5, and a current value of $50. In return P1 has received the 50% of P1 stock (also worth $50) that it was not already deemed to have owned under the prior application of the rule.

[11/] It should be noted that even if the Deemed Redemption Rule had not applied initially in Example 1 (because, for example, asset A was not appreciated at the time of its contribution), the Deemed Redemption Rule should only apply on the liquidation to the extent the economic interests of the partners immediately prior to the liquidation are altered by the liquidation.

The Deemed Redemption Rule would apply again on the liquidation. Thus, as to 25% of asset A previously contributed by P1, P1 would recognize $45 of gain. P's basis in that 25% would increase from $5 to $50. P1's basis in P, which was originally $20 and initially increased by $40 of gain recognized, would increase by another $45 of gain, to $105. Of the $105, $83.17 would be allocable to the $100 of P1 stock distributed to P1, and $21.83 would be allocable to the 25% interest in asset A distributed to P1. [12/] Because the basis of the P1 stock distributed to P1 has been reduced from $100 to $83.17, $16.83 of additional gain would be recognized by P1 by virtue of the Modified Distribution Rule described above. As a result, all potential gain has been recognized or preserved. [13/]

e. Contributions to Existing Partnerships. The rule should apply in the usual manner if P2 contributes P1 stock to an existing partnership with P1 that owns appreciated property (Example 3), or if P1 contributes appreciated property to an existing partnership that owns P1 stock (Example 4).

> Example 3. P1 and P2 each contribute $50 cash to equal partnership P. The cash is invested in asset A, which appreciates to $200. At that time, P2 contributes 200 shares of P1 stock worth $200, increasing its interest in P from 50% to 75%.

[12/] P's basis in asset A is its $60 original basis increased by P1's gain of $45 on the disproportionate distribution, and so P's basis in the 25% of asset A distributed to P1 is $26.25. P's basis in the P1 stock distributed to P1 is $100. P1's basis in each asset is thus P's basis multiplied by $105/$126.25.

[13/] Of total appreciation in asset A of $180, P1 has recognized $85 ($40 plus $45) under the Deemed Redemption Rule and $16.83 under the Modified Distribution Rule, P1 has built-in gain of $28.17 in asset A (value of $50 less basis of $21.83), and P2 has aggregate built in gain of $50 (since it received assets worth $150 in exchange for a partnership interest with a basis of $100).

At the time of the contribution, P1's interest in asset A (worth $200) has decreased from 50% to 25% at the same time P1 has acquired a 25% interest in 200 shares of its stock (worth $200). Thus, P1 should be treated under the Deemed Redemption Rule as having redeemed 50 shares of its stock (worth $50) in exchange for $50 worth of its interest in asset A. Since P1's basis in 25% of asset A is $25, P1 has $25 of gain. P1's remaining gain of $25 is preserved through its basis of $25 in its remaining interest in 25% of asset A.

> Example 4. An existing partnership between P2 and P3 owns 100 shares of P1 stock with a basis and value of $100. P1 contributes asset A with a basis of $20 and a value of $100 and becomes a 50% partner.

Again, P1 should be treated as having redeemed 50 shares of its stock in exchange for $50 worth of its interest in asset A, resulting in recognition of $40 gain.

f. Treatment of P2 when P1 Stock Is Appreciated. All the examples so far have involved the situation where the P1 stock which P1 is deemed to redeem has not appreciated in value. Consider the situation where the P1 stock has appreciated.

> Example 5. P1 contributes asset A with a basis of $20 and value of $100. P2 contributes 100 shares of P1 stock with a basis of $50 and value of $100. P is a 50/50 partnership.

Under the normal application of the Deemed Redemption Rule, P1 is deemed to redeem half the P1 stock with half of asset A. P1 has $40 of gain. P1's basis in P, and P's basis in asset A, are each $20 plus $40, or $60.

Now consider P2. P2 has in substance used appreciated property (the P1 stock) to acquire an interest in asset A, and then contributed asset A to P. Thus, it could be argued that P2 should be taxed on the deemed redemption of P1 stock, just as P1 was taxed on that redemption. However, P2's contribution of P1 stock to P appears to be no different than if P2 had contributed any other appreciated asset to a partnership (or, for that matter, if P2 had contributed appreciated P1 stock but P1 had contributed an <u>unappreciated</u> asset). In all such cases, the normal partnership rules would apply. Those rules would not require P2 to recognize immediate gain, but as discussed above would defer (but not eliminate) the gain. The built-in gain on the asset contributed by P2 (namely the P1 stock) would be recognized by P2 under § 704(c) when P sold that stock. Thus, it seems clear that P2 should not be taxed immediately merely because the Deemed Redemption Rule applies to P1.

Assume hereinafter that this conclusion is correct, and return to Example 5. How should the basis rules apply to P2, given the overriding principle that all built- in gain must be preserved? Since P2 has not recognized gain on its contribution of the P1 stock to P, the rules only appear to work properly if (1) P2's basis in P equals P2's former basis in the contributed P1 stock, and (2) P's basis in the P1 stock equals P2's former basis in that stock. The remaining built-in gain in asset A and in the P1 stock then would be allocated respectively to P1 and P2 under § 704(c).

In Example 5, P's total basis in asset A would be $60 (P1's original basis in asset A of $20 plus P1's gain of $40) and its basis in P1 stock would be $50 (P2's basis). P1's basis in P is $60, and P2's basis in P is $50. Of the original unrealized gain of $130, P1 has recognized $40, P1 will recognize another $40 under § 704(c) when asset A is sold, and P2 will recognize $50 under § 704(c) when the P1 stock is sold. Thus, all gain is preserved and taxed to the appropriate party at the appropriate time. Moreover, taking into account the Modified Distribution Rule, all gain would be preserved following the pro rata liquidation of P. [14]

g. Other Securities of a Corporate Partner. Suppose P1 contributes appreciated asset A to P, and P2 contributes P1 warrants to P. Just as P1 can receive its own stock in a distribution from P and thereby create permanent avoidance of gain on the appreciation in asset A, exactly the same result will arise if P1 receives a distribution of its warrants from P. §

[14] P1 would receive half of asset A (basis to P of $30) and half the P1 stock (basis to P of $25). P1's basis in P of $60 would be allocated proportionately $32.73 to asset A and $27.27 to the P1 stock. Of the $90 of remaining unrecognized gain, P2 will recognize $50 (since the assets to be received will take a total basis equal to P2's basis in P of $50 and will have a value of $100). P1 still has built-in gain of $50 less $32.73, or $17.27, on asset A. Moreover, the Modified Distribution Rule will tax P1 on the liquidation in an amount equal to $22.73 (the $50 value of the P1 stock distributed to P1 at the time of its contribution to P by P2, less the $27.27 basis of that stock in the hands of P1). Note that P's tax basis in the P1 stock ($25) increased in the hands of P1 (to $27.27), illustrating the need for the Modified Distribution Rule to use contribution value rather than tax basis.

1032. Thus, the Deemed Redemption Rule should apply equally to P1 warrants and P1 stock.

In the case of a contribution by P2 of P1 debt, the need for the applicability of the Deemed Redemption Rule is less clear. That rule would be necessary if P1 could receive its own debt in a distribution from P, take a basis in the debt below its fact amount, and never recognize gain equal to the difference. However, the more logical approach would be to interpret current law to provide that a distribution to P1 of its own debt is treated as a distribution of cash in the face amount of the debt. [15/] This rule would make the Deemed Redemption Rule inappropriate in the case of P1 debt, since P's acquisition of P1 debt would result in deferral, rather than permanent avoidance, of tax to P1 on appreciation in asset A. To avoid uncertainties and the opportunity for aggressive tax planning, the Committees suggest that this rule concerning the distribution of partner debt to a partner be codified in the partnership regulations.

[15/] The theory is that P1 is relieved of an obligation to pay the face amount of the debt, which is the equivalent of the receipt of the same amount of cash.

h. Retransfer to Contributing Partners. Consider the case where a partnership is liquidated and each partner receives back its contributed property.

> Example 6. Same as Example 1, except that the P1 stock is distributed to P2 and asset A is distributed to P1 in liquidation of P.

The gain recognized to P1 on the deemed redemption that occurred upon formation of the partnership should not be reversed. The Deemed Redemption Rule does not apply to the liquidation because P1 is receiving more of asset A (and less P1 stock) than its underlying share of P. The normal partnership rules should apply to the liquidation. [16/]

i. Non Pro Rata Partnerships. The Deemed Redemption Rule should be applied to non pro rata partnerships using the same principles that apply to pro rata partnerships.

> Example 7. P1 contributes asset A with a basis of $0 and a value of $100, and P2 contributes 100 shares of P1 stock with a basis and value of $100. P is a 50-50 partnership except that the first $100 of post-acquisition income and gain is allocated to P1. At the end of the first taxable year, P has operating income of $100, all of which is allocated to P1 and is retained by P in the form of cash.

[16/] Under a strict aggregate approach to partnership taxation, on the liquidation P1 could be viewed as purchasing a portion of asset A with its own stock, giving P1 a fair market value tax basis in that portion of asset A.

If the partnership liquidated with no income immediately after its formation, P1 would be distributed one-half of asset A and 50 shares of its stock. Thus, on the formation of the partnership, the Deemed Redemption Rule results in recognition of $50 gain to P1 attributable to one-half of its interest in asset A.

At the end of the first taxable year, on a liquidation analysis P1 is entitled to a distribution of $200 as a result of the allocation of $100 of income for that year. Thus, the partners' percentage interests have changed. P1 is now entitled to a distribution of 67 shares of its stock, two-thirds of asset A and $67 cash. The Deemed Redemption Rule would not then apply, since P1 has not reduced its interest in asset A, even though its interest in its own stock has increased. This is the correct result, since P1 has in effect used $33 of cash to acquire 17 shares of its stock and a 17% interest in asset A. No economic exchange of appreciated assets for stock has occurred.

There are situations, however, where application of the Deemed Redemption Rule in non pro rata situations is less clear.

> Example 8. P1 and P2 each contributes $100 to P, which buys asset A for $100 and 100 shares of P1 stock for $100. P is entirely 50-50 except that the first $100 of income or gain is allocated to P1. When asset A is worth $200 and the P1 stock is worth $100, P is liquidated with P1 receiving 2/3 of asset A (worth $133) and 67 shares of P1 stock (worth $67).

Note that as a literal matter, P1's percentage interest in asset A never declines, and in fact increases from 50% to 67%. Thus, the Deemed Redemption Rule does not seem to apply.

However, the example could be analyzed as if economically, P1 were entitled to receive upon the liquidation (1) a portion of asset A having a basis of $50 (P1's share of P's original cost) and value of $150 (P1's share of the original cost as well as P1's 100% share of the $100 increase in value of asset A), and (2) P1 stock having a basis and value of $50. Instead, P1 received 17 extra shares of P1 stock (67 rather than 50) each worth $1, and $17 less in value of asset A ($133 rather than $150). P1 could thus be viewed as having given up $17 of the appreciation in asset A to which it was entitled under the partnership agreement, and having received 17 of its own shares in exchange therefor. The Deemed Redemption Rule would then tax P1 on this $17 of gain.

The Committees believe the Deemed Redemption Rule should apply in this situation, since there has been an economic exchange of appreciated assets for stock. Under this interpretation, the Deemed Redemption Rule would not be limited to a partner's receipt of an interest in its own stock in exchange for an <u>actual decrease</u> in the partner's interest in an

appreciated asset contributed by that partner to the partnership. Rather the rule would also apply to a partner's receipt of its own stock in lieu of an increase in the partner's interest in an asset necessary to take into account post-contribution appreciation in that asset that is allocable to that partner. [17/]

Even this interpretation of the Deemed Redemption Rule would not be the ultimate in theoretical correctness, since a theoretically correct rule would require annual deemed exchanges in ongoing partnerships based solely on the varying values of partnership assets. However, the Committees believe that mere changes in values of underlying partnership assets should not be an occasion for application of the Deemed Redemption Rule. Only a distribution of assets or other action within the control of the partners (such as an amendment to the partnership agreement) should be an occasion for testing whether there has occurred a deemed exchange of appreciated assets for stock.

[17/] Even if the Deemed Redemption Rule were construed so as not to cover this situation, the Modified Distribution Rule would tax P1 on the same $17 of gain. P1's basis in P of $100 will be allocated among asset A and the P1 stock in proportion to their respective bases to P of $67 and $67, or $50 of basis to each in the hands of P1, resulting in a step-down of basis of $17 on the P1 stock.

Next, consider the case where the P1 stock, rather than asset A, has appreciated in value since the formation of P.

> Example 9. Same facts as Example 8 (i.e., P1 and P2 each contributes $100 in cash, and the first $100 of income is allocated to P1), except that asset A retains its value of $100 and the P1 stock increases in value from $100 to $200. P is liquidated with P1 receiving 2/3 of asset A (worth $67) and 67 shares of P1 stock (worth $133).

As in Example 8, P1's percentage interest in asset A increases (from 50% to 67%) rather than declines. Thus the Deemed Redemption Rule does not seem to apply. Moreover, on the liquidation of P, P1 would be economically entitled to one-half of asset A worth $50 and 75 shares of P1 worth $150 (i.e., P1's original share of $50 plus all the appreciation of $100). P1 in fact receives more of asset A ($67 in value) and less of the P1 stock ($133) than its share based on the underlying economic arrangement, and so P1 has not given up appreciated assets in exchange for its own stock. Thus, even under this approach the Deemed Redemption Rule would not seem to apply.

There has, however, been $100 of appreciation on P1 stock in this example. Adopting the aggregate approach of partnership taxation, discussed above, and taking into account P1's 50% initial interest in the capital of the partnership, half the appreciation in P1 stock should not be taxed because of § 1032. However, the other $50 of the appreciation arises from P1

stock attributable to P2's initial interest in the capital of P. That appreciation should not be protected by § 1032 and should be taxed to P1 upon the liquidation or in the future, to be consistent with General Utilities repeal.

However, taking into account the Modified Distribution Rule, on the liquidation of P there will be immediate taxable gain to P1 of $17 and deferred taxable gain to P1 of $17. [18/] To reach the correct aggregate taxable gain of $50, the Modified Distribution Rule must be "amended" to tax not only the basis step-down in the P1 stock distributed to P1, but also the partnership-level appreciation in the P1 stock not previously allocable to P1 that is in fact distributed to P1. Since P1 received 67 shares of P1 stock rather than the 50 shares that previously "belonged" to it, the result would be to also tax P1 on the $17 appreciation in 17 shares in the hands of P (value of $33, cost to P of $17).

Finally, consider the following additional example involving appreciation in P1 stock.

[18/] P1's basis in P of $100 will be allocated $50 to asset A and $50 to the P1 stock (since P had a basis of $67 in each). Thus, P1 will have taxable gain of $17 when it sells asset A for $67. In addition, the Modified Distribution Rule taxes P1 on the $17 step-down in basis ($67 to $50) of the P1 stock.

Example 10. P1 contributes asset A with a basis of $0 and value of $100. P2 contributes P1 stock with a basis and value of $100. P1 and P2 are equal partners, except P1 is entitled to the first $100 of future income or gain. After the P1 stock increases in value to $200 (and asset A remains valued at $100), P is liquidated. P1 receives 2/3 of asset A(worth $67)and 2/3 of the P1 stock (worth $133).

On the initial contribution, the normal application of the Deemed Redemption Rule would result in P1 having $50 of gain and a $50 basis in P. P would have a $50 bas is in asset A (worth $100) and a $100 basis in P1 stock (worth $100). On the liquidation of P, the Deemed Redemption Rule should not apply because P1's interest in asset A has increased (from 50% after the first application of the rule to 67%) rather than decreased. Moreover, based on the underlying sharing ratios, P1 would have been entitled to half of asset A (worth $50) and 75% of the P1 stock (worth $150); when P1 receives more of asset A and less P1 stock, the Deemed Redemption Rule likewise should not apply. This conclusion is consistent with the fact that after application of the Modified Distribution Rule, there is no "lost" taxable gain. [19]

[19] When P1 receives 2/3 of asset A (worth $67) and 2/3 of the P1 stock (worth $133), P's basis in the portion of asset A distributed to P1 is $33 (2/3 of P's $50 basis in asset A). P's basis in the P1 stock distributed to P1 is $67. Thus, under § 732(c), P1's entire basis of $50 is allocated $17 to asset A and $33 to the P1 stock. There is $50 of untaxed gain on asset A and $50 of untaxed gain on the P1 stock not previously attributable to P1 (assuming that P1's half of the gain on the P1 stock is treated as exempt from tax under the aggregate theory). This $100 of gain is preserved through (1) the remaining built-in gain to P1 on asset A of $67 less $17, or $50, (2) immediate tax to P1 of $33 under the Modified Distribution Rule because of the step-down from $67 to $33 in the basis of P1 stock distributed to P1, and(3)immediate tax to P1 of $17 under the Modified Distribution Rule representing partnership-level appreciation (basis $17, value $33) in the P1 stock not previously attributable to P1 that is distributed to P1.

j. Investment of Partnership Income in Partner Stock. Consider next the situation where P1 contributes appreciated property to P, and where taxable income of the partnership is invested in stock of P1.

> Example 11. P1 contributes asset A with a basis of $0 and a value of $100, and P2 contributes $100 cash, to P, a 50/50 partnership. P operates a business that generates $100 of cash and taxable income (allocated $50 each to P1 and P2). P purchases 100 shares of P1 stock for $100.

The Committees do not believe the Deemed Redemption Rule should apply to P's purchase of P1 stock, because P1 has not economically reduced its interest in asset A as a result of that purchase. Rather, P1 has been taxed on the income used to buy the P1 stock, and P1 should be no worse off than if it had received a distribution of the income and purchased its own stock on the market.

However, suppose P liquidates and distributes its assets pro rata. P1 will receive $50 cash, one-half of asset A worth $50, and 50 shares of P1 stock worth $50. Under § 732(b), the cash received will reduce P1's basis in P from $50 (taking into account its $50 distributive share of income) to $0. P1 will have a $0 basis in half of asset A (worth $50) and in the P1 stock (worth $50). P2 will have an aggregate basis of $100 in its share of asset A and the P1 stock. While $50 of appreciation in asset A is "lost", this loss is offset by P1's recognition of $50 of gain under the Modified Distribution Rule (representing the step-down in the P1 stock basis from $50 to $0).

k. De minimis Exception. A de minimis exception to the Deemed Redemption Rule would clearly be appropriate. The principal reasons would be to exempt transactions that are least likely to be intended as "disguised sales", and to avoid having the rule apply to every partnership that happens to acquire a small amount of stock of a corporation that happens to be a partner in the partnership.

The exception could be written, for example, so that the rule did not apply to a corporate partner whose interest in a partnership did not exceed a stated percentage of capital or profits, or whose contribution to (or purchase price for) the partnership did not exceed a specified dollar amount. Alternatively, an exception could be made for any partner only if both the percentage and dollar limitations were satisfied. Taking a different approach, the exception could apply if the fair market value of the contributed asset did not exceed some percentage (such as 110%) of its tax basis (perhaps also with a dollar cap for the value of the asset).

6. Evaluation of the Distribution Rule

This Report now considers the Distribution Rule. The rule is a change from current law, under which the tax-free treatment provided to P1 by § 731 would control notwithstanding § 311(b). [20/]

[20/] Rev. Rul. 79-314, 1979-2 C.B. 132 (corporation X does not recognize gain when it receives its own stock held by corporation Y in exchange for Y stock held by X); Rev. Rul. 80-101, 1980-1 C.B. 70 (corporation not taxed on receipt of its own stock on complete liquidation of another corporation).

The Distribution Rule can best be evaluated by considering a number of simple examples that raise fundamental issues of partnership tax law.

> Example 12. P1 and P2 each contributes $100 to P, a 50/50 partnership. P buys on the market 2 shares of P1 stock for $100 each. After receiving $10 of dividends on each share, P sells the shares on the market for $150 each. P liquidates and distributes $160 in cash to each partner. P2 clearly has $10 of dividend income (eligible for the 70% dividends received deduction) and $50 of capital gain. What is the treatment of P1?

This example raises the difficult question of whether P1's tax treatment should be determined under the "entity" or "aggregate" approach. Under the entity approach, P is treated as a separate entity with separate tax items, and those items are simply divided among its partners. P1 would have gross income equal to its share of P's income, namely $10 of dividend income and $50 of capital gain. P1 might be entitled to the 70% dividends received deduction, or conceivably to the 100% deduction under §§ 243(a)(3) and (b)(1), but would be taxed on $50 of capital gain income.

Alternatively, under the aggregate approach, the underlying tax items of P are treated as if earned directly by the partners. P1 would be treated as if it bought in one of its outstanding shares for $100, paid itself nontaxable dividends of $10, and reissued the share of stock for $150. None of these transactions would be taxable to P1. As a technical matter, these results could be achieved in Example 12 only if P1's tax basis in P were increased by the dividend and capital gain income of P that was nontaxable to P1, by analogy to § 705(a)(1)(B) (increasing a partner's basis by its share of the partnership's tax-exempt income), leaving P1 with a tax basis of $160 to match its cash distribution of $160.

Under current law, there appears to be no authority answering the question whether the entity or aggregate approach should be used in Example 12. [21/] This leaves only the well-established doctrine that the determination of whether to apply the entity or aggregate approach depends upon which approach is more appropriate to effectuate the purposes of a particular provision of the Code. [22/]

It is not clear how a court faced with Example 12 under current law would decide the case. However, the Committees believe that the aggregate approach is appropriate in this situation. There is no reason that P1 should be taxed on income computed at the partnership level when that income would have been exempt if earned directly by P1. Likewise, P1 should not be entitled to deduct its share of P's losses on transactions in P1 stock. These conclusions are consistent with § 1032, stating that

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[21/] Compare Treas. Reg. § 1.702-1(b) (stating that the "character" in the hands of a partner of any separately stated partnership item is determined "as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership") with PLR 6909269010A (corporate partner liquidating under former § 337 cannot rely on § 337 to avoid gain recognition on its distributive share of partnership's gain on partnership's sale of assets pursuant to its own plan of liquidation; partner not treated as if it sold the assets directly).

[22/] Most recently, see Rev. Rul. 89-85, 1989-27 I.R.B. 9 (applying the aggregate approach to the deferred intercompany transaction rules of the consolidated return regulations); Holiday Village Shopping Center v. U.S., 773 F.2d 276 (CAFC 1985) (applying the aggregate approach to § 1250 on a corporation's liquidating distribution of a partnership interest).

a corporation does not recognize gain or loss on the sale of its own stock. In fact, it is difficult to believe that the Service would allow a partner to deduct its share of partnership losses on transactions in partner stock.

The aggregate approach is also consistent with the rule in § 702(a)(5) that dividends received by a partnership are eligible for the dividends received deduction in the hands of a corporate partner, and the rule in § 702(a) that partnership level capital gains and losses are treated for all purposes as if they were incurred directly at the partner level. Moreover, the aggregate approach does not appear inconsistent with the purposes of any other provision of the tax law.

Perhaps as important as the conclusion of the entity/aggregate analysis in this situation is the observation that the analysis has nothing to do with General Utilities repeal. General Utilities repeal relates to the question of whether and how a corporation can dispose of appreciated assets on a tax-free basis. On the simple facts of Example 12, there is no such disposition of assets, and thus the entity/aggregate analysis can be made without regard to that doctrine.

> Example 13. Same facts as Example 12, except that instead of P selling the P1 stock and liquidating, P1 sells its partnership interest (representing $10 and a share of P1 stock worth $150) for $160.

Because of § 741, this example would present a more difficult case for P1 to avoid gain recognition under current law than would Example 12. Nevertheless, for the same reasons as in the discussion of Example 12, the Committees believe that the aggregate approach is the “right” result in this situation for purposes of evaluating the Distribution Rule. The principles of § 1032 should be available to treat P1 as if it sold its own stock without recognition of gain. Again, it is difficult to believe that General Utilities repeal should change this result.

> Example 14. Same facts as Example 12, except that instead of selling the shares of P1 stock on the market, P liquidates and distributes one share (and $10 of cash) to each of P1 and P2.

In this case the aggregate approach would still result in no tax to P1, just as if P1 had bought in its stock on the market for $100 and paid a dividend of $10 to itself. The entity approach would also not result in any tax to P1 on the share distributed to P1, by virtue of § 731. However, the Distribution Rule would result in P1 having a capital gain of $50 in this situation, on the theory that P1 had redeemed its stock with appreciated property (namely its partnership interest in P).

The theory of the Distribution Rule, as applied in this situation, would have to be that P1 has an appreciated asset, namely its partnership interest, and that P1 should not be

permitted to engage in a transaction that permanently eliminates the appreciation in that asset. To be sure, P1 could receive from P any asset other than its own stock without immediate recognition of gain under the Distribution Rule, but the built-in appreciation in the partnership interest would then be transferred to that other asset with no permanent loss to the tax system of potential future gain. On the other hand, when P1 receives back its own stock that was redeemed with its appreciated partnership interest, the appreciation inherent in that stock (or on the partnership interest) will never again be taxed. Thus, the theory continues, the appreciation must be taxed on the liquidation of P to prevent permanent avoidance of the taxable gain, a result that would be inconsistent with General Utilities repeal.

In the view of the Committees, this theory of the Distribution Rule is simply wrong as applied to Example 14, where all contributions to and distributions from P are completely pro rata. There are a number of reasons for this conclusion.

First, the Distribution Rule, which is entirely dependent on the entity approach, seems to be fundamentally inconsistent with the Deemed Redemption Rule, which is based

on the aggregate approach. It is difficult to see the logic of applying both rules to the same types of transactions.

Second, the Distribution Rule is not necessary to preserve any appreciation in underlying assets that should properly be taxed, but that would otherwise go untaxed because P1 stock is involved. The Deemed Redemption Rule, as well as the Modified Distribution Rule proposed above, together assure that the full amount of taxable gain that should ever be recognized is in fact recognized. The additional taxable gain created by the Distribution Rule is inappropriate for the reasons discussed above.

Third, there is no reason to believe that General Utilities repeal was intended to narrow the scope of § 1032. The so-called appreciation of P1's partnership interest simply represents P1's share of the appreciation in its own stock. The ultimate question should still be whether the entity or aggregate approach should apply in Examples 12 and 13. If the aggregate approach should apply in those cases (as the Committees believe it should), so that P1 should not be taxed when P sells the P1 stock, or when P1 sells the partnership interest, there should not be imposed any tax on P1 in Example 14 (when the stock is distributed in kind rather than sold).

Fourth, the Committees recognize, as indicated above, that their preferred aggregate approach may not be correct as an

interpretation of current law, particularly in Example 13. Assume, therefore, that the Committees' aggregate approach is incorrect and that the entity approach is the proper approach in Examples 12 and 13. Thus, P1 is taxed when P sells the P1 stock or P1 sells its interest in P. In that case, arguably the Distribution Rule is correct, and in Example 14 P1 should be taxed on its receipt of the P1 stock (to avoid permanent avoidance of the tax arising in Examples 12 and 13).

However, even on this assumption, the Distribution Rule in the Notice seems to be an inappropriate vehicle for taxing P1. The Notice attempts to resolve the secondary question in Example 14 without resolving the more fundamental entity/aggregate question in Examples 12 and 13. Moreover, even if the entity approach is considered the technically correct result in Examples 12 and 13, the resulting gain to P1 in those examples is at best a trap for the unwary (since no well-informed corporation would ever be a partner in a partnership owning its stock). Thus, it is far from clear that permitting that gain to be avoided by the liquidation of P (as in Example 14) creates an abusive end-run around General Utilities repeal. In other words, it is far from clear that if P1 were not taxable in Example 14, the repeal of General Utilities would be improperly avoided despite the disappearance of the appreciation in P1's interest in P. After

all, § 1032 is still in the Code notwithstanding General Utilities repeal. An illogical rule of present law should not therefore be extended beyond its present scope by regulations designed to prevent avoidance of General Utilities repeal.

This opposition to the Distribution Rule, standing alone, would leave untouched non pro rata transactions that would otherwise have been covered by the Deemed Redemption Rule but for the effective date of that rule where the partnership had been formed but not liquidated by March 9, 1989. However, as discussed in Section 8 below, the Committees do not object to the adoption of the Distribution Rule as a transition rule directed solely to those transactions.

Finally, it could be argued with some force that despite the Committees' valid theoretical objections to the Distribution Rule, that rule has the great virtue of simplicity. The Committees, recognizing that the Deemed Redemption Rule does not Pick up all "lost" taxable gain when P1 stock is involved, have proposed the Modified Distribution Rule to Pick up that gain. The latter rule Picks up the § 732(c) basis step-down in all P1 stock held by P and distributed to P1, as well as the appreciation in the hands of P of P1 stock not allocable to P1 but distributed to P1. In fact, it appears that the only gain the Modified Distribution Rule will not Pick up is the appreciation in the

hands of P of P1 stock allocable to P1 and distributed to P1, which is the specific application of the Distribution Rule to which the Committees object. [23/]

Thus, in order to avoid an over inclusive but simple rule, the Committees have proposed a more complex but narrower rule, with the additional complexity (such as determining what is P1's share of P1 stock held by P) necessary to achieve the theoretically correct result.

Since few if any normal commercial transactions involve a partnership holding partner stock, it can be argued that the Treasury should not go out of its way to adopt a more complex, but more precisely targeted, rule solely to be fair to noncommercial transactions.

While it is a close question, the Committees nevertheless favor the more precisely directed approach. The principal reason is that whether the narrow or broad approach is taken on this question, the result will be to stop the tax-motivated transactions involving P1 stock. Only a few transactions will remain and they will not be tax-motivated,

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[23/] In fact, the Committees would have no objection if the Distribution Rule were simply modified to exclude from its scope any appreciation in P1's interest in P attributable to appreciation in P1 stock allocable to P1 while that stock was held by P. This change in formulation would not, of course, change the relative complexity of the proposed rule.

meaning that fairness is probably more important than a moderate amount of additional complexity. In addition, as discussed above, even the Modified Distribution Rule can be considered an interim solution pending needed revisions to the § 732(c) basis allocation rules applicable to all kinds of assets. A narrowly targeted rule that eliminates the precise problem of disappearing gain under § 732 (as well as disappearing gain on P1 stock attributable to P2 that is distributed to P1) thus seems more appropriate than the broad Distribution Rule that on its face has nothing to do with § 732 and would be likely to survive any modification to § 732. Finally, the Committees are very reluctant to support a rule such as the Distribution Rule, even though it is simple, that is fundamentally incorrect as a conceptual matter and that could be used as a precedent for further extension of the incorrect concept (i.e., entity treatment of partnerships).

7. Technical Analysis of the Distribution Rule

In this section of the Report the Committees assume that, despite the foregoing criticism, the Distribution Rule is to be adopted in something like its present form. Various suggestions are made concerning issues that arise in implementing the rule.

a. Warrants. To the extent the Distribution Rule is justifiable, it is justifiable because the appreciation in P1's partnership interest in P is permanently eliminated (by virtue of § 1032) when P1 receives P1 stock in exchange for that interest. Since § 1032 also exempts P1 from gain on its issuance of warrants to buy P1 stock, the Distribution Rule should logically be extended to cover the receipt by P1 of P1 warrants from P.

b. Debt. Assuming that current law is clarified concerning the results of a distribution by a partnership of debt of a partner to that partner (see Section 5.g above), P's acquisition of P1 debt will never result in permanent avoidance of gain recognition. Therefore, the Distribution Rule should not apply to P1 debt.

c. Allocation of basis. Suppose P1 receives a liquidating distribution from P consisting in part of P1 stock and in part of appreciated property. Presumably P1 is only required to recognize § 311(b) gain on the portion of its partnership interest exchanged for P1 stock, and the normal rules of § 732 would apply to the exchange of the remainder of P1's partnership interest for other assets. This requires an allocation of P1's basis in its partnership interest between the P1 stock and the other assets received.

It is not clear whether this allocation of basis should be made in proportion to the relative fair market values of the

distributed property (P1 stock versus all other assets) or in proportion to P's tax basis in the distributed property. The latter allocation is probably more appropriate, because P1's taxable gain will then better reflect the underlying appreciation in P1 stock in the hands of P. That allocation is also more consistent with § 732(c). An allocation of P1's partnership basis in proportion to the relative values of the distributed assets would also tend to undercut the Distribution Rule, since the greater the appreciation in P1 stock in the hands of P, the greater the amount of P1's basis in its partnership interest that would be allocated to the stock. Moreover, an allocation on the basis of relative fair market values would often be impractical, because it would require valuation of all assets of P, not only the P1 stock.

d. Nonliquidating distributions. The Distribution Rule applies to nonliquidating as well as liquidating distributions of P1 stock to P1. Thus, on a nonliquidating distribution, P1's tax basis in P must likewise be allocated between the P1 stock distributed (on the one hand) and all other distributed and undistributed assets (on the other hand). This allocation should also be made in proportion to P's bases in the various assets.

e. Losses. As noted above, the Distribution Rule can only be justified if P1 would be taxable on its share of any gain recognized by P on P's sale of P1 stock, or on gain on its sale of its partnership interest attributable to appreciation in P1 stock. If P1 were so taxable, however, P1 should logically be entitled to deduct its share of any loss recognized by P on P's sale of P1 stock, or to deduct any loss on the sale of its partnership interest attributable to depreciation in the P1 stock. If these results were accepted, it might be argued that P1 should be entitled to recognize any loss on its partnership interest when it receives P1 stock in exchange therefor. This is contrary to the Distribution Rule, which provides for the recognition of gain but not loss.

The Distribution Rule appears to be correct in this regard. The asymmetry is fundamental to § 311(b), which provides that a corporation must recognize gain (but not loss) when it redeems its stock with property. Thus, it is reasonable for P1 to recognize gain but not loss on the so-called use of its partnership interest to redeem stock, even though it would recognize loss on actual sale of the partnership interest.

f. Effect of S 734. Suppose P has a § 754 election in effect, and P distributes P1 stock to P1 triggering gain to P1 under the Distribution Rule. The question arises as to whether the basis of the remaining P property should be adjusted under § 734.

The purpose of the § 734 adjustment is to prevent appreciation in underlying partnership assets from being shifted between partners as the result of a distribution to, or redemption of, one partner, and to maintain conformity of aggregate inside basis with aggregate outside basis. In general, if an asset were distributed to P1 in a nonliquidating distribution, § 734 would not apply unless P's basis in the asset is greater than P1's basis in its partnership interest. § 732(a)(2). In other circumstances involving nonliquidating distributions, P1's basis in the distributed asset will be equal to P's basis in the asset, maintaining conformity. §§ 732(a)(1), 733.

However, if the assets distributed to P1 in a liquidating or nonliquidating distribution include P1 stock, as indicated above P1 must allocate its basis in its partnership interest between that P1 stock and its remaining interest in P, in order to determine its gain under the Distribution Rule. To the extent that the portion of P1's basis in P that is so allocable to the distributed stock differs from P's pre-distribution basis in the P1 stock, P1's basis in P will be reduced on account of the distribution by an amount that differs from P's basis in the distributed property. In order to maintain equality between aggregate inside and outside basis, it would be appropriate to apply § 734 to adjust the basis of the remaining partnership assets up or down to take account of this difference. Note that the recognition of gain by P1 is irrelevant to this adjustment of the partnership's basis in its remaining assets, because it is simply an acceleration of gain to P1 that would have been preserved by the basic rules of § 732 had the distributed property not been P1 stock.

Example 15. P1 contributes asset A with a basis and value of $100. P2 contributes P1 stock with a basis of $20 and a value of $100. The P1 stock appreciates to $200, at which time P1 is distributed $100 of P1 stock and $50 of asset A in liquidation of its partnership interest.

P1's basis in P allocable to the P1 stock would be $17. [24/] Under the Distribution Rule, P1 would recognize $83 gain on the liquidating distribution, the excess of the value of its partnership interest attributable to the P1 stock ($100) over its basis allocable to the P1 stock ($17).

Section 734(b)(2)(B) provides that the basis of the remaining partnership property is reduced by the $40 excess of outside basis for the distributed property ($100) over inside basis ($60). P's remaining basis in asset A is $50 and its

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[24/] P's tax basis for the P1 stock distributed to P1 is $10 and its tax basis for asset A distributed to P1 is $50. Thus, 1/6 of P1's $100 tax basis in P is allocated to the P1 stock.

remaining basis in P1 stock is $10. Therefore, the $40 basis reduction results in a $20 aggregate basis for the assets, an amount equal to P2's basis in its partnership interest.

g. Constructive Termination. The Distribution Rule should not apply on a constructive termination of P. All potential gain is preserved following the constructive termination and there seems to be no reason to trigger a tax at that time.

8. Effective Date Considerations

Under the Notice, the Deemed Redemption Rule is effective to any transaction (or series of transactions) occurring after March 9, 1989 (the date of the Notice) that has the prohibited economic effect. However, the Distribution Rule applies to all distributions of corporate stock to a corporate partner occurring after March 9, 1989. As a result, if contributions to a partnership resulted in an economic deemed exchange prior to March 9, 1989, but the partnership distributes a corporate partner's stock to that partner after March 9, 1989, the Distribution Rule will apply at the time of the distribution.

As discussed above, the Committees oppose the adoption of the Distribution Rule because it covers many situations for which immediate taxation of a partner is neither appropriate

nor necessary. The Committees surmise that one reason for the Notice's adoption of the Distribution Rule was to cover, on a facially nonretroactive basis, the transactions described in the preceding paragraph that had already "begun" by March 9, 1989. The Committees do not oppose this limited application of the Distribution Rule because they believe that such transactions are inconsistent with General Utilities repeal. Thus, assuming the Distribution Rule is not to be adopted generally, the Committees would not oppose adoption of the Distribution Rule as a transition rule, i.e., by limiting its application to distributions from partnerships where a deemed exchange otherwise subject to the Deemed Redemption Rule was exempt solely because it occurred prior to March 10, 1989, whether or not there was then in effect a plan for a subsequent distribution from the partnership. We believe this approach would fully deal with the Treasury's justifiable concern with transactions that had already begun (but had not been completed) by the date of the Notice.

9. Effect of the Revenue Reconciliation Act

The pending Revenue Reconciliation Act of 1989 would amend § 704(c). It would provide that if property contributed to a partnership by one partner is distributed to another partner (at any time in the House version, or within three years in the

Senate version), then upon the distribution the contributing partner must recognize gain or loss, to the extent provided under existing § 704(c)(i.e., to the extent of the built-in gain or loss at the time of contribution), as if the property were sold at its fair market value at the time of the distribution.

This provision appears to be intended primarily as an extension of the "disguised sale" rules of § 707(a)(2)(B). As such, it would primarily accelerate gain that would otherwise be deferred under the normal partnership rules.

To be sure, in the absence of the Deemed Redemption Rule, the provision would also apply to situations involving partner stock. For example, in Example 1, if P were later liquidated with P1 receiving its own stock and P2 receiving asset A with its original value, P1's built-in gain on asset A would be recognized by P1. Thus, it could be argued that the legislation would make the Deemed Redemption Rule unnecessary.

However, the proposed legislation would be simple to avoid in a number of ways, resulting in the same permanent gain elimination that arises at present in the absence of the Deemed

Redemption Rule. [25] First, if the final legislation only applies to a distribution within a fixed number of years, the provision could be avoided if the appreciated asset were not distributed by the partnership for that period of time. Second, even if a distribution within the prohibited period were desired, returning to Example 1, it would only be necessary to have a third partner (P3) contribute a small amount of cash or unappreciated P1 stock. P1 would later be redeemed out with its own stock, recognizing no gain or loss. P would have two partners, P2 and P3, and would own asset A (basis $20 and value $100) and perhaps the cash contributed by P3. On a sale of asset A and liquidation of P, P2 and P3 would recognize no net gain or loss, and P1 apparently would not recognize gain under the legislation because it was no longer a partner. Third, in lieu of finding a third partner, the parties could avoid the legislation by special allocations of income from the different assets to the different partners. This would have the economic effect of a redemption, without the need for an actual redemption subject to the legislation.

In conclusion, the Deemed Redemption Rule remains necessary to cover large gaps in the pending legislation.

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[25] To be sure, similar techniques to avoid the legislation could be used in situations not involving P1 stock. However, in such cases, gain would be deferred (as at present), not eliminated.

INTERNAL REVENUE SERVICE ADVANCE NOTICE 89-37, ON USE OF PARTNERSHIPS TO AVOID GENERAL UTILITIES REPEAL, ISSUED MARCH 9,1989 (TEXT)

(Note: Notice 89-37 is scheduled to appear in Internal Revenue Bulletin 1989 13, dated March 27, 1989.)

Notice of Intent to Promulgate Regulations Addressing Use of Partnerships to Avoid General utilities Repeal NOTICE 89-37

Section 631 of the Tax Reform Act of 1986 (the "1986 Act") was intended to repeal the General Utilities doctrine which, under certain circumstances, permitted a corporation to distribute appreciated assets to its shareholder without recognizing gain. Following the 1986 Act, the Internal Revenue Code generally requires a corporation to recognize gain up the distribution of appreciated property (see section 311(b) and 336(a)). Section 631 of the 1986 Act also added section 337(d) to the Code, as amended by section 1006(e)(5) of the Technical and Miscellaneous Revenue Act of 1988, to protect the integrity of the repeal of the General Utilities doctrine. Section 337(d) directs the Secretary to prescribe the regulations that may be necessary or appropriate to carry out the purposes of the 191 Act's repeal of the General Utilities doctrine, including regulations to ensure that such purposes are not circumvented through the use of any provision of law or regulations.

The Service has determined that, in certain circumstances, the acquisition (or mere ownership) by a partnership of stock in one of its corporate partners (or stock of any member of the affiliated group of which such partner is a member) results in avoidance of General Utilities repeal.

These circumstances are present to the extent the corporate partner, in substance, relinquishes an interest in appreciated property in exchange form interest in its stock (or the stock of any member of the affiliated group of which such partner is a member). The Service intends prescribe regulations under its general rulemaking authority and section 337(d) to provide for gain recognition by a corporate partner in such circumstances.

Application of section 311(b) notwithstanding section 731

The Service has determined that, in order to carry out the purposes to the repeal of the General Utilities doctrine, a partnership distribution to a corporate partner of the stock of such corporation (or the stock of any member of the affiliated group of which such partner is a member) should be characterized as a redemption of the corporate partner's stock with property consisting of its partnership interest. Therefore, the Service will issue regulations providing, that section 311(b), rather than general nonrecognition rule of section 7311(a), will be applicable whenever a partner receives a distribution of its own stock (or the stock of any member of the affiliated group of which such partner is a member). Accordingly, under section 311(b), gain (but not loss) with respect to the partner's partnership interest will be recognized. This rule will apply to all such distributions of corporate stock occurring after March 9, 1989.

Deemed redemption

The Service also intends to adopt rules under which gain will be recognized at the time of, and to the extent that, my transaction (or series of transactions) has the economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock (or the stock of any member of the affiliated group of which such partner is a member) owner or acquired by the partnership. In general, the gain that would be required to be recognized by the corporate partner under this rule would include the gain attributable to appreciation accruing during the period (i) before the property was contributed by the corporate partner to the partnership, and (ii) after the property was contributed to, or acquired by, the partnership and prior to the deemed redemption.

For example, if a corporation contributes appreciated property to a partnership-in exchange for a thirty percent interest in the partnership and another person exchanges stock of the corporate partner for the other seventy percent interest in the partnership, the corporate partner can properly be treated as having relinquished seventy percent of its interest in the appreciated property in exchange for a thirty percent interest in its own stock at the time of the acquisition of such stock. without regard to whether such stock is or will be distributed to the corporate partner. Other transactions to which the deemed redemption rule may apply include, but are not limited to partnership purchases of a corporate partner's stock, disproportionate distributions, and amendments to the partnership agreement. The Service is considering whether any exemptions, such as a de minimis rule, might be appropriate. The deemed redemption rule will apply to any transaction (or series of transaction) with the above described economic effect occurring after March 9, 1989.

Other Principles and rules

Certain transactions that would be subject to the regulations to be issued, as described in this Notice, ah may be sub- to taxation under the "substance over form" principle or section 707(a)(2)(B). For example, the "substance over form" principle and section 707(a)(Z)(B) are each relevant to the analysis of any transaction in which a corporate partner contributes appreciated property to a partnership that ac-quires (or owns) stock of the corporate partner pursuant to an understanding that such stock will be distributed to the corporate partner by the partnership.

No inference should be made based upon this Notice regarding the scope of the "substance over form" principle or the disguised sale rules of section 707(a)(2)(B).

Administrative Pronouncement

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(t) of the Income Tax Regulations ad may be relied upon to the same extent as a revenue ruling or a revenue procedure. See Rev. Rul. 87-138,1987-2 C.B. 287

Further information

For further information regarding this announcement, contact either John N. Geracimos (CC:CORP:4) or Dexter A. Johnson (CC:P&SI:3) at (202) 566-3651 or (202) 566-4751, respectively (not toll-free calls).