REPORT #803

TAX SECTION

New York State Bar Association

Draft Technical Comments on GATT Revenue Provision
Taxing Partnership Distributions of Marketable Securities

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TAX SECTION
New York State Bar Association

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To: Glen Kohl
John Buckley

From: Michael Schler

Attached as we promised yesterday is a draft of some "quick and dirty" technical comments on the Senate bill language of the proposed GATT provision concerning partnership distributions of marketable securities. Given the time schedule, this represents the input of only a few people and is by no means intended to be definitive.

I hope this is helpful to you. Feel free to call me if you have any questions.

Draft Technical Comments on GATT Revenue Provision Taxing Partnership Distributions of Marketable Securities

1. Section 731(c)(2)(A)(i) defines “marketable securities” to mean securities for which there is a market on an established securities market “or otherwise”.

The “or otherwise” reference is extremely broad as well as vague, since the concept of a “market” is very open-ended. One possibility would be to require that a security be “readily tradeable” on a non-established market.

2. Section 731(c)(2)(B)(ii) provides that to the extent provided in regulations, marketable securities includes property readily convertible into money or marketable securities.

This provision might be more appropriate in the basic definition of marketable securities and not require regulations to be operative.

3. Section 731(c)(3)(B) provides that, in general, the taxable gain to a partner on a distribution under section 731(c)(1) is reduced by the partner's “allocable share” of the hypothetical “aggregate gain” to the partnership if the partnership had, immediately before the distribution, instead sold all its securities of the type (same class and issuer) distributed. (An adjustment is made if, after the distribution, the partner still has an interest in the partnership.) Thus, for example, a partner can receive tax-free its pro rata share of each type of security held by the partnership.

It might be clarified that (1) “aggregate gain” on securities of a single type is required to be reduced by losses that would arise on a sale of such securities with an above-market tax basis (rather than simply adding together any and all gains on such hypothetical sales), (2) aggregate gain at the partnership level is determined without regard to Section 754, and (3) a partner's “allocable share” is determined on some pro rata basis without regard to special allocations at the partnership level, or alternatively without regard only to special allocations intended to avoid the effect of the distribution rule (so that a partner could not take unintended advantage of the rule by having the partnership agreement specially allocate all or most of the gain on a single type of security to that partner, thereby permitting a non pro rata distribution of all securities of that type to that partner with little or no gain recognition).

4. Section 731(c)(3)(B) (flush language) provides that, under regulations, all marketable securities held by the partnership may be treated as being of the same class and issuer as the distributed securities. This could, for example, permit a partner to receive tax-free a non-pro rata distribution of partnership securities. On the other hand, it could have anti-taxpayer results if a partner received a pro rata distribution of appreciated securities of one type but the partnership continued to hold depreciated securities of a different type (so that by treating all partnership securities as being of the same type the partner's share of net unrealized appreciation would be less than by looking solely to the securities of the type actually distributed).

> We question whether the basic policy issues raised by this provision should be left to regulations, particularly with no guidance in the statute as to the standards to be applied in adopting regulations. Absent more guidance in the statute, regulations could significantly negate the apparently intended benefits to taxpayers of (c)(3)(B).

5. Section 731(c)(3)(C)(i) provides that an investment partnership must “never” have engaged in a trade or business and substantially all its assets must have “always” consisted of specified types of assets.

> It may be difficult for an investment partnerships to determine whether these conditions were satisfied many years before the determination is required. Perhaps only a 5- or 10-year lookback should be required, at least for existing partnerships that presently meet the activity and asset tests.

6. Section 731(c)(3)(C)(i) provides that an investment partnership must have substantially all its assets invested in money, corporate stock, debt instruments, certain financial instruments, or other assets specified in regulations. Moreover, section 731(c)(3)(C)(iv) provides that except as provided in regulations, a partnership holding an interest in another partnership is treated as if it directly held its share of the underlying assets of the latter partnership.

We question whether an investment partnership should never be permitted (except as provided in regulations) to be a partner in a partnership that itself engages in a trade or business. For example, an investment partnership should be permitted to be a limited partner in a widely held or publicly traded partnership. See the definition of “security” in Section 475(c)(2). Arguably an investment partnership should be permitted to hold <u>any</u> limited partnership interest (or comparable interest in an entity such as an LLC) as long as it does not participate in management of the entity.

7. Section 731(c)(3)(C)(ii) provides that a partnership shall not be treated as engaged in a trade or business by reason of any activity undertaken as an investor, etc. in a permitted investment asset, or by reason of any other activity specified in regulations.

It would be helpful if a specific statutory exception were provided for a partnership's receipt of commitment fees, break-up fees or similar fees incidental to its investment activities.

8. Section 731(c)(3)(C)(iii)(II) provides that an eligible partner in an investment partnership (generally any partner that does not contribute prohibited assets to the partnership) does not include “the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner (without regard to this subclause)”. This was apparently intended to mean that an ineligible partner could not remove the taint by transferring its partnership interest to a new partner in a nonrecognition transaction.

It appears that to carry out the purpose of this provision, the final parenthetical clause should be deleted. Suppose ineligible partner P transfers its interest to PI which in turn transfers the interest to P2. PI would be an eligible partner absent application of clause (II), but application of clause (II) to the first transfer makes PI ineligible. On Pi's transfer to P2, P2 is only ineligible if clause (II) applies to that transfer, but clause (II) does not literally apply because of the quoted parenthetical (i.e., PI is only ineligible because of a prior application of clause (II), and thus PI is eligible without regard to clause (II), and thus clause (II) does not apply to the second transfer). Since double transfers are presumably not intended to be exempt from the rule, the parenthetical should be deleted.

9. Section 731(c)(6) provides that gain recognized under section 731(c) is ordinary income if it arises on a distribution of a marketable security that is an unrealized receivable or inventory item under Section 751.

It should be made clear that section 751 applies to the distributee partner before section 731(c). For example, if a partner receives a distribution of an inventory item and the partnership holds non-section 751 items, under section 751 the other partners will recognize some ordinary income and the distributee partner will recognize some capital gain. The latter capital gain will increase the basis of the distributee partner and correspondingly reduce the amount of income (which would be ordinary) to be recognized by that partner under section 731(c).

This will result in the correct aggregate amount of ordinary income being reported. On the other hand, if section 731(c) applied prior to section 751, under the above provision all the gain of the distributee partner would be ordinary, which would duplicate (in character) the ordinary income recognized by the other partners under section 751; the distributee partner might also be subject to a duplicate amount of gain if, after full gain recognition under section 731(c), section 751 subsequently applied.

Subtitle F — Other Provisions

SEC.___.PARTNERSHIP DISTRIBUTIONS OF MARKETABLE SECURITIES.

(a) IN GENERAL. — Section 731 (relating to extent of recognition of gain or loss on distribution) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

“(c) TREATMENT OF MARKETABLE SECURITIES.

“(1) IN GENERAL. — For purposes of subsection (a)(1) and section 737 -

“(A) the term 'money' includes marketable securities, and

“(B) such securities shall be taken into account at their fair market value as of the date of the distribution.

“(2) MARKETABLE SECURITIES. –

“(A) IN GENERAL. — For purposes of this subsection, the term 'marketable securities' means —

“(i) securities for which, as of the date of the distribution, there is a market on an established securities market or otherwise, and

“(ii) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such

entity consist (directly or indirectly), as of such date, of marketable securities, money, or both.

"(B) OTHER READILY TRADABLE PROPERTY. — To the extent provided in regulations prescribed by the Secretary, the following property shall be treated as marketable securities for purposes of this subsection:

"(i) Any property (other than a security) for which there is a market on an established market or otherwise.

"(ii) Any property which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities.

"(iii) Any other property the value of which is determined substantially by reference to the value of one or more marketable securities.

"(iv) Any interest in an entity not described in subparagraph (A)(ii) but only to the extent of the value of such interest which is attributable to marketable securities, money, or both.

"(3) EXCEPTIONS. –

"(A) IN GENERAL. — Paragraph (1) shall not apply to the distribution from a partnership of a marketable security to a partner if –

“(i) the security was contributed to the partnership by such partner, except to the extent that the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) to the entity to which the distributed security relates,

“(ii) to die extent provided in regulations prescribed by the Secretary, the security was not a marketable security when acquired by such partnership, or

“(iii) such partnership is an investment partnership and such partner is an eligible partner thereof.

“(B) LIMITATION ON GAIN RECOGNIZED. - In the case of a distribution of marketable securities to a partner, the amount taken into account under paragraph (1) shall be reduced (but not below zero) by the excess (if any) of—

“(i) such partner's allocable share of the aggregate gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over

“(ii) such partner's allocable share of such aggregate gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction.

Under regulations prescribed by the Secretary, all marketable securities held by the partnership may be treated as marketable securities of the same class and issuer as the distributed securities.

“(C) DEFINITIONS RELATING TO INVESTMENT PARTNERSHIPS. - For purposes of subparagraph (A)(iii) —

“(i) INVESTMENT PARTNERSHIP. - The term 'investment partnership' means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of —

“(I) money,

“(II) stock in a corporation,

“(HI) notes, bonds, debentures, or other evidences of indebtedness,

“(TV) interest rate, currency, or equity notional principal contracts,

“(V) foreign currencies,

“(VI) interests in or derivative financial instruments (including options, forward contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity on or subject to the rules of a board of trade or commodity exchange,

“(VII) other assets specified in regulations ^prescribed by the Secretary, or

“(VIII) any combination of the foregoing.

“(ii) EXCEPTION FOR CERTAIN ACTIVITIES. — A partnership shall not be treated as engaged in a trade or business by reason of—

“(I) any activity undertaken as an investor, trader, or dealer in any asset described in clause (i), or

“(II) any other activity specified in regulations prescribed by die Secretary.

“(iii) ELIGIBLE PARTNER. –

“(I) IN GENERAL. — The term 'eligible partner’ means any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in clause (i).

“(II) EXCEPTION FOR CERTAIN NONRECOGNITION TRANSACTIONS. - The term 'eligible partner' shall not include the > transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner (without regard to this subclause).

“(iv) LOOK-THRU OF PARTNERSHIP TIERS. — Except as otherwise provided in regulations prescribed by the Secretary —

“(I) a partnership shall be treated as engaged in any trade or business engaged in by, and as holding (instead of a partnership interest) a proportionate share of the assets of, any other partnership in which the partnership holds a partnership interest, and

“(II) a partner who contributes to a partnership an interest in another partnership shall be treated as contributing a proportionate share of the assets of the other partnership.

“(4) BASIS OF SECURITIES DISTRIBUTED. –

“(A) IN GENERAL. — The basis of marketable securities with respect to which gain is recognized by reason of this subsection shall be —

“(i) their basis determined under section 732, increased by

“(ii) the amount of such gain.

“(B) ALLOCATION OF BASIS INCREASE. - Any increase in basis attributable to the gain described in subparagraph (A)(ii) shall be allocated to marketable securities in proportion to their respective amounts of unrealized appreciation before such increase.

“(5) SUBSECTION DISREGARDED IN DETERMINING BASIS OF PARTNER’S INTEREST IN PARTNERSHIP AND OF BASIS OF PARTNERSHIP PROPERTY. - Sections 733 and 734 shall be applied as if no gain were recognized, and no adjustment were made to the basis of property, under this subsection.

“(6) CHARACTER OF GAIN RECOGNIZED. - In the case of a distribution of a marketable security which is an unrealized receivable (as defined in section 751(c)) or an inventory item (as defined in section 751(d)(2)), any gain recognized under this subsection shall be treated as ordinary income to the extent of any increase in the basis of such security attributable to the gain described in paragraph (4)(A)(ii).

“(7) REGULATIONS. - The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations to prevent the avoidance of such purposes through arrangements involving changes in partnership allocations and distributions rights, multiple distributions, related entities, or otherwise.”

(b) CONFORMING AMENDMENTS. –

(1) The last sentence of section 737(c)(1) is amended to read as follows: “For purposes of determining the basis of the distributed property (other than money), such increase shall be treated as occurring immediately before the distribution.”

(2) Section 737 is amended by adding at the end the following new subsection:

“(e) MARKETABLE SECURITIES TREATED AS MONEY. -

“For treatment of marketable securities as money for purposes of this section, see section 731(c).”

(c) EFFECTIVE DATE. -

(1) IN GENERAL. - Except as otherwise provided in this subsection, the amendments made by this section shall apply to marketable securities distributed after the date of the enactment of this Act.

(2) CERTAIN DISTRIBUTIONS BEFORE JANUARY 1, 1995. - The amendments made by this section shall not apply to any marketable security distributed before January 1, 1995, by the partnership which held such security on July 15, 1994.

(3) DISTRIBUTIONS IN LIQUIDATION OF PARTNER'S INTEREST. - The amendments made by this section shall not apply to the distribution of a marketable security in liquidation of a partner's interest in a partnership if -

(A) such liquidation is pursuant to a written contract which was binding on July 15, 1994, and at all times thereafter before the distribution, and

(B) such contract provides for the purchase of such interest not later than a date certain for —

(i) a fixed dollar amount of marketable securities that are specified in the contract, or

(ii) other property.

The preceding sentence shall not apply if the partner has the right to elect that such distribution be made other than in marketable securities.

(4) MARKETABLE SECURITIES. — For purposes of this subsection, the term “marketable securities” has the meaning given such term by section 731(c) of the Internal Revenue Code of 1986, as added by this section.