Tax Report #847

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

NYSBA

October 2, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: **Proposed Regulations 1.704-4**
<u>and 1.737-1 through 1.737-5</u>

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to submit a report on the proposed Treasury regulations sections 1.704-4 and 1.737-1 through 1.737-5. The report was prepared by Andrew N. Berg and William B. Brannan, Co-Chairs of our Committee on Partnerships, and Lori S. Hoberman, a member of that Committee.

The report generally supports the proposed regulations, and commends you for organizing the complex rules and principles of Code sections 704(c)(1)(B) and 737 into an understandable format. The report also offers substantive comments on certain aspects of the proposed regulations.

Many of the comments relate to the interaction of sections 704(c)(1)(B) and 737, and the proposed regulations, with section 708 terminations.

The technical construct of a section 708 termination is that it gives rise to a constructive distribution of partnership assets, followed by a constructive contribution of those assets to a new partnership. In the 704(c)(1)(B)/737 context, these deemed distributions and contributions raise a number of technical questions. The 1989 legislative history dealt specifically with section 708 terminations, but upon further consideration the Committee questions whether certain results suggested in the legislative history are in fact appropriate. Specifically, the report questions the complex and potentially harsh results that stem from applying sections 704(c)(1)(B) and 737 anew to all partnership assets following a technical termination, given that those assets were and continue to be in partnership solution.

The report also expresses the view that the "anti-shifting" rule suggested by the legislative history is a significant departure from current law and, if implemented, would require either a fundamental overhaul of established section 708 rules, or the development of a complex hybrid system for making different built-in gain and loss allocations for section 704(c)(1)(B) purposes. Neither of these developments is desirable. The Committee instead recommends that the existing section 708 allocation methodology apply for all purposes, with any particular concerns being met by a specific anti-abuse rule. The report also makes general recommendations regarding the apportionment of gain and loss among properties following a partnership termination.

With respect to section 737, the report recommends that the definition of non-taxed distributions of the same property as was contributed should include situations in which fungible property, or undivided interests in property, are contributed to and subsequently distributed by a partnership.

The report also offers technical comments on the liquidation exemption, on the effective date provision, and on the proposed anti-abuse rules. In regards to this last point, we are concerned that the inclusion of paraphrased versions of regulation section 1.701-2 in specific subchapter K regulations might be interpreted as the imposition of a second, different, and less clear set of anti-abuse rules. We believe that restating parts of the general anti-abuse rule as separate, section-specific anti-abuse rules is unnecessary and unwise. We recommend instead that these regulations either include a specific rule treating a constructive distribution as an actual distribution, or else cross reference to regulation section 1.701-2, and then set forth specific factors and examples describing abusive and non-abusive situations in these particular contexts.

Please do not hesitate to call if we can be of any further assistance in the development of the final regulations. We thank you for this opportunity to comment on the proposed regulations.

Very truly yours,

Carolyn Joy Lee

Carolyn Joy Lee
Chair

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Tax Report # 847

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON PARTNERSHIPS

Report on Proposed Treasury Regulation Sections 1.704-4 and 1.737-1 Through -5

October 2, 1995

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON PARTNERSHIPS[*]

Report on Proposed Treasury Regulation
Sections 1.704-4 and 1.737-1 Through -5

I. INTRODUCTION

This report comments on Proposed Treasury Regulations § 1.704-4 (the "Proposed 704(c)(1)(B) Regulations") and §§ 1.737-1 through -5 (the "Proposed 737 Regulations"), hereafter collectively referred to as the "Proposed Regulations".[1] The Proposed Regulations implement the statutory provisions that require a partner that contributes built-in gain or loss property to a partnership to recognize gain or loss upon certain partnership distributions of the contributed property to another partner or of other partnership property to the contributing partner.

The Committee supports the adoption of the Proposed Regulations with certain modifications, discussed below. Moreover, the Committee commends Treasury for assembling an extremely complex set of legal principles into orderly and understandable regulations.

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*. This report was prepared by a working group consisting of Andrew N. Berg, William B. Brannan and Lori S. Hoberman. The principal draftsperson was Lori S. Hoberman. Helpful comments were received from William L. Burke, Peter C. Canellos, Richard G. Cohen, Stuart J. Goldring, Stephen B. Land, Carolyn Joy Lee, Richard L. Reinhold, Michael L. Schler and Ralph O. Winger.

1. The Proposed 704(c)(1)(B) and 737 Regulations were promulgated by PS-76-92 and PS-51-93, respectively, 60 Fed. Reg. 2352 (January 9, 1995).

II. SUMMARY OF THE PROPOSED 704(c)(1)(B) REGULATIONS

The Proposed 704(c)(1)(B) Regulations require a contributing partner to recognize built-in gain or loss on a distribution of the contributed property to another partner within five years of its contribution to the partnership (a "Section 704(c)(1)(b) distribution"). The amount of built-in gain or loss required to be recognized is equal to the amount of gain or loss that would have been allocated to the contributing partner under Section 704(c)(1)(A)[2] and Treasury Regulation § 1.704-3 if the partnership had sold, rather than distributed, the property to the distributee partner at its fair market value at the time of the distribution (the "deemed Section 704(c)(1)(B) gain" or "deemed Section 704(c)(1)(B) loss"). That amount is equal to the difference between the fair market value of and the contributing partner's adjusted tax basis in the contributed property as of the date of contribution, as decreased to reflect subsequent reductions in the difference between the property's book value and its adjusted tax basis (contributed property with built-in gain or loss is hereafter referred to as "Section 704(c) property").

The character of deemed Section 704(c)(1)(B) gain or loss is determined as if the partnership had sold the Section 704(c) property to the distributee partner for fair market value. For example, the character of deemed Section 704(c)(1)(B) gain or loss realized upon a distribution of Section 704(c) property to a

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2. Unless otherwise noted, all "Section" references herein are to the Internal Revenue Code of 1986, as amended.

greater-than fifty percent partner takes into account the application of Section 707(b).[3]

A. Built-in Gain or Loss Taint

Section 704(c) property retains its built-in gain or loss taint for Section 704(c)(1)(B) purposes for a five-year period. In addition, if the partnership exchanges the Section 704(c) property for other property in a nonrecognition transaction, the taint transfers to the new property. Similarly, if the contributing partner transfers all or a portion of his partnership interest, the transferee effectively steps into the shoes of the contributing partner.

B. Exceptions and Special Rules

The Proposed Regulations contain certain exceptions and special rules. For example, a contributing partner does not recognize deemed Section 704(c)(1)(B) gain under certain limited circumstances in connection with a partnership liquidation. Section 704(c)(1)(B) gain is not triggered by a deemed liquidation associated with a technical termination of a partnership under Section 708(b)(1)(B), but the deemed contribution to a new partnership is treated as an actual contribution for purposes of applying Section 704(c)(1)(B) to the post-termination partnership. Section 704(c)(1)(B) gain is also not recognized where the contributing partner receives a distribution of like-kind property within 180 days of the

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3. See example at Prop. Reg. § 1.704-4(b)(2).

contribution (but not later than the due date of the contributing partner's tax return for the taxable year of the distribution).

C. Ordering Rules and Basis Adjustments

The contributing partner's adjusted tax basis in his partnership interest is increased by the deemed Section 704(c)(1)(B) gain that is recognized.[4]

The partnership's adjusted tax basis in the distributed Section 704(c) property is adjusted immediately prior to the distribution for any deemed Section 704(c)(1)(B) gain or loss recognized by the contributing partner. Thus, in a non-liquidating distribution, the distributee partner's basis in the distributed property is affected by the Section 704(c)(1)(B) gain or loss recognized by the contributing partner. Basis adjustments made under Section 734(b) as a result of a Section 754 election are made after, and take into account, the Section 704(c)(1)(B) basis adjustments.

III. SUMMARY OF THE PROPOSED 737 REGULATIONS

The Proposed 737 Regulations require a partner that contributes built-in gain property to recognize gain if he receives a distribution of other partnership property (other than money) within five years of that contribution (a "Section 737

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4. If Section 704(c)(1)(B) and Section 737 distributions occur at the same time, the deemed Section 704(c)(1)(B) gain is calculated first. Such gain is added to the contributing partner's basis in his partnership interest for purposes of determining the amount of gain recognized in the Section 737 distribution.

distribution"). The amount of built-in gain required to be recognized (the "Section 737 gain") is equal to the lesser of

> (i) the excess of the fair market value of distributed property received over the contributing partner's basis in his partnership interest (an "excess distribution")[5]; or
>
> (ii) the gain that would have been recognized under the Proposed 704(c)(1)(B) Regulations if the partnership had actually distributed all the Section 704(c) property of the contributing partner to another partner (the "net pre-contribution gain")[6].

The character of Section 737 gain recognized is a pro rata share of all of the gain in the contributed property, determined as if the partnership had sold all of the originally-contributed property to an unrelated third party for fair market value.

A. Exempt Distributions

Certain partnership distributions do not trigger Section 737 gain recognition. A liquidating distribution following a transfer by a partnership of all its assets and liabilities to a second partnership is exempt from Section 737 gain recognition. Similarly, distributions following certain

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5. For purposes of determining the amount of a partner's excess distribution, any adjustments to the partner's basis in his partnership interest resulting from the Section 737 distribution (other than the Section 737 gain itself) are taken into account. For example, an increase or decrease in the contributing partner's share of partnership liabilities must be reflected in accordance with Section 752.

6. Net pre-contribution gain is reduced by any Section 734(b)(2)(A) basis adjustments made to the Section 704(c) property and by any deemed Section 704(c)(1)(B) gain recognized.

partnership incorporations are exempt from Section 737 gain recognition.

B. Basis Adjustments

The contributing partner's adjusted tax basis in his partnership interest is increased by the amount of Section 737 gain that is recognized.

The partnership's basis in property contributed by the partner recognizing the Section 737 gain is increased by the amount of such gain.[7] Adjustments made as a result of a Section 754 election are made after, and take into account, the Section 737 basis adjustments.

IV. SUMMARY OF RECOMMENDATIONS

We have a number of comments designed to help clarify certain aspects of the Proposed Regulations. The Committee's principal substantive comments are as follows:

1. The Committee believes the Proposed Regulations provide inadequate guidance concerning the effect of a partnership termination under Section 708(b)(1)(B) (a "Section 708 termination"). The Committee's specific recommendations include the following:

    a. The Committee recommends that the final regulations adopt an approach that is consistent with long-established Section 708 principles with respect to

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7. The Proposed 737 Regulations provide rules for allocating this increase in basis among the partnership properties; any such increase is recovered by the same method available for newly purchased property. See Prop. Reg. § 1.737-3(c)(3).

built-in gain attributable to previously-contributed property. The Committee believes that Treasury's concern about the potential for shifting built-in Section 704(c)(1)(B) gain following a Section 708 termination can be adequately addressed through the anti-abuse provisions.

b. The Committee believes that consideration should be given to not treating the deemed contribution associated with a Section 708 termination as an actual contribution for purposes of subjecting post-contribution changes in the value of partnership property to Sections 704(c)(1)(B) and 737.

c. If the recommendation in (b) above is not accepted, the Committee recommends that guidance be provided concerning the apportionment of pre- and post-contribution built-in gain among the partnership's properties following a Section 708 termination and that the Proposed Regulations be more explicit that a new five year period for previously contributed property that is deemed distributed and recontributed in a Section 708 termination only applies with respect to any post-contribution appreciation in the value of such property.

2. The Committee recommends that the exemption from Section 737 gain for distributions to a contributing partner of his originally-contributed Section 704(c) property be

extended to distributions of undivided interests in a single asset and distributions of fungible property where the partner originally contributed the same type of property and it is not possible to determine whether the property being distributed is the same property. Likewise, the Committee recommends that these partners be exempt from deemed Section 704(c)(1)(B) gain on distributions of such property.

V. GENERAL COMMENTS AND RECOMMENDATIONS

A. Effect of Section 708 Terminations

As discussed in more detail below, the Committee believes the final regulations should provide clear guidance concerning the treatment of Section 708 terminations. In particular, the Committee strongly believes such guidance should adopt an approach to sharing the built-in gain following Section 708 terminations that is consistent with the established treatment of Section 708 terminations for all other tax purposes. The Committee acknowledges that its recommendations conflict with certain statements in both the House Budget Committee Report and in the Senate Finance Committee Report explaining Section 704(c)(1)(B) (the "Legislative History").[8] However, the

8. See House of Representatives Budget Committee Report, H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1357 (1989) ("House Budget Committee Report") and in the Senate Finance Committee Report, Unnumbered Senate Report (S. Print 101-56), 101st Cong., 2d Sess. 198 (1989) ("Senate Finance Committee Report"). The Committee Reports explaining Section 737 contain similar language indicating that 704(c) built-in gain sharing requirements remain unchanged following a Section 708 termination. H.R. Rep. 1018, 102nd Cong., 2d Sess. 429 (Oct. 5, 1992); Senate Finance Committee Technical Explanation, 138 Cong. Rec. S11246, S11266 (daily ed. August 3, 1992).

Committee does not believe that Treasury is absolutely bound to follow those statements, given the complex and undesirable consequences they entail.

1. Established Section 708 Principles. Under Section 708(b)(1)(B), when 50% or more of the capital and profits interests in a partnership are transferred within any 12-month period, the partnership is deemed to terminate. Under Treasury Regulation § 1.708-1(b)(1)(iv) (the "708 Regulations"), the terminated partnership is deemed to distribute its assets in kind to its partners, who are deemed to immediately contribute those assets to a new partnership. The assets that are deemed to have been distributed and then recontributed effectively represent individual undivided interests in the properties of the terminated partnership.[9]

Under Section 704(c)(1)(A), partnership tax allocations after a Section 708 termination reflect a shifting of the

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9. There admittedly is a slight ambiguity in the language in the 708 Regulations, which speaks in terms of a distribution to the partners "in proportion to their respective interests in the partnership properties", but the only logical reading of that language is that the distribution is pro rata based upon the economic interests of the partners. That reading is confirmed by the private letter rulings that have addressed the issue. See, e.g., Private Letter Rulings 8540093 (July 12, 1985); 8217207 (Jan. 29, 1982); and 8130131 (Apr. 30, 1981). See generally McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners ¶ 12.05(2) (1990) and Willis, Pennel and Postlewaite, Partnership Taxation § 162 (1995). A contrary reading could result in surprising and potentially harsh consequences under Section 731(a)(1), Section 751(b) and other provisions of the Code.

original built-in gain or loss among partnership properties, as illustrated in Example (1).[10]

> **EXAMPLE (1):** A and B form Partnership AB on January 1, 1995, with each having a 50% interest. A contributes non-depreciable property with a fair market value of $500 and a tax basis of zero ("Property A"); B contributes similar non-depreciable property with a fair market value of $500 and a tax basis of $500 ("Property B"). Subsequently, but at a time when the properties have not changed in value, B sells its interest to C for $500, triggering a Section 708 termination of Partnership AB.
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> According to the 708 Regulations, the tax bases of the assets that are deemed to be distributed to and then recontributed by C (a 50% undivided interest in Property A and a 50% undivided interest in Property B) are, reflecting the Section 743 adjustment for C's purchase price, stepped up to $250 for the interest in Property A and $250 for the interest in Property B;[11] the tax bases of the assets that are deemed to be distributed to and then recontributed by A remain at zero. A's $500 of Section 704(c)(1)(A) gain with respect to Property A becomes, following the termination, $250 of gain with respect to each of Properties A and B.
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> If Property A is sold in 1999 for $500, A will recognize $250 of gain on the sale under Section 704(c)(1)(A).

In the foregoing example, A has effectively split his $500 of pre-contribution built-in gain in Property A between Properties A and B. While A has decreased his Section 704(c)(1)(A) gain with respect to Property A to $250, A now has

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10. Unless otherwise indicated, all examples assume that a valid Section 754 election is in effect for the partnership.

11. Absent a Section 754 election, and absent adjustment under Section 732(d), C will also have post-708 termination built-in gain in Property A and built-in loss in Property B.

$250 of newly-created potential Section 704(c)(1)(A) gain with respect to Property B. The sale of Property B prior to the Section 708 termination would have resulted in no gain to A. A post-termination sale of Property B, however, gives rise to $250 of Section 704(c)(1)(A) gain for A.

In addition to the above-described effect of a technical termination for the contributing partner with respect to the built-in gain or loss attributable to his original contribution, Section 704(c)(1)(A) has further application following a Section 708 termination for the contributing partner and all the other partners to the extent that they are deemed to contribute any asset with a built-in gain or loss attributable to a change in the value of such asset or other factors. As a result, even a partner that originally contributed only cash to the partnership may become subject to Section 704(c)(1)(A) after a Section 708 termination, as illustrated in Example (2).

EXAMPLE (2): A, B and C form Partnership ABC on January 1, 1995. A and B each have a 20% interest in the Partnership, C has a 60% interest. A contributes non-depreciable property with a fair market value of $200 and a tax basis of zero ("Property A"); B and C each contribute cash equal to $200 and $600, respectively.

On December 31, 1998, C sells its interest to D for $720, triggering a Section 708 termination of Partnership ABC. At this time, Property A has increased in value to $400.

Solely with respect to B, the unsuspecting cash partner, the 708 termination results in the deemed distribution of $160 cash (20% x $800) and $80 in value of Property A (20% x $400). Under Section 755, B's $200 basis is allocated first to the cash and the remaining

> $40 of B's bas is allocated to Property A, leaving B with an unexpected $40 of built-in gain in Property A as it is recontributed to the post-708 termination partnership. B would have to recognize $40 of gain under Section 704(c)(1)(A) on a subsequent sale of Property A.

2. Relevance of Section 708 Terminations Generally. As a threshold matter, it must be determined what relevance, if any, the deemed distribution by the "old" partnership and the deemed contribution to the "new" partnership should have for Section 704(c)(1)(B) and Section 737 purposes. The Legislative History specifically states that the deemed distribution should not trigger built-in gain or loss, presumably because the deemed distribution is not a real distribution that implicates the policy behind Section 704(c)(1)(B) and Section 737 of preventing transactions designed to shift built-in gain or loss through a "mixing bowl" transaction.[12] That statement is followed in the Proposed Regulations.[13] However, the Legislative History also states (without any explanation) that the deemed contribution should be treated as an actual contribution for purposes of applying Section 704(c)(1)(B) and Section 737 to all the partners after the contribution, which means that a post-termination distribution of property could trigger gain or loss to one or more partners under Section 704(c)(1)(B) or Section 737.[14] That

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12. See note 8, supra.

13. See Prop. Reg. §§ 1.704-4(c)(3) and 1.737-2(a).

14. Identical statements are found in the House Budget Committee Report, supra note 8, at 1357 and in the Senate Finance Committee Report, supra note 8 at 198.

statement also is followed in the Proposed Regulations, at least for Section 704(c)(1)(B) purposes.[15]

The Committee questions whether the deemed contribution associated with a Section 708 termination should result in Section 704(c)(1)(B) or Section 737 having any greater applicability than before the termination. Since the deemed contribution is a technical construct of the tax law, and does not represent any economic shift in the ownership of the property, that contribution obviously does not represent the first step in a "mixing bowl" transaction that is intended to enable a partner to shift built-in gain or loss to other partners. Moreover, as the balance of this portion of the report only begins to illustrate, treating the deemed contribution as a real contribution can lead to enormous complexity, potentially subjecting every partner to Section 704(c)(1)(B) and Section 737 gain or loss with respect to every item of partnership property. Indeed, the application of Sections 704(c)(1)(B) and 737 to partnership terminations in the manner stated in the Legislative History subjects to the "mixing bowl" regime properties that were purchased and always owned by a partnership. Thus, while the Committee recognizes that the Legislative History is clear on the intended treatment for deemed contributions (and, unlike the Legislative History's position on the more narrow issue discussed in Part V(A)(3) below, does not conflict with established tax

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15. Prop. Reg. § 1.704-4(a)(4)(ii). There is no express rule to the same effect in the Section 737 Regulations, but Proposed Regulation § 1.737-2(d)(1) seems to contemplate that result. Compare Prop. Reg. § 1.737-2(b). This point should be clarified in the final regulations.

principles), the Committee urges the Treasury to reconsider the necessity for the rule.

3. Treatment of a Contributing Partner as to Preexisting Gain or Loss. Even if the Committee's recommendation in Part V(A)(2) above is accepted, guidance must be provided as to how to treat a contributing partner after a Section 708 termination with respect to the gain or loss associated with his prior contribution.

The Legislative History of Section 704(c)(1)(B) contains two sentences that appear to be inconsistent with the analysis of Section 708 terminations for Section 704(c)(1)(A) purposes that is set forth in Part V(A)(1) above. Specifically, the Legislative History states that, while Congress intended that the Treasury coordinate Section 704(c)(1)(B) distributions with the rules governing Section 708 terminations, such coordination was

> intended to be limited in scope, and to provide the following results . . . a constructive termination does not change the application of the sharing requirements of 704(c) (as amended by the bill) to pre-contribution gain or loss with respect to property contributed to the partnership before the termination.[16]

Given long-established Section 708 principles (under which built-in gain or loss does shift to other properties), the Committee seriously questions whether the drafters of the above-quoted language fully appreciated its consequences. Implementation of a literal reading of that sentence would

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16. See note 15, supra.

require either a radical revision of the treatment of partnership terminations or the imposition of a complex hybrid system for Section 704(c) dispositions -- where one type of deemed distribution occurs (a pro rata distribution) for most purposes and another type for Section 704(c)(1)(B) purposes. The Committee believes the current state of the law is that the Section 704(c)(1)(A) gain that is required to be allocated to the original contributor on a subsequent sale of property is determined by reference to the pre-existing 708 Regulations, as illustrated in Example (1). One would assume that the results following a subsequent Section 704(c)(1)(B) transaction would be the same as illustrated in Example (1) in Part V(A)(1) above, since Section 704(c)(1)(B) and Section 704(c)(1)(A) are intended to operate in tandem. Indeed, the amount of gain required to be recognized under Section 704(c)(1)(B) in the Proposed 704(c)(1)(B) Regulations is

> an amount equal to the gain or loss that would have been allocated to such partner under Section 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the distributee partner . . .[17]

Following the Legislative History, however, appears to require gain on a Section 704(c)(1)(B) distribution to be determined under a "anti-shifting" rule, as illustrated below in Example (3).

> **EXAMPLE (3):** Assume the same facts as in Example (1), but instead of selling Property A, the partnership distributes it in

17. Prop. Reg. § 1.704-4(a)(1).

1999 to C in partial liquidation of C's interest.

According to the "anti-shifting" rule suggested by the Legislative History, for Section 704(c)(1)(B) purposes, the earlier Section 708 termination presumably results in C receiving and recontributing Property B with a tax basis equal to its fair market value of $500. A receives and recontributes Property A with a tax basis of zero and a fair market value of $500.

The 1999 distribution of Property A to C triggers deemed Section 704(c)(1)(B) gain for A of $500. In contrast, if such property had been sold, as illustrated in Example (1), A would have recognized $250 of gain under Section 704(c)(1)(A).

The Committee strongly believes that the hybrid approach suggested by the Legislative History is undesirable and unnecessary. The Committee recognizes the possibility that imposition of a hybrid system could be avoided by interpreting the Legislative History as applying the "anti-shifting" rule both to sales under Section 704(c)(1)(A) and to distributions under Section 704(c)(1)(B). That interpretation is questionable,[18] however, as is the House Budget and Senate Finance Committees intent to erase long-standing regulatory authority under Section 708(b)(1)(B) with two sentences in a Committee Report that does not acknowledge such a broad scope.

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18. Given the reference in the Legislative History that "704(c) (as amended by the bill) be <u>coordinated</u> with the rules governing partnership terminations" (emphasis added), it seems unlikely that the Legislative History intended that there be a significant revision of the treatment of Section 708 terminations outside of the Section 704(c)(1)(B) context.

While contrary to the Section 704(c)(1)(B) Legislative History, the Committee nonetheless strongly recommends adopting a uniform, consistent approach for all Section 704(c) property dispositions by a partnership that has undergone a Section 708 termination; the benefits of a uniform rule outweigh the problems that would be associated with a rigid adherence to the Legislative History.

Furthermore, the Legislative History suggests a complicated "anti-shifting" rule to address the concern that Partner A was spreading his pre-contribution built-in gain among other partnership assets via a Section 708 termination, which

> could otherwise cause a shift of pre-contribution built-in gain or loss away from the contributed property to other property, which is contrary to the purpose of this provision of the bill.[19]

The Committee believes, however, that the anti-abuse rule contained in Proposed Regulation § 1.704-4(f) is adequate to deal with any abuse potential created by built-in-gain shifting. The Committee recommends adding an appropriate example to that Section covering use of Section 708 as a shifting device. The Committee believes that concern about post-Section 708 termination dilution of deemed Section 704(c)(1)(B) gain would be adequately, and more appropriately, dealt with under anti-abuse rules, rather than by devising intricate anti-shifting rules.

4. <u>Apportioning Pre-and Post- Contribution Built-In-Gain Among Partnership Properties following a Section 708</u>

19. <u>See</u> note 15, <u>supra</u>.

Term: :ion. The Committee recommends that final regulations provide guidance concerning the apportionment of pre- and post-contribution built-in gain among the partnership's properties following a Section 708 termination. Even if final regulations adopt the Committee's recommendation in Parts V(A)(2) and (3) above, more guidance should be given to coordinate Sections 708(b)(1)(B) and 704(c)(1)(B). In particular, it should be clarified that the individual undivided interests that are deemed to be recontributed by each partner to a post-708 termination partnership should be treated as separate items of property for Section 704(c) purposes, as illustrated by Example 4.

> **EXAMPLE (4):** A and B form Partnership AB on January 1, 1995, with each having a 50% interest. A contributes non-depreciable property with a fair market value of $500 and a tax basis of zero ("Property A"); B contributes similar non-depreciable property with a fair market value of $500 and a tax basis of $500 ("Property B").
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> On December 31, 1998, B sells its interest to C for $800, triggering a Section 708 termination of Partnership AB. At this time, Property A has increased in value to $700 and Property B has increased to $900. The tax bases of the assets that are deemed to be distributed to C (a 50% undivided interest in Property A and a 50% undivided interest in Property B) are, reflecting the Section 743 adjustment for C's purchase price, stepped up to $350 for the interest in Property A and $450 for the interest in Property B[20]; the tax bases of the assets that are deemed to be distributed to A remain at zero.
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> A, however, now has two types of built-in gain: pre-contribution built-in gain of

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20. Absent a Section 754 election, and absent adjustment under Section 732(d), C would have post-708 termination built-in loss with respect to Property A and built-in gain with respect to B.

$500, and post-708 termination built-in gain of $300.

The Proposed Regulations do not indicate how A is to allocate those two types of built-in gain between Properties A and B. The Committee sees a number of possibilities. Consistent with the Committee's recommendation for uniform treatment of Section 704(c)(1)(A) and Section 704(c)(1)(B) dispositions following a Section 708 termination, the Committee believes the following should result:

- A's pre-contribution built-in gain is allocated pro-rata in accordance with the relative fair market values of Properties A and B, resulting in A having $218.75 and $281.25 of "old and cold" built-in gain with respect to Properties A and B, respectively, and $131.25 and $168.75 of new built-in gain with respect to Properties A and B, respectively.

Another possibility would be:

- The pre-contribution built-in gain is allocated first to Property A; any excess is allocated to Property B, resulting in $350 and $150 pre-contribution built-in gain in Properties A and B, respectively; all the post-contribution built-in gain is allocated to Property B.

A third outcome, suggested by the "anti-shifting" approach contained in the Legislative History discussed above would be:

- A is treated as receiving $600 of the fair market value of Property A ($500 to the extent of pre-contribution built in gain and 50% of the remaining $200 of value). Consequently, A is only allocated $200 of Property B. C receives $100 in value of Property A and $700 in value of Property B.

In a partnership with many partners and many properties, the Section 708 termination would result in an increase in the number of Section 704(c) properties that the partnership must keep track of from the number of properties actually contributed and those properties that it owned prior to the Section 708 termination, up to double[21] the product of (i) the total number of properties that it owns, and (ii) the number of partners that it has. Moreover, if our recommendation in Part V(A)(2) is not accepted, each of these different Section 704(c) properties would have different five year clocks. The complexities engendered by this system are considerable, and illustrate the undesirability of adding to the record-keeping already required by either a hybrid basis allocation rule for 704(c)(1)(B) purposes or a second set of five-year clocks.

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21. The product is doubled to reflect the two types of gain that result from a Section 708 termination: pre-contribution built-in gain and post-708 termination built-in gain.

5. New Five Year Period Begins Solely with Respect to Post-Contribution Built-In Gain. If the Committee's recommendation set forth in Part V(A)(2) above is not accepted, the Committee recommends that final Section 704(c)(1)(B) regulations be more explicit that a new five-year period begins solely with respect to built-in gain attributable to contributed property that is attributable to appreciation or other factors arising after the contribution; the original five-year clock should continue to run for the contributing partner on his pre-contribution built-in gain or loss.[22]

The Proposed 704(c)(1)(B) Regulations provide that a new five-year period begins for each asset

> but only to the extent that the pre-termination built-in gain or loss, if any, on such property, was not already required to be allocated to the original contributor under Section 704(c)(1)(A) and § 1.704-3.[23]

It is possible to read this provision as requiring a new five year clock for all deemed recontributed property, since such gain would not have previously been "allocated to the original contributor."[24] In such case the contributing partner could potentially have a never-ending built-in gain recognition period.

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22. This clarification will automatically eliminate the same question under Section 737, since net precontribution gain for Section 737 purposes is determined by reference to Section 704(c)(1)(B). *See* Prop. Reg. § 1.737-1(c)(1).

23. Prop. Reg. § 1.704-4(a)(4)(ii).

24. The Committee appreciates that the better reading emphasizes "required to be allocated" and therefore produces the intended result.

The preamble to the Proposed Regulations, however, makes clear that the effect of the Proposed 704(c)(1)(B) Regulations is to

> begin a new five year period for post-contribution changes in the value of partnership property whenever there is a termination of the partnership under Section 708(b)(1)(B).[25]

The Committee recommends that the final 704(c)(1)(B) regulations clarify that all pre-termination deemed Section 704(c)(1)(B) gain potentially allocable to the contributing partner, regardless of whether such gain has actually been recognized by such contributing partner, is subject to the original five year clock that began on the actual contribution date. The Committee suggests the following clarifying language be substituted for Proposed Regulation § 1.704-4(a)(4):

> (ii) Section 708(b)(1)(B) terminations. A termination of the partnership under Section 708(b)(1)(B) does not begin a new five-year period with respect to any built-in gain or loss existing immediately prior to the termination. A new five-year period is begun for all other built-in gain and built-in loss. See § 1.704-3(a)(3)(ii) for the definitions of built-in gain and built-in loss on Section 704(c) property.

B. Undivided Interests and Fungible Property

Section 737(a)(1) provides that Section 737 gain is not triggered if the contributing partner receives a distribution of the property he originally contributed. The Committee recommends that the final Section 737 regulations contain a

25. See the preamble to Proposed Regulations.

special provision indicating that Section 737(a)(1) may apply in situations involving contributions of undivided interests in a single asset and contributions of certain types of fungible property (such as stock, securities or commodities), specific units of which are not separately identifiable.[26] The Committee also suggests that final 704(c)(1)(B) regulations include a matching exemption for such property distributions.

As illustrated by Example (5), contributors of undivided interests in a single asset or such fungible property are faced with a unique situation -- they have no way to track the specific contributed property through the partnership. Thus, they have no way to determine whether property received in a subsequent distribution is the same as or different from the originally-contributed property.

> **EXAMPLE (5):** On January 1, 1995, siblings A, B and C contribute one-third undivided interests in Property D to Partnership ABC. As of the date of contribution, Property D has an adjusted tax basis of $300 and a fair market value of $3,000. On December 31, 1998, C wishes to leave the partnership and hold her share of Property D as a one-third tenant-in-common. Assuming Property D's value is unchanged, C might have to recognize up to $900 of Section 737 gain upon receipt of her portion of Property D even though C

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26. In the case of stock and securities, separate units may be identifiable in some circumstances due to the maintenance of separate lots or separate accounts. In the case of tangible property (e.g., commodities), separate units may be identifiable if they are stored separately.

contributed a one-third interest in Property D to the partnership.[27]

The Committee believes that C's distribution should be exempt from Section 737 gain recognition and that Treasury should add a special rule to the final regulations treating C as though she received the property she originally contributed. C has received something of exactly the same nature as she put in. The Committee believes it would be unfair to penalize taxpayers because they cannot identify whether the property they have received in distribution is exactly the same property they contributed.

While the contribution of undivided interests may seem like an unusual situation, it does happen in practice. In addition to actual contributions of undivided interests, every partnership that undergoes a Section 708 termination is faced with this issue.

C. <u>Certain Technical Comments</u>

1. <u>Section 704(c)(1)(B) Exemption for Certain Complete Liquidations</u>. Proposed Regulation § 1.704-4(c)(2) provides a limited exemption from the recognition of Section 704(c)(1)(B) gain for certain liquidating distributions. The Committee understands that the purpose of this exemption is to cover the circumstance where a portion of previously contributed property must be distributed to a noncontributing partner because

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27. One possible result is that C is treated as receiving one-third of each of the interests contributed by A, B and C. In such case C would recognize $600 of gain.

the value of such property at the time of liquidation exceeds the value of the contributing partner's interest in the partnership. The Committee believes it would be appropriate to state the type of situation this exemption is intended to cover in the preamble to the final regulation. The Committee also suggests a technical revision to the regulation, discussed below.

The exemption in Proposed Regulation § 1.704-4(c)(2) applies to the extent that the built-in gain or loss in the interest distributed to the contributing partner

> is equal to or greater then the built-in gain or loss on the property that would have been allocated to the contributing partner without regard to this paragraph (c)(2)[28]

The amount of gain that would have been allocated to the contributing partner includes only the built-in gain on the portion of the property distributed to the other partners, not the built-in gain on the portion distributed to the contributing partner. The Committee notes that this appears inconsistent with the example in Proposed Regulation § 1.704-4(c)(4).[29] The Committee recommends that Proposed Regulation § 1.704-4(c)(2)(ii) be revised to read as follows:

> (ii) The built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the

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28. Prop. Reg. § 1.704-4(c)(2) (emphasis added).

29. The penultimate sentence of that example refers to $10,000 of built-in gain, which is the entire potential Section 704(c)(1)(B) gain in the property. Since only 25% of the property was distributed to another partner in the example, only $2,500 of Section 704(c)(1)(B) gain would have been recognized absent the exemption.

> built-in gain or loss that would have been allocated to such partner under Section 704(c)(1)(B) had all of such property been distributed to another partner on such date.

2. Effective Date Provision. The Proposed Regulations apply to partnership distributions on or after January 9, 1995 of property contributed to the partnership after October 3, 1989. The Committee would suggests adding a grandfather provision exempting property contributions that were required to be made after October 3, 1989, under a binding partnership agreement, subscription agreement or formation agreement entered into on or before October 3, 1989.

3. Anti-Abuse Rule. The Proposed Regulations include anti-abuse rules (Proposed Regulations § 1.704-4(f)(1) and 1.737-4(a)), each of which state that the statute and regulations are to be applied "in a manner consistent with the purpose of Section [704(c)(1)(B) and 737]", and that if

> a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of [such sections], the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of [such sections].[30]

These anti-abuse rules essentially paraphrase the first two sentences of Treasury Regulation § 1.701-2(b). They do not, however, repeat Treasury Regulation § 1.701-2 in its entirety, raising questions as to whether the anti-abuse rules

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30. Prop. Reg. §§ 1.704-4(f)(1) and 1.737-4(a).

articulated in the Proposed Regulations are different from the general Subchapter K rule, and if so how, and why.

In a report dated July 1, 1994 (No. 797) the Tax Section commented on the then proposed anti-abuse rule of Treasury Regulation § 1.701-2, generally supporting the introduction of a Subchapter K anti-abuse rule, but making specific comments on its scope and application. While the Committee believes that the general anti-abuse rule of Treasury Regulation § 1.701-2 clearly does and should apply to Sections 704(c)(1)(B) and 737, and we encourage the articulation of examples specific to these Proposed Regulations, we question the need for separate anti-abuse rules in these regulations, as well as the wisdom of paraphrasing the comprehensive and carefully thought-through anti-abuse regulation in each new set of Subchapter K regulations. We believe that the Proposed 704(c)(1)(B) and 737 Regulations should either (i) simply state as an operative rule what seems to be the chief concern here, namely, that an arrangement that is the substantial equivalent of a distribution of property shall be treated as an actual distribution for these purposes, or (ii) cross reference Treasury Regulation § 1.701-2, and then set forth specific factors that are relevant in applying that anti-abuse rule in these contexts along with examples of how such rule applies.