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January 22, 2010

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Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Washington, DC 20224

Re: Report on Notice 2009-70

Dear Sirs:

We write in response to Notice 2009-70, in which the Internal Revenue Service sought comments on a number of issues that arise in applying Section 704(c) and associated sections of the Internal Revenue Code of 1986 (the "Code") to complex partnership structures and to transactions involving partnerships, including mergers and divisions.

The Code includes a number of provisions that limit, or authorize regulations to limit, the shifting of income among partners that can result from the contribution of appreciated and depreciated property to a partnership, including Section 704(c). Regulations implementing these provisions have been final for a number of years, but those regulations do not provide substantial guidance in a number of areas, including

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partnership mergers and tiered partnerships. Efforts by the Internal Revenue Service to issue guidance applying these provisions in the context of partnership mergers have recently led to substantial commentary. Subsequent to the issuance of proposed regulations regarding partnership mergers, the Internal Revenue Service issued Notice 2009-70, seeking comments on the application of the provisions to single partnerships, tiered partnerships, mergers and divisions.

As described in more detail below, in general we believe that large partnerships should be required to separately track Section 704(c) items; that items should continue to be tracked following a partnership merger (that is, the two Section 704(c) "layers" should not be netted post-merger); that tiered partnerships should be required to use the Aggregate Approach rather than the Entity Approach to maintaining Section 704(c) layers, and that certain coordination rules should be imposed that would permit or require consistency of treatment of Section 704(c) items by the partnerships in the tiered structure; that the treatment of partnership mergers and divisions should generally be conformed to the treatment of tiered partnerships; and that partnerships should be given substantial flexibility in choosing methods to apply Section 704(c) and related provisions, subject to anti-abuse rules.

The principal recommendations of the report are as follows:

1. Partnerships generally should be required to maintain Section 704(c) layers following a revaluation of property and should not be permitted to net offsetting layers following any such event. In light of the potential complexity created by requiring partnerships to track Section 704(c) layers, a partnership should be permitted to opt out of such tracking if the partnership's gross asset value is below a threshold amount, or the asset(s) for which a Section 704(c) layer would be maintained have a value below a lower threshold amount or would give rise to an adjustment of less than a specified percentage of the partnership's aggregate assets.

2. For a partnership with multiple Section 704(c) layers, substantial flexibility should be permitted in allowing the partnership to choose how to allocate tax items among the layers.

3. New holding periods for purposes of Section 704(c)(1)(B) and Section 737 should not be created with respect to reverse Section 704(c) items as a result of a revaluation event.

4. Tiered partnerships generally should be required to use the Aggregate Approach (which treats a tiered partnership as a single partnership) in maintaining Section 704(c) layers, and information requirements should be imposed to permit that approach to be used.

5. If tiered partnerships are not required to use the Aggregate Approach in maintaining Section 704(c) layers, when an upper-tier partnership contributes Section 704(c) property to a lower-tier partnership, the lower-

tier partnership should be required to use the same Section 704(c) method used by the upper-tier partnership with respect to Section 704(c) layers of the Section 704(c) property pre-existing at the time of such contribution, but the lower-tier partnership should be permitted to utilize any reasonable method with respect to other Section 704(c) layers, whether created at the time of such contribution or thereafter.

6. Property revaluations should be permitted in the case of partnership recapitalizations. In addition, in the case of tiered partnerships, property revaluations should be permitted at a lower-tier partnership when a revaluation is permitted at an upper-tier partnership that holds more than a de minimis interest in the lower-tier partnership, and should be mandatory if the lower-tier partnership is controlled by the upper tier partnership.

7. Consideration should be given to exempting publicly traded partnerships from certain of the requirements of Section 704(c) because public trading of partnership interests is unlikely to implicate the policies of Section 704(c).

8. Choice of Section 704(c) methods should be subject to a broadly applicable anti-abuse rule.

9. The treatment of partnership mergers should be conformed, to the extent possible, with the treatment of tiered partnerships because an over-arching goal of final regulations relating to Section 704(c) and Section 737 must be to avoid providing economic advantages, under the tax rules, to mergers over tiered partnership structures and vice versa. Accordingly, the approach of the existing proposed regulations relating to partnership mergers in which Section 704(c) layers are netted if they offset must be reconsidered if, as we recommend, such layers are not netted in other circumstances to avoid providing optionality between mergers and tiered structures.

10. Generally, following a partnership merger, the acquiring partnership should not be permitted to elect new Section 704(c) methods with respect to Section 704(c) layers that existed at the merged partnership (consistent with recommendations 5 and 9).

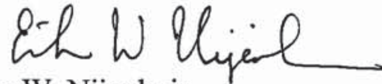
11. The "undivided interest" rule with respect to property of merged partnerships should be clarified. We recommend an approach similar to that which we recommend for allocation of tax items to Section 704(c) layers (in recommendation 2), in which the Service would permit a partnership to use any reasonable method, would provide examples of allocation methods that would be reasonable, and would provide that other methods may also be reasonable, subject to an overall requirement that the method not be chosen with a tax avoidance purpose.

12. The de minimis change exceptions to the merger regulations should make clear that (i) the determination of whether there is a change in partners' shares of income and loss is made under the partnership agreements, assuming compliance with Section 704(b), (ii) Section 704(c) items are not taken into account, and (iii) the determination of whether there has been a change in the partners' shares of liabilities does not take into account nonrecourse liabilities.

13. Generally, consistent with our other recommendations, we believe that Section 704(c) layers should be maintained through partnership divisions where such layers are not eliminated as part of the transaction. Consideration should be given to (i) expanding the "pro rata" partnership division rules to include a de minimis exception and (ii) whether a ("unified") partnership interest should be divided in certain partnership division situations.

We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,



Erika W. Nijenhuis
Chair

Enclosure

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