NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE REQUEST FOR COMMENTS ON SECTION 704(C) LAYERS RELATING TO PARTNERSHIP MERGERS, DIVISIONS AND TIERED PARTNERSHIPS

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Report No. 1202

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON THE REQUEST FOR COMMENTS ON SECTION 704(C) LAYERS RELATING TO PARTNERSHIP MERGERS, DIVISIONS AND TIERED PARTNERSHIPS

This Report[1] responds to Notice 2009-70[2] (the "Notice") issued by the Treasury Department (the "Treasury") and the Internal Revenue Service (the "Service") seeking public comments regarding the impact on partnerships of multiple layers of Section 704(c)[3] gain and loss. The Notice seeks information so that the Treasury and the Service can further study previously proposed regulations (the "Proposed Merger Regulations")[4] before finalizing them or proposing new regulations. The Notice solicits comments on a number of questions and the overall issues facing layering rules for Section 704(c). Specifically, comments are sought on the application of such rules to single partnerships, tiered partnerships, mergers, divisions, and international taxation. This Report will address the first four topics.

I. Summary.

The principal recommendations of this Report are as follows:

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1 This Report was prepared by members of the Committee on Partnerships of the Tax Section of the New York State Bar Association. The principal drafters of this report were Lee Allison and David Mayo. Substantial contributions were made by Jose Berra, Audry Casusol, Sam Chen, John Fiore, Kathleen Gregor, Catherine Hines, Monte Jackel, Colin Kelly, Vince Lee, Marc Nawyn, Wendy Sheu and Eric Sloan. Helpful comments were received from Steve Mills, Andrew Needham, Elliot Pisem and Michael Schler.

2 2009-34 I.R.B. 255.

3 Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986 as amended (the "Code") or to its predecessor, the Internal Revenue Code of 1954 (the "1954 Code").

4 REG-143397-05 (Prop. Treas. Reg. §§ 1.704-3, 1.704-4, 1.737-1, 1.737-2, 1.737-5), 2007-41 I.R.B. 790, *corrected by* Announcement 2008-53, 2008-23 I.R.B. 1137 (June 5, 2008).

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.

II. Background.

The Code contains provisions that generally limit, or authorize regulations to limit, the shifting of income among partners that can result from the contribution of appreciated or depreciated property to a partnership. In 1984, Congress enacted Section 704(c)(1)(A), which mandates allocating income, gains, losses and deductions attributable to built-in gains or losses on contributed property in a manner that takes into account the variation between tax basis and fair market value at the time of contribution.[5] Prior law simply permitted this practice.[6]

Recognizing that when contributed property was distributed to another partner there would be no future opportunity to allocate the built-in gain or loss to the contributing partner, Congress added Section 704(c)(1)(B) to the Code in 1989.[7] Section 704(c)(1)(B) provides that if such a distribution occurs within seven (originally five) years, the contributing partner is required to recognize the remaining pre-contribution gain or loss as if the property had been sold by the partnership for its fair market value. A companion provision, Section 737, was enacted in 1992.[8] It provides that if a partner contributes property with built-in gain and subsequently (defined today as within seven years) receives a distribution of other property, the distributee partner must recognize its

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5 Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 71(c), 98 Stat. 494, 589. This provision became Section 704(c)(1)(A) upon the enactment of the Omnibus Reconciliation Act of 1989, Pub. L. No. 101-239, sec. 7642 (a), § 704(c), 103 Stat. 2106, 2379-80.

6 Section 704(c)(1982); *see also* H. Conf. Rep. No. 98-861, at 854 (1984), *reprinted in* 1984-3 pt. 2 C.B. 1, 109. The initial version of Section 704(c) was part of the 1954 Code as it was originally enacted. Pub. L. No. 83-591, § 704(c), 68A Stat. 1, 240.

7 Omnibus Budget Reconciliation Act of 1989, *supra* note 5, sec. 7642(a), § 704(c)(1)(B), 103 Stat. at 2379; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, sec. 1063(a), 111 Stat. 788, 947 (extending time period to seven years).

8 Energy Policy Act of 1992, Pub. L. No. 102-486, sec. 1937(a) 106 Stat. 2776, 3032-33; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, *supra* note 7, sec. 1063(a) (extending time period to seven years).

"net precontribution gain" to the extent that the value of the distributed property exceeds the adjusted tax basis of the distributee partner's interest in the partnership. Net precontribution gain for purposes of Section 737 means the net gain that would be recognized under Section 704(c)(1)(B) if all of the property contributed by that partner (and still held by the partnership at the time of the distribution) had been distributed to another partner.[9] Together, Sections 704(c)(1)(A), 704(c)(1)(B), and 737 seek to ensure that the contribution of property to a partnership will not lead to another partner taking into account the pre-contribution gain or loss in such property.

The most recent addition to Section 704(c) is Section 704(c)(1)(C), added in 2004.[10] In general the purpose of Section 704(c)(1)(C) was to limit the ability of a partner to transfer loss to another person by contributing built-in loss property to a partnership. Pursuant to that provision, in the case of property contributed with a built-in loss, the built-in loss is required to be taken into account only in determining items allocated to the contributing partner and, except as provided in regulations, in determining items attributable to the non-contributing partners, the initial tax basis of the contributed property in the hands of the partnership is equal to the fair market value of the property at the time it is contributed.[11] Built in loss is equal to the excess of the adjusted tax basis of the property over its fair market value at the time of contribution.[12] In general the purpose of Section 704(c)(1)(C) was to limit the ability of a partner to transfer loss to another person by contributing built-in loss property to a partnership.

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[9] Section 737(b).

[10] American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 833(a), 118 Stat. 1418, 1589.

[11] Section 704(c)(1)(C).

[12] *Id.*

Crafting the regulatory details to carry out the mandate of Section 704(c) and Section 737 has at times required complexity and created uncertainty.[13] Regulations implementing mandatory Section 704(c) were first proposed on December 24, 1992.[14] They generally provided that when a partner contributed property with a built-in gain or loss to a partnership, the partners and the partnership could use any reasonable method, consistently applied, of making allocations so that the contributing partner received the tax burdens and benefits of the built-in gain or loss.[15] Although any reasonable allocation method that met the requirements of Section 704(c) was acceptable,[16] the proposed regulations specifically described three allocation methods that generally would be considered reasonable: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the deferred sale method. The traditional method and the traditional method with curative allocations were retained in the final regulations and, as finalized, are described below.[17]

Under the deferred sale method, a contribution of property to the partnership was treated as a sale of the property to the partnership on the date of

[13] The prospect of complexity was recognized upon the initial passage of what became Section 704(c)(1)(A). *See* H.R. Conf. Rep. No. 98-861, *supra* note 6, at 857, *reprinted in* 1984-3 pt. 2 C.B. at 854 ("The conferees are concerned with complexities that may arise in applying this new rule to allocations of depreciation and depletion.").

[14] Prop. Treas. Reg. § 1.704-3, 1993-1 C.B. 857, 861. There were regulations implementing optional Section 704(c) before that date. Treas. Reg. § 1.704-1(c) (as amended in 1991), *removed by* T.D. 8500, 1994-1 C.B. 183, 185.

[15] Prop. Treas. Reg. § 1.704-3(a)(1), *supra* note 14, at 861.

[16] The proposed regulations allowed a partnership to use different reasonable allocation methods with respect to different items of Section 704(c) property; however, a partnership could not use more than one method with respect to the same item of Section 704(c) property. In addition, the allocation method used for an item of Section 704(c) property was required to be consistently applied to that item by both the partnership and the partners from year to year. *See id.* An allocation method was not reasonable if the contribution of property and the allocation of tax items were made with a view to substantially reducing the partners' aggregate overall tax liability. *Id.* Prop. Treas. Reg. § 1.704-3(a)(5), *supra* note 14, at 862.

contribution for fair market value, with the partner deferring recognition of any gain or loss realized on the sale.[18] The partnership was treated as having a tax basis in the property, at the time of contribution (and deemed sale), equal to its fair market value.[19] Upon contribution, the contributing partner's basis in the partnership interest was increased by an amount equal to the partner's adjusted tax basis in the property.[20] In general, the contributing partner was required to recognize the deferred gain or loss to the extent, and at such time as, the partnership received a tax benefit or detriment from the adjusted partnership basis generated or foregone by using the deferred sale method, or when the contributing partner's interest in the partnership was reduced.[21] The character, source, and other attributes of any deferred gain or loss recognized would be determined as if the deferred sale property had been sold to the partnership at the time of the contribution.[22] The proposed regulations provided special rules for dispositions of deferred sale property in certain nonrecognition transactions.[23]

Final regulations implementing Sections 704(c) and 737 were promulgated in 1993 and 1995,[24] and deal mostly with relatively straightforward situations involving a single partnership in which each item of property was contributed at a single time and in which capital accounts had not been revalued. Under those regulations, "Section 704(c)

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17 *See infra* text accompanying notes 32-33.

18 Prop. Treas. Reg. § 1.704-3(d)(1), *supra* note 14, at 864.

19 *Id.*

20 *Id.* The partner's basis thereafter increased or decreased by the amount of deferred gain or loss recognized by the partner each year. *Id.*

21 Prop. Treas. Reg. § 1.704-3(d)(2)(i), *supra* note 14, at 861.

22 Prop. Treas. Reg. § 1.704-3(d)(3)(i), *supra* note 14, at 862.

23 *See* Prop. Treas. Reg. § 1.704-3(d)(4), *supra* note 14, at 862.

24 Treas. Reg. § 1.704-3 (as amended by T.D. 8500, 1994-1 C.B. 183); Treas. Reg. §§ 1.737-1 to -5 (as amended by T.D. 8642, 1996-1 C.B. 126).

property" is property if at the time of contribution to the partnership its book value differs from the adjusted tax basis of the contributing partner, with book value determined under the capital account maintenance rules of Regulation Section 1.704-1.[25] Built-in gain on Section 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis, and built-in loss is the excess of the contributing partner's adjusted tax basis over the value of the property, in each case at the time of contribution.[26]

The Section 704(a) regulations provide that a partnership must allocate items with respect to Section 704(c) property so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution using a reasonable method that is consistent with the purposes of Section 704(c).[27] The regulations provide that they and Section 704(c) are to be applied on a property by property basis, not on an aggregate basis.[28] A partnership may use different methods with respect to different items contributed to it, provided that a single reasonable method is applied for each property and the overall method or combination of methods utilized are reasonable based on the facts and circumstances and consistent with the purposes of Section 704(c).[29]

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[25] Treas. Reg. § 1.704-3(a)(3)(i) (as amended in 2005). As a result, book value for this purpose is the fair market value of the property at the time of contribution. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[26] Treas. Reg. § 1.704-3(a)(3)(ii).

[27] Treas. Reg. § 1.704-3(a)(1).

[28] Treas. Reg. § 1.704-3(a)(2).

[29] *Id.* The regulations provide examples of potentially unreasonable combinations of methods. *Id.*

The regulations provide three methods that are deemed to be generally reasonable for purposes of making allocations with respect to Section 704(c) property.[30] These are the traditional method, the traditional method with curative allocations and the remedial method. The deferred sale method was eliminated. According to Preamble to the Section 704(c) regulations promulgated in 1993, the Treasury and the Service determined that the results of the deferred sale method in the original proposed regulations could be achieved using a less complex method -- the remedial method. The Preamble states "the remedial allocation method contained in these temporary regulations permits the use of remedial allocations to achieve results substantially similar to the results under the deferred sale method contained in the original proposed regulations without the complexity of that method."[31]

Under the traditional method, when a partnership has tax items relating to Section 704(c) property it must make appropriate allocations of those items (as opposed to book items) to its partners in a manner that avoids inappropriate shifting of the tax consequences of the built-in gain or loss to non-contributing partners. For example, if a partnership recognizes gain from the sale of Section 704(c) property, the built-in gain or loss inherent in the property at the time of contribution must be allocated to the contributing partner (to the extent it does not exceed the built-in gain or loss remaining at the time of sale).

[30] Treas. Reg. § 1.704-3(a)(1).

[31] T.D. 8501, 1994-1 C.B. 191, 192; *see also* Blake D. Rubin & Seth Green, *The Proposed Regulations on Partnership Allocations with Respect to Contributed Property*, 59 TAX NOTES 257, 267 (1993) ("Conceptually, the deferred sale method is arguably the simplest of the three methods set forth in the proposed regulations. Unquestionably, however, it is the most complex in application.").

The contributing partner also bears the tax consequences of built-in gain or loss with respect to the partnership's allocation of depreciation deductions. Accordingly, the contributing partner generally is the last partner to be allocated tax (again, as opposed to book) depreciation with respect to Section 704(c) property with built-in gain. Cost recovery deductions with respect to Section 704(c) property for tax purposes are first allocated to the non-contributing partner to the extent of the corresponding "book" deductions (that is, the cost recovery deductions determined under the capital account maintenance rules of Section 704(b)).

Under the "ceiling rule," however, the aggregate amount of tax items allocated to partners of a partnership using the traditional method cannot exceed the aggregate amount of tax items actually realized by the partnership.[32] In the case of a contribution of depreciable property with substantial built-in gain, the consequences of the ceiling rule may be to limit, for the non-contributing partner, the allocation of items of tax depreciation with respect to such property even though economically the non-contributing partner may be viewed as having "paid" for such items.

The second method treated as generally reasonable under the regulations is the traditional method with curative allocations. Under this method, a partnership is permitted to make reasonable curative allocations to eliminate the distortions created by the ceiling rule (that is, to eliminate disparities between book and tax items for non-contributing partners). A curative allocation is an allocation of a tax item that differs from the allocation of the corresponding book item and that is used to compensate for a shortfall under the ceiling rule of an allocation (generally with respect to another

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[32] *See* Treas. Reg. § 1.704-3(b)(1).

property) of another tax item. Thus, for example, if as a result of the ceiling rule a non-contributing partner is allocated an amount of tax depreciation that is less than the corresponding book depreciation, the partnership may allocate tax depreciation from another item of property to that partner in order to eliminate the ceiling rule distortion.[33]

The final generally reasonable method is the remedial method. As is the case with the other two generally reasonable methods, a partnership using the remedial method first allocates book items and then allocates any tax items using the traditional method.[34] If the ceiling rule causes the book allocation to differ from the tax allocation of an item for a non-contributing partner, the partnership creates a remedial item that it allocates to such partner to offset the distortion of the ceiling rule. The partnership also allocates an offsetting remedial item to the contributing partner. The two allocations exactly offset each other so that, on an overall basis, only the total net income or loss of the partnership is allocated.

The regulations provide an anti-abuse rule. Pursuant to it, an allocation method (or combination of methods) is not reasonable if the contribution of property and the allocation of tax items with respect to the property are made with a view to shifting tax consequences of built-in gain or loss among the partners in a matter that substantially reduces the present value of the partners' aggregate tax liability.[35]

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[33] *See* Treas. Reg. § 1.704-3(c)(1). The regulations contain significant restrictions that apply in determining whether curative allocations are reasonable. Treas. Reg. § 1.704-3(c)(3).

[34] In determining book depreciation, the partnership is required to conform book depreciation to tax depreciation in recovering the amount of book basis equal to tax basis, and is permitted to recover any excess book basis using any method available for property newly placed in service. Treas. Reg. § 1.704-3(d)(2).

[35] Treas. Reg. § 1.704-3(a)(10).

The principles of Section 704(c) also apply to differences between book value of property and adjusted tax basis in circumstances in which a partnership revalues its capital accounts. These allocations are often referred to as "reverse 704(c)" allocations. Although the regulations contain little specific guidance as to the application of those principles, they do provide substantial flexibility. For example, a partnership is not required to use the same Section 704(c) method for reverse 704(c) allocations as it uses for contributed property even if an item of property is already treated as Section 704(c) property at the time of the revaluation, nor is a partnership required to use the same method each time it revalues its property. The allocation method for reverse 704(c) items is, however, required to be reasonable and consistent with the purposes of Section 704(b) and (c).[36]

The existing regulations address tiered partnerships only in passing. Regulation Section 1.704-3(a)(9) provides that if a partnership contributes Section 704(c) property to a second (i.e., lower tier) partnership, or if a partner that has contributed property to a partnership in exchange for a partnership interest contributes that partnership interest to a partnership (an upper-tier partnership), the upper-tier partnership must "allocate its distributive share of lower-tier partnership items with respect to . . . section 704(c) property in a manner that takes into account the contributing partner's remaining built in gain or loss."[37] Generally, this regulation treats each partnership as an entity, but this broad statement of principle provides little guidance beyond that. Consequently, it is not

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[36] Treas. Reg. § 1.704-3(a)(6)(i).

[37] Treas. Reg. § 1.704-3(a)(9).

surprising that the Notice remarks that "practitioners are taking positions based upon different interpretations of" Regulation Section 1.704-3(a)(9).[38]

Similarly, the existing regulations provide relatively little guidance on the treatment of partnership mergers. In general, in the case of a disposition of Section 704(c) property in a non-recognition transaction, the substituted basis property is treated as Section 704(c) property with the same amount of built-in gain or loss as the property disposed of.[39] The Section 704(c) allocation method must be the same for the substituted basis property as for the property disposed of.[40] Regulations, however, provide[41] that Sections 704(c)(1)(B) and 737 do not trigger recognition of built-in gain or loss in an assets-over merger, or in any situation where (i) a transferor partnership transfers its assets to a transferee partnership in exchange for transferee partnership interests and (ii) the transferor partnership then liquidates.[42] A subsequent distribution of the transferred Section 704(c) property by the transferee partnership, however, to a partner of the transferor partnership is subject to Section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to Section 704(c)(1)(B).[43]

The Service has attempted to provide more guidance regarding the treatment of Section 704(c) gains and losses in assets-over partnership mergers, though the effort has

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[38] Notice 2009-70, *supra* note 2, at 255.

[39] *See* Treas. Reg. § 1.704-3(a)(8)(i).

[40] *See id*.

[41] Treas. Reg. §§ 1.704-4(c)(4) (as amended in 2005); 1.737-2(b) (as amended in 2005).

[42] Such a transaction is deemed to occur in an assets-over partnership merger. *See* Treas. Reg. § 1.708-1(c)(3) (as amended in 2001).

[43] Treas. Reg. § 1.704-4(c)(4).

proven problematic. In Revenue Ruling 2004-43[44] the Service ruled that (1) Section 704(c)(1)(B) did not apply in an assets-over partnership merger, but new Section 704(c) gain or loss was created in the transferred Section 704(c) property; (2) in a post-merger distribution of the transferred Section 704(c) property, Section 704(c)(1)(B) applied to the newly created Section 704(c) gain or loss; and (3) in a post-merger distribution of the transferred Section 704(c) property, Section 704(c)(1)(B) did not apply to reverse 704(c) gain or loss created by a later revaluation of the property in the transferee partnership.[45] The ruling regarding the creation of new Section 704(c) layers contradicted the views of many commentators, both before and after the issuance of the Ruling, who had maintained that Regulation Sections 1.704-4(c)(4) and 1.737-2(b) provided that no gain or loss would be triggered (and no new seven-year holding period would be created) in such circumstances.[46] Shortly after it was issued, the Service revoked Revenue Ruling 2004-43 in Notice 2005-15, [47] but announced in the same notice its intent to issue regulations implementing the principles of the ruling.

The Proposed Merger Regulations were proposed in 2007.[48] They provide that built-in gain in Section 704(c) property transferred in an assets-over merger will not be triggered by Section 704(c)(1)(B) as a result of the merger transaction,[49] and that the original seven-year time period of Section 704(c)(1)(B) does not restart as a result of the

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44 2004-1 C.B. 842.

45 Similar rules applied to precontribution gain under Section 737. *Id.*

46 *E.g.,* Karen Garre Lohnes & John G. Schmalz, *Controversial Ruling Requires Gain to Be Recognized on Distributions from Merged Partnership*, 101 J. TAX'N 71, 71 n.1 (2004) (compiling a list of viewpoints expressed on the subject prior to the issuance of Revenue Ruling 2004-43).

47 2005-1 C.B. 527.

48 The Proposed Merger Regulations, and Example 3, are discussed in more detail in connection with the treatment of mergers, *infra* text accompanying notes 95-111.

49 Prop. Treas. Reg. § 1.704-4(c)(4)(i).

merger,[50] but that new Section 704(c) layers may be created by the merger in the property of the transferor partnership.[51] On the other hand, property of the continuing partnership revalued at the time of the merger (creating new reverse 704(c) gain or loss) is not subject to Section 704(c)(1)(B) as a result of the merger.[52] Concurrently, the Proposed Merger Regulations establish that net precontribution gain under Section 737 includes the new Section 704(c) gain or loss created by the transfer of assets in an assets-over merger, which is subject to a new seven year holding period, but not the reverse 704(c) gain or loss in an accompanying revaluation.[53]

Included in the Proposed Merger Regulations were a series of examples, one of which, Example 3,[54] drew significant response. In Example 3, built-in gain property was contributed to a partnership by one partner, and cash was contributed by a second partner. Subsequently, a third partner was admitted to the partnership at a time when the contributed property had declined in value from its value on the date of contribution (but with a value still in excess of its adjusted tax basis). The example requires the surviving partnership to offset the revaluation loss in the Section 704(c) property against the initial built-in gain, signaling that the Section 704(c) layers should be collapsed in this factual scenario in a partnership merger. Commentators took significant issue with Example 3, noting, for instance, that Example 3 conflicted with the approach used for reverse 704(c) layers in Section 704(c)(1)(A) and also left a merged partnership in a different position

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50 Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(A).

51 Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(B).

52 Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(c)(2).

53 Prop. Treas. Reg. § 1.737-2(b)(1)(ii)(B), (f).

54 Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(F), Ex. 3.

with respect to subsequent distributions of Section 704(c) property than partnerships that remained separate.[55]

Much of the complexity involving the application of Section 704(c) in tiered partnerships and among multiple layers arises as a result of the ceiling rule, which applies to partnerships that use the traditional method of allocation for Section 704(c) items. Initially, the ceiling rule may distort expected economic outcomes to a non-contributing partner by limiting favorable tax items the non contributing partner would otherwise be allocated. This consequence will be exacerbated if reverse 704(c) items are created, because reverse 704(c) items of the same sign as the forward items increase the likelihood of the ceiling rule applying. Additional parties may also be affected by the ceiling rule following the event that creates the reverse 704(c) items. Tiered structures and mergers create the possibility of the creation of new Section 704(c) items, as well as reverse 704(c) items, and extreme complexity in tracking multiple layers of Section 704(c) items. The consequence of tracking multiple layers of Section 704(c) items, and the allocation decisions relating to these items, will be particularly relevant when dealing with ceiling rule distortions, in contrast to items allocated under the remedial method.

It is in the context of the Proposed Merger Regulations having been outstanding for nearly two years that the Notice was released. The Notice expresses the desire of the Treasury and the Service to address the impact of multiple Section 704(c) layers and in particular to address the effect of mergers and divisions on Section 704(c) property. To aid in the development of future guidance on these projects, the Notice requests

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[55] American Bar Association Section of Taxation, *Comments on Proposed Regulations Concerning Consequences of Certain Mergers under Section 704(c)(1)(B) and 737*, *reprinted in* Tax Notes Today (April 18, 2008) (2008 TNT 77-53) (hereinafter "ABA COMMENTS").

comments and solicits feedback on nineteen questions (many of them with subsidiary questions) grouped into a series of categories: “Single Partnership with Layers – No Tiers,” “Tiers of Partnerships with Layers,” “Mergers,” “Divisions,” and “International Issues.”

The Notice recognizes that one of the more fundamental questions in analyzing the effect of Section 704(c) on tiered partnerships is whether the partnerships should be treated collectively, with partners of the upper-tier partnership treated as owning directly a portion of lower-tier partnership assets (the “Aggregate Approach”), or separately, with the upper-tier partnership having an interest in the lower-tier partnership, but not its assets (the “Entity Approach”). Accordingly, many of the specific questions asked by the Notice probe the aggregate versus entity distinction.

III. Comments.

A. Single Partnership with Section 704(c) Layers.

1. Revaluation Events.

Under existing regulations, a partnership is permitted to increase or decrease the capital accounts of its partners to reflect a revaluation of its property if, among other requirements, the adjustments are made principally for a substantial non-tax business purpose in connection with certain events.[56] The events provided in the regulations are (i) a contribution of money or other property (other than a *de minimis* amount) to the partnership as consideration for an interest in the partnership, (ii) the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the

[56] Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2008).

partnership, and (iii) the grant of an interest in the partnership (other than a *de minimis* interest) as consideration for the performance of services to or for the benefit of the partnership by a new or existing partner acting in that capacity.[57]

The first question in the Notice is whether any changes or additions should be made to the events in which a revaluation is permitted. We believe that there is at least one additional event should permit a revaluation, namely a partnership recapitalization — that is, a transaction in which the partners' sharing of profit or loss (or both) change on a going-forward basis. Like the other events that permit capital account revaluations, a partnership recapitalization can constitute a significant event that alters the economic relationships of the partners, which would be an appropriate circumstance in which to revalue assets. Such an addition would clarify the availability of a revaluation when, for example, common partnership interests are exchanged for preferred interests, or when partners are assigned tracking interests for certain assets. Moreover, adding the opportunity for a revaluation of capital accounts in such circumstances would be consistent with the tax treatment of conversions of general partnership interests to limited partnership interests, which under Revenue Ruling 84-52[58] is treated as a contribution of the general partner interests to the partnership in exchange for the limited partner interests. This treatment arguably (though by no means clearly) permits the partnership to undertake a revaluation under Regulation Section § 1.704-1(b)(2)(iv)(f)(5)(i).

We note that a recapitalization transaction is an event that the Service previously recognized as potentially appropriate for a revaluation. At the time the

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[57] *Id.* In addition, certain partnerships are permitted to revalue assets under generally accepted industry accounting standards. *Id.*

[58] 1984-1 C.B. 157.

Service proposed the addition of the grant of a partnership interest in exchange for services as an event permitting a revaluation, it indicated a willingness to consider a broader expansion of the revaluation regulations, stating, "One approach under consideration would allow revaluations any time there is more than a *de minimis* bona fide change in the manner in which partners agree to share profits or losses."[59]

We discuss a second event that would permit revaluations of capital accounts in connection with tiered partnerships.

2. Netting or Creation of New of Section 704(c) Layers.

When a partnership revalues its assets under Regulation Section 1.704-1(b)(2)(iv)(f), book-tax disparities are created implicating the rules of Section 704(c)(1)(A).[60] If the revalued property previously was Section 704(c) property, there are two potential methods of accounting for the new book-tax differential. The first is to alter the pre-existing Section 704(c) amount; the second is to maintain the then-existing Section 704(c) amount and establish a separate Section 704(c) layer to handle the effect of the revaluation. In many situations, the choice between the two approaches has no lasting impact. However, when forward and reverse Section 704(c) amounts offset each other, such as when there is a built-in gain upon contribution of an asset but a loss in value upon a revaluation, there is a potentially significant economic impact depending on whether the Section 704(c) layers are netted or kept separate. For example, if a series of book ups to a property is followed by a book down and then a sale of the property results in a tax gain, that gain may be allocated differently depending on the approach taken with respect to the Section 704(c) layers. The allocation results of such a scenario are outlined

[59] Section 704(b) and Capital Account Revaluations, 68 Fed. Reg. 39,498, 39,499 (July 2, 2003).

in the Appendix. Netting is most likely to cause distortion when the partnership uses the traditional method under the Section 704(c) regulations because of ceiling rule limitations; curative or remedial allocation generally would eliminate the distortions.

Especially in light of the potentially distortive impact of netting, we believe that the sounder approach is generally to require the creation and maintenance of separate layers. Most importantly, we believe that the underlying policy of Section 704(c), which is to assign to contributing partners the tax consequences resulting from the recognition of built-in gains or losses,[61] calls for creating separate layers and tracking them independently of one-another. Events that require a revaluation of partnership capital accounts and that lead to reverse 704(c) allocations are independent of the original contribution transaction and should not change the tax consequences of the initial contribution transaction. This result is most readily obtained by creating and maintaining separate layers for each event. In addition, in the case of a book up event, the continuing partners in a partnership conceptually are contributing partners with respect to the historic assets of the partnership (even though such assets are not being contributed to a new partnership). The "pre contribution" (meaning pre-book up event) built-in items are appropriately allocated to those partners under the reverse 704(c) rules. To net offsetting layers fails to maintain the distinction among original partners as "contributing" or "non-contributing." Netting also fails to recognize that on a book up event a continuing partner is essentially a contributing partner with respect to historic partnership assets.

Furthermore, the economic expectations of the partners are better maintained if the separateness of Section 704(c) layers is preserved. When a partnership

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[60] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4), (g)(1).

is established, the partners that do not contribute appreciated assets generally will attempt to negotiate an arrangement that ensures that they receive the initial benefit of positive tax attributes, such as depreciation and amortization, through the Section 704(c) allocation process (for example, by negotiating for remedial or curative allocations). When the value of the partnership assets subsequently changes, and the partnership revalues its capital accounts in connection with an independent transaction, the partners would be faced with the prospect that such revaluation could rearrange entirely the tax consequences of the initial partnership agreement if the Service were to establish netting as the norm for Section 704(c) layers. That would create significant uncertainty for would-be partners regarding how built-in gains will affect the tax consequences of their economic arrangement. A new Section 704(c) layer of course does not leave the original partnership bargain unaffected, but it does better isolate the effect of the interim change in asset value and allows it to be handled in a way that respects the economic arrangement among the partners that is created at the time that the new layer is created without changing the treatment that the original partners agreed to.

Finally, the fact that existing regulations permit different allocation methods to be applied to each Section 704(c) layer makes a strong technical argument for maintaining separate layers. Under Regulation Section 1.704-3(a)(6)(i), both the first time a property is revalued, and on subsequent revaluations, any reasonable allocation method can be chosen for the reverse 704(c) allocation. A partnership can, for instance, use the traditional allocation method for Section 704(c) property upon its initial contribution, but then use the remedial method to allocate the book-tax differential

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[61] *See* Treas. Reg. § 1.704-3(a)(1) (as amended in 2005).

created by a revaluation. If the Section 704(c) layers are collapsed, the ability to use different allocation methods is lost, which is unnecessarily restrictive.

We acknowledge that there is an apparent mathematical simplicity to netting of layers and that technical accuracy can come with significant compliance costs. Further, a netting approach would avoid the uncertainty and confusion that may arise when there are multiple forward and reverse 704(c) layers and the property is depreciable.[62] For example, if the partnership property is depreciable and there is a book down of partnership properties on a revaluation, it is unclear how depreciation (assuming that the traditional method was adopted) would be calculated with respect to the reverse 704(c) layer.[63] Similarly, it would be possible for assets to be sold for book gain (or book loss) when they had Section 704(c) layers of book loss or book gain, that must be accounted for on sale. Netting would eliminate the need for an elaborate set of rules to govern this system for tracking of layers and allocating tax items to them.[64]

In light of the potential complexity created by requiring partnerships to track Section 704(c) layers, we believe that if the Service adopts our recommendation, it should permit a partnership to opt out of such tracking if the partnership is below certain thresholds based on the value of its assets. We believe that two value-based thresholds are appropriate. The first is an overall threshold based on the partnership's gross asset value. If a partnership did not have gross assets with a value meeting the threshold it would not be required to maintain Section 704(c) layers, although it would be permitted

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62 *See* Blake D. Rubin & Andrea R. Macintosh, *Exploring the Outer Limits of the 704(c) Partnership Built-In Gain Rule (Part 3)*, 89 J. TAX'N 271, 273-276 (1998).

63 *See* Monte A. Jackel, *A Response to Notice 2009-70*, 124 TAX NOTES 1133, 1142 (2009).

64 On the other hand, if a taxpayer can keep a record of each of these economic items, arguably the regulations can apply a more appropriate tax rule, regardless of the complexity of the rule.

to do so, provided that maintaining such layers was not done pursuant to a plan with a principal purpose to avoid taxes. We suggest that this threshold be set initially at $20 million and that it be periodically adjusted to account for inflation. Although not *de minimis*, we believe that many partnerships with assets below that threshold would be unable to afford the relatively sophisticated tax compliance and accounting functions necessary to maintain Section 704(c) layers.

The second threshold would be applied on an asset-by-asset basis. Under this threshold, Section 704(c) layers would not be required to be maintained for any asset with a value less than a certain amount, although a partnership would be permitted to do so subject to a similar anti-abuse rule. We would suggest $1 million as the asset-by-asset threshold. We also suggest that these thresholds be adjusted periodically to reflect inflation.[65]

Finally we suggest that separate Section 704(c) layers not be required in the case of adjustments of less than 3% of the partnership's carrying value of its aggregate assets, regardless of the amounts involved, because we do not believe that relatively small changes in the value of assets are likely to implicate the anti-shifting policies of Section 704(c).

We also note that under the current regulations the definitions of the terms "built-in gain" and "built-in loss" imply that layers with "different signs" should be netted against each other.[66] In particular, the definition of the term "built-in gain"

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[65] *Cf.* Section 1(f) (inflation adjustments for tax brackets); Section 63(c)(4) & (5) (inflation adjustments for personal exemptions).

[66] *See* Barksdale Hortenstine, Gregory J. Marich & Robert Honigman, *Section 704(c) and the Regulations Thereunder*, *in* 4 PRACTISING LAW INSTITUTE, THE PARTNERSHIP TAX PRACTICE SERIES: TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER

provides that built-in gain in an asset is reduced by decreases in the difference between the property's book value and adjusted tax basis and that of built-in loss provides, similarly, that built-in loss is reduced by decreases in the difference between the property's adjusted tax basis and book value. Those provisions clearly apply, for example, to differing tax and book cost recovery deductions, but they may also be read to apply to changes in book value on a revaluation that move "opposite" an existing Section 704(c) layer. We suggest that these definitions be modified to remove ambiguity if the Service adopts our recommendation that layers be kept separately.

3. Allocations of Tax Items Among Layers.

The regulations promulgated under Section 704(b) create a regime for allocating the income of a partnership to its partners. In general, they provide for the allocation of "book" income and loss – that is, very generally, income and loss that accrues after the formation of the partnership. This is consistent with the goal of Section 704(c) of having tax items that arise from built-in gain or loss at the time of contribution be for the account of the contributing partner. The Section 704(b) regulations accomplish the goal of allocating post-formation income in part by crediting partners' capital accounts with an amount equal to the fair market value (rather than adjusted tax basis) of property contributed, and computing items of "book" income and deduction (e.g., gain on disposition and depreciation) on the basis of those amounts. As a result, there may be tax items, such as gain on the sale of contributed property, that do not exist (or exist in different amounts) for Section 704(b) book purposes.

STRATEGIC ALLIANCES 2009 [hereinafter "TAX PLANNING"] 1135, 1172–74 (Louis S. Freeman ed., 2009).

Example A. On January 1, 2010, Partner A and Partner B form partnership AB with Partner A contributing non-depreciable asset X, with a fair market value of $100 and a tax basis of $80, and Partner B contributing $100 of cash. On July 1, 2010, AB sells X for $100. AB has book gain of $0 on the sale and has tax gain of $20 on the sale.

Multiple Section 704(c) layers would create the potential for additional layers of tax items for which there is not a corresponding book item. The question arises as to how to allocate the actual tax items, when realized, among the Section 704(c) layers.

Example B. On January 1, 2010, Partner A and Partner B form partnership AB with Partner A contributing depreciable asset X, with a fair market value of $100 and a tax basis of $40, and Partner B contributing $100 of cash. On January 2, 2011, when X has appreciated in value to $200 and partnership AB continues to hold $100 of cash, C is admitted to the partnership as an equal partner in exchange for $150 in cash.

At the time of the formation of partnership AB, X is Section 704(c) property and there is a Section 704(c) item of $60 representing the built-in gain in X. For 2010, assuming that X has a five-year life and straight line depreciation is used, there will be $20 of book depreciation and $8 of tax depreciation. The full amount of tax depreciation will be allocated to Partner B, the noncontributing partner. If partnership AB uses the traditional method (or the traditional method with curative allocations and there are not sufficient curative items), the ceiling rule will limit Partner B's depreciation deduction to $8.

Following the admission of Partner C, there will be a reverse 704(c) item of $120 (the excess of the $200 fair market value of X at the time of Partner C's admission over the $80 book value of X). In 2011, book depreciation of X will be $50 ($200 divided by a four year remaining life) and tax depreciation will continue to be $8.

There are a number of possible methods to use for allocating tax items, such as the ceiling rule limited depreciation in Example B, to or among Section 704(c)

layers. One would be to allocate them to the oldest layers first – in Example B, all to Partner B. This has the consequence of imposing all of the ceiling rule limitation on Partner C. The second would be to allocate tax items to the newest layers first, which would allocate all of the tax depreciation to Partner C and impose an additional ceiling rule burden on Partner B in Example B. A third would be to allocate the tax items among the layers, for example pro rata based on the amount of each layers (although other, more complicated variations are possible), which has the effect of sharing the ceiling rule burden among all non-contributing partners.

An argument can be made that requiring allocation of tax attributes to the oldest layer first is consistent with the requirement to create and maintain separate Section 704(c) layers – essentially, once the layer is created the tax attributes attributable to it should be fixed and not subject to change if new layers are created. In addition, that allocation fixes the benefits and burden of contributed property among the partners of the partnership at the time of the contribution, and does not permit the shifting of tax benefits to subsequent partners. We do not believe, however, that requiring the creation and maintenance of layers necessarily compels this allocation method with respect to the allocation of the attributes to the layers, nor that the benefit of tax basis is necessarily required to be fixed at contribution without regard to subsequent events. An argument also can be made that allocating the tax items to the newest layer is appropriate, because the newest partner, which acquires its interest at a time the property is more valuable then when it was contributed, should obtain the tax benefits attributable to its contribution to the partnership and suffer the least distortion arising out of the ceiling rule. We do not believe that regulations should mandate this economic decision either. Instead, we feel

that the partners in the partnership should be permitted flexibility to choose a reasonable method to allocate the tax attributes attributable to the partnership property. We note, however, that allocating basis only to the forward Section 704(c) layer – the first-in approach – may be most administrable, and may be the rule that taxpayers (at least historic partners) would expect to apply.

We believe that each of the three approaches, first-in-first-out, last-in-first-out, and pro-rata, described above generally would be reasonable.[67] Accordingly, we recommend that regulations not mandate a specific approach when multiple Section 704(c) layers exist, but instead provide (i) a default first-in rule in which, absent an election, all basis is allocated to forward Section 704(c) layers; (ii) that partnerships be permitted to elect any reasonable method for allocation of tax items among Section 704(c) layers; and (iii) that the first-in-first-out, last-in-first-out, and pro-rata should be treated as generally reasonable.[68] Furthermore, methods other than the three most common may be appropriate, and there are a number of variations on the pro rata method that could be used. For example, pro ration may be straightforward based on the interests of each partner in the partnership, or it may be a more complicated calculation involving the hypothetical splitting of the asset subject to the Section 704(c) layers into two or more components and assigning attributes to each. In light of the number of alternatives, we recommend that a non-exclusive approach be used whereby methods other than those

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[67] We note that these choices also interact with the use of the remedial method, because remedial allocations may change the amount of a tax item previously allocated to a particular layer. We believe a partnership should be permitted to deal with such interactions using any reasonable method subject to an overall requirement that the method not be chosen with a principal purpose of tax avoidance and that any such method must be consistently applied.

[68] We note that in many cases it would be possible for a partnership with multiple forward and reverse Section 704(c) items to create a tiered structure and to achieve the result described in (ii), even if tiered partnerships are required to use the Aggregate Approach.

treated as generally reasonable would be permitted if such other methods are reasonable. A similar approach apparently has worked well with general Section 704(c) allocation methods where the three methods described above are generally treated as reasonable Section 704(c) methods,[69] but the use of other methods is not inherently limited by the enumeration of those three.[70]

The discussion above dealt only with allocation of tax items among multiple gain layers. It is of course possible to have different scenarios, which can raise additional allocation issues.

> Example C. On January 1, 2010, Partner E and Partner F form partnership EF with Partner E contributing depreciable asset Y, with a fair market value of $1000 and a tax basis of $1000, and Partner F contributing $1000 of cash. On January 2, 2011, when Y has depreciated in value to $600 and partnership AB continues to hold $1000 of cash, Partner G is admitted to the partnership as an equal partner in exchange for $800 in cash.

At the time of the formation of partnership EF, Y is not Section 704(c) property. Assuming a five-year life and straight-line depreciation, immediately before Partner G's admission to the partnership, the asset has a tax and book basis of $800. The admission of Partner G creates a reverse 704(c) layer of $200. Tax basis, however, remains at $800. All of the tax depreciation deductions attributable to the reverse 704(c) loss would be allocated to Partners E and F, because Partners E and F bore the economic burden of the loss in value.

> Example D. On January 1, 2010, Partner H and Partner I form partnership HI with Partner H contributing depreciable asset Z, with a fair market value of $1000 and a tax basis of $400, and I contributing $1000 of cash. On January 2, 2011, when Z has depreciated in value to $600 and partnership HI continues to hold $1000 of cash, Partner K is admitted to the partnership as an equal partner in exchange for $800 in cash.

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[69] *See* Treas. Reg. § 1.704-3 (as amended in 2005).

[70] *See* Treas. Reg. § 1.704-3(a)(1).

In this more complicated example involving gain and loss layers, at the time of the formation of partnership HI, Z was Section 704(c) property and had a Section 704(c) gain of $600. Assuming a five-year life and straight-line depreciation, in 2010 there is tax depreciation of $80 and book depreciation of $200. As in Example B, all of the tax depreciation would be allocated to Partner I. Immediately before Partner K's admission to the partnership, Z has a tax basis of $320 and a book basis of $800. The admission of Partner K creates a reverse 704(c) layer of $200. Tax basis, however, remains at $320. Thus, in each year there continues to be tax depreciation of $80, but book depreciation is now $150. The tax depreciation could be allocated entirely to Partner I, or could be allocated between Partners H and I to reflect the post-contribution decrease in the value of Z.

Although we believe it is appropriate to provide maximum flexibility for partners to arrange their affairs, we recognize that a method should not be permitted if its selection is motivated primarily by the reduction in the aggregate tax liability of the partners. Accordingly, we suggest that the allocation of tax items between and among Section 704(c) layers be subject to a broadly applicable anti-abuse rule. As to a matter of regulatory drafting, we believe that this rule, as well as the other anti-abuse rules that we recommend in this report should, be embodied in a single broadly drafted section of the regulations, similar to current Regulation Section 1.704-3(a)(10) with appropriate modifications to make it clear that it applies to all situations in which the regulations provide electivity to partnerships and partners to choose methods of allocating Section 704(c) items, and perhaps should include a non-exclusive list of situations to which it applies.

4. Other Section 704(c) Issues Raised by Revaluations.

The Service raised the question of what other Section 704(c) issues are raised by Section 704(c) layers.

Although not limited to a situation in which property is revalued, we believe that the Service should consider certain issues relating to an "all cash" partnership — that is, a partnership that has sold or disposed of all of its assets and holds only cash as a result — when it promulgates regulations on the issues raised in the Notice.

At its most basic, this issue arises when a partnership is left with only cash after having distributed its Section 704(c) property. In some circumstances, a book-tax disparity will still exist even after such a distribution. For example, if Section 704(c) property were distributed to a non-contributing partner more than seven years after its contribution, Section 704(c)(1)(B) would not apply to the distribution and the Section 704(c) item would remain.

> Example E. Partner A and Partner B each contribute $100 in cash to partnership ABC and Partner C contributes property with a fair market value of $100 and a tax basis of 0 to partnership ABC. After 8 years, the property, still with a fair market value of $100, is distributed to Partner A in redemption of its interest in the partnership. No gain is triggered under Section 704(c)(1)(B), so the Section 704(c) item relating to the built-in gain remains.

A similar scenario is possible any time partnership Section 704(c) property is distributed on a non-pro rata basis.[71]

Of course, in Example E, gain in an amount equal to the Section 704(c) item would be triggered on a liquidation of the partnership following the redemption of A's interest. It is not necessarily the case, however, that the partnership would be

[71] *See* Howard E. Abrams, *Reverse Allocations: More Than Meets the Eye*, 20 Tax Mgmt. Real Est. J. 3, 14 (2004).

liquidated, in which event the difference between inside and outside basis could continue indefinitely.

Secondly and similarly, when an interest in an all-cash partnership is transferred to another partnership, the Service should consider whether Section 704(c) can apply to the transferred partnership assets. For example, a partner's interest in a partnership could have an outside basis greater than the value of the cash inside the partnership. The interest in the historic partnership, now a lower-tier partnership, would be Section 704(c) property in the hands of its owner, but the lower-tier partnership itself would hold no Section 704(c) property. It is not readily apparent how Section 704(c) should apply (if at all) to this situation. It may be possible to allow curative or remedial allocations even when a partnership has no Section 704(c) property in order to address book-tax differentials resulting from the historic actions of the partnership. We recognize, however, that such a regime could be subject to abuse – for example, taxable investors could acquire the partnership interest that would be allocated the remedial deduction items[72] – and may in any event not be justified as a matter of policy. Accordingly, we do not make any recommendation.

In addition, the treatment of Section 704(c) and reverse 704(c) items under Section 704(c)(1)(B) and Section 737 must be considered — in particular, whether new holding periods should be created in the case of revaluation events. Unlike Section 704(c), Section 704(c)(1)(B) and Section 737 are time limited – both apply only to distributions that occur within seven years of the contribution transaction. This

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[72] Although other potential for abuse may exist, we believe that most circumstances in which all cash partnerships could arise do not lend themselves to circumventing Section 704(c), at least at a time that the provisions of Section 704(c)(1)(B) and Section 737 are not time barred.

apparently indicates that Congress believed that after a sufficiently long period of time (namely, seven years), a distribution transaction was not likely to implicate Section 704(c) anti-shifting policies. This is the case even though such a distribution transaction generally would shift some or all of the built-in gain from the contributing partner to the distributee partner. It may also reflect the determination that sales transactions and cost recovery deductions are more common than distributions of property to non-contributing partners and as such warrant a longer (and unlimited) "tail" for the Section 704(c) consequences. We do not believe that a reverse 704(c) layer created in connection with a revaluation event should give rise to a new holding period for purposes of Section 704(b)(2) or Section 737, and do not believe that the Service would have authority to impose such a period in the absence of a contribution transaction without a change in the statute.

B. Tiers of Partnerships with Layers.

The second set of questions in the Notice related to various issues raised by tiered partnerships.

1. Contributions and Distributions Within Tiered Partnerships.

Within any set of tiered partnerships, a tracking mechanism must be in place to ensure that Section 704(c) property continues to be accounted for properly in partnership allocations when the property is contributed and distributed to partnerships within the partnership structure. At present, Regulation Sections 1.704-3(a)(7) and 1.704-3(a)(8) seek to accomplish this goal. The Service asked whether any changes were necessary in those regulations. Although we believe that these regulations generally accomplish their goal, we suggest an alternative rule for the situation in which the upper-

tier and lower-tier partnerships use different Section 704(c) allocation methods with respect to particular Section 704(c) items.

Regulation Section 1.704-3(a)(7) provides that when partnership interests are transferred, the transferee partner steps into the shoes of the transferor partner for Section 704(c) purposes. Thus, if a partner that contributed property to a partnership transfers its interest in such partnership to a new (upper-tier) partnership, the contributed property retains its Section 704(c) characteristics and the new partnership will be treated as the contributing partner with respect to the Section 704(c) items of the contributed (historic) partnership. A contribution to an existing partnership, including one in which the contributing partner is a member, should give rise to the same result.

Regulation Section 1.704-3(a)(8) establishes that certain property received in exchange for Section 704(c) property will itself be treated as Section 704(c) property. Most importantly, substituted basis property received in a non-recognition transaction that replaces Section 704(c) property will itself be treated as Section 704(c) property under this regulation.[73] Thus, the contribution of Section 704(c) property by a partnership to a new (lower-tier) partnership in exchange for an interest in the new partnership will result in the interest in the lower tier partnership being treated as Section 704(c) property in the hands of the contributing partnership because the partnership interest that it receives is substituted basis property.[74] As with contributions of partnership interests, a contribution to an existing partnership should give rise to the same

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[73] Installment obligations received in an installment sale of Section 704(c) property and property received under a contract when the contract constituted Section 704(c) property also will be treated as Section 704(c) property values this regulation.

[74] *See* Section 7701(a)(42).

results. The tracking rule of Regulation Section 1.704-3(a)(8), however, does not apply in the context of an assets-over partnership merger.[75]

The current regulations do not address the situation in which Section 704(c) property is contributed to a partnership that uses a different Section 704(c) method with respect to the property than the contributing partnership. Analogous regulations suggest that different allocation methods would be respected. First, the contribution of partnership property to a lower-tier partnership is economically similar to the admission of a new partner coupled with a book-up. Because the Section 704(c) regulations explicitly authorize a partnership to use different methods for reverse Section 704(c) allocations with respect to an item of property than for forward Section 704(c) allocations as a result of its contribution, it would seem appropriate to allow a lower-tier partnership to use a different Section 704(c) method with respect to its property than the upper-tier partnership. Second, Regulation Section 1.708-1(b)(iv), creates a transitory tiered partnership in the process of effecting a termination of an old partnership. The new (momentarily lower tier) partnership is not required to adopt the same Section 704(c) allocation method as the terminated (upper tier) partnership.[76]

If a lower-tier partnership is allowed full independence in selecting its Section 704(c) allocation methods, the allocation rules may produce inconsistent results.[77] This is particularly the case with respect to existing Section 704(c) items. For example, if an upper-tier partnership using the traditional method with respect to a

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[75] *See infra* Part III.C.

[76] *See* Rubin & Macintosh, *supra* note 62 at 278.

[77] As discussed more fully below in connection with the Aggregate Approach, we recommend more generally that tiered partnerships be required to use the same allocation methods for the same Section 704(c) layers, which would mitigate or eliminate the issue discussed in the text.

Section 704 property contributes the property to a lower-tier partnership using the remedial method, the lower-tier partnership's sale of the Section 704(c) property may create remedial gain or loss allocable to the upper-tier partnership. The regulations do not provide adequate guidance as to how the upper-tier partnership should allocate the remedial allocation among the upper-tier partnership's partners. One possibility would be to allocate the remedial allocation solely to the partner that contributed the Section 704(c) property to the upper-tier partnership. Another possibility would be to allocate the remedial allocation according to book basis. Assuming that the drop-down to the lower-tier partnership followed by a sale should have the same results – at least as far as the upper-tier partnership's partners are concerned – as a sale by the upper-tier partnership, the preferable approach would be for the upper-tier partnership to allocate the remedial allocation according to book basis.[78]

In the absence of the adoption of the Aggregate Approach, the Service should adopt a special rule for transfers subject to Regulation Section 1.704-3(a)(8) in which the upper-tier and lower-tier partnerships use different Section 704(c) allocation methods with respect to related Section 704(c) items. (In Part III.B.4, below, we recommend that tiered partnerships generally be required to use the Aggregate Approach to maintain Section 704(c) layers, which would have the effect of treating tiered partnerships as a single partnership for this purpose and eliminate the possibility of using different Section 704(c) methods for related Section 704(c) items.) When an upper-tier partnership transfers Section 704(c) property to a lower-tier partnership, the regulations

[78] Ruben & Macintosh, *supra* note 62, at 279-80. Similarly, for allocations of depreciation, a lower-tier partnership that uses the traditional method can undermine an upper-tier partnership's use of the remedial method. *See id.* at 280-81.

should treat that transfer as a contribution of two properties. The first property would have carryover basis and carryover book value. The lower-tier partnership would be required to use the same Section 704(c) allocation method with respect to this property as was used by the upper-tier partnership. If the contributed property is appreciated (relative to its book value) the second property would have zero basis and a book value equal to the excess of fair market value over the book value in the hands on the upper-tier partnership. If the contributed property has a lower fair market value than book value, the second property would also have a zero basis but would have a negative book value equal to such amount. In any case, this property would be of the same type as the first property (e.g., with respect to depreciation). The lower-tier partnership would be able to choose a different Section 704(c) allocation method with respect to this property.[79] This rule has the advantage of allowing tiered partnerships independently to adopt Section 704(c) allocation methods while minimizing book-tax distortions. We do not believe, however, that this rule should be mandated unless the upper tier partnership holds a greater-than 50% interest in the lower-tier partnership, although we do believe that tiered partnerships with lower ownership thresholds should be permitted to elect its application, subject to an anti-abuse rule.

2. Revaluations in Tiered Partnerships.

The Service asked several questions regarding revaluations in the context of tiered partnerships. The first question was a general one as to whether there are different considerations in making property revaluation decisions in a tiered partnership as opposed to a single partnership, including the specific questions of whether revaluation

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[79] *See id* at 281. Commentators have suggested a similar solution to the problem of book-ups upon the admission of new partners to a partnership. *See id.* at 276.

events in tiered partnership structures should be linked and whether the answer was dependent on there being a significant interest in the lower-tier partnership. The second question was whether the order of the revaluations affects the resulting layers and whether existing guidance permitted taxpayers to make revaluations in the appropriate order.

At present, none of the revaluation events listed in Regulation Section 1.704-1(b)(2)(iv)(f) link a revaluation at one tier of a group of partnerships to entities in other tiers. The resulting general inability to undertake simultaneous revaluations across tiers can be problematic. For example, if an appreciated interest in a partnership is contributed to another (upper-tier) partnership by a newly-admitted partner, despite the fact that the upper-tier partnership would be permitted to engage in a revaluation, there is no explicit mechanism for the original (lower-tier) partnership to revalue its assets.[80] Thus, a Section 704(c) built-in gain layer is created at the upper-tier partnership (in the interests in the lower-tier partnership) without a corresponding Section 704(c) layer at the lower-tier – instead, the lower tier merely retains its existing book capital accounts and book values in its assets.

> Example F. Partner A and Partner B own partnership AB which owns a nondepreciable asset that it purchased for cash that has a value of $200 and a book and tax basis of $100. Partner B contributes its share of AB to CD, an existing partnership owned by Partner C and Partner D, for a 50% interest in CD. CD is permitted to revalue its assets as a result of the contribution. CD holds its interest in AB as Section 704(c) property with a built-in gain of $50. AB sells the nondepreciable asset for less than its value on the date of the contribution of the interest in AB to CD but more than $100 (its book and tax basis).

[80] An argument can be made that Regulation Section 1.704-1(b)(2)(iv)(q), which allows for adjustments to capital accounts in circumstances where guidance is not provided, supports a revaluation in this situation. *See* Gary R. Hoffman & Barksdale Hortenstine, *Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships*, Taxes, Mar. 2008, at 179, 200-01.

As a result of the sale, book and tax gain is allocated to CD, even though CD has suffered an economic loss in its investment in AB. If CD uses the traditional method of allocating Section 704(c) items it will allocate all of the gain allocated to it to Partner B, but will not be permitted to allocate any loss to Partner C or Partner D. As a result, the upper-tier's Section 704(c) gain layer will not be resolved and part of the precontribution gain in the asset will be shifted to C and D, who are non-contributing partners. The result of shifting pre-contribution gain to non-contributing partners is inconsistent with the policies of Section 704(c).[81]

The possibility of this occurring could be reduced if the lower-tier partnership were permitted to revalue its assets at the time the upper-tier partnership undergoes its own revaluation and thereby create a reverse 704(c) layer that corresponded to the Section 704(c) layer at the upper-tier partnership. The result would be a decreased risk of a shifting of pre-contribution gains among the upper-tier partners. Therefore, we recommend that the revaluation of an upper-tier partnership be included as a triggering event under Regulation Section 1.704-1(b)(2)(iv)(f) to permit a lower-tier partnership to undertake a revaluation at the same time. (We do not believe a revaluation event at a lower-tier entity implicates the same concerns, and therefore do not recommend that such event permit revaluation at upper-tier partnerships.)

Subject to a mandatory revaluation rule in the case of controlled partnerships, in keeping with current regulatory practice, these revaluations should be at the discretion of each partnership. Revaluations are currently elective in all situations in

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[81] If AB sold the asset for, say, $160, there would be $60 of book and tax gain. One–half of those items would be allocated to Partner A. The balance would be allocated to partnership CD. $30 of gain would be allocated to Partner B (as a partner in CD) pursuant to Section 704(c). Under the traditional allocation method, no loss would be allocated to C or D.

which they are permitted,[82] except for distributions of property to partners when revaluation of the distributed property is required in connection with decreasing the capital accounts of the distributees by the fair market value of the property.[83] We recognize that in a tiered partnership structure there is an argument that all entities should be compelled to revalue if one entity does, but we do not believe the Service should compel revaluations of the assets of all lower-tier partnerships merely because of events that occur at upper-tier partnerships (even if the upper-tier undertakes a revaluation), given that the partners and partnerships involved could be largely unrelated to each other and in light of the potential constraints on information sharing between the lower-tier and upper-tier partnerships, especially when small interests are involved. We do believe, however, that the Service should make explicit that contributions without revaluations, as well as combinations of contributions with and without revaluations, are not permitted if a principal purpose of not revaluing is tax avoidance.

Notwithstanding our general preference for elective revaluation, we recommend that revaluation be mandatory (subject to a threshold discussed below) in the case of lower-tier partnerships where the upper-tier partnership owns more than 50% of the capital or profits of the lower tier partnership. We believe that in such a control situation barriers to the receipt of information should not exist and that the possibility of abuse of a revaluation by contributing assets to a controlled partnership would exist if revaluation was not mandated.

If revaluations within tiered structures are mandated, we believe that there should be a valuation threshold below which a lower-tier entity would not be required to

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[82] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) (as amended in 2008).

revalue its assets. This is for much the same reasons that we suggest a similar threshold before requiring the maintenance of Section 704(c) layers.[84] Pursuant to this threshold, where a partnership does not own interests in other partnerships having (in the aggregate) gross assets with a value meeting the threshold, the lower-tier partnerships would not be required to revalue their assets at a time that the upper-tier partnership revalues its assets. In such circumstances, lower-tier partnerships would be permitted to do so, subject to an anti-abuse rule. We suggest that this threshold also be set at $20 million, and we suggest that this threshold be revisited periodically to account for inflation.

The Service raised two other questions regarding revaluation in tiered structures: whether a minimum interest in the lower-tier entity should be required in order for the lower-tier partnership to be permitted to revalue its assets and the order in which revaluations should take place. We believe that so long as revaluations are elective it is unnecessary to require that the upper-tier partnership have a substantial interest in the lower-tier partnership before allowing the lower-tier partnership to engage in a revaluation when triggered by an upper-tier revaluation. Each partnership would be permitted to opt-in or opt-out of the revaluation. Nonetheless, we believe at some point an interest would become sufficiently *de minimis* so as to not support a lower-tier revaluation. We believe a 1% interest in capital or profits is sufficient to avoid provide this support, and suggest a *de minimis* rule that would prohibit revaluations involving partnership interests that are smaller than that.

When revaluations do occur across tiers in a tiered partnership structure, we believe that the ordering of those revaluations should be mandated by regulations. In

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[83] Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1).

our view, the appropriate procedure would be to have revaluations occur at the lowest tier first, and then have them proceed up through successively higher tiers. We believe that this provides the most straightforward means to ensure that Section 704(c) layers are accounted for properly at each level because each partnership would be able to take advantage of its own capital accounting mechanics in allocating built-in gain or loss to higher tiers.

3. Additional Tiered Partnership Concerns.

The Notice asks whether there are additional Section 704(c) issues that taxpayers or regulators need to consider in the context of tiered partnerships. We believe existing regulations should be expanded to cover certain situations that they do not currently cover and that the Service should consider certain issues raised by publicly traded partnerships.

The regulations governing tiered partnerships should be expanded to govern certain situations not currently covered. As discussed in more detail below, Regulation Section 1.704-3(a)(9) governs how an upper-tier partnership must adjust its Section 704(c) layers to account for Section 704(c) items at a lower tier. This provision, however, only applies in two specified situations, namely when a partnership has contributed Section 704(c) property to another partnership and when a partner (that in the past contributed Section 704(c) property) transfers its partnership interest to another partnership. As a result, there are situations where Section 704(c) layers should be calculated with reference to another partnership, but that fall outside the purview of Regulation Section 1.704-3(a)(9). For example, when a partnership formed initially with

[84] *See supra* text following note 67.

contributions only of cash acquires property that appreciates, and then a partner in that partnership (the lower-tier partnership) contributes its interest to a newly-created (upper-tier) partnership, the appreciated property (or, from an Entity Approach perspective, the appreciation in the partnership interest in the lower-tier partnership) represents Section 704(c) property for the upper-tier partnership.

> Example G. In 2010, Partner A and Partner B form equal partnership GP which, with the capital commitments of various LP investors, raises an investment fund (the "fund") in which GP receives a 20% profits interest in exchange for its services. The fund enjoys success on its initial portfolio investments, which appreciate from $200 to $600 by 2011. Also in 2011, Partner A and Partner B contribute their GP shares to newly formed partnership, PTP. At the time of this contribution, Partner A and Partner B will have contributed property to PTP with a combined unrealized gain of $80 (20% of $400). Immediately after such contribution, the PTP, issues shares to the public.

Because there has been (i) no contribution of Section 704(c) property by a *partnership* and (ii) no transfer of partnership interests by a partner *that previously contributed Section 704(c) property*, Regulation Section 1.704-3(a)(9) is not applicable.[85] The fund's investments are not themselves Section 704(c) property as they were not, post-appreciation, contributed to a partnership in an exchange pursuant to Section 721 and did not have unrealized appreciation at the time they were acquired by the fund. As a result, the upper-tier allocation is not compelled to account for the related lower-tier Section 704(c) layer. Therefore, we recommend that Regulation Section 1.704-3(a)(9) be broadened to more closely link Section 704(c) layers to the property that underpins, even when that property is located in another partnership in the tiered partnership structure.

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[85] *See* Hoffman & Hortenstine, *supra* note 80, at 195–98; Rubin & Macintosh, *supra* note 62, at 277 & n.17.

That result would follow automatically if the regulations adopt an Aggregate Approach with respect to tiered partnerships, as we recommend below.

A question each tiered partnership faces is whether the upper-tier and lower-tier partnerships must use the same method of allocation when the upper-tier partnership contributes Section 704(c) property to the lower-tier. Publicly traded partnerships ("PTP") face unique issues in complying with Section 704(c) as a result of the need to maintain fungibility of all interests in the PTP. We address these issues in response to question 8 of the Notice, which discusses the Aggregate and Entity Approaches to accounting for Section 704(c) layers in tiered partnerships.

4. The Aggregate and Entity Approaches.

The Service asked when an Aggregate Approach and when an Entity Approach to maintaining Section 704(c) layers should be permitted, what the results should be under both, and whether any other methods should be permitted for dealing with tiered Section 704(c) allocations.

Generally, the Entity Approach would treat each partnership in a tiered structure as a separate entity with its own attributes and would limit the interaction between the entities. The Aggregate Approach, on the other hand, would generally ignore the existence of separate entities in a tiered structure and treat tiered partnerships as a single partnership in applying Section 704(c) rules.

As currently configured, Regulation Section 1.704-3(a)(9) endorses the Entity Approach. The Entity Approach has the virtue of being consistent with the general approach of Section 703 that items of taxable income are to be calculated by each

partnership.[86] However, we believe that the Aggregate Approach better fulfills the anti-shifting policy goals of Section 704(c), and therefore recommend that Regulation Section 1.704-3(a)(9) should be amended to require that tiered partnerships be analyzed in the aggregate for Section 704(c) purposes possibly subject to exceptions for certain publicly traded partnerships.

Partnerships are treated as entities for certain federal income tax purposes and as aggregates for others. In some circumstances the result is dictated by the choices made in the Code. In others, such as this one, the Code does not dictate a result. In general, an aggregate approach arises because a partnership is a conduit that passes its tax items to its partners. If some characteristic of an item of partnership income is relevant at the partner level, that suggests it is appropriate to view the partnership as an aggregate rather than an entity.[87]

Under Regulation Section 1.704-3(a)(9), when a partnership contributes Section 704(c) property to a subsidiary partnership or when a partner that contributed Section 704(c) property transfers its partnership interest to another partnership, "the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss." The procedure outlined in this regulation is based on the view that the partnerships are separate entities.

Nonetheless, it is our view that the Aggregate Approach is much superior to the Entity Approach when dealing with Section 704(c) property. The underlying policy of Section 704(c) is to avoid the shifting of tax items from a contributing to a non-

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[86] *See* Hoffman & Hortenstine, *supra* note 80, at 195 & n.117.

contributing partner. Thus, the character of a Section 704(c) item is relevant at (perhaps only at) the partner level for the initial contributing partner. Thus, under general partnership tax principles a partnership would be treated as an aggregate when considering Section 704(c) items. If Section 704(c) property is contributed to a lower-tier partnership, the Section 704(c) layer remains relevant to the original contributing partner, and that relevance can best be tracked through the use of the Aggregate Approach. Similarly, if the contributing partner contributes the partnership interest to a new partnership, treating the two partnerships as aggregates best tracks the relevance of the Section 704(c) layer to the original contributing partner.

In implementation, a key differentiator in the mechanics between the Aggregate and Entity Approaches is whether the upper-tier and lower-tier partnerships must use the same method of allocation when the upper-tier partnership contributes Section 704(c) property to the lower-tier. As discussed above, existing regulations do not address this topic. We believe it appropriate if the Aggregate Approach is used that the allocation methods across tiers be aligned. We recognize that in other areas, such as multiple Section 704(c) layers, a partnership is permitted great flexibility. In this respect, the choice of allocation method differs from the choice that is made when a single partnership must decide what method to apply to a reverse 704(c) layer. When revaluations are conducted, the choice of allocation method for new reverse Section 704(c) layers is independent of the methods the partnership has used previously for the same asset.[88] In the case of the formation of a tiered partnership, the Section 704(c) layer existed before the tier existed, and a choice of methods was made in respect of the layer.

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[87] *See id.* at 185 n.54.

Merely creating a new entity should not permit a new choice to be made. Accordingly, using the Aggregate Approach, we believe the methods should align so that the original contributing partner essentially continues to stand in the same shoes notwithstanding the structural changes.

This result is entirely consistent with the analogy to single-tier partnerships. In effect, the dropping down of assets into a lower-tier partnership is economically the same as the admittance of a new partner to a partnership. The latter would trigger a revaluation under Regulation Section 1.704-1(b)(2)(iv)(f), which would allow the partners to select a different allocation method for the *reverse* Section 704(c) layer. However, the revaluation should not (under the no-netting approach advocated earlier) alter the allocation method for the pre-existing Section 704(c) layer(s). Therefore, because the admittance of a new partner allows for the selection of any reasonable Section 704(c) method only for a *newly-created* layer, it follows that economically similar lower-tier and upper-tier partnership arrangements should be permitted to use different allocation methods to the extent they represent new Section 704(c) items, as opposed to replications of earlier Section 704(c) layers. Given that this is an area that is unaddressed by existing regulations, we believe that it would be of value for new tiered partnership regulations to explicitly state that upper-tier and lower-tier partnerships can use different Section 704(c) allocation methods, but only to the extent that the lower-tier partnership's Section 704(c) layer is not linked to that asset's Section 704(c) layers at the contributing upper-tier partnership.

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[88] Treas. Reg. § 1.704-3(a)(6)(i) (as amended in 2005).

As noted above, special considerations apply to a PTP. As with any publicly traded vehicle, it is essential that the shares of the same class in a PTP be fungible so as to be freely marketable. Thus, shares acquired at Time 1 (for example, at the founding of a partnership) must, at any given Time 2 (in a secondary offering, for example), be economically indistinguishable to a purchaser from all other shares in the same partnership — the shares cannot have variable tax attributes depending on the identity of the seller. With corporate entities, fungibility between outstanding shares of the same class is accomplished as a matter of course. Because corporations are separate taxpayers from their shareholders, there is no reason why their shares would be burdened by disparate tax attributes. Accordingly, to a purchaser of corporate stock, the identity of the prior shareholder will be irrelevant for purposes of determining the after-tax returns associated with the ownership of such stock.

By contrast, as a result of the pass-through nature of a partnership and the function of capital accounts, shares of a partnership are rarely identical, even under the most straightforward of capital structures. For example, the shares of a simple, single-tier partnership that makes disparate distributions (for taxes or other reasons) would not be fungible. Similarly, as a result of Section 704(c), if even one partner contributes appreciated property to the partnership in exchange for a partnership interest, the shares of such partnership will not, without further steps, be fungible. Comparable principles apply with respect to book-tax disparities resulting from reverse 704(c) allocations caused by revaluations. Because a transferee partner generally must "step into the shoes" of the transferring partner, inheriting from the transferor its capital account for both book

and tax purposes,[89] a purchasing partner will care a great deal about the identity and circumstances of the selling partner.

A private partnership generally need not be concerned about fungibility of its interests. The mechanics of selling or transferring an interest in the private sphere affords the parties significant latitude to account for the tax profile of the interest when negotiating the purchase price. Such market adjustment is not possible, however, with shares of a PTP. These shares trade daily on the market and in each such trade, the respective seller and buyer are unidentified to each other. Thus, it is impossible for a purchaser to know whether it is acquiring a share that is tainted by Section 704(c) or not. For this reason, in order for a PTP to work in the marketplace, it must be that each share of a PTP will be functionally identical despite Section 704(c).

The fungibility problem for PTP units is not new, nor is it irremediable. To achieve fungibility, a PTP can make a Section 754 election, pursuant to which a purchaser can insulate itself from its predecessor's allocable Section 704(c) gain through the Section 743(b) basis step-up. For this to work, the PTP must also elect the "remedial method" of Section 704(c) allocations, lest the ceiling rule operate to prevent an effective offset of future Section 704(c) allocations through depreciation of the basis step-up.[90]

In order for this fungibility "fix" to work in the context of a tiered partnership, each partnership in the structure must separately make both the Section 754 and remedial allocation elections. This approach presents administrative burdens that can

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[89] Treas. Reg. § 1.704-3(a)(7).

[90] Until 1998, even the optional basis adjustment would not preserve fungibility in every instance. This "glitch" was corrected with amendments in 1999 to the Treasury regulations under Section 743(b). An express purpose of the amendments was to allow partnerships that also elected to allocate Section 704(c) gain using the remedial method to preserve fungibility. *See* T.D. 8847, 1999-2 C.B. 701.

be unwieldy and onerous. It also tends to accelerate the recognition of Section 704(c) items to the historic partners.

Notwithstanding this option, and perhaps in light of the issues identified with this option, some PTPs have taken a different approach to preserving fungibility. This approach capitalizes on the uncertainty regarding the amount of look-through that is possible or required between tiers of related partnerships. This tack, which relies on an entity approach to tiered partnerships and a narrow reading of the applicable Treasury Regulations described above, essentially takes the view that the only relevant Section 704(c) asset at the upper-tier level is the interest in the lower-tier partnership, which is, of course, never sold or amortized. By adopting this approach — common in public investment partnerships since 2007 — the PTP purports to achieve fungibility without the compliance burdens associated with Section 754 elections and the remedial allocation method.

The approach described in the preceding paragraph is inconsistent with the Aggregate Approach. If the Aggregate Approach were imposed on PTPs, PTPs would generally be required to use Section 754 elections and the remedial method to maintain fungibility of interests. It is unclear, however, to what degree Section 704(c) should apply to PTPs. Treasury may ultimately determine that PTPs, as a result of their unique role in the partnership context and the innate conflict that may always exist between maintaining fungibility and complying with the strictures of Section 704(c), should be excused from the administrative burdens of Section 704(c). Trading in the public market does not appear likely to implicate the anti-gain shifting policies that Section 704(c) was intended to implement. Further, the transaction costs of applying Section 704(c) in a

manner that maintains fungibility of interests in the PTP, which is required for the public market to operate, may be substantial.

On the other hand, there may be opportunities to manipulate gain recognition between the founder or founders of the PTP, which may have substantial Section 704(c) items allocated to them representing built-in gain in assets contributed by them that existed at the formation of the PTP, and the other interest holders that acquired their interests in the public market. Those opportunities would militate towards having Section 704(c) apply at least with respect to founders.[91] Accordingly, the Service may determine that Section 704(c) should apply to property contributions but that reverse 704(c) should not apply as a result of public trading in interests in the PTP. The Service also may take the view that the unique status of PTPs is not sufficient grounds to exempt them even in part from the application of Section 704(c). To the extent that special rules need be put in place for problems unique to PTPs, including such rules in part IV of subchapter K (the "Special Rules for Electing Large Partnerships") seems apt.

If the application of Section 704(c) to PTPs is ultimately changed or clarified, equity favors permitting an adjustment period during which PTPs that have operated under the strict entity approach could restructure themselves as necessary. Moreover, Treasury should be cautious in the scope of any such reform, avoiding implementing overbroad measures that may have economic consequences in the public markets. Tiered partnerships with less significant overlapping ownership, for which this problem is not implicated in the same manner, should not be adversely impacted by any such changes. To accomplish this, Treasury may wish to adopt a minimum of

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[91] "Founder" for this purpose would be any person that holds an interest in the PTP that was acquired for property (other than money) in a substituted basis transaction.

overlapping ownership between tiers (for example, 80%) that must apply before look-through is warranted.

5. Maintenance of Lower-Tier Section 704(c) Layers Under the Aggregate Approach.

The Service asked how, under the Aggregate Approach, Section 704(c) layers would be maintained by the lower-tier partnership. We believe we have covered this issue above in connection our discussion of requiring Section 704(c) layers to be maintained on a single-entity basis and the use of the same Section 704(c) allocation method for replicated Section 704(c) layers at each tier in a partnership structure at which such layer exists. To the extent the question implicates information sharing, we discuss those issues in the response to the next question.

6. Information Constraints on the Aggregate Approach.

The Service asked if the information necessary to maintain Section 704(c) layers under the Aggregate Approach is readily available and, if the Aggregate Approach were permitted, what, if any, additional rules would be necessary for partnerships to secure the necessary information.

Under the current entity approach of Regulation Section 1.704-3(a)(9), partnerships generally are not required to obtain Section 704(c) related information from other partnerships in a tiered structure. Nonetheless, we believe that it should be relatively straightforward for partnerships to compile and share the information necessary to comply with Section 704(c) using an Aggregate Approach. Under current law there is significant information that must be shared between a contributing partner and a partnership in order to comply with tax rules, including most significantly for this discussion the adjusted tax basis of property contributed. Whether an item of property is

Section 704(c) property in the hands of a contributing partnership should be known to the contributing partnership and would become part of the "diligence" necessary when property is contributed by one partnership to another. Similarly, partnerships are already obligated to report substantial tax information to their partners. In our experience, such information often goes beyond, in frequency and scope, the information required to be reported on Schedule K-1. Thus, we do not believe that the information necessary for upper-tier partnerships to report tax items relating to Section 704(c) property held by lower-tier partnerships should be especially burdensome to compile or report.

Nonetheless, although we believe that well-advised partners and partnerships could negotiate for and obtain the right to obtain the necessary information to maintain Section 704(c) layers by contract, we recommend that the Service require that lower-tier partnerships report the book value and inside tax basis of Section 704(c) property as part of the Schedule K-1 reporting process. Such a rule would eliminate a trap for the unwary, which is entirely appropriate in the context of tax compliance. It would reduce transaction costs by reducing the need for parties to negotiate the extent of the information to be provided. Finally, it would reduce compliance costs by standardizing, at least in part, the form and content of the information provided.

7. <u>Accounting for Upper-Tier Book-Tax Differences Under the Entity Approach.</u>

The Service asked how, under the Entity Approach, book-tax differences should be resolved at an upper-tier partnership if all of the Section 704(c) property at the lower-tier partnership is disposed of and not all of the upper tier book-tax differences are resolved. This situation is conceptually similar to the situation of an all-cash partnership that has unresolved Section 704(c) layers, which is discussed above. As in the case of the

all cash partnership, the unresolved Section 704(c) layers would be resolved on the ultimate liquidation of the upper tier partnership. Similar to our suggestion above, we believe that the upper-tier partnership should be permitted to utilize curative or remedial Section 704(c) allocations to resolve such amounts more quickly.

C. Mergers.

In light of the fact that the transferor partnership terminates in a merger, and the Proposed Merger Regulations describe special rules that apply to a partnership merger, the Notice asks, whether mergers raise different Section 704(c) issues, as well as several related questions.

1. Different Issues in Mergers.

The Proposed Merger Regulations provide rules relevant to Section 704(c) that are only invoked when a merger does occur. To understand these special merger rules, we first review the tax treatment of a merger under current rules and the Proposed Merger Regulations. As a reminder, the Proposed Merger Regulations contain the principles that the IRS expressed in Notice 2005-15[92] and also contain clarifications and additional provisions, some of which with respect to Section 704(c)(1)(B)[93] are summarized below. Second, Example 3 of the Proposed Merger Regulations is discussed in detail to illustrate better certain issues that mergers raise, and which are subsequently discussed. Finally, we discuss the Section 704(c) issues that arise in connection with a partnership merger.

[92] 2005-1 C.B. 527. This is true with respect to both Section 704(c)(1)(B) and precontribution gain under Section 737.

[93] Similar rules generally apply to precontribution gain under Section 737.

a. Background: Asset-over Mergers and Section 704(c) Rules.

For federal income tax purposes, a merger of two or more partnerships into one can be treated as either an assets-over or assets-up merger.[94] In an assets-over merger, the transferring partnership contributes all of its assets and liabilities to the transferee partnership in exchange for an interest in the transferee partnership, and then immediately thereafter distributes its interests in the transferee partnership to its partners in liquidation.[95] In contrast, in an assets-up merger, first the transferring partnership terminates and distributes its assets directly to its partners and its partners assume its liabilities, and then the partners contribute those assets and liabilities to the transferee partnership in exchange for an interest in the transferee partnership.[96] For purposes of this discussion on mergers, the assets-over form will be presumed in all instances unless stated otherwise.

Under current regulations and the Proposed Merger Regulations, Section 704(c)(1)(B) does not apply to an assets-over merger.[97] In general, Regulation Section 1.704-3(a)(8) provides that when Section 704(c) property, originally contributed by a partner to a transferring partnership, is contributed by the transferring partnership to a transferee partnership in exchange for an interest in the transferee partnership, the interest in the transferee partnership received is treated as "successor Section 704(c) property".[98] Therefore, without the existence of the current assets-over merger rule, Regulation

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94 Treas. Reg. § 1.708-1(c)(3) (as amended in 2001).

95 Treas. Reg. § 1.708-1(c)(3)(i).

96 Treas. Reg. § 1.708-1(c)(3)(ii).

97 Treas. Reg. § 1.704-4(c)(4) (as amended in 2005); Prop. Treas. Reg. § 1.704-4(c)(4).

98 *See* James B. Sowell, *Partnership Mergers: The Saga Continues,* 119 TAX NOTES 727, 728 & n.8 (2008).

Section 1.704-3(a)(8) would trigger application of Section 704(c)(1)(B) in connection with the distribution of the partnership interest that is treated as taking place as part of the merger, resulting in gain or loss recognition for partners who did not initially contribute the 704(c) property to the transferor partnership.

For purposes of determining the consequences of the application of Section 704(c)(1)(B) in a subsequent distribution, the Proposed Merger Regulations (with much more clarity than the current regulations) provide rules concerning the treatment of original Section 704(c) gain or loss and new Section 704(c) gain or loss.[99] "Original 704(c) gain or loss" with respect to a property is defined as the difference between the property's fair market value and the contributing partner's adjusted tax basis at the time of contribution of the property to the extent that the difference has not been eliminated by prior Section 704(c) allocations, prior revaluations, or in connection with the merger.[100] Reductions as a result of prior Section 704(c) allocations are provided for in the Proposed Merger Regulations and intuitively make sense because any Section 704(c) allocation should reduce future Section 704(c) allocations; similarly, reductions in connection with a merger seem logical because the original Section 704(c) gain or loss of a property should not exceed the total built-in gain or loss that exists with respect to the property at the time of merger.[101] Reductions due to prior revaluations, on the other hand, create more complex issues and are discussed in greater detail in Section III.A. "New 704(c) gain or loss" is not explicitly defined in the Proposed Merger Regulations, but appears to

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99 *See* REG–143397-05, *supra* note 4, at 790-91 (Preamble).

100 Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(A).

101 *See* Sowell, *supra* note 98, at 730.

be any portion of the aggregate Section 704(c) gain or loss resulting from the merger that is not already accounted for in the "original 704(c) gain or loss."

The Proposed Merger Regulations state that the seven-year time period in Section 704(c)(1)(B) for original Section 704(c) gain or loss at the transferring partnership level continues (that is, does not restart), but that new Section 704(c) gain or loss at the transferee partnership level starts a new Section 704(c)(1)(B) seven-year time period.[102]

Original Section 704(c) gain or loss is allocated to the original contributing partner and new Section 704(c) gain or loss is to be allocated among the partners of the transferor partnership consistent with the principles of Regulation Section 1.704-3(a)(7) and newly designated (by the Proposed Merger Regulations) Regulation Section 1.704-3(a)(10). The Proposed Merger Regulations provide that neither original Section 704(c) gain or loss nor new Section 704(c) gain or loss trigger Section 704(c)(1)(B) to the extent that Section 704(c) property is returned to the deemed contributors of the property when each Section 704(c) layer was created. Consequently, original Section 704(c) gain or loss is not recognized if property originally contributed by a partner to the transferor partnership is distributed to such partner. Though the rationale is not clear, the Proposed Merger Regulations provide that each partner is deemed to contribute an "undivided interest" in the Section 704(c) property. This undivided interest principle is discussed in greater detail in Part III.C.1.c.v.

As further discussed in Part III.C.l.c.vii, the Proposed Merger Regulations provide that Section 704(c)(1)(B) will not apply to new Section 704(c) gain or loss in any

[102] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(A)-(B).

Section 704(c) property in a merger if each partner owns identical, or at least 97% identical (*de minimis* exception), interests in each of the transferor and transferee partnerships.

The Proposed Merger Regulations also provide that a transferee partnership may adopt any reasonable allocation method for both new Section 704(c) gain or loss and original Section 704(c) gain or loss, regardless of the transferring partnership's method with regard to such gain or loss. A detailed discussion regarding this issue can be found in Part III.C.1.c.iv.

Finally, the Proposed Merger Regulations state a subsequent merger rule which provides that, in the event the transferee partnership merges into a different partnership, a second new Section 704(c) gain or loss would be created with a seven-year clock. Any previous 704(c) gain or loss layer will not receive a restart of its seven-year clock.

b. Example 3.

The Notice discusses Example 3 of Proposed Regulation Section 1.704-4(c)(4)(ii)(F) ("Example 3") because it illustrates a number of issues that arise when analyzing how to apply Section 704(c) in mergers. Example 3 involves a situation where Section 704(c) gain property contributed to the transferor partnership has both a revaluation loss in the transferor partnership and additional gain upon merger with the transferee partnership, before a subsequent distribution of the Section 704(c) property to a non-contributing partner. Example 3 concludes in part that the Section 704(c) layers are collapsed in the merger and that upon contribution to the transferee partnership the

property had only built-in gain and no built-in loss. Below we discuss in detail the outcome of Example 3 under the Proposed Merger Regulations.

i. Text in the Proposed Regulations.

> Example (3). Revaluation loss and merger gain. (i) Facts. On January 1, 2005, A contributes Asset 1, with a basis of $200x and a fair market value of $300x, to partnership PRS1 in exchange for a 50 percent interest. On the same date, B contributes $300x of cash to PRS1 in exchange for a 50 percent interest. Also on January 1, 2005, C contributes Asset 2, with a basis of $100x and a fair market value of $200x, to partnership PRS2 in exchange for a 50 percent interest. On the same date, D contributes $200x of cash to PRS2 in exchange for a 50 percent interest. PRS1 and PRS2 both have provisions in their respective partnership agreements requiring the revaluation of partnership property upon entry of a new partner. PRS2 would not be treated as an investment company (within the meaning of Section 351) if it were incorporated. Neither partnership holds any unrealized receivables or inventory for purposes of Section 751. In addition, neither partnership has a Section 754 election in place. Asset 1 and Asset 2 are nondepreciable capital assets.
>
> Later on in 2005, PRS2 admitted E as a new partner in PRS2 at a time when the fair market value of Asset 2 was $150x and PRS2's only other asset was cash of $200x. In exchange for a contribution of cash of $175x, E was admitted as a one-third partner in PRS2. In accordance with the terms of PRS2's partnership agreement, the partnership revalued its assets upon admission of E so that the unrealized loss of $50x attributable to Asset 2 was allocated equally between C and D, or $25x each. On January 1, 2008, PRS 2 merges into PRS1. At the time of the merger, PRS1's only assets are Asset 1, with a fair market value of $900x, and $300x in cash. PRS2's only assets are Asset 2, with a fair market value of $600x, and $375x in cash. After the merger, the partners have book capital and profits and loss interests in PRS1 as follows: A, 27.5%; B, 27.5%; C, 15%; D, 15%; and E, 15%. On January 1, 2013, Asset 2 is distributed to A when its value is still $600x.[103]

ii. Discussion of Example 3.

Example 3 is informative because it not only demonstrates the step-by-step analysis that mergers involving Section 704(c) property require, but, as discussed

[103] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(F), Ex. 3.

below, it also exposes additional issues that should be considered by the Service in preparing future regulations relating to Section 704(c) and partnership mergers.

(a). Overall Summary.

The important sequence of events in Example 3 is that: (i) Partner C contributes Asset 2, which is Section 704(c) property with built-in gain, to the transferring partnership, which results in the creation of an original Section 704(c) gain layer in the property; (ii) in connection with the entrance of another partner, Partner D, into the transferring partnership PRS2, a revaluation occurs that results in a reverse 704(c) loss layer in the property; (iii) PRS2 merges into the transferee partnership PRS1 in an assets-over merger where a new Section 704(c) gain layer is created in Asset 2; and (iv) Asset 2 is distributed at a later time to Partner A, who is not the original contributing partner.

The results are that: (i) the merger causes the reverse 704(c) loss layer to collapse into the original Section 704(c) gain layer, thus reducing the original Section 704(c) gain layer ($100x) by the amount of the reverse 704(c) loss ($50x); (ii) a new Section 704(c) gain layer is created and its value is determined by subtracting the now-reduced original Section 704(c) gain layer ($50x) from the total built-in gain in the Section 704(c) property at the time of merger ($500x); and (3) upon later distribution of the Section 704(c) property, Section 704(c)(1)(B) gain ($450x) is allocated to the three partners (C, D and E) to whom the still applicable (that is, not time-barred) Section 704(c) layers are attributable.

The effect of the differing seven-year time periods for the original Section 704(c) gain and the new Section 704(c) gain is highlighted by the fact that only the new

Section 704(c) gain is recognized on the distribution of Asset 2. Consistent with that result, the original Section 704(c) gain that was time-barred will not be recognized until the affected partners liquidate their interest in the transferee partnership (or later transferee partnership in the event of any subsequent mergers), because the transferee partnership no longer possesses the property to which the book-tax disparity is attributable. Though this result is exactly the type that Section 704(c)(1)(B) was meant to prevent, the existence of the seven-year period in Section 704(c)(1)(B) would seem to evidence that Congress did not intend to require recognition of built-in gain or loss in these circumstances indefinitely, regardless of whether the parties engaged in transactions for the purpose of tax avoidance or deferral.

(b). Analysis of Each Partner's Situation.

This Section discusses the treatment of each partner in Example 3 under Section 704(c)(1)(B).

Partners A and B

Neither Partner A nor Partner B is affected by application of Section 704(c)(1)(B).

Partner C

Partner C has both original and new Section 704(c) gain with respect to Asset 2. Partner C was the original contributor of Asset 2 to PRS2, and is deemed to have contributed an undivided interest in Asset 2 to PRS1 in the merger. Partner C's original Section 704(c) gain in Asset 2 was \$100x because Partner C contributed Asset 2 when its fair market value was \$200x and its adjusted tax basis was \$100x. Upon Partner E's entrance into PRS2 when the value of Asset 2 was \$150x, a reverse 704(c) loss layer

of $50x was created. The merger caused the $50x reverse 704(c) loss layer to be collapsed into the $100x original 704(c) gain layer, resulting in a $50x original Section 704(c) gain layer. The time lapse between Partner C's initial contribution of Asset 2 to PRS2 and the distribution of Asset 2 to Partner A exceeded seven years, so the original Section 704(c) gain was not recognized when Asset 2 was distributed. Instead, the original Section 704(c) gain is deferred indefinitely because, as previously noted, there will not be any further recognition events with respect to the gain until Partner C liquidates its interest in PRS1.

Although the unrecognized original Section 704(c) gain in Asset 2 is $50x, Partner C actually defers $75x of total gain as a result of Partner C initially having $100x of Section 704(c) gain from contributing Asset 2 to PRS2 but only being allocated its portion ($25x) of the reverse 704(c) loss layer ($50x) due to the collapsing of layers upon the merger.

The merger also created a new Section 704(c) gain layer of $450x: Asset 2's fair market value at the time of merger ($600x) exceeded its adjusted tax basis ($100x) by $500x, and after subtracting the $50x original Section 704(c) gain, the difference was $450x. The new Section 704(c) gain was evenly split ($150x each) between the three partners of PRS2. On the distribution, Partner C also recognized that $150x of gain. Subsequent to the distribution, Partner C has a capital account balance of $325x and an adjusted tax basis of $250x in its interests in PRS1 that reflects the $75x of gain not recognized. Partner C likes this result (or at least should).

Partner D

Partner D has pre-merger reverse 704(c) loss and new Section 704(c) gain with respect to Asset 2. First, as noted above, when Partner E entered PRS2 after the value of Asset 2 had decreased to $150x, this created a reverse 704(c) loss layer. But this loss layer did not affect any gain recognition when Asset 2 was distributed to Partner A because the primary original Section 704(c) gain was outside the seven-year period of recognition when Asset 2 was distributed to Partner A. (Even if the original Section 704(c) gain had been created within seven years of the distribution to Partner A, this would not have changed Partner D's recognition amount because the reverse 704(c) loss layer collapses into the original Section 704(c) gain layer and arguably only the original contributing partner (Partner C in this case) could ever recognize gain or loss from original Section 704(c) gain or loss.)[104]

Second, Partner D recognizes its $150x share of the new Section 704(c) gain upon PRS1's distribution of Asset 2 to Partner A. Third, though Partner D was allocated a book loss of $25x when the revaluation took place, Partner D was not allocated any corresponding tax loss. Accordingly, immediately after Partner D's recognition of this $150x of new Section 704(c) gain, Partner D has a capital account balance of $325x and an adjusted tax basis of $350x in its interests in PRS1 (again, that reflects the $25x of reverse 704(c) loss layer not recognized). Partner D dislikes this result. This $25x difference will not be recognized by Partner D until it liquidates its interest in PRS1.

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[104] *See* Sowell, *supra* note 98, at 732 & n.39.

Partner E

Partner E has new Section 704(c) gain with respect to Asset 2 through the merger, but does not have any connection to Asset 2's original Section 704(c) gain because Partner E neither contributed Asset 2 nor was a partner in PRS2 before a revaluation event. Partner E recognizes its $150x share of the new Section 704(c) gain on the distribution of Asset 2. Subsequent to the distribution, Partner E has a capital account balance of $325x and an adjusted tax basis of $325x in its interests in PRS1. Partner E is indifferent about this result.

(c). <u>Possible Distortion of Timing of Gain/Loss Recognition.</u>

This Section discusses three slightly different fact patterns from that in Example 3 to demonstrate how the timing of gain or loss recognition could be "distorted" or "corrected."

Effect of Collapse of Reverse Layers on New Section 704(c) Gain or Loss

Because the determination of new Section 704(c) gain or loss depends on the amount of original Section 704(c) gain or loss, new Section 704(c) gain or loss would be affected if reverse 704(c) gains or losses were not taken into account.[105] For instance, in Example 3 if reverse 704(c) layers were *not* taken into account upon the merger and if the distribution of Asset 2 to Partner A had occurred *within* seven years of the initial contribution of Asset 2 by Partner C to PRS2, Partner C would have recognized total Section 704(c) gain of $233.33x ($100x initial original 704(c) gain plus new Section

704(c) gain of $133.33x (1/3 of ($600x-$200x))). In this scenario, Partner C would have a capital account balance of $325x and an adjusted basis of $333.33x in its interests in PRS1. Partner D would recognize new Section 704(c) gain of $133.33x (1/3 of ($600x-$200x)) and have a capital account balance of $325x and an adjusted basis of $333.33x. Partner E would recognize new Section 704(c) gain of $133.33x (1/3 of ($600x-$200x)) and have a capital account balance of $325x and an adjusted basis of $308.33x.

This result is clearly different from, and conceptually worse than, the actual results in Example 3, because the capital account of each Partner post-distribution does not equal its adjusted tax basis, unlike the actual results in Example 3 when at least Partner E's capital account equaled its adjusted tax basis. Moreover, as in Example 3, the resulting book-tax disparities cannot be corrected until the respective partners liquidate their interest, which is not the ideal economic result for partnership tax law.

Traditional 704(c) Allocation Method

Though Example 3 does not account for any particular method of Section 704(c) allocation selected by PRS2 with respect to Asset 2, it appears that in Example 3 the partnerships use the traditional method. As stated in the Notice, commentators have suggested that the results in Example 3, and by extension the results in many other situations, could be different if the transferor partnership used another method of allocation, such as the remedial method.[106]

[105] There is not certainty as to this issue though a literal reading of how original section 704(c) gain or loss is calculated would mean that revaluation reverse layers are *not* taken into consideration – however, arguably that seems conceptually incorrect.

[106] *See* IRS Notice 2009-70, *supra* note 2.

To form a basis for comparison with the remedial method (discussed in detail further below), the facts of Example 3 are slightly modified and the traditional allocation method is applied. The remainder of this Section will assume all of the same facts in Example 3 except that PRS2 does not terminate after the contribution of its assets to PRS1 and Asset 2 is thereafter sold to a third party for its fair market value ($600x).[107] As a result of the asset contribution, a tier structure is created in which PRS2 is the upper-tier partnership holding only a partnership interest in PRS1. The major consequence of this change is that because a merger has not occurred, the original Section 704(c) gain layer and the reverse 704(c) loss layer with respect to Asset 2 in PRS2 are not collapsed.[108]

When PRS2 contributes Asset 2 to PRS1, PRS1 has an initial tax basis in Asset 2 equal to PRS2's adjusted tax basis in the asset ($100x). Therefore, the sale of Asset 2 to a third party results in $500x of total Section 704(c) gain, all of which is allocable to PRS2 in accordance with Section 704(c)(1)(A).

Under Regulation Section 1.704-3(a)(9), which applies the Entity Approach,[109] PRS2 would allocate the $500x gain to its Partners C, D and E, accounting for the built-in gain with respect to Asset 2. This allocation would seem to depend upon the PRS2's allocation method with respect to Asset 2. Though unclear how Section 704(c) would be applied in this situation if the Entity Approach were used, one option is to treat Asset 2 as if it were sold twice (a "successive sales" approach) – once at an

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[107] *See* Blake D. Rubin, Jon G. Finkelstein & Gale E. Chan, *Recent Developments in Partnership Taxation, in* 2 TAX PLANNING *supra* note 66, at 147, 255.

[108] As discussed in the analysis of Example 3, *supra* in Part III.C.1.b.iia.

[109] As discussed *supra* Part III.B.4.

amount equal to the value at the revaluation event (entrance of Partner E to PRS2) and once at an amount equal to the fair market value upon sale to a third party – to fully realize all of the $500x total gain.[110]

Under the traditional method and this successive sales approach, at the revaluation event when Asset 2 was worth $150x, PRS2 would have been allocated $50x book loss and $50x tax gain. PRS2 would allocate $25x book loss each to both Partners C and D, and all of the $50x tax gain to Partner C. Though Partner D would have a $25x book loss, the ceiling rule would prevent Partner D from recognizing any tax loss. When Asset 2 is later sold to a third party, there is additional gain of $450x to be allocated among PRS2's three equal partners. Each of Partners C, D and E recognize $150x tax gain with respect to this $450x gain. In the aggregate, Partner C would be allocated $200x tax gain, and Partners D and E would each be allocated $150x tax gain. As in Example 3, Partner E has a capital account that equals its adjusted basis, Partner D has a capital account that is $25x less than its adjusted basis, and Partner C does not have a capital account that equals is adjusted basis.

We note that the Aggregate Approach, which we recommend earlier in this Report should apply to a tiered partnership (subject to certain exceptions such as information constraints), likely would produce results similar to those described immediately above when comparing how many partners' capital accounts equal the partners' adjusted tax bases.

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[110] This approach is discussed above in connection with Section 704(c) allocation methods in tiered partnerships, *supra* text accompanying notes 77-79; *see also* Rubin, Finkelstein & Chan, *supra* note 107, at 256.

Remedial Allocation Method

The remedial allocation method results in substantially different results than the traditional method. Using the remedial method, assuming that there had been a realization event at the revaluation event when Asset 2 is worth $150x, PRS2 would have had $50x of book loss and $50x of tax gain to allocate. As discussed above, under the traditional allocation method, Partners C and D would each be allocated $25x book loss and Partner C would be allocated $50x tax gain. Under the remedial method, however, to alleviate the effect of the ceiling rule, PRS2 would also allocate a $25x notional tax loss to Partner D to eliminate its book-tax disparity, and allocate an offsetting $25x notional tax gain to Partner C. This allocation should be followed when Asset 2 is actually sold to a third party. In addition, at that point there is a gain of $450x to be allocated among three equal partners. Just as in the traditional allocation method example above, each of Partners C, D and E recognize $150x tax gain. In the aggregate, Partner C would be allocated $225x tax gain, Partner D would be allocated $125x tax gain, and Partner E would be allocated $150x tax gain. As a consequence of the use of the remedial method, Partners C, D and E each receive tax allocations that fully reflect the economic arrangement among the three partners. In contrast to the results in Example 3 and under the traditional method with successive sales approach in (b) above, the remedial method with successive sales approach (made possible by assuming a tier structure rather than a merger) results in elimination of the book-tax disparity in the accounts of the partners of PRS2.

Though the successive sales approach is not the only possible alternative approach to analyzing Section 704(c) layers in mergers and this example has different

facts than Example 3, this example and this approach should be considered (or at least understood) when analyzing what the mechanics of the Proposed Merger Regulations should be and what they should not be.[111]

c. Response to Question 12: Issues Raised by Mergers (No Partnership Tiers).

The following discussion raises various issues raised by mergers of partnerships with respect to the Section 704(c) layer rules, and provides recommendations for consideration in preparing regulations that apply Section 704(c)(1)(B) and Section 737 to partnership mergers. For simplicity for the reader, references in this discussion are made to Section 704(c)(1)(B) only when the same concept applies equally to both Section 704(c)(1)(B) and Section 737.

In Notice 2009-70, the Service stated that it is not requesting comments on the principles described in Notice 2005-15. Because Notice 2005-15 does not explicitly demarcate the principles for which it stands, there could be differing views on the breadth of issues that may be deemed "principles" of Notice 2005-15. Consequently, though we realize that the Service may not be seeking comments on some of the issues discussed below, we believe that all of the issues discussed herein merit consideration both individually and in the context of the greater analysis of the Proposed Merger Regulations.

i. Collapsing of Reverse Section 704(c) Layers.

A significant issue that the Service should consider in providing any guidance concerning Section 704(c) layers and mergers is whether Section 704(c) gain and loss layers should be collapsed (and, if so, how) in any or all merger circumstances.

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[111] *See id.* at 257.

The Proposed Merger Regulations indicate that, in the context of an assets-over merger, Section 704(c) property either has a built-in gain or built-in loss upon the merger but not both, and pre-merger reverse 704(c) gains or losses will be collapsed into the original Section 704(c) layer if the reverse 704(c) layer reduces the original Section 704(c) loss or gain (the "collapsing rule"). The examples in the Proposed Merger Regulations illustrate these principles (including Example 3 discussed above in this Report). As discussed above, and contrary to the provisions of the Proposed Merger Regulations, outside the context of a merger we recommend that offsetting layers not be collapsed.

Three significant consequences result from the Proposed Merger Rules implementing the collapsing rule, which by itself is a simple rule. First, two sets of Section 704(c) items are created in which the amount of the second Section 704(c) item is dependent on the amount of the first Section 704(c) item: see the definitions of "original 704(c) gain or loss" and "new 704(c) gain or loss." Second, a rule is needed to provide for allocations of future revaluations between each of the two Section 704(c) items (that is, original and new). Finally, transactions that are not mergers normally would not create the same consequences as a merger with respect to Section 704(c) items because this new collapsing rule only applies to mergers (so far). These consequences are discussed in more detail immediately below and generally throughout the remaining discussion of mergers and divisions.

With respect to the first two issues above, how should revaluation affect *pre-merger* Section 704(c) gain or loss? In Example 2 of the Proposed Merger Regulations, built-in gain property that was contributed to the transferor partnership had a subsequent revaluation *gain* in the transferor partnership and additional gain on merger

with the transferee partnership.[112] It is unclear as to whether the pre-merger revaluation gain layer is retained or collapsed upon the merger. The Proposed Merger Regulations, however, permit the transferee partnership to use an allocation method "to account for differences between book value and adjusted tax basis as a result of a prior revaluation" that may differ from the allocation method used for the additional Section 704(c) layer of gain created in the merger.[113] This would appear to signal that it would be possible to preserve prior revaluation layers following a merger, but the extent to which these prior revaluation layers may be preserved is unclear.[114] Example 3, on the other hand, clearly provides that certain layers – those with opposite signs – are to be collapsed. Hence, the collapsing rule does not apply to all types of *pre-merger* Section 704(c) gain or loss in the same manner.

With respect to revaluation layers *after a merger*, the Proposed Merger Regulations require that a revaluation of a Section 704(c) property contributed to the transferee partnership that reduces the built-in gain or loss of the property must reduce new Section 704(c) gain or loss before reducing any original Section 704(c) gain or loss.[115] Although this ordering rule is discussed in more detail as a separate issue below, presumably the collapsing concept as it applies to *post-merger* Section 704(c) gain or loss could be handled more than one way as well.

Another detail to consider with respect to the first two consequences described above is the following: in contrast to the collapsing of reverse 704(c) layers

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[112] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(F), Ex. (2).

[113] Prop. Treas. Reg. § 1.704-3(a)(9).

[114] *See*, *e.g.,* Sowell, *supra* note 98, at 741.

[115] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(C)(2).

upon a merger, which simply alters the portion of forward Section 704(c) layer created in the merger that would be original or new Section 704(c) gain or loss, collapsing in the post-merger context appears to have the potential to prevent, indefinitely, the application of Section 704(c)(1)(B) to a portion of Section 704(c) gain or loss that is otherwise subject to a seven-year clock.[116] This detail illustrates the complex fallout that can follow from a relatively simple rule.

Because the collapsing rule is proposed only to apply to mergers (the third consequence mentioned above) the collapsing rule can create, as illustrated by the analysis above of Example 3, (i) an imbalance between a partner's capital account and its adjusted tax basis that will not be equalized until the partner's interest in the partnership is terminated and (ii) a different result in a post-merger disposition of property than would have occurred in the absence of a merger when tiered partnerships are created and the Aggregate Approach (or a variation) is applied.

Despite the fact that the collapsing rule is proposed to apply only to mergers, the collapsing of Section 704(c) layers in mergers raises issues similar to those discussed in Part III.A.2. above regarding the collapsing of reverse 704(c) layers. In our view, the handling of Section 704(c) layers should be the same in both situations, to the extent it can be from a practical perspective. To do otherwise would elevate the form of a transaction over its substance to too great an extent, because similar economic outcomes could be obtained through tiered structure and mergers, but with difference tax results. Applying different rules in these two contexts would also encourage a major distinction

[116] For further discussion of this point, see Sowell*, supra* note 98*,* at 735.

to develop between the distribution of assets, on the one hand, and the sales or depreciation of assets, on the other.

The Service should also consider whether more collapsing would be beneficial. It seems reasonable to consider the collapsing rule as adding too much additional complexity to the already intricate accounting involved in tracking Section 704(c) property.[117] For example, in Example 3, the partnership was required to track not only two forward Section 704(c) layers (i.e., original and new), but also additional reverse 704(c) layers and part of the Section 704(c) gain or loss is outside of the seven-year period. Consequently, a threshold rule, similar to the rules we have suggested in the context or non-merger layering, with respect to any final merger collapsing rule should be considered.

After considering these issues that arise from imposing the collapsing rule in mergers, we recommend that any collapsing rule implemented by regulations applying to mergers (i) favor similar economic results from a merger and from a transaction structure that is similar to a merger, such as a tiered partnership, to avoid an abusive situation for either the taxpayer or Treasury, (ii) reflect "economic reality" (that is, a partner's capital account equaling its adjusted tax basis) to the extent reasonably possible, and (iii) allow certain taxpayers to avoid complex tax rules when preparing their tax returns and to avoid being subject to overly burdensome tax record-keeping requirements.

ii. Ordering Rule -- Treatment of Post-Merger Revaluation Gain or Loss "Layers" under Proposed Merger Regulations.

If post-merger revaluation gains or losses are collapsed into forward Section 704(c) layers pursuant to the Proposed Merger Regulations, how should

[117] *See id.* at 736.

revaluation gain or loss be allocated between the new and original Section 704(c) gain or loss layers?

The Proposed Merger Regulations provide guidance regarding the extent to which revaluation gains or losses will be collapsed into a forward Section 704(c) gain or loss layer after a merger. Under the Proposed Merger Regulations, "revaluations after a merger that reflect a reduction in the amount of built-in gain or loss inherent in property will reduce new Section 704(c) gain or loss prior to reducing original 704(c) gain or loss."[118]

If the Service were to adopt the rule that revaluation gains or losses are to be collapsed after a merger, we do not believe that regulations should mandate a specific ordering rule but should permit any reasonable approach subject to a broadly applicable anti-abuse rule. For example, we recommend that a first-in-first-out, pro rata, or last-in-first-out (which appears to describe the rule currently provided under Proposed Regulation Section 1.704-4(c)(4)(ii)(C)(2)) should all be considered reasonable methods. This recommended approach is consistent with the general policy under Subchapter K to provide maximum flexibility to partners to arrange their affairs. Moreover, as a policy matter, this approach should be consistent with the ordering rule with respect to allocations of other tax items among multiple Section 704(c) layers.[119]

iii. Consistency with Tiered Partnership Rules.

While the first issue raised in the merger section discussed the very specific issue of collapsing Section 704(c) layers in partnership mergers and did so by comparing mergers to partnership tiers to accentuate certain observations regarding the

[118] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(C)(2).

Proposed Merger Regulations, the following discusses a different issue: whether treatment of Section 704(c) layers in a merger should be consistent with their treatment in the context of a tiered partnership structure in general, as an overall policy matter.

We discuss issues regarding tiered partnerships more generally above.[120] The Proposed Merger Regulations are intended to address Section 704(c) issues in the context of assets-over mergers, and it is unclear whether the principles established in these Proposed Merger Regulations will or should apply more broadly to contributions of Section 704(c) property in a tiered partnership structure for which there is very limited guidance (and for which we make certain recommendations above).

Treasury and Service officials have indicated in informal discussions that the rules in the Proposed Merger Regulations will apply only to assets-over mergers and not to drop-down transfers, so there will not be layers outside of the assets-over context.[121] These officials stated in addition that there are good policy reasons to have different rules for mergers and non-mergers because in the assets-over merger context, the transferor partnership disappears and its layers are no longer tracked. In contrast, in the tiered partnership context, pursuant to (current) Regulation Section 1.704-3(a)(9), the upper-tier partnership (the transferor of property) will continue to track the contributing partner's built-in gain or loss with respect to assets contributed to the lower-tier partnership.[122] However, some practitioners believe that the preservation of forward and reverse Section 704(c) gain or loss layers should apply similarly in both the tiered

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[119] See Part III.A.3. above for our recommendations regarding the allocation of tax items among layers.

[120] See *supra* Part III.B.

[121] *See* Jeremiah Coder, *Government Officials Explain Proposed Partnership Rules*, 117 TAX NOTES 664 (2007).

[122] *See id.*

partnership and merger context, and we recommended above that tiered partnerships generally track Section 704(c) layers using an Aggregate Approach, which would be consistent with tracking layers following a merger.[123]

In addition, we believe that the creation of a tiered partnership structure will often be economically similar to a partnership merger and thus having inconsistent results apply to the treatment of Section 704(c) layers in economically similar transactions in our view unnecessarily elevates form and invites abuse. Recall that, under the modified facts of Example 3 in Part III.C.1.b.ii(c) above, the allocations to Partners C and D changed when a tiered structure occurred (rather than a merger) and when the remedial allocation method was applied (instead of the traditional method).

Accordingly, it should be a over-arching goal of preparing regulations on the anti-mixing bowl regime that tiered-partnership structures do not provide economic advantages, under the tax rules, when compared to partnership-merger structures and vice versa. Otherwise, history suggests that there could (and, some of the contributing authors for this Report think, there will) be huge abuse for no apparent tax policy reason. In our view, this militates heavily against a stand-alone collapsing rule for partnership mergers.

iv. Possible Allocation Methods for Original Section 704(c) Layers and for New Section 704(c) Layers.

Should the transferee partnership in a merger be permitted to apply a Section 704(c) method to original Section 704(c) gain or loss that is different from the method applied by the transferor partnership with respect to Section 704(c) property contributed by the transferor partnership in the merger? Are there similar concerns with

[123] *See* Notice 2009-70, *supra* note 2.

respect to the Section 704(c) method applied to new Section 704(c) gain or loss created in the merger?

Current regulations provide substantial flexibility to partnerships with respect to choice of Section 704(c) methods. They generally permit the use of different Section 704(c) methods with respect to different items of contributed property (subject to a requirement that the overall method or combination of methods be reasonable).[124] They also permit the use of different allocation methods for reverse 704(c) allocations with respect to partnership property each time the partnership revalues its property, and permit different methods for reverse 704(c) allocations and contributed property even if at the time of revaluation the property at issue is already subject to Section 704(c).[125]

In the context of tiered partnership structures, current regulations do not address whether the upper-tier and lower-tier partnerships must use the same method of allocation with respect to a Section 704(c) gain or loss layer when the upper-tier partnership contributed the relevant Section 704(c) property to the lower-tier partnership.[126] However, as discussed in further detail in Part III.B.4 above, we believe that the Aggregate Approach should be used in the case of tiered partnerships and accordingly, that the allocation methods across tiers be aligned so that an original contributing partner would continue to receive allocations under the method that had been made in respect of a layer notwithstanding structural changes.

The Proposed Merger Regulations, however, provide an even more, and in our view too, flexible rule. Pursuant to the Proposed Merger Regulations, following an

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[124] Treas. Reg. § 1.704-3(a)(2) (as amended in 2005).

[125] Treas. Reg. § 1.704-3(a)(6)(i). *See also* Rubin & Macintosh, *supra* note 62, at 278.

[126] *See supra* text accompanying notes 77-79.

assets-over merger, the transferee partnership may continue to use the Section 704(c) allocation method adopted by the transferor partnership with respect to pre-existing Section 704(c) layers *or* it may adopt any other reasonable Section 704(c) method.[127] Consistent with existing regulations, with respect to the new Section 704(c) gain or loss "in excess" of the amount attributable to differences between book value and adjusted basis as a result of a prior revaluation (that is, the newly created Section 704(c) gain or loss upon the merger), the transferee partnership may adopt "any reasonable Section 704(c) method."

The elective and flexible nature of the current and Proposed Merger Regulations regarding allocation methods is consistent with the general policy underlying Subchapter K to provide partnerships with flexibility with respect to how allocations are made among partners. However, as a policy matter this flexibility is inconsistent with other principles relevant to assets-over mergers, as described below, as well as with the proper treatment of tiered partnerships discussed above.

An assets-over merger involves a transitory tiered partnership structure in which the transferor partnership holds interests in the transferee partnership before distribution of those interests to the partners of the transferor partnership in liquidation of their transferor partnership interests. If one takes the view, as we recommend, that the Aggregate Approach should be applied in the case of a tiered partnership arrangement,[128] and that an assets-over merger should be analyzed consistent with the principles that apply to a tiered partnership arrangement, then pre-existing layers of Section 704(c) gain

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[127] Prop. Treas. Reg. § 1.704-3(a)(9). With respect to each "layer" described in the text above, the transferee partnership must use a reasonable method that is consistent with the purpose of Sections 704(b) and 704(c).

[128] *See supra* Part III.B.4.

or loss (or at least original Section 704(c) gain or loss) should continue to be accounted for using the Section 704(c) allocation method adopted by the transferor partnership. Under the Aggregate Approach, in a tiered structure, the properties of the transferor and transferee partnership are treated as belonging to a single aggregate partnership and the partners of the transferring partnership are treated as transferors of the Section 704(c) property. There is little justification to permit the allocation method for a pre-existing Section 704(c) layer to be changed merely because of the partnership merger. Accordingly, the original partners of the transferor partnership should continue to benefit from the allocation method that had been elected with respect to pre-existing Section 704(c) layers, thereby preserving the economic arrangement that was presumably bargained for by the partners of the transferor partnership. A new allocation method could be adopted by the transferee partnership only if new Section 704 layers were created in the transaction. As in the context of tiered partnerships, we recommend that the Aggregate Approach be used in the context of assets-over mergers when dealing with Section 704(c) property. In particular, we recommend that tiered partnership and assets-over mergers are treated in a consistent manner to minimize the potential for abuse.

As a practical matter, we believe that the tracking of multiple Section 704(c) layers and the application of a particular allocation method to each layer can be implemented most efficiently by using a "bifurcation approach." Under this approach, a contribution of Section 704(c) property would be treated as consisting of a contribution of two or more separate properties: one with the remaining book-tax disparity in the originally contributed property and a second property or additional properties with a

deemed zero basis and a fair market value equal to the revaluation adjustment.[129] From a practical perspective, this approach would facilitate a continuing partnership's ability to track separate pre-merger forward and reverse 704(c) layers, and to apply a different allocation method with respect to each layer, as necessary.

v. Distributions of Section 704(c) Property by the Transferee Partnership Post-Merger to a Contributing Partner.

In determining whether a post-merger distribution of Section 704(c) property is made to a contributing partner for purposes of Section 704(c)(1)(B),[130] how should the "undivided interests" in such property deemed contributed by the partners of the transferor partnership be determined following the merger?

Section 704(c)(1)(B) provides an exception from nonrecognition treatment if property previously contributed by a partner is distributed to that partner.[131] The concept of undivided interests applies in the context of determining what portion of the Section 704(c) property is deemed to be contributed by the partners of the transferor partnership in a merger. The Proposed Merger Regulations provide some guidance with regards to undivided interests in the context of a merger, but the guidance is extremely vague and leaves unanswered questions. The relevant provisions of the Proposed Merger Regulations provide that, for purposes of Section 704(c)(1)(B), "a partner of the transferor partnership is deemed to have contributed to the transferee partnership an undivided interest in the property of the transferor partnership." The same regulations go

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[129] *See supra* text accompanying note 79 (discussion of contributions in tiered partnerships). *See also* Jackel, *supra* note 63, at 1139 n.34 (in the case of loss properties, values can be treated as being negative to achieve the appropriate result); Rubin & Macintosh, *supra* note 62, at 276.

[130] This discussion can equally be applied to Section 737 which is treated in parallel fashion under different provisions.

[131] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(B).

on simply to state that "the determination of the partners' undivided interest for this purpose shall be determined by the transferor partnership using any reasonable method."[132] There is no further guidance regarding how to determine whether a certain method is reasonable and no relevant examples are given.[133]

The best way to highlight the issues surrounding undivided interests is by an example.

> Example H. Partner A contributes property with a value of $200 and tax basis of $50 to partnership AB, and Partner B contributes $200 cash to partnership AB. Partners A and B share profits and losses equally. The property contributed by Partner A is later depreciated such that its book value equals $100 for purposes of determining capital accounts under Section 704(b), and the adjusted tax basis is reduced to $25 as a result of depreciation taken for federal tax purposes. Then, when the property has a value of $200 (and partnership AB still holds $200 cash), partnership AB is merged into partnership CD in an assets-over merger in which partnership CD is treated as the survivor. Partner A will have $75 of original Section 704(c) gain and $50 of new Section 704(c) gain as a result of the merger. Partner B will have $50 of new Section 704(c) gain following the merger.[134]

Absent the merger, the entire property was originally contributed by Partner A and would continue to be treated as such. As a result of the merger, however, Partner B has Section 704(c) gain of $50 and should be treated as a contributing partner with respect to the property to that extent. Thus, Partner A would have $125 of Section 704(c) gain and Partner B would have $50 of Section 704(c) gain. This still would leave a portion of the property equal to its $25 adjusted tax basis to be allocated among the partners as previously contributed property. It would appear reasonable to allocate that portion of the property to Partner A in connection with Partner A's original contribution

[132] *Id.*

[133] *See* ABA COMMENTS, *supra* note 55, at 10.

[134] Sowell, *supra* note 98, at 739.

of the property to the transferor partnership because A initially was given capital account credit in the transferor partnership for that portion of the property and, absent the merger, that amount would have been allocated to A. It also would appear to be reasonable to allocate the $25 of tax basis among the partners (i.e., between Partner A and Partner B) based on their relative shares of Section 704(c) gain (both original and new) with respect to the property, because the relative Section 704(c) gain amounts provide an indication of the partners' historic economic sharing in the asset. The current economic sharing ratios of the partners also may represent a reasonable means of allocating the residual portion of the asset, as that amount represents each partner's current economic share of the underlying asset.[135]

This simple example highlights the issue regarding undivided interests in Section 704(c) property deemed contributed by the partners of the transferor partnership in a merger. The issue is complex and if there is no further guidance regarding what methods are reasonable could easily create confusion because of differing views with regards to what is reasonable. For instance, the American Bar Association has proposed a safe harbor standard for determining undivided interests based on the book value of the Section 704(c) property contributed by each partner in the merger and each partner's new Section 704(c) gain or loss in the property.[136] The safe harbor methodology is, by the ABA's own admission, extraordinarily complex.[137] We recommend an approach similar to that which we recommend for allocation of tax items to Section 704(c) layers, in which the Service would permit a partnership to use any reasonable method, would provide

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[135] *See generally id.*

[136] *See* ABA COMMENTS, *supra* note 55, at 11.

[137] For details of the ABA's safe harbor, see *id.* at 10.

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. We view each of the methods outlined in the preceding paragraph as generally reasonable, and recommend that the Service endorse them as such.

vi. Ordering Rule – Determination of Proportionate Amount upon Partial Distribution of Section 704(c) Property.

If less than all of an item of Section 704(c) property is distributed, then what proportion of original Section 704(c) gain or loss must be recognized and what proportion of new Section 704(c) gain or loss must be recognized?

Current regulations do not provide guidance as to how much of the gain or loss triggered under Section 704(c)(1)(B) would relate to original Section 704(c) gain or loss or new Section 704(c) gain or loss, when an undivided interest in Section 704(c) property is distributed by a partnership. The Proposed Merger Regulations explicitly provide that if less than all of a Section 704(c) property is distributed, then "a proportionate amount of original and new Section 704(c) gain or loss must be recognized" under Section 704(c)(1)(B).[138] The following example illustrates these principles:

> Example I. On January 1, 2007, Partner C contributes Asset 1 (a nondepreciable capital asset) with a fair market value of $200 and an adjusted tax basis of $100 to partnership CD in exchange for a 50 percent interest in partnership CD. On the same date, Partner D contributes $200 in cash to partnership CD in exchange for a 50 percent interest in partnership CD. On January 1, 2010, Partnership CD merges into partnership AB. Partnership CD is the terminating partnership under Regulation Section 1.708-1(c)(3). At the time of the merger, Asset 1 has a

[138] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(C)(1).

> fair market value of $300 and an adjusted tax basis of $100. Thus, with respect to Asset 1, there is $100 of original Section 704(c) gain, and $100 of new Section 704(c) gain. On January 1, 2015, when Asset 1 has a fair market value of $300 and an adjusted basis of $100, partnership AB distributes a one-half interest in Asset 1, with a fair market value of $150, to Partner B, a historic partner of partnership AB and the non-contributing partner of Asset 1.[139]

Because the distribution occurs within seven years of the merger, but not within seven years of Partner C's contribution of Asset 1 to partnership CD, Partners C and D each would recognize its proportionate share of the new Section 704(c) gain, or $25 each, under Section 704(c)(1)(B), but Partner C should not recognize any original Section 704(c) gain.[140]

Alternatively, assuming the facts of the example were modified such that the distribution of Asset 1 to Partner B occurs on January 1, 2013, because the distribution occurs within seven years of Partner C's contribution of Asset 1 to CD, Partner C would recognize its proportionate share of the original Section 704(c) gain, or $50. In addition, each of Partner C and D would recognize its proportionate share of the new Section 704(c) gain, or $25 each.

We applaud the Service's guidance in situations where less than all of a Section 704(c) property is *distributed*.[141] We recommend that the Service expand this concept to non-distribution transactions: Because the need for this ordering rule did not exist before the Proposed Merger Regulations were drafted, we believe the Service

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[139] This example appears in ABA COMMENTS, *supra* note 55.

[140] *Id.*

[141] We recommend that the Service change the words "must be recognized" in Proposed Regulation Section 1.704-4(c)(4)(ii)(C)(1) which, read literally, would require recognition of a proportionate amount of original and new Section 704(c) gain or loss without regard to whether the distribution is made within the applicable seven-year period. We believe the Service's intent is to require recognition of a proportionate amount of each layer of Section 704(c) gain or loss only to the extent that the

should add an ordering rule mirroring the ordering rule in Proposed Regulation Section 1.704-4(c)(4)(ii)(C)(1) that applies in non-distribution contexts of less than all of a Section 704(c) property, such as a sale of a portion of Section 704(c) property.[142]

vii. <u>Scope of Identical Ownership and *De Minimis* Change in Ownership Exceptions.</u>

Other than in the case of a merger of partnerships owned by the same owners in the same proportions, under what circumstances should new Section 704(c) gain or loss created in a merger be excepted from application of Section 704(c)(1)(B)?

As previously discussed, Section 704(c)(1)(B) was enacted to prevent the shifting of pre-contribution gain and loss among partners upon partnership distributions of property. In the context of an assets-over merger in which the partners involved do not materially change their economic interests in the underlying assets (that is, there is only a change in the form of ownership), there is minimal potential for the shifting of built-in gain or loss that would offend the principles underlying Section 704(c)(1)(B). In recognition of this, the Proposed Merger Regulations contain the "identical ownership" and "*de minimis* change in ownership" exceptions. Pursuant to these two exceptions, Section 704(c)(1)(B) does not apply to new Section 704(c) gain or loss in any property contributed in an assets-over partnership merger where both the transferor partnership and the transferee partnership are "owned by the same owners in the same proportions" or the difference in ownership is "*de minimis*."[143]

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distribution is made within the seven-year period relevant to that layer. This comment was also set forth by the American Bar Association. *See* ABA COMMENTS *supra* note 55, at 27-28.

[142] For a similar recommendation, see *id.*

[143] Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(E).

The transferor and transferee partnerships are considered to be owned by the same owners in the same proportions if each partner owns "identical interests in book capital and in each item of income, gain, loss, deduction and credit, and identical shares of distributions and liabilities in each of the transferor and transferee partnerships."[144] A difference in ownership is considered to be *de minimis* "if ninety seven percent of interests in book capital and each item of income, gain, loss, deduction and credit and shares in distributions and liabilities of the transferor partnership and transferee partnership are owned by the same owners in the same proportions."[145] The *de minimis* exception could apply where there is a small divergence in ownership interests among the same partners, or permit completely different partners to own up to three percent of the ownership interests in the partnerships.

It is not clear under the Proposed Merger Regulations how the partners' shares of "income, gain, loss, deduction and credit" and of distributions and liabilities are determined in specific circumstances. We recommend that the Service clarify that such amounts are to be determined under the partnership agreement, assuming that the partnership allocations comply with Section 704(b). The language of the Proposed Merger Regulations does not make clear whether Section 704(c) gain or loss is taken into account in determining the partners' shares of "income, gain, loss, deduction, and credit."[146] If these items are required to be taken into account, this would clearly limit application of the exceptions even in cases where the partners maintain identical

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144 *Id.*

145 *Id.*

146 *See* Sowell, *supra* note 99, at 740-41. Sowell points out that Example 5 in the Proposed Regulations would seem to imply that Section 704(c) items are not taken into account for purposes of the identical ownership and *de minimis* change exceptions. *See* Prop. Treas. Reg. § 1.704-4(c)(4)(ii)(F), Ex. 5.

economic interests in all other items of the partnerships. We recommend that the Service clarify that Section 704(c) items are not taken into account, which we believe is consistent with the overall approach of Section 704(c) of treating tax items relating to pre-contribution appreciation and depreciation as for the account only of the contributing partner.

The requirement that partners have identical shares of liabilities in the merging partnerships would presumably require partners to have identical shares of nonrecourse liabilities as well. Pursuant to the regulations under Section 752 applicable to non-recourse liabilities, allocation of these liabilities to each partner is made with reference to the Section 704(c) rules. As explained below, this may often result in varying allocations of non-recourse liabilities among the partners even if partners have identical interests in other partnership items.[147]

Generally, under Section 752(a), any increase in a partner's share of partnership liabilities is treated as a contribution of money by that partner to the partnership. Similarly, a decrease in a partner's share of liabilities is treated as a distribution to the partner. The regulations under Section 752 provide that a partner's share of nonrecourse liabilities equals the sum of the following:

> 1. A partner's share of partnership minimum gain pursuant to Section 704(b) and the regulations thereunder ("first tier" allocation);
>
> 2. The taxable gain that would be allocated to the partner under Section 704(c) if the partnership disposed of all partnership property subject to nonrecourse liabilities for no consideration other than full satisfaction of the liabilities ("second tier" allocation); and

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[147] *See, e.g.,* Rubin, Finkelstein & Chan, *supra* note at 105; Sowell, *supra* note 98, at 741; ABA COMMENTS, *supra* note 55.

> 3. The partner's share of the excess nonrecourse liabilities determined in accordance with the partner's share of partnership profits ("third tier" allocation).[148]

In other words, if a partner contributes to a partnership property that has an adjusted tax basis that is less than the amount of nonrecourse debt that the property secures (i.e., Section 704(c) minimum gain), a portion of the debt equal to that excess must be allocated to the contributing partner.[149] When Section 704(c) property secures debt, and the forward or reverse 704(c) gain with respect to that property exceeds the partnership minimum gain and Section 704(c) minimum gain as described under the first two tiers of allocations, partners are permitted to allocate that debt up to their share of "excess Section 704(c) gain" with respect to the property securing the debt.[150]

If nonrecourse liabilities are taken into account, the requirement that partners have identical shares of liabilities could severely restrict use of the identical ownership and *de minimis* change in ownership exceptions because there can be varying allocations of partnership nonrecourse liabilities among partners even if the partners may have identical economic interests in the partnerships. Because nonrecourse liabilities by their nature are not economically shared by partners of a partnership and therefore do not effect the relative returns of particular partners, we believe they should not be taken into account in determining whether a merged partnership meets the identical ownership or *de minimis* change exceptions, and recommend that final regulations so provide.[151]

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[148] Treas. Reg. § 1.752-3(a)(1)-(3). For a detailed discussion of this issue, see Rubin & Macintosh, *supra* note 62.

[149] *See also* Sowell, *supra* note 98.

[150] Treas. Reg. § 1.752-3(a)(3).

[151] Partner loans, guarantees and similar arrangements could also create non-pro-rata sharing of liabilities, which could restrict the use of the identical ownership and de minimis change in ownership exceptions. Because such arrangements could effect the relative returns of the partners we see less cause to not

Finally, the exceptions appear to take into account only the direct owners of the interests in the merging partnerships to determine whether the ownership structures satisfy the requirements of the exceptions and do not take into account the existence of tiered-partnership structures.[152] In determining whether this exception applies, we recommend that the Service apply the Aggregate Approach when the facts involve tiered partnerships, consistent with prior recommendations in this respect.

One issue to be considered concerns the proper scope of the *de minimis* change in ownership exception.[153] As explained in the Preamble, the Proposed Merger Regulations recognize that when the ownership of both partnerships is identical or when the difference in ownership is *de minimis*, the merger more accurately represents a change in form and therefore generally should have no substantive tax consequences. Arguably, all partnerships mergers are, at least in part, merely a reorganization of the ownership of assets in modified partnership form, and the potential for taxpayers to use a merger to effectuate a sale would seem to be diminished in the context of mergers between related partnerships.[154] In this sense, the ninety-seven percent threshold provided under the Proposed Regulations appears too restrictive and unnecessarily limits the use of the *de minimis* exception. We recognize, however, that at some point changes

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take them into account in determining whether this test is met. This point is observed in Sowell, *supra* note 98, at 740-741.

[152] *See* Rubin, Finkelstein & Chan, *supra* note 105, at 258.

[153] Note that the American Bar Association has highlighted a technical correction that should be made to clarify that the ninety-seven percent identity of ownership was intended to set forth a threshold requirement (rather than only one percentage interest at which the exception would apply) by modifying the language to provide that a change in ownership is *de minimis* if at least the requisite percentage is met." ABA COMMENTS, *supra* note 55, at 32.

[154] *Id.* at 33.

in relative ownership cease to be *de minimis*, and suggest that 10% would be an appropriate threshold.

The Proposed Merger Regulations do not address the timing of when the requisite level of identical ownership must exist. The examples in the Proposed Merger Regulations illustrate the application of the identical ownership exception in a situation in which the partners of both transferor and transferee partnerships held their interests for fifteen years before the mergers. We recognize that ownership interests could be restructured before but in contemplation of a merger so that a shift in ownership that exceeds the *de minimis* threshold, regardless of where the threshold is set, would not in form be exceeded by the merger. Accordingly, the regulations should clarify whether, and to what extent, the partners of the transferor and transferee partnerships may restructure before and in contemplation of a merger to satisfy the requirements of the identical ownership or *de minimis* change in ownership exceptions.[155]

viii. Contributed Property with "Original Section 704(c) Loss".

Are there different considerations in the context of an assets-over merger in which the property contributed from the transferor partnership had "original Section 704(c) *loss*"?

The examples in the Proposed Merger Regulations address only property contributed with original Section 704(c) gain. In the case of contributed property with original Section 704(c) gain, the Proposed Merger Regulations provide that the original Section 704(c) gain equals the difference between the fair market value and the contributing partner's adjusted basis at the time of contribution to the extent such

[155] *Id.* at 35 (highlighting and seeking clarification on this timing issue).

difference has not been eliminated by Section 704(c) allocations, prior revaluations or in connection with the merger.

Section 704(c)(1)(C) was added to the Code in 2004. It provides special rules for determining the basis of loss property contributed to a partnership. The Treasury Department and the Service have noted that the Proposed Merger Regulations do not address the impact of Section 704(c)(1)(C) in applying these rules, but when the regulations are finalized they will clarify the application of Section 704(c)(1)(C) to these rules.

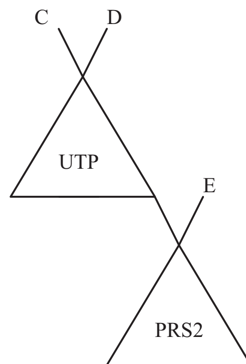
Because Section 704(c)(1)(C) concerns contributions of built-in loss property, read literally it would seem to apply in the context of an assets-over merger (the transaction steps of which are described above). Similarly, Section 704(c)(1)(B) would appear literally to apply to such transactions. Current regulations and the Proposed Merger Regulations, however, prevent Section 704(c)(1)(B) from applying to the actual transfer in an assets-over merger transaction (although it certainly may apply to later transactions involving the built-in gain property that was transferred upon the merger by the transferor partnership to the transferee partnership). We recommend, consistent with the treatment of Section 704(c)(1)(B), that Section 704(c)(1)(C) not apply to the actual transfer in an assets-over merger transaction (or for that matter, to a partnership division or drop down of assets).

2. Responses to Questions 13 through 16 – Issues Raised by Mergers Involving Tiered Partnerships.

Questions 13 through 16 essentially ask whether a merger that involves a tiered partnership is somehow different from either a partnership merger or a tiered partnership that is not involved in a merger. In short, the general answer (at least in the

context of this Report) is “there is no difference”. The reason for this answer is that (i) the Proposed Merger Regulations impose the collapsing rule (discussed above in Part III.C.1.c.i) in a merger but not in other transactions and (ii) under the Aggregate Approach (which this Report favors over the Entity Approach) a tiered partnership is treated as a single entity. Consequently a discussion of tiered partnerships involved in mergers would largely replicate the combined prior discussion on a partnership with tiers (Part III.B) and prior discussion on mergers (Part III.C). A discussion of partnership tiers involved in mergers might be somewhat different from the prior sections if the Report favored the Entity Approach over the Aggregate Approach.

To demonstrate the answer “there is no difference” in the prior paragraph, this Part will consider a variation on Example 3 of the Proposed Regulations in which Partners C, D, and E are, immediately before the merger in Example 3, in a tiered partnership structure that is depicted by the following diagram:



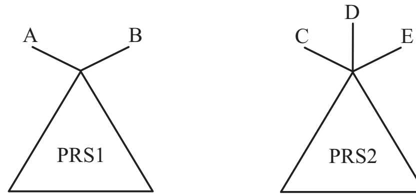
This structure can be created using either an "assets down" approach or an "interests up" approach. The "assets down" approach uses the same facts as in Example 3 except that the Aggregate Approach is used. Partnership PRS2 is named “UTP.” Before Partner E would join the partnership in Example 3, Partnership UTP and Partner E instead create Partnership PRS2 on Date 2 (which is a date before the merger involving

Partnership PRS1 in Example 3), with Partnership UTP contributing all of the assets contributed to it by Partner C and Partner D on the date Partnership UTP was formed, and Partner E contributing cash. Partnership UTP thereby becomes the upper-tier partnership in a two-tiered partnership structure with Partnership PRS2 being the lower-tier partnership (see diagram above). Partnership UTP's only asset is its interest in Partnership PRS2, and its only Partners are C and D.

In contrast, the "interests up" approach uses the same facts as in Example 3 except that the Aggregate Approach is used. Immediately following Partner E's entry into Partnership PRS2, Partners C and D contribute their interests in PRS2 to newly created Partnership UTP. Partnership PRS2 thereby becomes the lower-tier partnership in a two-tiered partnership with Partnership UTP being the upper-tier partnership (see diagram above). As a result, Partners C and D hold their interests in the assets they contributed to Partnership PRS2 indirectly through Partnership UTP. Partnership UTP’s only asset is its interest in Partnership PRS2.

The particular way in which the two-tiered structure is created under the assets down approach or the interests up approach will not affect the analysis of the merger that follows in these two revised Example 3s, because immediately before the merger in both revised Example 3s the tiers will be ignored under the Aggregate Approach and Partners C and D will be treated always as holding direct interests in the assets of Partnership PRS2 alongside Partner E (see diagram below), just as in the original Example 3.

Partnership PRS1 and Partnership PRS2 immediately before the merger in Example 3and in the two revised Example 3s above (under the Aggregate Approach)



At this factual point in each of the two revised Example 3s, no other facts would change, either with respect to the merger or afterwards. Therefore, the analysis of these two revised Example 3s (which use the Aggregate Approach) would be the same as the analysis of Example 3 discussed above in the response to Question 12. Additionally, the tiered-partnership issues raised in the revised Example 3s (whether discussing the UTP-PRS2 partnership structure before the merger or the UTP-PRS1 partnership structure after the merger) would largely be the same as those tiered-partnership issues discussed in the responses to Questions 5 through 11 above (to the extent discussed above).

Hence, the general answer to Questions 13 through16 is "there is no difference" when using the Aggregate Approach. If an Entity Approach were used, the results would obviously differ.

D. Divisions

The Notice asks questions regarding partnership divisions similar to those it asks about partnership mergers. Though initially one would expect partnership divisions to mirror partnership mergers, divisions do not do so entirely. They do raise the same basic Section 704(c) issues previously discussed above with respect to layers and tiers and, conceptually, mergers, but because non-pro rata divisions cause a termination of at least some partnership tax items and involve distributions subject to Section

704(c)(2)(B) and Section 737, the more interesting aspects of divisions are not "new issues" but instead are issues previously raised in this Report that "look new" in the context of partnership divisions. Accordingly, this section discusses the background rules pertinent to answering Questions 17 and 18 before responding to those questions.

1. Background.

a. Forms of Divisions

Treasury regulations recognize two forms of divisions: assets-up and assets-over. An assets-over division is the contribution of certain assets and liabilities of the existing partnership to a new partnership (or partnerships) followed by distribution of interests in the new partnership to some of the partners of the existing partnership. In contrast, an assets-up division is the distribution of certain assets by an existing partnership to its partners followed by contribution of those assets to a new partnership. As is the case for mergers, any division not clearly in assets-up form is taxed as an assets-over division.[156]

As an example of the fact that a partnership division is not the opposite of a merger, the regulations introduce a special vocabulary to describe the various partnerships involved in a division.[157] These terms, with the meaning ascribed to them

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[156] Treas. Reg. §§ 1.708-1(d)(3)(i)-(ii) (as amended in 2001).

[157] The "prior partnership" is the local tax law entity that exists before the division. Treas. Reg. § 1.708-1(d)(4)(ii). Each "resulting partnership" is a local law entity that results from and exists after the division and has at least two partners that were partners in the prior partnership. Treas. Reg. § 1.708-1(d)(4)(iv). A "continuation of the prior partnership" (here sometimes referred to as a "continuing partnership") is a resulting partnership whose members held more than 50% of the capital and profits of the prior partnership. Treas. Reg. § 1.708-1(d)(1). A division may result in no continuing partnerships or one or more continuing partnerships. Any resulting partnership that is not a continuing partnership is a "new partnership." *Id.*

One of the resulting partnerships may be treated as the "divided partnership." The divided partnership is the partnership that is treated for tax purposes as transferring assets and liabilities to recipient partnerships as part of the division, either directly (assets-over) or indirectly (assets-up). Treas. Reg. § 1.708-1(d)(4)(i). If only one resulting partnership is a continuing partnership then that

by the Service, are set out in the footnotes and should be understood as they are used frequently in the following discussion.

b. Partnership Division Regulations – Current and Proposed.

Treasury has been considering for several years, with respect to each of the deemed steps in a partnership division, whether gain or loss recognition should occur under Sections 704(c)(1)(B) and Section 737 and whether new layers of Section 704(c) gain or loss should be created. The current regulations and Proposed Merger Regulations under Sections 704(c)(1)(B) and 737 provide only limited guidance.

In particular, Regulation Section 1.737-2(b)(2) provides a carve-out from the application of Section 737 to distributions in a particular subset of divisions. Under this provision, Section 737 does not apply to divisions in which the transferor partnership contributes *all* of the Section 704(c) property contributed to it by a partner to a second partnership in exchange for a transferee partnership interest and then distributes such interest in complete liquidation of such partner's transferor partnership interest. Treasury's Proposed Regulation Section 1.737-3 retains this rule. In fact, the current regulations and the Proposed Merger Regulations are very similar, and there is no parallel rule for Section 704(c)(1)(B) in either the current or proposed regulations.

The Preamble to the 2001 Section 708 regulations provides an additional exception to the application of Sections 704(c)(1)(B) and 737 for "pro rata" divisions.

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partnership is the divided partnership. *Id.* If there is more than one continuing partnership, the divided partnership is the continuing partnership that in form (i.e., under state law) transferred the assets and liabilities. *Id.* If the partnership that in form transfers the assets is not a continuing partnership or no form is adopted for the division, and more than one resulting partnership is considered a continuing partnership, the resulting partnership with the assets having the greatest fair market value (net of liabilities) is treated as the divided partnership. *Id.* If there is no continuing partnership, none of the resulting partnerships is the divided partnership; the divided partnership terminates for tax purposes. Treas. Reg. § 1.708-1(d)(1).

Specifically, Treasury stated that those Sections should not apply "[t]o the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change) . . . ."[158] The Preamble went on to say that the application of these Sections might be appropriate where (i) a partnership division is non-pro rata, (ii) some partnership property is extracted or (iii) the economic relationship between the parties otherwise changes as a result of the division.[159] The extent of the availability of the carve-out for pro rata divisions is unclear, as no definition of pro rata exists in either the current or proposed regulations. The application of Sections 704(c)(1)(B) and 737 to pro rata and non-pro rata divisions is discussed in more detail below.

i. Assets-Over Division.

This section described the steps that are deemed to occur pursuant to applicable Regulations in an assets-over division and the tax treatment of each of these steps.

(a). Steps of Transaction.

In an assets-over division, if *at least one resulting partnership is a continuing partnership*, the divided partnership contributes *certain* assets and liabilities to recipient partnership(s) in exchange for interests in them and then immediately thereafter the divided partnership distributes the interests in the recipient partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided

[158] T.D. 8925, 2001-1 C.B. 496, 499.

[159] *Id.* at 499-500.

partnership.[160] The resulting partnership that is also a continuing partnership retains its remaining assets and liabilities.

If *no resulting partnership is a continuing partnership*, the divided partnership will be treated as contributing *all* of its assets and liabilities to new resulting partnerships in exchange for interests in them and immediately thereafter, the divided partnership is treated as liquidating by distributing interests in the new resulting partnerships to the partners of the divided partnership.[161]

In either case, there are at least two steps: a contribution of assets and liabilities to resulting partnerships and a distribution of partnership interests in the resulting partnerships to the partners of the prior partnership.

(b). Tax Treatment of the Contribution Step

Generally, upon contribution of assets and liabilities to a resulting partnership, there is no recognition of built-in gain or loss and the resulting partnership takes carryover basis in the contributed assets.[162] The contributing partner (here, the divided partnership) takes an initial tax basis in its interests in the resulting partnership equal to the divided partnership's adjusted tax basis in the property contributed.[163] These results are altered by Section 704(c)(1)(B) and Section 737 (discussed immediately below) and by the application of Sections 743(b) and 751, detailed discussion of which are beyond the scope of this Report.[164] See Section II(B) of this Report for discussion of

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[160] Treas. Reg. § 1.708-1(d)(3)(i)(A).

[161] Treas. Reg. § 1.708-1(d)(3)(i)(B).

[162] Sections 721, 723.

[163] Section 722.

[164] Section 743 generally applies to cause a partnership to adjust the inside basis of its assets upon a transfer of a partnership interest in the event that (i) the partnership has made an election pursuant to Section 754, or (ii) the assets of the partnership are held at a built-in loss of more than $250,000.

how the tiered partnership that exists momentarily between the contribution step and the distribution step should be treated.[165]

One Section 704(c) issue raised by assets-over divisions (discussed in more detail below) is whether the contribution step should create a new layer of Section 704(c) gain or loss or Section 737 net precontribution gain. As described above, the Preamble to the 2001 regulations on partnership divisions indicates that the anti-mixing bowl rules may apply to the deemed contribution to create a new layer of Section 704(c) gain or Section 737 net precontribution gain, except to the extent the division is pro rata. We believe that result is appropriate as a default rule.

(c). Tax Treatment of the Distribution Step.

Generally, upon distribution of the interests of the resulting partnership to the partners of the prior partnership, in the absence of Section 704(c) property, no gain (or loss) is recognized by the partnership or its partners.[166] The recipient partner, if not liquidating its interest in the prior partnership, will generally take carry-over basis in the new partnership interests but such basis cannot exceed the partner's tax basis in the prior partnership; and if the recipient partner is liquidating its interest in the prior partnership, its initial tax basis in the distributed partnership interests is carry-over basis unless that basis exceeds the partner's adjusted tax basis in the prior partnership, in which case the partner's initial tax basis in the distributed partnership interests will be equal to its

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Aggregate adjustments under Section 743 are calculated by comparing the basis of the partnership interest in the hands of the transferee to the transferee's share of the adjusted basis of partnership property (in the hands of the partnership). In the context of a contribution to a partnership, existing Section 743(b) adjustments are treated as contributed to the new partnership. Treas. Reg. § 1.743-1(h). Thus, the resulting partnership with a Section 754 election in place will continue to track the Section 743 adjustments relating to property held by it to the extent that the partners to whom the Section 743 adjustments relate continue to be partners in the relevant resulting partnership.

[165] Treas. Reg. § 1.704-3(a)(9); Prop. Treas. Reg. § 1.704-3(a)(10).

adjusted tax basis in the liquidated partnership interests.[167] If none of the resulting partnerships is the divided partnership, then the prior partnership terminates. Elections made by a terminated divided partnership are not applicable to resulting new partnerships.[168]

The tax treatment described above will be different if the distribution is subject to other rules, such as Section 743 or 751(b), however detailed discussion of the impact of rules other than those relating to Section 704(c) and Section 737 are beyond the scope of this Report.[169]

Section 704(c)(1)(B) and Section 737 generally apply to the deemed distributions in an assets-over division.[170] If the divided partnership contributes Section 704(c) property to the recipient partnership, the interest in the recipient partnership that the divided partnership receives in exchange is treated as successor Section 704(c) property.[171] Thus, if the deemed distribution of the portion of the resulting partnership

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[166] Section 731.

[167] Section 732.

[168] A Section 754 election made by the terminating partnership, for instance, will not carry over to the resulting new partnerships.

[169] Section 751(b) normally applies to distributions that alter a partner's interests in unrealized receivables and substantially appreciated inventory ("Section 751 property"), as may be the case in the context of a division, resulting in recognition of gain or loss for both the partner and the partnership. Section 751(b). In a tiered partnership structure, such as the temporary tiered structure after the contribution step in an assets-over division, a look-through rule applies. The upper tier partnership is treated as owning its proportionate share of the Section 751 in the lower tier partnership for purposes of determining whether the property of the upper tier partnership is Section 751 property. Section 751(f). Thus, distribution of a lower tier partnership interest to a partner of the upper tier partnership generally will be subject to Section 751(b) to the extent the distribution results in a non-pro rata distribution of interests in Section 751 property held by the lower tier partnership. *Id.;* Treas. Reg. § 1.751-1(b)(1). Furthermore, if the divided partnership terminates, the deemed distribution of interests in a new partnership is usually a transfer for purposes of Section 743. Treas. Reg. § 1.761-1(e).

[170] *See* T.D. 8925, *supra* note 160, at 499 (stating that it would not be "wise" to extend exceptions under Sections 704(c)(1)(B) and 737 to divisions).

[171] Treas. Reg. §§ 1.704-4(d)(1), 1.704-3(a)(8); Prop. Treas. Reg. §§ 1.704-4(d)(1), 1.704-3(a)(8). Treas. Reg. § 1.704-4(d)(1) states that property received by a partnership in exchange for Section 704(c) property in a nonrecognition transaction is treated as Section 704(c) property for purposes of Section

interest that relates to such Section 704(c) property occurs within seven years of the contribution of the original property and is made to partners other than the partner that contributed the original property, some or all of the built-in gain or loss under Section 704(c)(1)(B) must be recognized by the original contributing partner.[172] Corresponding basis adjustments are made to the contributing partner's tax basis in its interest in the divided partnership and the tax basis of the distributed recipient partnership interests.[173] To the extent that gain (or loss) is recognized by the contributing partner, the adjusted tax basis in its divided partnership interest is increased (or decreased).[174] The amount of the divided partnership interest basis increase or decrease is taken into account in determining the amount of Section 737 gain, if any, on a distribution to the contributing partner that is part of the same distribution (as is discussed in detail in the next paragraph).[175] The tax basis of the distributed property is determined under Section 732.

The distribution of recipient partnership interests to a partner that contributed Section 704(c) property may also result in gain recognition under Section 737 if the recipient partnership also has property other than property contributed by the contributing partner. Property received by the divided partnership (here, recipient partnership interests) in exchange for contributed Section 704(c) property is treated as the

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704(c)(1)(B) to the extent that the property received is treated as Section 704(c) property under Regulation Section 1.704-3(a)(8). The latter regulation provides that if a partnership disposes of Section 704(c) property in a nonrecognition transaction, the substituted basis property is treated as Section 704(c) property with the same amount of built-in gain or loss as the Section 704(c) property for which it was exchanged. The allocation method for the substituted basis property must be consistent with the method chosen for the original property. Treas. Reg. § 1.704-3(a)(8); Prop. Treas. Reg. § 1.704-3(a)(8).

[172] Section 704(c)(1)(B)(i).

[173] Section 704(c)(1)(B)(iii).

[174] Treas. Reg. § 1.704-4(e)(1).

[175] *Id.*

contributed property with regard to the contributing partner for purposes of Section 737. To the extent the contributing partner is deemed to have been distributed its contributed property, no gain is recognized under Section 737; instead, the usual nonrecognition rules apply to the distribution to the contributing partner.[176] Gain may be recognized under Section 737, however, in respect of the portion of the interest that is attributable to other property contributed. If such gain is recognized by a partner, the partner's adjusted tax basis in its interest in the divided partnership is increased by the amount of the gain.[177] The partner's adjusted tax basis in the distributed interests in the new partnership is determined under Section 732(a) or (b), as applicable.[178] The partnership's adjusted tax basis in certain "eligible property" is increased by the amount of the Section 737 gain recognized by the distributee partner.[179]

Currently, there is only one exception to the application of Section 737 in an assets-over division. Regulation Section 1.737-2(b)(2) and Proposed Regulation Section 1.737-2(b)(2) provide that if a partnership transfers all of the Section 704(c) property contributed by a partner to another partnership and then distributes an interest in the transferee partnership in compete liquidation of that contributing partner's interest in the transferor partnership, Section 737 does not apply to the transfer. This exception is likely to apply to a limited number of divisions where a partner does not continue to hold any interest in the prior partnership (i.e., where there is a division of partners as well as assets).

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[176] Treas. Reg. § 1.737-2(d)(1).

[177] Treas. Reg. § 1.737-3(a).

[178] Treas. Reg. § 1.737-3(b).

[179] Treas. Reg. § 1.737-3(c).

Because an assets-over division of a partnership holding Section 704(c) property will generally result in gain recognition, taxpayers may seek to avoid this result by using the assets-up form (discussed next).

ii. Assets-Up Division.

This section describes the steps that are deemed pursuant to the applicable Regulations to occur in an assets-up division and the tax treatment of those steps.

(a). Steps of Transaction.

In an assets-up division, assets are distributed to the partners of the prior partnership. The partners then contribute these assets to the resulting partnerships.[180] If the distributing partnership is a continuing partnership, then only those assets going to the new partnership are deemed to be distributed and then contributed to the new partnership.[181] If there are no continuing partnerships and certain assets are distributed to some or all of the partners in partial or complete liquidation of their interests and immediately thereafter, they contribute the interests to a resulting partnership, the assets-up form will be respected. However, if there is no continuing partnership and the prior partnership does not liquidate under state law, the assets and liabilities it retains are treated as contributed to a new resulting partnership under the assets-over form described above.[182]

(b). Tax Treatment of the Distribution Step.

Generally, upon distribution of the prior partnership's assets to the partners, no gain or loss is recognized by the partners or the partnership. Gain is

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[180] Treas. Reg. § 1.708-1(d)(3)(ii).

[181] Treas. Reg. § 1.708-1(d)(3)(ii)(A).

[182] Treas. Reg. § 1.708-1(d)(3)(ii)(B).

recognized by a partner to the extent that any money distributed exceeds the adjusted tax basis of the partner in its partnership interest.[183] If a partner receives a distribution in liquidation of its interest, its initial tax basis in the distributed property (other than money) is generally equal to the adjusted tax basis the partner had in its partnership interest reduced by any money distributed in the same transaction.[184] If the distribution is not a liquidating distribution, the partner takes a carry-over basis in the property up to the amount of the adjusted tax basis of its interest in the partnership, again reduced by any money distributed in the same transaction.[185]

Section 704(c)(1)(B) and Section 737 may apply to the deemed distributions in assets-up divisions.[186] To the extent that the divided partnership distributes Section 704(c) properties to the partners that contributed them (i.e., makes non-pro rata distributions), there is no gain or loss recognition under Section 704(c)(1)(B) or Section 737.[187] In contrast, if the distribution of assets is pro rata (or any other distribution that results in distribution of Section 704(c) properties to other than the contributing partner(s)) gain or loss would be recognized under Section 704(c)(1)(B) or Section 737 to the extent they apply. Corresponding basis adjustments would be made to the tax basis of the distributed property in the hands of the non-contributing partner. To the extent that gain (or loss) is recognized by the contributing partner, the basis in its

[183] Section 731(a)(1).

[184] Section 732(b).

[185] Section 732(a). Though not discussed in detail in this Report, as in an assets-up division the application of Sections 751, 754, 734 and 743 might affect the treatment described above, including gain recognition in certain circumstances, adjustments to the basis of the distributed property in the hands of the distributee partner and the divided partnership's basis in its remaining assets, particularly where a division is not pro rata.

[186] *See* T.D. 8925, *supra* note 158, at 499 (stating that it would not be "wise" to extend exceptions under Sections 704(c)(1)(B) and 737 to divisions).

divided partnership interest, and the property distributed to that partner in the first step of the division, is increased (or decreased). The amount of the divided partnership interest basis increase or decrease is taken into account in determining the amount of Section 737 gain, if any, on a distribution to the contributing partner that is part of the same distribution. The basis of the distributed property is determined under Section 732 as described above.

(c). Tax Treatment of the Contribution Step.

Generally, no gain is realized upon contribution of the distributed assets to the resulting partnerships and the contributing partner takes an initial tax basis in its interest in the resulting partnership equal to the adjusted tax basis of the property contributed (plus any money).[188] The resulting partnership generally takes carryover tax basis in the contributed assets.[189] Thus, the resulting partnership receives carryover tax basis in the assets transferred by the divided partnership.

As in an assets-over division, new Section 704(c) property and Section 737 net precontribution gain may be created on the deemed contribution, although with different consequences because no deemed distribution of a partnership interest is involved in the assets-up form. Thus, in the case of non-pro rata divisions, Section 704(c) and Section 737 will likely apply to the property deemed to be contributed to a resulting partnership (that is not the divided partnership). If new layers of Section 704(c) gain or loss or Section 737 precontribution gain are created upon the deemed contribution, then the resulting partnership will be required to track new Section 704(c)

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[187] Sections 704(c)(1)(B), 737(d)(1).

[188] Sections 721, 722.

[189] Section 723.

gain or loss and Section 737 precontribution gain. However, because the property is distributed first to the individual partners of the prior partnership, any resulting partnership that is not a continuing partnership will *not* be required to track pre-existing Section 704(c) gain or loss or Section 737 net precontribution gain. This stands in contrast to the requirements placed on a continuing partnership that will simply continue to track pre-existing §704(c) property and Section 737 net pre-contribution gain.

2. Response to Question 17 – Issues Raised by Divisions.

The Service raised the question in the Notice of what issues arise in the division of a single tier or multiple tier partnership. The issues discussed below in response to this question do not raise any new issues relative to the issues raised by prior questions and answers, because no tax rule applies to a division that does not also apply in the contexts addressed by the prior answers. Consistent with our recommendations above, we believe that Section 704(c) layers should be maintained through partnership divisions where such layers are not eliminated as part of the transaction. This is the only way to actually keep track of the real economic sharing relationships between partnerships. The need for such a rule is exacerbated in a division where the application of the rules described above can be particularly draconian as a result of the partial termination of economic relationships between some partners and some assets. In addition, partnership tiers in the context of partnership divisions present no new issues relative to the partnership tier discussion above. We therefore recommend maintaining Section 704(c) layers through divisions in essentially the same manner as discussed above.

Nevertheless, partnership divisions do raise "new" and interesting applications of the same Section 704(c) issues previously discussed because, unlike transactions discussed earlier, a division can cause a termination of certain economic sharing relationships among partners of the terminated partnership, unless the division is completely pro rata.

a. Pro Rata Versus Non-Pro Rata Divisions.

Pro rata divisions are *not* taxed, but non-pro rata divisions potentially are subject to tax (once the taxpayer parses through the myriad of rules triggered by the division), and thus the definition and application of "pro rata" are very important. Below are a few observations on the pro rata concept.

There are likely to be situations that do not fit squarely into a pure "pro-rata" construct or where a pure "pro rata" division is impossible to achieve, and as such, the Preamble provides little guidance for divisions other than the simplest structures. The definition of "pro rata" might most obviously include two situations: (1) the partner base is divided among two or more partnerships, but each partner continues to hold, indirectly, the same interests in property (i.e., each item of property is divided proportionately between the two partnerships) and (2) the same partners remain in multiple resulting partnerships in the same sharing percentages, but where different partnership property (e.g., different businesses or activities) are split between the resulting partnerships. However, the application is unclear in the context of any division that is a combination of the above two situations (perhaps with three or more resulting partnerships), or when there are slight deviations from a pure pro rata division of the assets as a result of business realities preventing division of assets in precisely pro rata percentages (for

example where the division of securities between two partnerships cannot be precise without the use of fractional shares (particularly in situation (1) above). The following example illustrates this issue.

> Example J. Four partners, Partner A, Partner B, Partner C and Partner D form partnership ABCD in Year 1, each contributing $1,000 cash to form an investment club partnership. After three years of investing, in Year 4, the partners have a falling out over investment strategy and decide to split into two equal partnerships. Partner A and Partner B form partnership AB, and Partner C and Partner D form partnership CD. But partnership ABCD is invested in several issuers holding an odd number of securities, and division of single securities into fractional shares is not possible. Furthermore, several of these securities are illiquid, and therefore, a single share cannot be traded on a market to divide the proceeds evenly. Thus, partnership AB and partnership CD will each take one extra security from a particular issuer to get to as close to an overall pro rata result as possible.

The Preamble to the Section 708 regulations is not clear as to whether the arrangement in Example J is close enough to pro rata to avoid creating new Section 704(c) property or Section 737 net precontribution gain. The Service should provide guidance to cover realistic situations where a pure pro rata division is impossible. A definition that expands the types of divisions qualifying for simplified treatment would help to avoid the application of Section 704(i) and Section 737 in situations where a division results in no material change to the economic relationship between parties. For example, we believe the Service should provide a threshold rule pursuant to which partnership divisions are treated as pro rata even if there are small shifts, such as no more than 3%, in the interests of the partners in items of partnership property. We do not believe that such small shifts implicate the anti-shifting policy of Section 704(c).

Treasury should also provide for exceptions to many, if not all, partnership contribution and distribution rules in the case of pro rata divisions. This would include expanding the simplified treatment suggested in the Preamble to include no effect on

originally contributed Section 704(c) property and Section 737 gain, as well as no effect on existing (or creation of new) Section 743 adjustments (even if partners have pre-existing differences in outside basis). The potential application of these provisions on partnership divisions under existing rules is discussed in greater detail below.

b. Recognition of Pre-existing Section 737 Net Pre-contribution Gain

Section 737 is often triggered by partnership divisions. Proposed and current regulations, however, have an exception where originally contributed Section 737 property is contributed to a new resulting partnership, and the original contributing partner's interest in the divided partnership is liquidated entirely in exchange for interests in the new resulting partnership. This current carve-out is narrow (and does not address Section 704(c)(1)(B)).

Section 737 was enacted to limit taxpayers' ability to achieve a tax-free disposition of an appreciated asset by contributing the asset to a partnership in exchange for a different asset from the partnership. The intent of Section 737 is to operate in a manner where partial recognition is required when contributed property is transferred to another partner. In the case of partnership divisions, the mechanical application of this rule is unclear except for the limited situation described above.

We encourage the Service to clarify (and, if reasonable, expand) the application of this rule in Section 737 (and Section 704(c)(1)(B)) in the context of divisions. For instance, we believe that there is no reason for there to be a triggering event under Section 704(c) in a partnership division where, following the division, under normal Section 704(c) mechanisms the Section 704(c) items of a partnership can be allocated to the original contributing partner of the property. We recommend that

regulations be promulgated that so provide. Perhaps a partial tracing system, discussed generally below, would allow these rules to have more exceptions without the exceptions being potentially abusive.

c. Application of Section 743(b) Mandatory Basis Adjustments and Section 754 Elections in Assets-Over Divisions.

In addition to the built-in gain and built-in loss tracking rules under Sections 704 and 737 that are discussed throughout this Report, the mandatory basis adjustment rules under Section 743 (with respect to built-in gain and built-in loss) might also apply to a partnership division. The book-keeping burdens on taxpayers created by Section 704(c) layers can be substantially increased if mandatory basis adjustments under Section 743(b) apply in the case of a partnership division.

The historical justification for mandatory Section 743(b) adjustments is similar to Section 704(c) and 737; Section 743 was intended to trace inside partnership basis to outside basis, and importantly, to prevent the gaming of tax losses in partnerships in situations where Section 704(c) and 737 might not otherwise apply.[190] Under the current rules governing an assets-over division, if the assets contributed to a new resulting partnership are held at an unrealized loss of more than $250,000 (in the aggregate), Section 743(b) is arguably triggered by the second step of the division (the deemed distribution of the new partnership interests). Because the distribution of a partnership interest is included in the definition of an exchange pursuant to Section 761(e), this second step presumably triggers the mandatory basis adjustment rules under Section 743(b) as well as any elective basis adjustments pursuant to a Section 754 election.

[190] H.R. Rep. No. 108-548 pt. 1, at 283-84.

In the case of a pro rata division, it may be the case that any Section 743 adjustments are immaterial, raising the question of whether the rule should apply in a purely pro rata division at all. However, in the case of a non-pro rata division, it is more likely that Section 743 adjustments would be material, particularly when the portfolio of assets moving to the new partnership is disproportionately appreciated or depreciated relative to the assets in the divided partnership. For example, if there are 10 partners in a particular resulting partnership that holds assets accounting for 75% of the basis of the original partnership, but only 50% of the value, it is likely that there will be inside and outside basis differences that would result in mandatory Section 743(b) adjustments. This would mean the partnership must track eleven different sets of bases for each of its assets that are held at the time of the division.

In cases like these, the administrative difficulties inherent in tracking such Section 743 basis adjustments could far outweigh any benefit to the fisc. We encourage Treasury to consider creating exceptions to Section 743, or allowing taxpayers to elect a simplified version of Section 743 tracking to ease this administrative burden, in the case of partnership division.

d. Application of Section 704(c)(1)(C) to Originally Contributed Property

As noted above, the existing and proposed regulations under Sections 704, 737 and 708 do not address the application of Section 704(c)(1)(C). Guidance regarding the application of Section 704(c)(1)(C) in partnership divisions would be helpful to taxpayers in at least two respects.

First, it is not clear how built-in loss in property originally contributed to the prior partnership is handled during divisions in general. One possible interpretation is

that contributing partners will likely lose the ability to realize such loss through the application of Section 704(c)(1)(C), though (as previously mentioned) we recommend this not be the result.

Second, in the case of contributed property that is subject to Section 704(c) or Section 737, it is not clear whether the requirement in the Preamble to the Section 708 regulations that a division be "pro rata" would require that contributed property follow the contributing partner. For example, if the partnership were splitting all assets proportionately between multiple partners, contributed property likely would be split (if possible) between the resulting partnerships, notwithstanding that the original contributing partner might only have an interest in a single resulting partnership. Thus, even if a "pro rata" division were to avoid the creation of new Section 704(c) property, such a division likely would not avoid implications under Section 704(c)(1)(C) for original Section 704(c) property.

e. Application of Section 704(c)(1)(C) to New Section 704(c) Property

A similar issue arises when new Section 704(c) property is created in the first step of an assets-over division. Creating potentially large economic distortions, Section 704(c)(1)(C) can affect partners' ability to deduct any built-in losses in partnership assets as of the date of a division. As discussed above, whether new Section 704(c) property is created depends on the definition of "pro rata." In both the assets-up form and the assets-over form, new Section 704(c) property can be created in the respective contribution steps. Although the Preamble to the Section 708 regulations appears to provide comfort that this should not occur in the case of a pro rata division, new Section 704(c) property will be created in the context of non-pro rata divisions.

The creation of new Section 704(c) property in the case of an assets-over transaction is particularly problematic where the property is held at a built-in loss. If Section 704(c)(1)(C) were to apply to the second step of an assets-over division, the tax basis of any property that is held at a built-in loss at the time of a division that is deemed transferred to a resulting partnership that is not the divided partnership will be marked-down to fair market value. This would be true regardless of the extent that the pre-existing partners still indirectly hold interests in such property. For example, a division where the partners in the resulting partnership (other than the divided partnership) still hold, indirectly, 90% of the same assets as were held prior to the division would still suffer a mark-down to fair market value of 100% of any built-in loss inherent in particular properties immediately prior to the division.

This issue can be alleviated by using the assets-up form instead of assets-over. However, in many situations, this is not a practical option (such as where direct ownership of the underlying assets, even for an instant, is precluded by law). One potential solution is to provide a carve-out for the application of Section 704(c)(1)(C) to the extent that a division does not result in a change in a partner's interests in assets. This would move the division rules closer to a pure basis and asset tracing system that has been proposed by some commentators and practitioners[191] (and discussed generally below in response to Question 18), but may be simpler to implement than a full scale restructuring of the partnership basis and asset tracing rules. We also believe the failure to provide such a rule would in some circumstances provide an undue elevation of the form of a transaction over its substance.

[191] *See* Jackel, *supra* note 63, at 1140-41.

3. Response to Question 18 – Issues Raised by Non Pro Rata Divisions.

The Notice asks how Section 704(c) layers should be created and maintained when a division is not pro rata or there otherwise are changes in the interests of partners in connection with divisions. As demonstrated in the response to Question 17, having Section 704(c) layers and applying the aggregate theory to tiers does not resolve all issues raised by partnership divisions. In a non-pro rata division, the economic relationship between a controlling partner and the property controlled may be fully or partially severed. For example, a division may liquidate the interests of two partners in a partnership with the in-kind distribution of an entire segment or business activity of the partnership. In that circumstance, we believe it would be appropriate to trigger the consequence of Section 704(c) to all partners if they are no longer a partner in a partnership holding an item of contributed property, because the partners are, in reality severing their relationship with the other partners and the main partnership. Alternately, the purpose of the division may be to split two businesses into separate entities, but with all partners continuing in both partnerships. In that circumstance, so long as the ordinary mechanism of Section 704 would still apply to allocate Section 704(c) items to the contributing partner, we believe that the partnerships should be permitted to continue to maintain the Section 704(c) layers, and we recommend that regulation be promulgated so providing. We do not believe that changes in the interests of the partners should change that result. Partnership agreements are sufficiently flexible that many of the results of a partnership division could be obtained in a single partnership by agreement, and such agreement would not trigger Section 704(c) consequences under current law, largely because the Section 704(c) consequences of a particular item of property still could be

allocated to the aggregate partners. To provide a different result in the case of divisions in which interests change would in our view inappropriately favor non-divisive transactions that may not fully achieve the economic goals of the partners.

Appendix: An Example of the Importance of Maintaining Separate Section 704(c) Layers

On January 1, 2010, A and B form a partnership AB with A contributing non-depreciable asset X, with a fair market value of $100 and a tax basis of $80, and B contributing $100 of cash. Partnership AB uses the traditional method of allocation for Section 704(c) items. Asset X is Section 704(c) property because of the book-tax disparity at the time of its contribution. Partner A is responsible for the initial Section 704(c) layer of $20. In no year does the partnership produce any net income.

Partner A		Partner B		
Capital Account	Outside Basis	Capital Account	Outside Basis	
$100	$80	$100	$100	Jan. 1, 2010

On January 1, 2011, with asset X having appreciated to $150, C is admitted as a new equal partner to the partnership (now named ABC) in exchange for a contribution of $125 to the partnership. Pursuant to Regulation Section 1.704-1(b)(2)(iv)(f), the partnership undertakes a revaluation and books the asset appreciation to the partners' capital accounts. Thus, if separate Section 704(c) layers are maintained, there is a new "reverse Section 704(c) layer" for the $50 of appreciation in value of asset X from $100 to $150. The $50 is divided equally between Partners A and B. Partnership ABC continues to apply the traditional allocation method to this layer.

Partner A		Partner B		Partner C		
Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	
$100	$80	$100	$100	$0	$0	Start of Jan. 1, 2011
$25	$0	$25	$0	$0	$0	Book-Up
$0	$0	$0	$0	$125	$125	Admission of C
$125	$80	$125	$100	$125	$125	End of Jan. 1, 2011

On January 1, 2012, with asset X having declined in value to $120 (and with $225 of cash still remaining in the partnership), D is admitted as a new, equal, partner to the partnership (now named ABCD) in exchange for a contribution of $115 to the partnership. Pursuant to Regulation Section 1.704-1(b)(2)(iv)(f), the partnership undertakes a second revaluation, this time resulting in a book-down of asset X. Thus, if separate Section 704(c) layers are maintained, there is an additional "reverse Section 704(c) layer" for the $30 decline in value of asset X from $150 to $120. Partnership ABCD continues to apply the traditional allocation method to this layer.

Partner A		Partner B		Partner C		Partner D		
Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	Capital Account	Outside Basis	
$125	$80	$125	$100	$125	$125	$0	$0	Start of Jan. 1, 2012
($10)	$0	($10)	$0	($10)	$0	$0	$0	Book-Down
$0	$0	$0	$0	$0	$0	$115	$115	Admission of D
$115	$80	$115	$100	$115	$125	$115	$115	End of Jan. 1, 2012

On January 1, 2013 partnership ABCD sells asset X for $110. Because the partnership's basis in asset X is $80, there is a $30 tax gain. For book purposes, asset X was last valued at $120 on January 1, 2012. Therefore, the sale for $110 represents a book loss of $10, allocated as a $2.50 loss to each of the four partners.

If the Section 704(c) layers are kept separate, they are as follows:

	Partner A	Partner B	Partner C	Partner D
Original Section 704(c) Layer	$20	$0	$0	$0
First Reverse Section 704(c) Layer	$25	$25	$0	$0
Second Reverse Section 704(c) Layer	($10)	($10)	($10)	$0

Here, it is not certain how exactly the $30 of gain should be allocated among the three layers. The various possibilities include the first-in-first-out, last-in-first-out, and pro-rata approaches, discussed in more detail in the text in response to Question 3 of the Notice. No matter which allocation approach is used, under the Ceiling Rule of Regulation Section 1.704-3(b)(1), the loss allocated to the partners as a whole cannot be greater than the total tax loss at the partnership level. Under a first-in-first-out approach, Partner A is allocated the first $20 of gain, and then partners A and B equally divide the final $10 of gain, meaning that the overall allocation is $25 of gain to A and $5 of gain to B. Under at least one pro-rata approach, the $30 in gain would be allocated $19.29 {=$30*($20+$25)/$70} to A and $10.71 {=$30*$25/$70} to B, with the second reverse Section 704(c) layer (and C) getting allocated no gain because it consists entirely of losses.

Whatever approach is used when separate layers are maintained, they all produce a different loss allocation than if the Section 704(c) layers were collapsed. The collapsed layers would be as follows:

	Partner A	Partner B	Partner C	Partner D
Collapsed Section 704(c) Layer	$35	$15	($10)	$0

In this scenario, if the netting is respected, $21 of gain {=$30*$35/$50} would be allocated to A and $9 of gain {=$30*$15/$50} would be allocated to B.

The magnitude of the difference in the treatment of Partners A and B between netting and keeping the Section 704(c) layers separate when using a pro rata allocation depends on the size of the layers, and may or may not be material. The value of the separate layers, however, is evident when the partners have a negotiated arrangement (utilizing the first-in-first-out approach) that recognizes that since A contributed appreciated property from the outset, it should bear the initial taxable gains on that property.