NEW YORK STATE BAR ASSOCIATION

TAX SECTION

# REPORT RESPONDING TO NOTICE 2006-14 RELATING TO THE TREATMENT OF PARTNERSHIP DISTRIBUTIONS UNDER SECTION 751(b)

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**Report No. 1122**

# NEW YORK STATE BAR ASSOCIATION TAX SECTION

## REPORT RESPONDING TO NOTICE 2006-14 RELATING TO THE TREATMENT OF PARTNERSHIP DISTRIBUTIONS UNDER SECTION 751(b)

This Report[1] responds to Notice 2006-14 (the "Notice"), which invites comments on the treatment of partnership distributions under Section 751(b) and proposes two new approaches to the application of Section 751(b).[2] The existing Section 751(b) regulations are exceedingly complicated and taxpayer compliance with those regulations is quite low. We commend the Service and Treasury for their efforts to revise the Section 751(b) regulations and support the approaches proposed in the Notice.

Under the so-called Hypothetical Sale Approach proposed in the Notice, Section 751(b) would be triggered if a distribution reduces any partner's share of the partnership's net built-in gain in its "hot assets". Under the so-called Hot Asset Sale Approach proposed in the Notice, if Section 751(b) is triggered, any partner whose share of hot-asset gain would otherwise be reduced by the distribution would be deemed to receive a distribution of "hot assets" from the partnership with an equivalent amount of built-in hot-asset gain and be deemed to sell the hot assets back to the partnership in a

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[1] The principal author of this Report is David H. Schnabel. Helpful comments were received from Andy Berg, Andy Braiterman, Kim Blanchard, Bill Brannan, Rafael Kariyev, Brian Knudson, David Miller, Stephen Mills, Andrew Needham, Deborah Paul, Joel Scharfstein, Michael Schler and David Sicular.

[2] All "Section" references herein are to the Internal Revenue Code of 1986, as amended to date (the "Code").

manner designed to offset the reduction in the partner's share of hot-asset gain.[3] We support both approaches because they would, as compared with the current Section 751(b) regulations, further the purpose behind Section 751(b) and make Section 751(b) easier to apply.

While the approaches proposed in the Notice appear relatively straightforward, they would call upon an assortment of complicated provisions under Subchapter K that are generally designed to ensure that various partnership transactions (including partnership distributions) leave intact each partner's share of the net built-in gain (or loss) inherent in the partnership's assets as well as the mix of net "hot-asset" gain and loss and "cold-asset" gain and loss. This is accomplished through a complicated series of adjustments to the basis of partnership assets (with some adjustments applicable to all partners and other adjustments applicable to only a single partner) and to the basis of assets distributed from a partnership. We believe that if the approaches described in the Notice are adopted, it would be appropriate and helpful for guidance to be provided as to how these other provisions of Subchapter K operate in applying the Hypothetical Sale Approach and the Hot Asset Sale Approach. Moreover, as identified in the Notice and as discussed in greater detail below, the application of the Hot Asset Sale Approach could trigger unintended basis adjustments under some provisions of Subchapter K, undermining the goal of preserving each partner's share of net hot-asset gain. As a result,

3 The distributee partner would also be deemed to contribute to the partnership the cash deemed to have been received by the distributee partner in the deemed sale of the hot assets to the partnership.

additional regulations would be needed to coordinate the approaches described in the Notice with the Code's basis adjustment provisions.

We believe that Section 751(b) would continue to be extremely complicated to apply even if the approaches proposed in the Notice are adopted. We therefore recommend that Treasury and Congress consider repealing Section 751(b) or revising the statute so that it operates more as an antiabuse rule. Alternatively, Treasury and Congress may wish to consider more modest revisions to Section 751(b) that further the Notice's objectives of targeting shifts in hot-asset gain and reducing complexity.

The remainder of this Report is divided into seven parts. Part I summarizes our primary recommendations. Part II summarizes the background against which the Notice has been issued. Part III explains the Hypothetical Sale Approach and the Hot Asset Sale Approach, as well as the thinking behind these approaches as expressed in the Notice. Part IV provides comments on the Hypothetical Sale Approach. Part V provides comments on the Hot Asset Sale Approach. Part VI discusses other guidance Treasury may wish to issue under Section 751(b). Part VII discusses our concern that Section 751(b) will continue to be an extremely complicated provision to apply and our recommendation that Treasury and Congress consider revising Section 751(b).

## Part I. Principal Recommendations.

1) The Hypothetical Sale Approach generally provides an accurate and appropriate measure for purposes of Section 751(b).

2) The Hot Asset Sale Approach generally provides an appropriate method for applying Section 751(b).

3) In light of the importance of reverse 704(c) principles under the Hypothetical Sale Approach, Treasury should issue additional guidance as to how to apply reverse 704(c) principles in a variety of contexts.

4) Special rules generally are not needed for cases where a partner's reverse 704(c) hot-asset gain exceeds the partner's interest in capital. However, Treasury may wish to clarify how Section 751(a) would apply to a sale of the partner's partnership interest in such a case. In addition, Treasury should consider a special rule for cases where a partner's reverse 704(c) hot-asset gain vastly exceeds the partner's interest in capital.

5) Implementing regulations should afford partnerships a fair degree of latitude in identifying which hot assets are involved in the sale that is deemed to occur under the Hot Asset Sale Approach. In addition, similar to the manner in which an asset with recapture is bifurcated under Section 751, we recommend that the hot-asset gain inherent in the relinquished property be treated as a separate zero basis asset and that the selling partner be treated as receiving and selling that separate asset under the Hot Asset Sale Approach.

6) Partnerships should be required to make adjustments so that Section 734(b) adjustments that would otherwise be made in connection with a partnership distribution do not undermine the Hypothetical Sale Approach and the Hot Asset Sale Approach. Partnerships should have some latitude in making these adjustments.

6) Treasury should consider, as an alternative to the Hot Asset Sale Approach, a "deemed gain approach" whereby the distributing partnership would be deemed to recognize gain in its hot assets equal to the aggregate reduction in the partners' shares of hot asset gain and allocate that gain to the appropriate partners.

7) We believe that Section 751(b) would continue to be extremely complicated to apply even if the Hypothetical Sale Approach and the Hot Asset Sale Approach were adopted. As a result, we recommend that Treasury and Congress consider revising Section 751(b) so that it operates more as an antiabuse rule. Alternatively, Treasury and Congress may wish to consider more modest revisions to Section 751(b) that further the Notice's objectives of targeting shifts in hot-asset gain and reducing complexity.

## Part II. Background.

Section 751(b) is one of a series of provisions in Subchapter K designed generally to ensure that various partnership transactions do not alter a partner's share of the built-in

gain (or loss) inherent in the partnership's assets or the mix of gain (or loss) inherent in the partnership's unrealized receivables and inventory items ("hot assets")[4] and other assets. As discussed in more detail below, Section 732(c)(1) generally prevents increases in the basis of hot assets that are distributed by a partnership, Section 735(a) generally preserves the ordinary income character of hot assets following their distribution from a partnership, and Section 751(a) generally requires the transferor of a partnership interest to include as ordinary income (or loss) the built-in gain (or loss) in the hot assets associated with the transferred interest. Similarly, Treasury Regulations under Section 755 generally prevent Section 734 and Section 743 adjustments from reducing a partner's share of hot-asset gain.

A. Overview of Certain Subchapter K Provisions Potentially Applicable in Applying Section 751(b).

It is helpful at the outset to review some of the rules under Subchapter K that are called upon in applying Section 751(b) today and that would be called upon in applying the approaches proposed in the Notice.

1. Summary of Certain Rules Applicable to Partnership Distributions.

*Income or Gain upon Partnership Distributions (apart from Section 751(b)).* Under Section 731, a partnership does not recognize gain or loss upon the distribution of property to a partner. Similarly, a partner generally does not recognize gain upon the

[4] Unrealized receivables and inventory items are defined in Section 751(c) and (d), respectively. Section 751(b) applies to unrealized receivables and inventory items which have appreciated substantially in value, whereas Section 751(a) applies to unrealized receivables and inventory items.

receipt of a partnership distribution, except that a partner does recognize gain to the extent that the partner receives money in excess of the partner's tax basis in its partnership interest.[5] Moreover, a partner generally does not recognize loss upon the receipt of a partnership distribution, except in certain cases involving liquidating distributions.

*Tax Basis of Distributed Assets.* Under Section 732, the basis of property distributed by a partnership to a partner (other than in liquidation of the partner's interest) is generally the same as the property's tax basis to the partnership immediately prior to the distribution, except that it cannot exceed the distributee partner's tax basis in its partnership interest (reduced by any cash received in the transaction). Under Section 732, the basis of property distributed by a partnership to a partner in liquidation of the partner's interest is generally equal to the partner's tax basis in its partnership interest.[6] When multiple properties are distributed (and the distribution is a liquidating distribution or a non-liquidating distribution subject to the cap described above), then (i) the distributee partner's basis in his partnership interest is generally first allocated to

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[5] Under Section 731(c), in certain cases marketable securities are treated like cash for purposes of Section 731. In addition, Section 731 can be triggered by a deemed distribution of cash resulting from a reduction in a partner's share of partnership liabilities under Section 752(b).

[6] However, the basis allocated to distributed hot assets cannot exceed the tax basis of such assets to the partnership. If the basis to be allocated upon a distribution in liquidation of a partner's entire interest is greater than the adjusted basis to the partnership of the hot assets distributed to the partner and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under Section 731(a)(2) to the extent of the unallocated basis of the partnership interest. Treas. Reg. § 1.732-1(c)(3).

distributed hot assets in an amount equal to the adjusted basis of such assets to the partnership and (ii) any remaining basis is generally allocated to distributed cold assets up to an amount equal to the basis of such assets to the partnership.[7]

In applying these rules, (i) the distributee partner's Section 743 special basis adjustment in the distributed property, if any, is treated essentially like actual partnership tax basis, (ii) any other partner's Section 743 special basis adjustment in the distributed property is disregarded (and, under other rules, hops over to other partnership property), and (iii) any Section 734 adjustments in the distributed property are treated essentially like actual partnership tax basis.[8]

*Character of Distributed Assets.* Under Section 735, gain or loss on the distributee partner's later disposition of distributed hot assets is generally treated as ordinary income or ordinary loss, except that this special character rule only applies for five years following the distribution of "inventory property". If any such property is disposed of in a non-recognition transaction, this treatment applies to any substituted basis property resulting from the transaction (except that it does not apply to stock received in an exchange described in Section 351).

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7 There are specific rules for cases where (i) there is insufficient outside tax basis to maintain the gain in the hot assets, (ii) there is insufficient outside tax basis to maintain the gain in the cold assets, and (iii) there is excess outside tax basis. See Section 732(c). There are also special rules that apply where a partner receives a distribution within two years of the partner's purchase of the partnership interest with respect to which a Section 754 election was not in effect. See Section 732(d).

8 See Treas. Reg. § 1.732-2(a) and (b); Treas. Reg. § 1.734-1(g). See also Treas. Reg. § 1.732-2(c)(special rules in the case of distributions of hot assets for which there is a special basis adjustment under Section 743(b) or 732(d)).

*Section 734 Adjustments.* In the case of a partnership distribution, the partnership is required to adjust the tax basis of its retained assets if an election is in effect under Section 754 or there is a substantial basis reduction.[9] Under Section 734, the partnership increases the tax basis of its retained assets by the sum of (i) the amount of gain recognized by the distributee partner upon the distribution and (ii) any step-down in the tax basis of the property distributed (that is, the excess of the tax basis of the distributed property to the partnership over the tax basis of the distributed property to the distributee partner). Alternatively, under Section 734 the partnership reduces the tax basis of its retained assets by the sum of (A) the loss recognized by the distributee partner, and (B) any step-up in the tax basis of the distributed property.

*Section 755 Allocation.* While Section 734 defines the increase (or decrease) in the partnership's tax basis as a result of a distribution, regulations under Section 755 prescribe how that change in tax basis is allocated among the partnership's assets. Under those regulations, the adjustment under Section 734 must be allocated to retained partnership property of a character similar to that of the distributed property.[10] For example, if the partnership's tax basis in distributed hot assets exceeds the basis in the hot assets to the distributee partner, the basis of in retained hot assets is increased by the

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[9] There is a substantial basis reduction if the amount of the loss recognized by the distributee partner plus the amount of the step-up in the tax basis of the distributed property exceeds $250,000.

[10] Treas. Reg. § 1.755-1(c)(1)(i). Where a Section 734(b) adjustment results from the recognition of gain or loss, the adjustment is made to capital gain property. Treas. Reg. § 1.755-1(c)(1)(ii).

excess. Similarly, if the distributee partner's tax basis of distributed cold assets exceeds the partnership's tax basis in those assets, the partnership is required to reduce (but not below zero) the tax basis of its retained cold assets. When an increase or decrease in the tax basis of partnership's retained assets cannot be made—either because the partnership does not hold any assets of a similar class or because the adjustment would reduce the tax basis below zero—the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.[11]

*Section 704(c) and Reverse 704(c).* Section 704(c)(1)(A) provides that income, gain, loss and deduction with respect to property *contributed* to a partnership shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value as of the time of contribution. Regulations under Section 704(c) afford partnerships a fair degree of latitude in accounting for such so-called "704(c) gain" and "704(c) loss" (that is, differences between the partnership's Section 704(b) "book" basis in its assets and the partnership's tax basis in its assets).

Section 704(b) governs the allocation of tax items not covered by Section 704(c) and generally provides that a partner's distributive share of income, gain, loss, deduction or credit shall be determined in accordance with the partner's interest in the partnership if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction or credit, or (2) the allocation of such items to a partner

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[11] Treas. Reg. § 1.755-1(c)(3).

under the agreement does not have substantial economic effect. The Treasury Regulations under Section 704(b) provide detailed guidance and safe harbors as to the application of Section 704(b).

The Section 704(b) regulations relating to the maintenance of capital accounts under the "substantial economic effect" safe harbor provide that a partnership may adjust the book value of each of its assets to its then fair market value upon various events, including a distribution of money or other property by a partnership to a partner as consideration for an interest in the partnership.[12] The Section 704(b) regulations further provide that if a partnership rebooks its assets under the rule described above, then the depreciation, amortization and gain or loss for tax purposes with respect to such property must be determined in accordance with the partners' interests in the partnership and must be shared among the partners in a manner that takes account of the variation between the tax basis of such property and its book value "in the same manner as variations between the tax basis and fair market value of property contributed to the partnership are taken into account under Section 704(c)."[13] Similarly, the regulations under Section 704(c)[14] provide that the principles of the Section 704(c) regulations apply to allocations with respect to property for which differences between book value and tax basis were created

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12 Treas. Reg. § 1.704-1(b)(2)(f).

13 Treas. Reg. § 1.704-1(b)(4)(i).

14 Treas. Reg. § 1.704-3(a)(6).

as a result of a partnership revaluation of its assets (so-called "reverse 704(c) gain" or "reverse 704(c) loss").[15]

2. Summary of Certain Rules Applicable to Transfers of Partnership Interests.

*Income or Gain upon Disposition.* Section 741 provides that in the case of a sale or exchange of a partnership interest, gain or loss shall be recognized to the transferor partner and (except as otherwise provided in Section 751) such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset.

*Section 751(a).* Section 751(a) provides that the amount of money (or the fair market value of any property) received by a transferor partner in exchange for all or part of his interest in the partnership attributable to hot assets shall be considered as an amount realized from the sale or exchange of property other than a capital asset.[16]

*Section 743 Adjustments.* In the case of a transfer of an interest in a partnership by a sale or exchange, Section 743(b) requires a partnership to adjust the tax basis of its assets if a Section 754 election is in effect with respect to the transfer or the partnership

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15 For example, assume that a partnership with two equal partners (A and B) has $50 of cash and land with a $0 tax basis and a FMV of $150. Further suppose that the partnership distributes the cash to A and thereby reduces A's interest from 50% to 33-1/3%. Typically, the partnership would (immediately prior to the distribution) "book up" the land from $0 to $150 and allocate $75 of book gain to each of A and B. If the partnership sold the land for $150 after the cash distribution, there would be $150 of tax gain (but no book gain), of which A would be allocated $75 (or 50%) (so as to reflect the prior allocation of the pre-distribution book gain), even though A is a 33-1/3% partner at the time of the sale of the land.

16 Section 751(a) is discussed in greater detail in Part IV.A.2.

has a "substantial built-in loss".[17] Section 743(b) adjustments are generally designed to put the transferee partner in a position similar to the position the partner would have occupied if the partner had purchased an undivided interest in the partnership assets and thereby received a step-up (or step-down) in the tax basis of partner's share of the partnership assets. The amount of the Section 743(b) adjustment equals the difference (which may be positive, negative or zero) between the transferee's tax basis in the transferred partnership interest and the transferee partner's share of the partnership's inside tax basis.

The transferee partner's share of the partnership's inside basis equals the partner's share of partnership liabilities, *plus* the amount of cash the transferee partner would receive under the terms of the partnership agreement if the partnership sold all of its assets for cash and liquidated (the "hypothetical transaction"), *plus* the amount of tax loss the transferee would be allocated from the hypothetical transaction, *minus* the amount of tax gain the transferee would be allocated from the hypothetical transaction.[18]

Section 743(b) further provides that under regulations prescribed by the Secretary, the Section 743(b) adjustments shall constitute adjustments to the basis of the partnership property only with respect to the transferee partner.

[17] A partnership has a "substantial built-in loss" if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property. Section 743(d).

[18] Treas. Reg. § 1.743-1(d).

*Section 755 Allocation.* While Section 743 defines the net increase (or decrease) in the partnership's tax basis as a result of a transfer of a partnership, the regulations under Section 755 prescribe how that change in tax basis is allocated among the partnership's assets. Under those regulations, the amount of the basis adjustment allocated to hot assets is equal to the total amount of income, gain or loss that would be allocated to the transferee from the sale of hot assets in the hypothetical transaction.[19] The amount of the Section 743(b) basis adjustment allocated to cold assets is equal to the total Section 743(b) adjustment, less the portion of the Section 743(b) adjustment allocated to the hot assets. The regulations expressly confirm that the portion of the Section 743(b) adjustment allocated to one class of property may be an increase while the portion of the Section 743(b) adjustment allocated to the other class of property may be a decrease and that such adjustments may be required even if the net section 743(b) adjustment is zero.[20]

B. Section 751(b) Background.

Specifically, Section 751(b)(1) provides as follows:

> To the extent a partner receives in a distribution
>
> (A) partnership property which is—
> (i) unrealized receivables, or
> (ii) inventory items which have appreciated substantially in value,
> in exchange for all or a part of his interest in other partnership property (including money), or

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[19] Treas. Reg. § 1.755-1(a)(ii) and -1(b)(2)(i).

[20] Treas. Reg. § 1.755-1(b)(1)(i).

> (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),
>
> such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

Treasury Regulations under Section 751(b) (the "Existing Regulations") have been largely unchanged since they were first issued in 1956. In very general terms, the Existing Regulations test whether a distribution results in an exchange of hot assets for other assets ("cold assets") by comparing the distributee partner's interest in the gross value of the hot and cold assets before and after the distribution. If there has been an increase in the distributee partner's interest in one class of assets (the "purchased assets") and a reduction in the distributee partner's interest in the other class of assets (the "forfeited assets"), then the distributee partner is deemed to have received a distribution of the forfeited assets (immediately prior to the actual distribution) and then exchanged[21] the forfeited assets with the partnership for the purchased assets.

The Existing Regulations are typically summarized by reference to a seven-step process described in McKee[22] for applying the regulations. In simple terms, the seven-step process works as follows:

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[21] The exchange is generally fully taxable to the distributee partner and the partnership.

[22] McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, ¶ 21.03 (Warren, Gorham & Lamont, 3rd Ed, 1997) ("McKee").

Step 1: Classify each asset held by the partnership as either (i) an unrealized receivable or substantially appreciated inventory ("hot assets")[23] or (ii) other property ("cold assets").

Step 2: Determine the distributee's interest in the value of each asset held by the partnership before the distribution and after the distribution, as well as the property actually distributed to the distributee.

Step 3: Determine whether there has been an exchange of hot assets for cold assets by creating a table comparing the distributee's pre-distribution interest in the value of each class of assets with the sum of (i) the post-distribution value of the distributee's interest in undistributed assets in each class and (ii) the value of each class of assets actually distributed to the distributee.

Step 4: Determine the actual assets treated as exchanged—that is, specifically which assets are treated as "sold" by the distributee to the partnership and which assets are treated as "sold" by the partnership to the distributee.

If the distributee's share of hot assets is going down (and the distributee's share of cold assets is going up), pretend that (immediately prior to the actual distribution) the distributee received the hot assets identified in step 4 in a non-liquidating distribution from the partnership and then sold them back to the partnership in exchange for the cold assets identified in step 4. If the distributee's share of cold assets is going down (and the distributee's share of hot assets is going up), pretend that (prior to the distribution) the distributee received the cold assets identified in step 4 in a non-liquidating distribution from the partnership and then sold them back to the partnership in exchange for the hot assets identified in step 4. In furtherance of the foregoing:

Step 5: Determine the tax basis of the assets treated as sold by the distributee partner to the partnership. In making this determination, the distributee is deemed to have received these assets in a non-liquidating distribution from the partnership

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[23] For purposes of Section 751(b), each inventory item would generally be treated as a hot asset only if the total fair market value of all inventory items exceeds 120% of the partnership's aggregate basis in such inventory items. Treas. Reg. 1.751-1(d).

(immediately prior to the actual distribution) and the distributee's basis in the assets is determined under Section 732.

Step 6: Determine the tax consequences to the distributee and the partnership of the deemed taxable exchange between the distributee and the partnership of the hot assets identified in step 4 and the cold assets identified in step 4.

Step 7: Determine the tax treatment of the portion of the actual distribution not included in the Section 751(b) exchange.

A few points quickly become clear in attempting to follow this seven-step procedure:[24]

First, the seven-step procedure is so complicated that applying it to a distribution from even a small partnership requires a substantial amount of time and effort and the assistance of a professional advisor who is expert at the workings of Subchapter K and Section 751(b) in particular.

Second, the Existing Regulations generally focus on the distributee partner's share of the gross value of the hot and cold assets rather than the distributee partner's share of the income and gain inherent in those assets.[25] As a result, a distribution may

[24] The Notice itself observes that "The current regulations under § 751(b) were published in 1956 and have not been amended to reflect significant changes in subchapter K and in the operations of contemporary partnerships. Moreover, the current § 751(b) regulations have been widely criticized as being extraordinarily complex and burdensome and as not achieving the objectives of the statute. As a result, a distribution may reduce a partner's pro rata share of the unrealized appreciation in the partnership's hot assets without triggering § 751(b), and a distribution can trigger § 751(b) even if the partner's pro rata share of the unrealized appreciation is not reduced."

[25] The impact of the focus on gross value is mitigated by the fact that accounts receivable will often have a zero basis and by the fact that the statute bifurcates property subject to recapture into two assets, a hot asset with a zero basis and a value equal to the recapture and a cold asset with a basis equal to the actual property basis

give rise to a taxable exchange under the Existing Regulations even if each partner's share of the hot-asset gain does not change as a result of the distribution. Similarly, a distribution may escape Section 751(b) so long as a distribution does not alter any partner's share of the gross value of the hot and cold assets, even if the distribution does alter a partner's share of the built-in hot-asset gain.

Third, nothing in the Existing Regulations (or otherwise) provides meaningful guidance on how to determine a partner's share of the gross value of a partnership asset. While this might be straightforward in a simple partnership with no debt, no assets subject to Section 704(c) (or reverse 704(c)) and partners with the same share in each of item income, gain, loss and deduction, there can be considerable uncertainty and further complexity in other cases, including standard commercial partnership arrangements.

Fourth, although there typically is not a readily ascertainable fair market value for most partnership assets, the application of Section 751(b) requires knowledge of the fair market value of each partnership asset. As a result, in applying Section 751(b), many partnership's seek a third-party valuation, while other partnerships undertake their own valuation. The factual and uncertain nature of these valuations creates additional uncertainty to taxpayers in applying Section 751(b), as the Section 751(b) analysis can be quite sensitive to modest changes in asset valuations. Moreover, each partnership asset must be classified as either a hot asset or a cold asset, which can be difficult in light of

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and a value equal to the actual value less the recapture. In these cases, the gross value of the bifurcated hot asset will equal the inherent gain.

the limited guidance as to what is considered an "unrealized receivable" and an "inventory item."

Fifth, it is not clear whether the deemed distribution of the forfeited assets under the Existing Regulations is treated as an actual distribution for other purposes of the Code, such as Sections 704(c)(1)(B), 707, 731(a)(1) and 737. The fact that the deemed distribution is probably treated as an actual distribution for some purposes (such as Section 731(a)) but not other purposes creates additional uncertainty and complexity.

**Part III. Explanation of the Hypothetical Sale Approach and the Hot Asset Sale Approach.**

A. Hypothetical Sale Approach.

The Notice proposes a new approach for determining whether a distribution triggers Section 751(b). Under this proposal (the "Hypothetical Sale Approach"), a distribution would trigger Section 751(b) only if it results in a reduction in a partner's share of the built-in hot-asset gain.[26] Section 751(b) would be triggered in the case of a reduction in hot-asset gain experienced by either the distributee partner or the other partners (that is, those not receiving a distribution).

In determining whether Section 751(b) is triggered, the Hypothetical Sale Approach would take into account any built-in gain or loss in the distributed hot assets immediately after their distribution (that is, in the hands of the distributee partner). In addition, the Hypothetical Sale Approach would generally take into account any "704(c)

[26] The Notice refers to the amount of ordinary income. We assume this is intended to be a net concept.

gain or loss" in the assets retained by the partnership as well as any "reverse 704(c) gain or loss" in those assets.

> Example 1: A, B and C each contribute $120 to Partnership, which puts $150 in the bank and buys land for $210. At a time when the partnership owns the land (which has appreciated to $300), $90 of zero-basis unrealized receivables (hot assets) and $150 in cash (total assets of $540), the partnership distributes $90 of cash to C and reduces C's interest from 1/3 to 1/5. Under the reverse 704(c) rules, such a distribution would effectively require the partnership to book up its assets and allocate the book gain based on the interests of the partners immediately prior to the book up and thereafter allocate any tax gain by applying Section 704(c) principles. As a result, if the partnership sold all of its assets immediately after the distribution, A, B and C would each be allocated $30 of ordinary income from the receivables and $30 of capital gain from the sale of the land, even though C would be a 20% partner at that time. Under the Hypothetical Sale Approach, Section 751(b) would not apply because the distribution would not reduce C's (or any other partner's) share of the built-in hot-asset gain due to the application of reverse 704(c) principles.

As a result of the impact of reverse 704(c) principles, Section 751(b) would generally be triggered under the Hypothetical Sale Approach only where (i) a hot asset is distributed or (ii) a distribution is made to a partner in complete liquidation of the partner's interest in the partnership. In other cases, reverse 704(c) principles would generally prevent a distribution from triggering Section 751(b). Stated differently, as illustrated by Example 1, Section 751(b) generally would not apply under the Hypothetical Sale Approach to a non-liquidating distribution of cold assets.

B. Hot Asset Sale Approach.

The Notice also proposes a new approach for defining the resulting tax consequences in cases where a distribution triggers Section 751(b). Under this proposal (the "Hot Asset Sale Approach"), if a distribution results in a reduction in any partner's share of the hot-asset gain (whether or not that partner is the distributee partner), that partner (the "selling partner") is deemed to (i) receive a distribution from the partnership of assets with built-in gain equal to the reduction, (ii) sell such assets back to the partnership for cash, and (iii) contribute the cash back to the partnership. Under this approach, as a general matter, only hot-asset gain is recognized and the amount of the gain is limited to what is necessary to prevent a specific partner from experiencing a reduction in hot-asset gain. By contrast, whenever Section 751(b) is triggered under the Existing Regulations (i) both hot-asset gain (or loss) and cold-asset gain (or loss) is generally recognized and (ii) both the distributee partner and the partnership generally recognize some of that gain (or loss), with the gain or loss recognized by the partnership being allocated to the non-distributee partners.

C. IRS Rationale in Proposing the Hypothetical Sale Approach and the Hot Asset Sale Approach.

The Notice quotes the following provisions from the legislative history of Section 751(b) in support of the Hypothetical Sale Approach and Hot Asset Sale Approach:

> "The provisions relating to unrealized receivables and appreciated inventory items are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income and on

> appreciated inventory. Amounts attributable to such rights would be treated as ordinary income if realized in the normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. *The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.*" (emphasis added in the Notice).[27]

The Notice explains the thinking behind the Hypothetical Sale Approach as follows:

> The legislative history of §751(b) emphasizes "income rights" of the partners and suggests that these rights may be treated as severable and subject to the same tax consequences as those of an individual entrepreneur. S. Rep. No. 1622, at 99. Consistent with this legislative history, in order to determine whether a distribution may be subject to §751(b), commentators have suggested that new regulations could require partnerships and their partners to compare the amounts of ordinary income that would be recognized by the partners if the partnership's hot assets (including distributed assets) were sold or exchanged for fair market value in a taxable transaction both before and after the distribution (hypothetical sale approach). If the amount of ordinary income that would be allocated to any partner (including the distributee) as a result of such a sale or exchange is reduced as a result of a distribution from the partnership, an analysis under § 751(b) would be required. The hypothetical sale approach, combined with the application of § 704(c) principles, could provide rules that achieve the objective of the statute in a less burdensome manner.

The Notice explains the thinking behind the Hot Asset Sale Approach as follows:

> The current §751(b) regulations impose a complex deemed distribution/ exchange approach for determining the tax

[27] S. Rep. No. 1622, at 99 (1954).

> consequences of a disproportionate distribution. One possible way to simplify this determination would be to treat a disproportionate distribution as triggering a taxable sale of the partners' shares of relinquished hot assets to the partnership immediately before the distribution (hot asset sale approach). The hot asset sale approach would apply §751(b) in a fully aggregate manner that is arguably consistent with its legislative history (under which each partner's tax treatment should be that of an individual entrepreneur).

Although not discussed in the Notice, it bears noting that the Hypothetical Sale Approach and the Hot Asset Sale Approach are conceptually consistent with the general approach taken by Treasury in issuing regulations in 1991 under Sections 743(b), 751(a), and 755. As discussed above, the regulations issued under Sections 743(b) and 755 generally adopt a hypothetical sale approach in defining the amount of the Section 743(b) adjustment and the manner in which such adjustment is allocated among the partnership's assets under Section 755. Similarly, the regulations under Section 751(a) (discussed below) generally adopt a hypothetical sale approach in determining the tax impact under Section 751(a) from the sale or exchange of a partnership interest.

**Part IV. Comments on the Hypothetical Sale Approach.**

We support the Hypothetical Sale Approach and believe it generally provides an accurate and appropriate measure for purposes of Section 751(b). First, the focus of the Hypothetical Sale Approach on reductions in a partner's share of hot-asset gain (as opposed to reductions in a partner's share of the gross value of the hot assets) furthers the basic purpose behind Section 751.

Second, the Hypothetical Sale Approach's focus on whether there has been a reduction in a partner's share of hot-asset gain provides a working principle that can be used in developing rules under Section 751(b) and in applying Section 751(b) to cases where guidance may be lacking. By contrast, the focus of the Existing Regulations on whether there has been a change in the distributee partner's share of the gross value of the partnership hot assets does not seem to be based on any particular principle that can be extended when working through a Section 751(b) issue.

Third, determining whether there has been a reduction in a partner's share of hot-asset gain (by comparing the amount of gain that would be recognized by the partner upon a deemed sale of assets at fair market value before and after the distribution) is something that practitioners with a general understanding of partnership tax would generally know how to do. As noted above, these calculations are already required in applying the regulations issued under Sections 743(b), 751(a), and 755.[28]

Fourth, we believe that the Hypothetical Asset Sale Approach is significantly less complicated to apply than the Existing Regulations.

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28 By contrast, practitioners generally do not know how to determine a partner's share of the gross value of a particular partnership asset and even the leading partnership tax commentators acknowledge that there is no clear way to do it. Monte A. Jackel & Avery I. Stok, Blissful Ignorance: Section 751(b) Unchartered Territory, Tax Notes, March 10, 2003, at 1559-1560 (hereinafter "Jackel & Stok"). Moreover, unlike the case today under the Existing Regulations, the Hypothetical Sale Approach and the Hot Asset Sale Approach generally would not themselves require the partnership to value its cold assets, although a valuation of these assets may be required under other provisions (*e.g.*, in determining the partner's reverse 704(c) gain in the retained assets).

A. Reverse 704(c) Issues.

1. Need for Additional Guidance.

The Notice emphasizes the role of reverse 704(c) principles in applying the Hypothetical Sale Approach and notes that under this approach and in light of these principles a non-liquidating distribution of cash or other cold assets generally would not trigger Section 751(b). There is little guidance about how to apply reverse Section 704(c) principles in general and no guidance as to how to apply these principles in the context of Section 751(b). As a result, we believe it would be appropriate and helpful for guidance to be issued in this area. In particular, we believe it would be helpful for guidance to be issued as to how reverse 704(c) principles apply in the case of distributions of appreciated property.[29]

> Example 2: A, B and C are equal 33-1/3% partners in Partnership with two assets (both of which are hot assets): Asset 1 has a FMV of $250 and a tax basis of $0 and Asset 2 has a FMV of $50 and a tax basis of $0. The partnership distributes Asset 2 to A and A's interest is reduced from 33-1/3 to 20%. A receives a $0 tax basis in the distributed asset.

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[29] In addition, we believe that implementing regulations should confirm the circumstances in which reverse 704(c) principles are required to be applied, including in the case of (i) a partnership that maintains capital accounts in accordance with the Section 704(b) regulations but does not "book up" its assets upon a non-liquidating distribution or (ii) a partnership that is "distribution driven" (that is, the partnership either does not maintain capital accounts or makes some effort to maintain capital accounts but does not require that liquidating distributions be made in accordance with capital accounts). For simplicity, this Report generally assumes that in each case the relevant partnership would maintain 704(b) capital accounts and would book-up its assets upon non-liquidating distributions and apply reverse 704(c) principles.

Under Section 704(b), immediately prior to the distribution, the Partnership would typically increase the 704(b) book value of Asset 1 to $250 and increase the 704(b) book value of Asset 2 to $50. Although not entirely clear, it appears that A, B and C would each (i) be allocated $83.33 of book gain from Asset 1 ($250 total), (ii) $16.67 of book gain from Asset 2 ($50 total), and (iii) have $83.33 of reverse Section 704(c) gain in Asset 1 going forward.[30] If so, the distribution would result in a reduction in B's and C's shares of built-in hot-asset gain from $100 to $83.33 (as B and C would no longer have any share of the built-in gain in Asset 2) and, if the Hypothetical Sale Approach applied, trigger the application of Section 751(b). However, the application of Section 751(b) in this instance seems inappropriate[31] since B and C did not exchange an interest in a partnership hot asset for an interest in a partnership cold asset, as the partnership in this example never owned any cold assets.[32]

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[30] Except as discussed below, this Report assumes that reverse 704(c) principles operate in this manner.

[31] The legislative history notes that Section 751(b) "is not applicable to a distribution to a partner of his proportionate share of partnership inventory items or unrealized receivables where such a distribution is not in exchange for his interest in other partnership property. If the distribution is, in part, a distribution of the distributee partner's proportionate share of unrealized receivables or inventory and, in part, a distribution in exchange for the distributee partner's interest in other partnership property, an allocation must be made, under regulations, between the two categories, both for the purposes of the distributee partner and the partnership." (Conf. Rep. to Accompany H.R. 8300, pt 2, at 15.)

[32] In fact, assuming reverse 704(c) principles apply, Section 751(b) would seem to be triggered under the Hypothetical Sale Approach upon any non-liquidating distribution of any appreciated hot asset, irrespective of the composition of the partnership's retained assets and irrespective of whether the distribution would

However, if B's and C's interests in the partnership were themselves seen as cold assets, applying Section 751(b) in Example 2 would be more justifiable. Absent the application of Section 751(b), B and C would (upon a sale of their partnership interests or a sale of all of the assets by the partnership followed by a liquidation of their partnership interests) have $83.33 of hot-asset gain (attributable to Hot Asset 1) and $16.67 of capital gain (attributable to their partnership interests). Since B and C each started with $100 of inherent hot-asset gain (and no cold-asset gain), it seems appropriate for Section 751(b) to apply since (without it) the distribution to A would effectively allow each of B and C to convert $16.67 of hot-asset gain into capital gain. However, it is not clear whether the partnership interest itself may be viewed as a relevant cold asset for purposes of Section 751(b) since the statute refers to exchanges of "partnership property".

Alternatively, in light of the fact that the distribution effectively shifts $33.34 of reverse 704(c) gain in Asset 1 from A and B to C, it might make sense to reduce C's reverse 704(c) gain in Asset 2 by a like amount and allocate this gain to A and B. Under this approach, (i) B and C would each have $100 of reverse 704(c) hot-asset gain in Asset 1 (and no interest in Asset 2) and (ii) A would have $50 of reverse 704(c) hot-asset gain in Asset 1 and $50 of inherent gain in Asset 2. If reverse 704(c) principles operated in this manner and the Hypothetical Sale Approach applied, Section 751(b) would not be triggered in Example 2 because the distribution would not change any partner's aggregate share of the total hot-asset gain. While this approach would require detailed guidance

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otherwise reduce any partner's share of the cold-asset gain inherent in the partnership's assets.

about how to apply reverse 704(c) and would create additional complexity in the case of distributions involving multiple properties or distributions of both hot and cold assets, it has some analytical appeal.[33]

If this approach were adopted, Treasury should consider whether it is appropriate to limit its application so that it applies only in cases where the reverse 704(c) gain in the partnership's retained assets is of the same character as the inherent gain in the distributed assets. If such a limitation applied, the reverse 704(c) rules would presumably avoid triggering Section 751(b) upon non-liquidating distributions of hot assets only to the extent that the distributee partner's share of the inherent gain in the partnership's retained hot assets were sufficient to absorb the "excess" hot asset gain in the distributed hot asset that was "shifted" to the distributee partner in the distribution. By contrast, if this limitation did not apply, it would somewhat more accurately preserve each partner's share of total gain (combined hot and cold) but rely on Section 751(b) to avoid shifts in hot asset gain. Thus, in Examples 3 and 4 (discussed below), the reverse 704(c) rules would create a shift in hot asset gain but Section 751(b) would be triggered to eliminate

[33] This approach seems most justifiable in the case of a distribution of an undivided interest in a single partnership asset. For example, suppose that A, B and C are equal 33-1/3% partners in a partnership with a single asset (which is a hot asset) with a FMV of $300 and a tax basis of $0. The partnership distributes a $50 interest in the asset to A and A's interest is reduced from 33-1/3 to 20%. A receives a $0 tax basis in the distributed asset. If the single asset is effectively bifurcated into two assets upon its distribution, the result would be the same as Example 2 above and, if the Hypothetical Sale Approach were adopted, Section 751(b) would apply. However, reverse 704(c) principles may be flexible enough to allow B and C to have $100 of reverse 704(c) gain in the portion of the assets retained by the partnership, so that (in the aggregate) the partners maintain their pre-distribution share of gain without recourse to Section 751(b).

that shift by taxing each partner whose share of hot asset gain went down. As a result, the issues present in Examples 3 and 4 would be avoided.[34]

2. <u>Special Rule for Cases Where a Partner's Reverse 704(c) Gain Exceeds the Partner's Interest in Capital</u>.

The Notice solicits comments on whether special rules would be necessary to address situations in which the distributee partner's interest in unrealized appreciation in hot assets prior to the distribution exceeds the partner's interest in partnership capital after the distribution. Before addressing the potential concerns raised by these situations, it is helpful to distinguish between two cases in which a partner's reverse 704(c) hot-asset gain may exceed the partner's interest in capital immediately after the distribution.

> Example 3: A and B are 50/50 partners in Partnership. Partnership has a Cold Asset 1 (with a FMV of $99 and a tax basis of $0), Cold Asset 2 (with a FMV of $1 and a tax basis of $0) and Hot Asset (with a FMV of $100 and a tax basis of $0). The Partnership distributes Cold Asset 1 to A and Cold Asset 2 to B, such that after the distribution, the partnership is owned 1% by A and 99% by B. Although A's 704(b) book capital account is $1, A has $50 of built-in income with respect to the Hot Asset under reverse 704(c) principles. Accordingly, upon a sale of the Hot Asset and liquidation of the Partnership, A would have $50 of ordinary income and a $49 capital loss (which capital loss in some respects offsets the $99 of gain inherent in Cold Asset 1 in the hands of A immediately after the distribution).

> Example 4: A and B are 50/50 partners in Partnership. Partnership has a Cold Asset (with a FMV of $2 and a tax basis of $0) and a Hot Asset (with a FMV of

[34] However, depending upon how the rules operated, the issues raised by Examples 3 and 4 could arise in other fact patterns, such as the distribution of non-appreciated cold asset.

> \$198 and a tax basis of \$0). The Partnership distributes the Cold Asset to A, such that after the distribution, the partnership is owned 49.5% by A and 50.5% by B. A has \$99 of built-in gain with respect to the Hot Asset under reverse 704(c) principles. A's 704(b) capital account is \$98.

These examples raise two questions. First, if A sold his remaining partnership interest for cash equal to the value of his capital interest, would A recognize ordinary income under Section 751(a) equal to A's reverse 704(c) hot-asset gain. Second, does the 1% interest retained by A in Example 3 justify allowing A to continue to defer A's share of the hot-asset gain, in light of the fact that this gain would have been triggered if A had been completely redeemed or had sold 99% of his partnership interest.

Looking at Treas. Reg. 1.751-1(a)(2), it seems fairly clear that A generally could not escape the reverse 704(c) hot-asset gain by selling his remaining partnership interest. Under this regulation, upon the sale or exchange of a partnership interest, (i) the income or loss realized by the partner upon the sale or exchange of the partner's interest in hot assets is the amount of income or loss from hot asset property that would have been allocated to the partner (to the extent attributable to the partnership interest sold) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately prior to the partner's transfer of the interest and (ii) the difference between the amount of capital gain or loss that the partner would realize in the absence of Section 751 upon a sale of its interest in the partnership and the amount of ordinary income or loss determined above is the transferor's capital gain or loss on the sale of its partnership interest.

The preamble to the proposed Section 751(a) regulations states that:

> Section 751(a) provides that to the extent an amount realized on the sale or exchange of a partnership interest is attributable to the transferor's interest in unrealized receivables or inventory items of the partnership, the amount realized is considered to be an amount realized from the sale or exchange of property other than a capital asset. Thus, the transferor partner may recognize ordinary income or loss on the sale or exchange of its partnership interest. Under the current section 751 regulations, the amount of income or loss realized by a partner on the sale or exchange of an interest in section 751 property is equal to the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the transferor partner's basis in its partnership interest allocated to the property. Generally, the portion of the total amount realized allocated to section 751 property is determined by the seller and purchaser in an arm's length agreement. The portion of the partner's adjusted basis in the partnership interest allocated to the section 751 property equals the basis that the property would have had under section 732 if the transferor partner had received its proportionate share of the property in a current distribution immediately before the sale.
>
> The proposed regulations amend these rules for determining the transferor partner's gain or loss from the sale or exchange of its interest in section 751 property. Rather than attempting to allocate a portion of the transferor partner's amount realized and adjusted basis to the section 751 property, the proposed regulations adopt a hypothetical sale approach. Thus, the income or loss realized by a partner from section 751 property upon the sale or exchange of its interest is the amount of income or loss that would have been allocated to the partner from section 751 property (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for fair market value immediately prior to the partner's transfer of the partnership interest.

Accordingly, under this regulation, (i) upon a sale of A's interest in Example 3 immediately after the distribution, A would have $50 of ordinary income and a $49 capital loss and (ii) upon a sale of A's interest in Example 4 immediately after the distribution, A would have $99 of ordinary income and a $1 capital loss.

However, some commentators have read Section 751(a) itself and Treas. Reg. 1.751-1(a)(1) as casting some doubt on this result.[35] Specifically, Section 751(a) provides as follows:

> The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to -
>
> (1) unrealized receivables of the partnership, or
> (2) inventory items of the partnership,
>
> shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

The question is whether Section 751(a) (and Treas. Reg. 1.751-1(a)(1), which largely repeats the statute) could be read to limit the amount realized from the sale of hot assets to the total amount received in exchange for the partnership interest (plus any partnership liabilities treated as part of the transferring partner's amount realized). Under this reading, (i) upon a sale of A's interest in Example 3 immediately after the distribution, A would have $1 of ordinary income and no capital gain or loss and (ii) upon a sale of A's interest in Example 4 immediately after the distribution, A would have $98 of ordinary income and no capital gain or loss.

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[35] Jackel & Stok, at 1581.

We believe that the approach taken in Treas. Reg. 1.751-1(a)(2) is reasonable and does not merit a special rule under Section 751(b) to address situations in which the distributee partner's interest in unrealized appreciation in hot assets prior to the distribution exceeds the partner's interest in partnership capital after the distribution. This approach is consistent with the general intent of Subchapter K to preserve each partner's share of hot-asset gain and with the Section 743(b) adjustments that may be made upon a transfer of a partnership interest. Further, we believe it is appropriate to read Section 751 and the regulations issued thereunder as a whole. Accordingly, if the Section 751 regulations provide that a partnership distribution does not trigger the distributee partner's share of hot asset gain under Section 751(b) due to the application of reverse 704(c) principles, we believe it is reasonable to effectively take the distribution into account in applying Section 751(a) upon a subsequent transfer by requiring that the transferring partner recognize the reverse 704(c) hot gain at the time.[36] Moreover, if Treasury is concerned that Section 751(a) is subject to the reading described above, we believe that the appropriate course of action is to clarify Section 751(a).

As noted above, Example 3 also raises the question whether the 1% interest retained by A justifies allowing A to continue to defer A's share of the hot-asset gain, in light of the fact that this gain would have been triggered if A had been completely redeemed or had sold 99% of the partnership interest. Notably, the legislative history of Section 751(b) does not appear concerned about the deferral of hot-asset gain. Rather,

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[36] Alternatively, a portion of the reverse 704(c) hot asset gain could be viewed as negative basis or comparable to an excess loss account.

the legislative history is concerned with eliminating hot-asset gain from the tax system altogether and shifting hot-asset gain among partners. Example 3 does not present either concern. Moreover, there is not an obvious and principled way of defining a point at which reverse 704(c) concepts should no longer apply and Section 751(b) should be triggered. Nevertheless, we believe that it would be inappropriate for the distributee partner in Example 3 to defer all of its reverse 704(c) hot-asset gain. Accordingly, we believe that the IRS and Treasury should consider prescribing special rules to address cases where a partner's reverse 704(c) hot asset gain vastly exceeds the partner's interest in partnership capital. In the event that such rules are adopted, we recommend that there be a bright line as to their potential application so that taxpayers know whether a distribution is potentially subject to the special rules (e.g., Example 3) and know when a distribution is outside of the special rules (e.g., Example 4).

3. Amortization of Reverse 704(c) Gain.

In cases where the reverse 704(c) hot-asset gain is attributable to an amortizable or depreciable asset, the reverse 704(c) gain will diminish over time as the partnership amortizes (or depreciates) the booked-up asset.

> Example 5: A and B are 50/50 partners in Partnership. Partnership has a Cold Asset 1 (with a FMV of $99 and a tax basis of $0), Cold Asset 2 (with a FMV of $1 and a tax basis of $0) and Goodwill (with a FMV of $100, a tax basis of $0 and $100 of recapture). Goodwill to the extent of recapture is a hot asset. The Partnership distributes Cold Asset 1 to A and Cold Asset 2 to B, such that after the distribution, the partnership is 99/1. Following the distribution, the partnership amortizes the Goodwill using "any reasonable method" so that after a period of years, the book/tax disparity in the Goodwill is eliminated (and A's

reverse 704(c) hot-asset gain in the recapture is similarly eliminated). See Treas. Reg. Sections 1.704-1(b)(2)(iv)(g)(3).

In the event the Goodwill in the above example had remaining tax basis that could be amortized for tax purposes over a period of years, the amortization of the reverse 704(c) gain associated with that asset would generally be made over that same period (assuming the remedial method is not used). While this may produce an appropriate result in cases where the remaining amortization period is meaningful, it could produce results that are inconsistent with Section 751(b) if the amortization period were artificially short. For example, it may be inappropriate to allow the reverse 704(c) gain to effectively burn off over an artificially short period that does not correspond to the actual useful life of the property. The reverse 704(c) regulations already require that a partnership making allocations with respect to revalued property use a reasonable method that is consistent with the purposes of Section 704(b) and (c). However, it would be appropriate and helpful for implementing regulations to provide further guidance as to the amortization of reverse 704(c) gain.

B. Impact of Partnership Liabilities.

The Notice solicits comments on whether the partners' shares of partnership liabilities should be considered in determining the partners' shares of partnership assets, and how the rules of Section 752 should be coordinated with those of Section 751(b).

One of the benefits of the Hypothetical Sale Approach is that it avoids the need to determine each partner's share of the gross value of partnership assets, including any assets funded with partnership debt or otherwise attributable to partnership debt. By

contrast, we would anticipate that partnership liabilities would be irrelevant in applying the Hypothetical Sale Approach, except to the extent (if at all) the liabilities impacted a partner's share of hot-asset gain. Moreover, contrary to Rev. Rul. 84-102 (discussed below), Section 751(b) itself could be read to require that partnership liabilities be disregarded in all cases, whether or not the Hypothetical Sale Approach is adopted.

In Rev. Rul. 84-102, A, B, and C were equal partners in partnership P and the value of each partner's interest was $25*x*. *D* acquired a 25% in P by contributing $25*x* to P. Prior to D's contribution, the liabilities of P totaled $100*x*, and each partner's share of the liabilities was approximately $33.3*x*. In addition, the unrealized receivables of P were $40*x*, and each partner's share of the unrealized receivables was approximately $13.3*x*. After the contribution by D, each partner's share of the liabilities of P was $25*x*; A, B, and C's share of P's liabilities each decreased by approximately $8.3*x*. Furthermore, after the contribution by D, each partner's share of P's unrealized receivables was (according to the ruling), $10*x*; A, B, and C's share of the unrealized receivables each decreased by approximately $3.3*x*. According to the ruling:

> In the instant case, A, B, and C are each treated as having received a cash distribution from P of 8.3*x* dollars in accordance with section 752(b) of the Code. Of this amount. 3.3*x* dollars is treated under sections 731(c) and 751(b)(1)(B) as being received by each partner in exchange for the interest in unrealized receivables given up. The remaining 5*x* dollars is treated in accordance with section 731(a) of the Code.
>
> Although D has a 10*x* dollar interest in the unrealized receivables of P upon becoming a partner, section 751(b) of the Code has no application with respect to D. There is no actual or deemed distribution of property

> from P to D as required by 751(b). Further, D has an "increased" interest in the unrealized receivables of P as a result of becoming a partner. Any distribution of property (other than property described in section 751(a)(1) or (2)) from P to D would have to result in a decreased interest in the unrealized receivables for 751(b)(1)(B) to apply.

Accordingly, the ruling holds that:

> The tax consequences to D of becoming a partner are determined under sections 721, 722 and 752(a) of the Code. D is treated as having contributed 50*x* dollars, the actual contribution of 25*x* dollars plus the deemed contribution of 25*x* dollars under section 752(a), in exchange for the partnership interest. D's basis in the partnership interest is 50*x* dollars in accordance with section 722 of the Code. Section 751(b) does not apply to new partner D because there is no actual or deemed distribution of property from P to D.
>
> Partners A, B, and C are each treated as having received a distribution of 8.3*x* dollars under section 752(b) of the Code. Of this amount, 3.3*x* dollars is treated under section 751(b)(1)(B) as being received by each partner in exchange for the interest in unrealized receivables given up.

Rev. Rul. 84-102 has been widely criticized.[37] First, the ruling does not take into account Section 751(b)(2)(A), which provides that Section 751(b)(1) shall not apply to a distribution of property that the distributee partner contributed to the partnership. Here the cash deemed to have been distributed as a result of the shift in liabilities is essentially the same cash that the distributee partners were deemed to contribute at the time the liability was incurred. As a result, it is hard to understand how a shift in liabilities can ever trigger Section 751(b).

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[37] See Jackel & Stok at 1563-65 (and citations therein).

Second, the IRS seemed bothered in the ruling by the fact that there was a shift in hot-asset gain from the existing partners to D upon D's admission and the IRS seems to be using the deemed distribution as a means of bootstrapping its way into taxing a portion of the shift. This seems inappropriate since the amount of the shift in hot-asset gain and the amount of the liability shift are wholly unrelated.[38] Moreover, since the liability shift does not give rise to an economic exchange it is hard to understand how Section 751(b) could be implicated.

Third, in most cases the partnership would in fact book-up its assets in connection with the admission of the new partner, in which case the IRS's concern in the ruling about the shift in hot-asset gain is addressed by the rules applicable to reverse 704(c) gain.

**Part V. Comments on the Hot Asset Sale Approach.**

We support the Hot Asset Sale Approach and believe it is an appropriate method for applying Section 751(b). Under this approach, gain is triggered under Section 751(b) only to the extent actually required to prevent a reduction in built-in hot-asset gain by a partner. By contrast, the Existing Regulations generally require gain (or loss) recognition in both hot assets and cold assets and generally result in each partner recognizing some gain (or loss) in the transaction, including partners who do not actually receive a distribution and whose interest in hot assets either remains constant or increases. The

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[38] For example, the ruling's conclusion that each of A's, B's and C's share of unrealized receivable was reduced to $10x after D's contribution would presumably still be true even if the P had no liabilities.

Hot Asset Sale Approach is more targeted than the Existing Regulations, is consistent with the basic purpose of Section 751(b) and will be easier to administer than the Existing Regulations. Moreover, we believe that the Hot Asset Sale Approach is significantly less complicated to apply than the Existing Regulations.

A. Identifying the Hot Assets that Are Deemed to Be Distributed and Then Sold to the Partnership.

The Notice indicates that under the Hot Asset Sale Approach, any partner whose share of hot assets is reduced (the "selling partner") will be treated as (i) receiving the relinquished hot assets in a deemed distribution, (ii) selling the assets back to the partnership for cash and (iii) contributing the cash back to the partnership. To the extent Section 751(b) is triggered under the Hypothetical Sale Approach as a result of an actual distribution of a hot asset, each of the other partners (i.e., those not receiving an actual distribution) would potentially be treated as a selling partner. In such a case, the "relinquished hot assets" deemed distributed to the selling partners would consist of some or all of the hot assets actually distributed. To the extent Section 751(b) is triggered under the Hypothetical Sale Approach as a result of a liquidating distribution, the distributee partner (i.e., the partner actually receiving a distribution) would be treated as a selling partner. In this case, the "relinquished hot assets" deemed distributed to the selling partner would consist of some or all of the hot assets retained by the partnership.

The Notice does not specify how to identify the assets that will be deemed to be distributed and then resold to the partnership under the Hot Asset Sale Approach. In order to make Section 751(b) more manageable from a compliance standpoint, we

believe that partnerships should be given some latitude in identifying the "relinquished assets". Although some partnerships may identify those assets which are likely to be sold first, we do not believe this would be inconsistent with the intent of Section 751(b) as it would have a timing impact but it would neither reduce total hot-asset gain nor allow hot-asset gain to be shifted among partners.

> Example 6: A and B are equal partners in a partnership with $150 of cash, Hot Asset 1 (with a basis of $15 and FMV of $75), and Hot Asset 2 (with a basis of $15 and FMV of $75). The partnership distributes $150 to A in complete liquidation of A's interest.[39] Under the Hypothetical Sale Approach, Section 751(b) would be triggered because A's share of hot-asset gain would otherwise be reduced from $60 to $0. Under the Hot Asset Sale Approach, A would be treated as a selling partner and would be deemed to receive hot assets with $60 of inherent hot-asset gain.

The Notice could be read to suggest that the "relinquished property" (that is, the property deemed distributed to A and deemed to be resold to the partnership) would be a 50% interest in each of the partnership's hot assets. While such an identification approach would certainly be consistent with Section 751(b), we believe it could create unnecessary administrative complexity in partnerships with a substantial number of hot assets. As a result, we believe that partnerships should be permitted, for example, to treat the relinquished property as consisting solely of Hot Asset 1, solely of Hot Asset 2 or consisting partially of Hot Asset 1 and partially of Hot Asset 2.

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[39] Assume for purposes of the example that the partnership continues even though it has only one remaining partner.

B. Defining the Hot Assets that Are Deemed to Be Distributed and Then Sold to the Partnership.

The Notice could be read to suggest that each selling partner would be deemed to receive a distribution of an undivided interest in the relinquished assets (that is, a vertical slice that include tax basis and gain) with an inherent gain equal to the selling partner's reduction in hot-asset gain. We believe that such an approach would add considerable complexity to the Hot Asset Sale Approach. Consistent with the Hypothetical Sale Approach in general, we recommend that the hot-asset gain inherent in the relinquished property be treated as a separate zero basis asset and that the selling partner be treated as receiving that separate asset in the deemed distribution. Thus, in Example 6 above, we believe that the relinquished property could be defined (for example) as an interest in Hot Asset 1 (with a $0 basis and a $60 FMV) or as an interest as Hot Asset 1 and Hot Asset 2 (each with a $0 basis and a $30 FMV).

C. Impact of the Distributee Partner's Tax Basis in the Partnership and Any Basis Adjustments Under Sections 734(b) and 743(b).

The Notice solicits comments on the extent to which regulations adopting the Hypothetical Sale Approach should take into account the distributee partner's basis in the partnership interest and basis adjustments under Sections 734(b) and 743(b), including basis adjustments resulting from the distribution.[40]

A number of benefits would result from adopting a simple rule that all basis adjustments under Section 734(b) or 743(b) in effect at the time of the distribution are

[40] Although this portion of the report relates more to the Hypothetical Sale Approach, it is better understood in the context of the Hot Asset Sale Approach and related issues.

taken into account in applying the Hypothetical Sale Approach (and, if relevant, the Hot Asset Sale Approach). First, taking these adjustments into account reflects what would occur if the partnership actually sold its assets. Second, it is more intuitive to take these adjustments into account than to disregard them.

However, Section 734(b) and 743(b) adjustments complicate the application of the Hypothetical Sale Approach and the Hot Asset Sale Approach because of the manner in which they are taken into account in applying other provisions of Subchapter K. For example, in determining the tax basis of property distributed to a partner, the distributee partner's Section 743 adjustments in the distributed property are taken into account and essentially treated like actual partnership tax basis but any other partner's Section 743 adjustments in the distributed property are disregarded (and, under other rules, hop over to other partnership property). As a result, the presence of Section 743(b) adjustments complicates the application of the Hypothetical Sale Approach and the Hot Asset Sale Approach.

> Example 7: A and B are equal partners in a partnership with Hot Asset ($25 FMV and $0 tax basis) and Cold Asset ($75 FMV and $50 tax basis). A and B each have a $25 tax basis in the partnership. B sells its interest to C for $50 and recognizes $12.50 of ordinary income under Section 751(a). There is a Section 754 election in effect at the time of the sale and therefore C has a $12.50 743(b) adjustment in Hot Asset and a $12.50 Section 743(b) adjustment in Cold Asset. Thereafter, the partnership distributes Hot Asset to A such that A becomes a 33-1/3 percent partner and C becomes a 66-2/3 percent partner.

As a starting point, we believe that on these facts (i) A should take a $12.50 tax basis in the Hot Asset so that upon a later sale A will recognize only $12.50 of ordinary

income and (ii) C should not recognize any ordinary income in respect of the Hot Asset (as C's share of the gain was previously recognized by B). If C's $12.50 Section 743(b) adjustment in the Hot Asset were taken into account for purposes of the Hypothetical Asset Sale Approach, then Section 751(b) would not be triggered because C's share of hot-asset gain would remain constant ($0 both before and after the distribution) and A's share of hot-asset gain would increase (from $12.50 to $25.00). However, under Section 732, A's basis in the Hot Asset would equal the lower of (i) the partnership's basis in the Hot Asset ($0) and (ii) A's basis in its partnership interest ($25.00). Because C's Section 743(b) adjustment is personal to C it would not be considered "partnership basis" for purposes of a distribution to A and therefore A would inherent the partnership's $0 tax basis in the Hot Asset.

Alternatively, if C's Section 743(b) adjustment were not taken into account for purposes of the Hypothetical Sale Approach but were taken into account in applying the Hot Asset Sale Approach, then (i) Section 751(b) would be technically triggered as C's share of hot-asset gain would be deemed to go down from $12.50 prior to the distribution to $0 after the distribution and (ii) under the Hot Asset Sale Approach, C would be deemed to receive a $12.50 interest in the Hot Asset and sell the interest back to the partnership for $12.50 cash. Since C's $12.50 Section 743(b) adjustment in the Hot Asset would be taken into account under Section 732 in determining C's tax basis in the portion of the Hot Asset deemed to have distributed to C, C would have a $12.50 tax basis in the asset and $0 of gain upon the deemed sale of the asset back to the partnership. The partnership would take a $12.50 tax basis in the portion of Hot Asset purchased from

C. Upon the distribution of the Hot Asset, A would have a $12.50 tax basis in the Hot Asset.

The impact of treating C's Section 743(b) in this manner would, at the cost of additional complexity, effectively override the general rule applicable when property with one partner's Section 743(b) adjustment is distributed to another partner and in doing so allow each partner's share of the hot-asset gain to be preserved under Section 751(b).

Alternatively, implementing regulations could take Section 743(b) adjustments into account for all purposes and (i) on these facts allow C's Section 743(b) adjustment to be treated like general partnership tax basis for purposes of computing A's tax basis in the distributed Hot Asset (so that, without the need to trigger Section 751(b), C would take a $12.50 tax basis in the Hot Asset) or (ii) simply ignore the fact the transaction has the effect of increasing the total hot-asset gain in the system.

D. <u>Tax Basis Adjustment Issues Arising from the Actual Distribution</u>.

The Notice includes two examples illustrating that special rules may be required to ensure that the basis adjustments flowing from the application of the Hot Asset Sale Approach are appropriate.[41] Specifically,

[41] This aspect of Section 751(b) reminds one of the Heisenberg Uncertainty Principle, which in simple terms states that the more accurately one tries to measure something, the less certain one can be of its characteristics because the act of measuring actually disturbs the subject.

> Example 8:[42] A, B and C are each 1/3 partners in a partnership that holds one hot asset and one cold asset, each with a tax basis of $0 and a FMV of $150. A, B and C each have an adjusted basis in the partnership interest of $0 and a $50 share of hot asset appreciation. A is fully redeemed by a distribution of 2/3 of the cold asset and in connection therewith, the partnership books up its assets. A's share of the hot-asset gain is reduced from $50 to $0 and therefore Section 751(b) would be triggered under the Hypothetical Sale Approach. Under the Hot Asset Sale Approach, A is deemed to have received a distribution of $50 in hot assets, sold the assets to the partnership in exchange for $50 (cash) and then contributed the cash back to the partnership. A's tax basis in the partnership would increase from $0 to $50 (by virtue of the deemed $50 contribution) and the partnership would take a $50 tax basis in the hot assets. A would then be treated as receiving the $100 interest in the cold asset and, under Section 732(b), A would receive a $50 tax basis in the cold asset. The remaining cold asset held by the partnership would have a $0 tax basis and would not be reduced below zero even if the partnership had a 754 election in place.

In cases where a Section 754 election is in effect, a negative Section 734(b) adjustment will generally be made where, as in Example 8, an asset is distributed by a partnership and the tax basis of the asset to the partnership ($0) is less than the tax basis of the asset to the distributee partner ($50). However, under Treas. Reg. 1.755-1(c)(1), (3) and (4), (i) a 734(b) adjustment can only be made to a partnership asset of the same class (hot or cold) as the distributed asset giving rise to the adjustment, (ii) a negative 734(b) adjustment with respect to a particular class of asset cannot exceed the partnership's actual tax basis in its assets of that class and (iii) if a negative

[42] Example 2 in the Notice.

Section 734(b) adjustment is so limited, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

The Notice states that $50 of capital gain is potentially eliminated from the system in this example. This statement seems focused on what would occur if (i) no Section 734(b) adjustment were made[43] and (ii) the partnership sold all of its assets but did not actually liquidate. However, the statement seems to disregard the fact that B and C would eventually recognize $25 of capital gain when they either sold their partnership interest or the partnership liquidated. Accordingly, while this example may illustrate timing issues, we do not believe it involves the elimination of capital gain from the system.

> Example 9:[44] Same as Example 8 except that the partnership fully redeems A with a $100 interest in the hot asset. Each of B's and C's share of the hot-asset gain is reduced from $50 to $25 and therefore Section 751(b) would be triggered under the Hypothetical Sale Approach. Under the Hot Asset Sale Approach, B and C are each deemed to receive a $25 distribution in hot assets, sell the assets back to the partnership for $25 (cash), and contribute the cash back to the partnership. Although A would be treated as receiving hot assets from the partnership with an inside tax basis of $50, A would take a $0 basis in the assets under Section 732. If a Section 754 election were in effect, the partnership would increase its tax basis in its remaining hot assets by $50 under Section 734.

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43 No Section 734(b) adjustment would be made if (i) Section 734(b) was not triggered to begin with (because the partnership did not have a Section 754 election in effect and the distribution did not result in a substantial basis reduction) or (ii) Section 734(b) was triggered but the partnership did not hold (and did not subsequently acquire) a cold asset to which the negative Section 734(b) adjustment could apply.

44 Example 3 in the Notice.

As the Notice observes, the results of this example (unless modified) are inconsistent with the intent of Section 751(b) because $50 of hot-asset gain has been effectively shifted from B and C to A. This is true because A's share of the hot-asset gain after the distribution would be $100, and B and C, who each recognized $25 of ordinary income, would recognize no additional ordinary income.

The Notice solicits comments on whether mandatory or elective capital gain recognition should be included in the Hot Asset Sale Approach in order to address the basis issues raised in Examples 8 and 9. This capital gain recognition would be in addition to the basic hot-asset gain recognition under the Hot Asset Sale Approach. Under this approach, in Example 8, B and C would presumably each be deemed to receive a $25 distribution in cold assets, sell the assets back to the partnership for $25 (cash), and contribute the cash back to the partnership. Assuming that the cold assets are the same as those distributed to A (or that a Section 754 election is in effect), the basis adjustment issue identified in Example 8 would be corrected so long as there was a Section 754 election in effect and so long as the retained cold assets were sufficient. Similarly, in Example 9, A would presumably be deemed to receive a $50 distribution in cold assets, sell the assets back to the partnership for $50 (cash), and contribute the cash back to the partnership. Because A would now have a $50 outside basis, A would take a $50 tax basis in the distributed hot assets. Since the tax basis in the distributed hot assets would now be the same to the partnership and the distributee partner, no Section 734(b) adjustment would be made by the partnership and B and C would each maintain $25 of unrealized hot-asset gain.

We recommend that regulations adopting the Hot Asset Sale Approach include rules that give partnerships the election to fix the basis issue present in Example 8 (deferral of cold-asset gain) and require partnerships to make adjustments to fix the basis issue present in Example 9 (shifting of hot-asset gain from one partner to another). Although requiring recognition of cold-asset gain would eliminate the tax basis issues in these examples, there are alternative approaches for fixing the issues, such as (in Example 9) eliminating the positive Section 734(a) adjustment.[45] A rule requiring cold-asset gain recognition would substantially increase the complexity of Section 751(b) and would unnecessarily accelerate gain recognition. Moreover, we are concerned that other fact patterns may exist in which other tax basis issues may arise that are inconsistent with Section 751(b) and that would not be fixed through cold-asset gain recognition.[46] Accordingly, we believe that taxpayers and the IRS would both be well served by a rule that requires partnerships to make adjustments to ensure that the Hot Asset Sale Approach does not eliminate or shift hot-asset gain, but provides partnerships with some latitude in exactly how this is accomplished (*e.g.*, the partnership could elect to eliminate a Section 734(b) adjustment that is inconsistent with Section 751(b) or the partnership

[45] Although A in Example 9 would have an extra $50 of hot-asset gain, A may well prefer this to the current recognition of cold-asset gain, particularly if A is a corporation.

[46] For example, the basis issue also arises in the partnership distribution illustrated in Example 2. However, since the partnership in Example 2 does not own any cold assets, the basis issue obviously cannot be fixed in that example through a deemed distribution of cold assets.

could elect to trigger the recognition of cold-asset gain). See, e.g., Treas. Reg. 1.704(c)-3 (which grants taxpayers a fair degree of latitude to account for any 704(c) gain or loss).

E. Distributions Taxable under Section 731.

We believe that Treasury and the IRS should consider whether special rules should apply to distributions taxable under Section 731.

> Example 10: A and B are 50/50 partners in a partnership with $100 of cash and a hot asset with a $0 tax basis and a $100 FMV. A's tax basis in its partnership interest is $50. A receives a distribution of $75 in cash from the partnership, which (without regard to 751(b)) would trigger $25 of gain under Section 731. If the Hypothetical Sale Approach applied without any special rules, assuming that the partnership booked-up the hot asset, Section 751(b) would not be triggered because A's and B's share of the hot asset gain would be maintained as a result of the application of reverse 704(c) principles.

This example raises a variety of issues. First, it seems inappropriate for A to recognize a $25 capital gain when all of the appreciation in the partnership's assets is attributable to hot assets. Second, upon a subsequent sale of the hot asset at its current value, A would be allocated $50 of ordinary income, bringing A's total recognized income and gain to $75 (which is $25 more than A's share of the partnership's inside gain and $25 more than the gain inherent in A's partnership interest). Third, while A would have a $25 capital loss inherent in its partnership interest that would be recognized upon a liquidation or sale of that interest, the restrictions on capital loss carrybacks may prevent A from being able to use that loss to offset the $25 of capital gain recognized upon the receipt of the cash distribution. In light of foregoing, we believe that Treasury and the IRS should consider whether implementing regulations should require (or

perhaps permit) A in the above example to trigger $25 of hot asset gain. This would allow the character of the gain recognized by A as a result of the distribution to reflect the character of the inherent gain in the partnership's assets and would more closely resemble the tax consequences that would have arisen upon a sale governed by Section 751(a).[47]

F. Alternative to the Hot Asset Sale Approach.

While we support the Hot Asset Sale Approach, we believe Treasury and the IRS should consider, in lieu of deeming a distribution, sale and contribution, simply requiring that (i) the partnership recognize gain in its hot assets equal to the aggregate reduction in the partners' shares of hot-asset gain, (ii) the gain be allocated to the partner(s) whose share of hot asset gain would otherwise be reduced, and (iii) appropriate basis adjustments be made to the partnership's assets to reflect the recognition of the hot asset gain. The primary benefits of such a "deemed gain approach" are (i) it may be conceptually easier to understand and apply and (ii) it eliminates unnecessary steps (the deemed distribution, sale and contribution) and the ancillary tax consequences that may result from those steps (*e.g.*, the basis limitation rules in Section 732). Moreover, while

[47] One could be tempted on these facts to conclude that Section 751(a) in fact applies since (i) Section 731(a) provides that any gain recognized under Section 731(a) shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner and (ii) Section 751(a) applies to amounts received by a transferor in exchange for all or a part of his interest in the partnership attributable to hot assets. However, Treas. Reg. 1.731-1(a)(3) makes it clear than gain recognized under Section 731 is capital gain. See also McKee @ 16.02[1](Section 751(a) is not applicable to amounts received as distributions from a partnership as the "legislative history, the language of Section 751(b), and the sense of the overall statutory scheme make it abundantly clear that Section 751(b), rather than Section 751(a), is the controlling provision with respect to both current and liquidating distributions").

the Hot Asset Sale Approach provides a useful paradigm for analyzing the tax consequences associated with triggering an offsetting amount of hot asset gain, applying that paradigm may produce inappropriate results in a variety of contexts (*e.g.*, the potential application of the loss disallowance rules in Section 707 and potentially the antichurning rules of Section 197).[48]

**Part VI. Additional Recommendations.**

The Notice also solicits comments on any other matters that should be addressed in future guidance under Section 751(b).

A. Exclude Certain Transactions from the Ambit of Section 751(b).

In order to simplify Section 751(b), we recommend that Treasury consider excluding from Section 751(b) certain partnership distributions that do not raise Section 751(b) concerns. For example, it would be helpful from an administrative compliance perspective to generally exclude distributions by partnerships in which all of the partners are domestic C corporations that do not have excess net operating losses. It would similarly be helpful to exclude distributions from partnerships with relatively small amounts of hot assets (e.g., less than 10%) and distributions involving small amounts of hot assets (e.g., less than 10% of the total assets being distributed).

[48] The potential application of the Section 707 loss disallowance rules would presumably only arise if the implementing regulations provided that Section 751(b) would be triggered in the event that there were a change in a partner's share of hot asset loss.

B. Clarify Application to the Incorporation of a Partnership.

Revenue Ruling 84-111 describes three alternative ways of incorporating a partnership from a tax perspective. It would be appropriate and helpful for guidance to be issued confirming how the Section 751(b) rules apply to each of the alternatives.

C. Clarify Application to Partnership Mergers and Divisions.

It would be appropriate and helpful for guidance to be issued confirming how the Section 751(b) rules would apply in the case of partnership mergers and divisions under Section 708.

D. Clarify the Ancillary Tax Consequences Stemming from the Application of the Hot Asset Sale Approach.

It would be appropriate and helpful for implementing regulations to clarify the extent to which the transactions deemed to result from the Hot Asset Sale Approach are treated as actual transactions for other purposes of the Code. In addition, it would be appropriate and helpful for implementing regulations to clarify the application of other rules that may relate to such transactions, such as whether the anti-churning rules could apply.

E. Prior Years.

In light of the uncertainty and complexity of the Existing Regulations, it would be appropriate and helpful for implementing regulations to provide that Treasury will generally respect any reasonable, good-faith interpretation of the rules applicable under Section 751(b) for partnership distributions that predate any new regulations. Cf. Notice 2006-79, 2006-43 IRB 763, Section 3.01 (reasonable, good-faith interpretation of Section 409A respected in certain circumstances).

**Part VII. Section 751(b) Revision.**

Although we believe that the adoption of the Hypothetical Sale Approach and the Hot Asset Sale Approach would be a significant improvement to current law, we recommend that Treasury and Congress consider revising Section 751(b) so that it operates more like an antiabuse rule. Even if the Hypothetical Sale Approach and the Hot Asset Sale Approach are adopted, Section 751(b) will continue to be extremely complicated to apply as a technical matter and extremely burdensome to apply as an administrative matter. Substantially all of the distributions we see are carried out for legitimate business reasons and are in no way designed to eliminate hot-asset gain or shift it among partners. Moreover, we expect that in the vast majority of cases, even if Section 751(b) were not in the Code, the distribution would not eliminate any hot-asset gain from the system and would involve shifts in hot-asset gain (if any) that are merely ancillary to the entire transaction. Further, in many cases all of the partners are in the same tax bracket (either all US individuals or all US corporation). In light of the foregoing, we believe that Treasury and Congress should consider revising Section 751(b) so that it operates as an antiabuse rule.[49] Alternatively, Treasury and Congress may wish to consider more modest revisions to Section 751(b) that further the Notice's objectives of targeting shifts in hot-asset gain and reducing complexity.[50]

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[49] Alternatively, revisions could be made to ensure that partnership distributions never alter the total hot-asset gain that will be subject to tax, but allow shifts in hot-asset gain among partners in non-abusive situations.

[50] Although a detailed discussion of possible legislative changes to Section 751(b) is beyond the scope of this Report, we note that Treasury and Congress may wish to

consider (i) whether it is possible to address potential shifts in hot-asset gain through basis adjustments and character adjustments without triggering any current gain, (ii) modifying Section 751(b)(2)(A) (which provides that Section 751(b) does not apply to the distribution of property which the distributee partner contributed to the partnership) and (iii) updating the definition of hot assets.