NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE ALLOCATION OF BASIS ADJUSTMENTS UNDER SECTION 743(B) TO CONTINGENT LIABILITIES

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New York State Bar Association Tax Section

Report on the Allocation of Basis Adjustments Under Section 743(b) to Contingent Liabilities

Introduction

This report[1] of the Tax Section of the New York State Bar Association addresses the question of whether and under what circumstances a partnership should be required to allocate basis adjustments under section 743(b)[2] to contingent liabilities.

This report is divided into three parts. Part I provides a summary of our recommendations. Part II provides a general summary and related background of the treatment of contingent liabilities under current law in both taxable asset acquisitions and taxable acquisitions of partnership interests, as well as the treatment of contingent liabilities in the partnership context. Part III discusses our recommendations and provides examples comparing the tax impact on the relevant parties of a sale of a partnership interest in a partnership with contingent liabilities with a direct sale of assets subject to contingent liabilities.

I. Summary of Recommendations

The principal recommendations of this report are as follows:

1. The Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") should issue guidance confirming that contingent liabilities constitute "built-in loss" property for purposes of computing basis adjustments under section 743(b) following the sale of a partnership interest and allocating those adjustments among partnership assets under section 755, regardless of whether the partnership has revalued its property and regardless of whether (i) the partnership previously assumed

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1 The principal authors of this report are Matthew W. Lay and Eric B. Sloan, with substantial assistance from Krista M. Lindhard and Michael A. Scaramella. Significant contributions were made by Stephen P. Foley and Andrew W. Needham. Helpful comments were received from Kimberly S. Blanchard, Andy H. Braiterman, David R. Franklin, Stephen B. Land, Michael L. Schler, David H. Schnabel, and Jodi J. Schwartz. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

2 Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

(or took property subject to) those contingent liabilities from a partner, or (ii) the contingent liabilities originated in the partnership before the sale.

2. Treasury and the IRS should issue guidance that disregards contingent liabilities in the initial calculation of basis adjustments to the transferee partner under section 743(b) and the allocation of such adjustments among the partnership's assets under section 755, deferring any future basis adjustments until the contingent liabilities are satisfied (either in whole or in part).

3. If our second recommendation is accepted, such guidance should also include specific rules addressing how and when the basis adjustment to the transferee partner under section 743(b) should be determined and how it should be allocated among the partnership's assets under section 755.

II. Background

A. General Overview of the Treatment of Contingent Liabilities in Taxable Asset Acquisitions

When a buyer assumes a *fixed* liability of the seller as part of an asset purchase (or purchases an asset subject to a fixed liability), the U.S. federal income tax consequences to the buyer and seller resulting from the assumption are relatively clear. From the seller's perspective, the amount realized for purposes of computing gain or loss on the sale includes the amount of the liability.[3] Depending on the type of liability assumed, the seller also may be allowed a deduction on the date of sale.[4] From the buyer's perspective, the cost of acquiring the acquired assets includes the amount of the liability.[5]

When a buyer assumes a *contingent* liability of the seller, the tax consequences are less clear. The seller generally must treat the sale as a closed transaction,[6] determining the

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3 *See generally* section 1001; Treas. Reg. § 1.1001-2(a)(1).

4 *See*, *e.g.*, *Commercial Security Bank v. Comm'r*, 77 T.C. 145 (1981) *acq.* 1986-2 C.B. 1; *James M. Pierce Corp. v. Comm'r*, 326 F.2d 67 (8th Cir. 1964); Treas. Reg. § 1.461-4(d)(5)(i); Treas. Reg. § 1.461-4(g)(1)(ii)(C); *see also* Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶304.01 (2012).

5 *See generally* section 1012.

6 *Cf.* Treas. Reg. § 1.1001-1(g)(2)(ii) ("Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable"); Temp. Treas. Reg. § 15a.453-1(d)(2)(iii) (open transaction method may be used "only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot reasonably be ascertained"); Treas. Reg. § 1.338-4(d)(1) ("In order to be taken into account in [aggregate deemed sale price ("ADSP")], a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. See § 1.1001-2(a)."); Treas. Reg. § 1.338-7(e), Example 4 (initial ADSP included an amount for contingent consideration that was determined under Treas. Reg. § 1.1001-1); Purchase Price Allocations in Deemed Actual Asset Acquisitions, REG-107069-97, 64 Fed. Reg. 43,462, 43,465 (Aug. 10, 1999) (modifying the rules for determining ADSP and adjusted grossed-up basis ("AGUB") in part because the prior rules "effectively afford[ed]

amount of the contingent liability at the time of sale, including the contingent liability in its amount realized, and claiming a deduction in the same amount.[7] Although not free from doubt,[8] the buyer must treat the amount of the assumed contingent liability as additional purchase price for the acquired assets, and thus as a non-deductible capital expenditure, when the liability is properly taken into account for federal income tax purposes.[9] The general rationale for treating

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old target open transaction treatment, which treatment generally is inconsistent with §§ 15a.453-1(d)(2)(iii) and 1.1001-1(g)(2)."). Some commentators have observed the possibility of a seller treating the sale as an open transaction. *See*, *e.g*., Robert H. Wellen, *Contingent Consideration and Contingent Liabilities in Acquisitions*, 973 PLI/Tax 1075 ("It is uncertain whether Target's contingent liabilities assumed by Acquiror are included in the amount realized at closing . . . Waiting until the liability becomes fixed before including it in Target's amount realized would be consistent with the exclusion of assumed contingent liabilities from the imputed interest/original issue discount regime and with the treatment of unaccounted-for acquisition debt under Reg. § 1.1001-2(a)(2)."); Kevin M. Keyes, *The Treatment of Contingent Liabilities in Taxable Acquisitions*, 931 PLI/Tax 46-1 ("The timing of the income recognition, if any, that occurs as a result of the assumption of a contingent liability . . . is a complex and unresolved issue. . . . [One] approach is to increase the seller's amount realized only when the [contingent] liability becomes fixed."); Glenn R. Carrington, *Tax Accounting in Mergers and Acquisitions*, ¶403.3.1 (2010) ("Under the second approach, the seller would increase the amount realized only when the [contingent] liability becomes fixed.").

7 Sellers, however, may not be allowed deductions for deferred compensation obligations that are subject to section 404(a)(5). *See Sol Jacobs, Jr. v. Comm'r,* 45 TC 133 (1965), and TAM 8939002 (June 15, 1989) (sellers were denied deductions for obligation to make payments under deferred compensation plans that were assumed by purchasers because, under section 404(a)(5), the payments were deductible only when includable in the gross income of employees participating in the plans). Treasury and the IRS have also reserved on guidance concerning a seller's ability to deduct an amount attributable to a contingent liability assumed by a buyer. *See* Treas. Reg. § 1.461-4(j); T.D. 8408, 57 Fed. Reg. 12411 (Apr. 10, 1992) ("Several commentators recommended that § 1.461-4(g)(1)(ii)(C) be applied to contingent liabilities. The Service and the Treasury Department believe that the tax treatment of contingent liabilities should be addressed in a separate regulations project. Accordingly, the final regulations do not adopt the recommendation."). A detailed discussion of the treatment of contingent liabilities in asset acquisitions is beyond the scope of this report. For examples of such discussions, see Jodi J. Schwartz, *It Doesn't Get Easier Than This? Liabilities and Asset Sales Reexamined*, Tax Forum No. 641 (Oct. 1, 2012); Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶304 (2012); Glenn R. Carrington, *Tax Accounting in Mergers and Acquisitions*, ¶401-406 (2010); Robert Willens, *Assumed Liabilities vs. Postacquisition Obligations*, 117 Tax Notes 53 (Oct. 1, 2007); Daniel Halperin, *Assumption of Contingent Liabilities on Sale of a Business*, 2 Fla. Tax Rev. 673 (1996); Alfred D. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 Tax Law. 765 (1991); New York State Bar Association Tax Section, *Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions* (Nov. 1, 1990), *reprinted in* 49 Tax Notes 883 (Nov. 19, 1990) (the "1990 NYSBA Report"); Michael L. Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 Tax L. Rev. 605 (1988).

8 *See*, *e.g*., *Nahey v. Comm'r*, 196 F.3d 866 (7th Cir. 1999) ("In some of the cases that Nahey cites, the court may have misclassified an expenditure (he points chiefly to *Pacific Transport Co. v. Comm'r*, 483 F.2d 209 (9th Cir.1973) (per curiam)), and treated an ordinary expense as a capital one. If so (which we needn't decide), those cases are incorrect"). In the 1990 NYSBA Report, we proposed among other things that a buyer generally should be able to deduct assumed contingent liabilities when the usual tests for deductibility are satisfied. New York State Bar Association Tax Section, *Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions* (Nov. 1, 1990), *reprinted in* 49 Tax Notes 883 (Nov. 19, 1990).

9 *See*, *e.g*., *David R. Webb Co., Inc. v. Comm'r*, 708 F.2d 1254, 1256 (7th Cir. 1983) (there is a "well-settled general rule that when an obligation is assumed in connection with the purchase of capital assets, payments satisfying the obligation are non-deductible capital expenditures"); *Pacific Transport Company v. Comm'r*, 483 F. 2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974); *Holdcroft Transportation Co. v. Comm'r,* 153 F.2d 323 (8th Cir. 1946). *See also* Treas. Reg. § 1.338-5(e)(1) ("In order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would

the amount as a non-deductible, capital expenditure is that "the payment of a liability by a subsequent purchaser is not the discharge of a burden, which the law has placed upon him, but is actually as well as theoretically, a payment of the purchase price."[10] This rationale has been followed even when the buyer settled the contingent liability for an amount in excess of the amount that the buyer estimated at the time of the sale.[11] As a result, even the excess amount was treated as a non-deductible capital expenditure.

B. Purchases of Partnership Interests

1. Treatment of Seller

When a partner sells an interest in a partnership, the partner generally recognizes a capital gain equal to the excess of the amount realized over the partner's adjusted basis in the interest, or recognizes a capital loss equal to the excess of the partner's adjusted basis in the interest over the amount realized.[12] Specifically, under section 741, a partner recognizes capital gain or capital loss on the sale or exchange of a partnership interest, except as provided under section 751(a). Section 751(a) provides that an amount of money, or the fair market value of any property, received by a partner in exchange for all or part of its partnership interest is treated as an amount realized from the sale or exchange of property other than a capital asset to the extent that the consideration is attributable to the partner's share of the value of partnership "unrealized receivables" or "inventory" (together, "section 751 property").

The selling partner's ordinary income or loss under section 751(a) equals the net amount of income or loss from the disposition of section 751 property (including any remedial allocation under Treas. Reg. § 1.704-3(d)) that would be allocated to the selling partner with

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apply if new target had acquired its assets from an unrelated person for consideration that included discharge of the liabilities of that unrelated person."); Treas. Reg. § 1.338-7(e), Example 1 (contingent liability assumed from seller and properly taken into account under general principles of tax law after the sale increased the AGUB allocated to the acquisition date assets). As a factual matter, it is often difficult to distinguish between contingent liabilities assumed from a seller and expenses a buyer incurs while operating the acquired business. *See, e.g.*, *Albany Car Wheel v. Comm'r*, 40 T.C. 831 (1963). The IRS and the courts have relied on a number of related factors to make this determination. *See, e.g.*, ILM 201036009 (Sept. 10, 2010) (discussing those factors); PLR 200730014 (May 1, 2007) (same).

10 *Pacific Transport Company v. Comm'r*, 483 F. 2d 209, at 214 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974).

11 *Illinois Tool Works, Inc. and Subsidiaries v. Comm'r*, 355 F.3d 997 (7th Cir. 2004) ("That a contingent liability, once fixed, exceeded the parties' expectations does not render it any less a part of the purchase price").

12 A seller's amount realized for purposes of computing gain or loss on the sale of property generally includes the amount of liabilities from which the seller is discharged in the sale. Section 1001; Treas. Reg. § 1.1001-2(a)(1). *See also* T.D. 7741, 45 Fed. Reg. 81,743 (Dec. 12, 1980) ("The Treasury decision also makes it clear that the amount realized from the sale or other disposition of a partnership interest includes the amount of partnership liabilities from which a transferor is discharged as a result of the sale or other disposition. Similarly, the transferee treats such liabilities as part of the cost of the partnership interest rather than as a contribution of money by the transferee to the partnership under section 752(a)."). If a partner sells an interest in a partnership, the amount realized from a sale or exchange of the partnership interest includes the transferor partner's share of partnership liabilities under section 752. Section 752(d); Treas. Reg. § 1.752-1(h); Treas. Reg. § 1.1001-2(c), Example (3).

respect to the transferred interest if the partnership sold all of its property for its fair market value (taking into account section 7701(g)) in a fully taxable transaction immediately before the sale.[13] The balance of the selling partner's recognized gain or loss is capital gain or loss.[14]

2. Treatment of Buyer

If a partner acquires a partnership interest from another partner rather than by contribution, section 742 provides that the partner's basis in its partnership interest is determined under the general basis rules for property (*e.g.*, section 1012). Thus, the basis of a partnership interest acquired by purchase is its cost,[15] increased by its allocable share of partnership liabilities under section 752.

Under section 743(a), if a person acquires an interest in a partnership from another partner, the basis of the partnership's assets is not adjusted. If, however, (i) an election under section 754 is in effect or (ii) the partnership has a "substantial built-in loss" immediately after the transfer,[16] the basis of the partnership's assets must be adjusted under section 743(b). In such cases, the partnership must (i) increase the adjusted basis of the partnership's assets by the excess of the transferee's basis in its partnership interest ("outside basis") over the transferee's share of the partnership's basis in the partnership's assets ("inside basis"), or (ii) decrease the basis of the partnership's assets by the excess of the transferee's share of the inside basis over the transferee's outside basis. Very generally, the purpose of these basis adjustments is to provide the transferee partner (and *only* the transferee partner) with a "cost basis" in its allocable share of the partnership's assets. If those assets are later sold, the transferee's basis adjustment will generally offset its share of any gain or loss existing in those assets as of the date of the original transfer.

For purposes of calculating the amount of a basis adjustment under section 743(b), a transferee's share of the inside basis is equal to the sum of the transferee's interest as a

13 Treas. Reg. § 1.751-1(a)(2). Section 7701(g) provides that in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of the property is treated as being not less than the amount of any nonrecourse indebtedness to which the property is subject.

14 *Id.*

15 Treas. Reg. § 1.742-1.

16 Under section 743(d), a partnership has a "substantial built-in loss" with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds the fair market value of such property by more than $250,000. Section 743(d), along with section 734(d) and section 704(c)(1)(C), was added in October of 2004 by the American Jobs Creation Act of 2004 (the "AJCA"). P.L.108-357. These changes were made because Congress believed that the partnership rules had allowed "the inappropriate transfer of losses among partners . . . [and that this had] allowed partnerships to be created and used to aid tax-shelter transactions." H.R. Rep. No. 108-548, at 283 (2004). The changes made by the AJCA were intended to limit "the ability to transfer losses among partners, while preserving the simplification aspects of the current partnership rules for transactions involving smaller amounts." *Id*. In the budget proposal for FY2013, the Obama Administration proposed "to amend section 743 to measure a substantial built-in loss also by reference to whether the transferee would be allocated a loss in excess of $250,000 if the partnership sold all of its assets immediately after the sale or exchange." *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013, Federal Receipts*, at 207.

partner in the partnership's "previously taxed capital" plus the transferee's share of partnership liabilities.[17] The regulations employ a "hypothetical transaction" construct to determine the transferee's interest as a partner in the partnership's "previously taxed capital." For this purpose, the "hypothetical transaction" is a fully taxable sale by the partnership of all of its assets for cash equal to their fair market value immediately after the transfer of the partnership interest.[18] Generally, a transferee's interest as a partner in the partnership's previously taxed capital (to the extent attributable to the acquired partnership interest) is equal to the sum of the following:

(i) The amount of cash that the transferee would receive on a liquidation of the partnership following the hypothetical transaction, increased by

(ii) The amount of tax loss (including any remedial allocations under Treas. Reg. § 1.704-3(d)) that would be allocated to the transferee in the hypothetical transaction, and decreased by

(iii) The amount of tax gain (including any remedial allocations under Treas. Reg. § 1.704-3(d)) that would be allocated to the transferee in the hypothetical transaction.[19]

Under this hypothetical sale construct, any built-in gain or loss that would have been allocated to the transferor under section 704(c)(1)(A) (discussed below) is taken into account in determining a transferee's share of the partnership's basis in the partnership's assets. As a result, some or all of a transferee's basis adjustment may be attributable to section 704(c) built-in gain or loss when a transferee purchases a partnership interest from the partner that contributed the section 704(c) property to the partnership.[20]

The basis adjustment under section 743(b) is allocated among the partnership's assets in accordance with section 755 and Treas. Reg. § 1.755-1.[21] If the transfer giving rise to a section 743(b) adjustment is a taxable purchase, then the amount of the section 743 adjustment is first allocated between two classes of partnership property: (i) capital assets and property described in section 1231(b) ("capital gain property"), and (ii) any other property ("ordinary income property"). The adjustment allocated to ordinary income property may be a positive amount, while the adjustment allocated to capital gain property may be a negative amount.

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17 Treas. Reg. § 1.743-1(d)(1).

18 Treas. Reg. § 1.743-1(d)(2).

19 Treas. Reg. § 1.743-1(d)(1)(i) - (iii).

20 *See* Adjustments Following Sales of Partnership Interests, REG -209682-94, 63 Fed. Reg. 4408, 4410 (Jan. 29, 1998).

21 Section 743(c).

If the transfer giving rise to a section 743(b) adjustment is a taxable purchase, then the amount of the basis adjustment allocated to the ordinary income property generally is equal to the total amount of income, gain or loss (including any remedial allocations under Treas. Reg. § 1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction.[22] The amount of the basis adjustment allocated to capital gain property is equal to the total amount of the section 743(b) adjustment, less the amount of the basis adjustment allocated to ordinary income property.[23] The portion of a basis adjustment allocated to each of these classes of property is then allocated among the assets within each class.[24]

C. Treatment of Contingent Liabilities in the Partnership Context

1. Background

On December 21, 2000, as part of the Community Renewal Tax Relief Act of 2000,[25] Congress enacted section 358(h) to address transactions in which property was transferred to a corporation in exchange for both stock and the assumption of certain obligations—often contingent liabilities—of the transferor. In these transactions, transferors took the position that the obligations were not "liabilities" within the meaning of section 357(c) or that they were described in section 357(c)(3) and therefore did not reduce the basis of the transferor's stock.[26] These assumed obligations, however, did reduce the value of the stock. The transferors then sold the stock and claimed a loss.[27] In this way, taxpayers attempted to duplicate the loss in the contributed assets in the corporate stock received in the section 351 transaction[28] and, by selling the stock, to accelerate deductions that typically were allowed only on the

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22 Treas. Reg. § 1.755-1(b)(2).

23 *Id.*

24 Treas. Reg. § 1.755-1(b)(3).

25 P.L. 106-554, 114 Stat. 2763, 2763A-638 (2001).

26 *See*, *e.g*., Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent environmental liabilities assumed by the transferee corporation in an exchange to which section 351 applied were not liabilities for purposes of section 357(c)(1) and section 358(d) because the liabilities had not yet been taken into account by the transferor corporation.

27 For examples of such transactions, see *Black & Decker v. United States*, 340 F. Supp. 2d 621 (D. Md. 2004), *aff'd in part and rev'd in part*, 436 F.3d 431 (4th Cir. 2006); *Coltec Indus. v. United States*, 62 Fed. Cl. 716 (Ct. Cl. 2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006).

28 In Rev. Rul. 95-74, the IRS ruled that contingent environmental liabilities of an accrual basis transferor corporation assumed by an accrual basis transferee corporation in an exchange to which section 351 applied were either deductible under section 162 or capitalized expenditures under section 263 by the transferee corporation under its method of accounting. The treatment of amounts incurred was to be determined as if the transferee corporation had owned the land subject to the contingent environmental liabilities for the period and in the same manner as the land was owned by the transferor corporation. *See also* PLR 200013044 (Jan. 5, 2000) (following the rationale of Rev. Rul. 95-74); CCA 201023056 (Sept. 22, 2009) (same); *but see*, *e.g*., FSA 200224011 (Mar. 5, 2002) (concluding that Rev. Rul. 95-74 did not apply and that payment of a rent obligation by a transferee corporation was capitalizable under *Holdcroft v. Comm'r*, 153 F.2d 323 (8th Cir. 1946), because the transferor did not transfer a trade or business).

economic performance of these types of obligations. Many taxpayers undertook similar transactions using partnerships.[29]

In the corporate context, section 358(h) addresses loss acceleration and duplication transactions by requiring that, after application of section 358(d), the basis in the stock received in an exchange to which section 351, 354, 355, 356, or 361 applies be reduced (but not below the fair market value of the stock) by the amount of any liability assumed in the exchange.[30] Except as provided by the Secretary, this rule does not apply if: (1) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange;[31] or (2) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.[32] The term "liability" for purposes of section 358(h) includes any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for other purposes of the Code.[33]

Congress also recognized that taxpayers were attempting to use partnerships and S corporations to carry out the same types of transactions that section 358(h) was designed to deter.[34] Congress therefore directed the Secretary to prescribe rules to provide "appropriate adjustments under subchapter K … to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) … in transactions involving partnerships" and to prescribe similar rules for S corporations.[35]

2. Partnership Contingent Liability Regulations

In June of 2003, Treasury issued proposed regulations to address the acceleration and duplication of losses through the assumption of obligations that are not treated as liabilities for purposes of section 752.[36] Treasury issued final regulations (the "Contingent Liability

29 *See* Notice 2000-44, 2000-2 C.B. 255. Notice 2000-44 addressed certain transactions (now commonly known as "Son-of Boss" transactions) intended to generate artificial deductible losses. Variations of these transactions include (i) the taxpayer borrowing at a premium, contributing the proceeds and the liability to a partnership and treating the amount of the liability assumption under section 752 as limited to the face amount of the debt, or (ii) the taxpayer purchasing and writing options, and transferring the positions to a partnership to create basis in the partnership interest with respect to the long option but not with respect to the short option.

30 Section 358(h)(1).

31 Section 358(h)(2)(A).

32 Section 358(h)(2)(B).

33 Section 358(h)(3).

34 T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005).

35 Section 309(c) of the Community Renewal Tax Relief Act of 2000. Section 309(d)(2) of the Community Renewal Tax Relief Act of 2000 provided that the rules prescribed under section 309(c) would apply to assumptions of liabilities after October 18, 1999, or such later date as may be prescribed in such rules.

36 REG-106736-00, 68 Fed. Reg. 37434 (Jun. 23, 2003). The proposed regulations applied to assumptions of "§ 1.752-7 liabilities" (defined below) occurring on or after June 24, 2003. At the same time, temporary regulations (Treas. Reg. § 1.752-6T) were issued that applied to liabilities assumed by a partnership after October 18, 1999, and

Regulations") in May of 2005.[37] These regulations added a definition of "liability" for purposes of section 752 in general to Treas. Reg. § 1.752-1 and provided detailed rules addressing other obligations that are not treated as liabilities for purposes of section 752.

An "obligation" is defined for this purpose as "any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code."[38] Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments, such as options, forward contracts, futures contracts, and swaps.[39]

An obligation is treated as a liability under section 752 only if, when, and to the extent that incurring the obligation (i) creates or increases the basis of any of the obligor's assets, (ii) gives rise to an immediate deduction to the obligor, or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.[40] If an obligation is treated as a liability, then each partner's share of that liability is determined under Treas. Reg. §§ 1.752-1 through -5, and each partner includes its share of partnership liabilities in determining its outside basis in the partnership.

If an obligation is not treated as a liability, it is generally classified as a "§ 1.752-7 liability" (referred to in the remainder of this report as a "contingent liability") and is subject to special rules under Treas. Reg. § 1.752-7.[41] The amount of a contingent liability is the amount of cash that a willing assignor would pay to a willing assignee to assume the liability in an arm's-length transaction, and a partner's share of the liability is the amount of any deduction that would be allocated to the partner with respect to the contingent liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than contingent liabilities), and paid an unrelated person to assume all of its contingent liabilities in a fully taxable arm's-length transaction

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before June 24, 2003. The text of Treas. Reg. § 1.752-6T also served as the text of Prop. Reg. § 1.752-6, which became Treas. Reg. § 1.752-6. Treas. Reg. § 1.752-6(a) provides that if, in a transaction described in section 721(a), a partnership assumed a liability (defined in section 358(h)(3)) of a partner (other than a liability to which section 752(a) and (b) apply), then, after application of section 752(a) and (b), the partner's basis in the partnership was reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. The basis reduction under Treas. Reg. § 1.752-6 is immediate, whereas the basis reduction under Treas. Reg. § 1.752-7 does not take effect until a triggering event, such as the sale of a partnership interest, occurs, as discussed further in the text. Treas. Reg. § 1.752-6(a) generally does not apply to transactions that meet the exceptions contained in section 358(h)(2)(A) and (B). Treas. Reg. § 1.752-6(b)(1). Under Treas. Reg. § 1.752-6(b)(2), however, the exception contained in section 358(h)(2)(B) does not apply to an assumption of a liability (defined in section 358(h)(3)) by a partnership as part of a transaction described in, or a transaction that is substantially similar to the transactions described in, Notice 2000-44.

37 T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005).

38 Treas. Reg. § 1.752-1(a)(4)(ii).

39 *Id.*

40 Treas. Reg. § 1.752-1(a)(4)(i).

41 Treas. Reg. § 1.752-7(b)(3)(i).

(assuming that the payment would give rise to an immediate deduction to the partnership).[42] A "§ 1.752-7 liability partner" is a partner from whom a partnership assumes a contingent liability as part of a § 1.752-7 liability transfer[43] or any person who acquires a partnership interest from the § 1.752-7 liability partner in a nonrecognition transaction.[44]

Paragraphs (e), (f), and (g) of Treas. Reg. § 1.752-7 provide complex rules for situations in which a partnership assumes such an obligation from a partner and, subsequently, that partner transfers all or part of the partnership interest or receives a distribution in liquidation of its partnership interest, or another partner assumes part or all of that obligation from the partnership.[45] Significantly, these complex rules do not apply if the partnership assumes the contingent liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution.[46] For this reason, those rules, and their application to partnership transactions, are not discussed in this report.

3. Interaction of Treas. Reg. § 1.752-7 with Section 704(c)

(a) Generally

Under section 704(c)(1)(A), if property is contributed to a partnership and, at the time of contribution, the adjusted tax basis of the property differs from its fair market value, the partnership must allocate income, gain, loss and deduction with respect to the property so as to take that difference into account. Under Treas. Reg. § 1.704-3(a)(6)(i), the same principles apply to allocations of income, gain, loss and deduction with respect to property with a book value that differs from its adjusted tax basis due to a "revaluation" of partnership property pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(*f*).

Thus, it is clear that the purpose of the Contingent Liability Regulations -- to prevent the acceleration and duplication of losses through the assumption of obligations not treated as liabilities for purposes of section 752 -- is intertwined with the purpose of section

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42 Treas. Reg. § 1.752-7(b)(3)(ii).

43 In general, a "§ 1.752-7 liability transfer" is any assumption of a contingent liability by a partnership from a partner in a transaction governed by section 721(a). Treas. Reg. § 1.752-7(b)(4).

44 Treas. Reg. § 1.752-7(b)(5).

45 These rules prevent the duplication of loss by prohibiting the partnership and any person other than the partner from whom the obligation was assumed from claiming a deduction, loss, or capital expense to the extent of the built-in loss associated with the obligation. These rules also prevent the acceleration of loss by deferring the partner's deduction or loss attributable to the obligation (if any) until the satisfaction of the contingent liability. Treas. Reg. § 1.752-7(a).

46 Treas. Reg. § 1.752-7(d)(2)(i)(A). This exception is similar to the exception provided in section 358(h)(2)(A). Aside from the trade or business exception, the only other exception provided in Treas. Reg. § 1.752-7(d)(2)(i) is if, immediately before the testing date, the amount of the remaining built-in loss with respect to all contingent liabilities assumed by the partnership (other than contingent liabilities assumed by the partnership with an associated trade or business) in one or more § 1.752-7 liability transfers is less than the lesser of 10% of the gross value of partnership assets or $1,000,000. Treas. Reg. § 1.752-7(d)(2)(i)(B).

704(c), which is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss.[47]

In fact, the link between the Contingent Liability Regulations and section 704(c)(1)(A) is made explicit in the regulations: Treas. Reg. § 1.752-7(a) and (c)(1)(i) provide that section 704(c) principles generally apply to a contingent liability assumed by a partnership from a partner. Accordingly, the contingent liability generally is treated under section 704(c) principles as built-in loss property having a built-in loss equal to the amount of the contingent liability at the time of its assumption by the partnership.[48] Further, when Treas. Reg. § 1.752-7 was finalized, Treasury and the IRS amended the regulations under section 704(c) to provide that contingent liabilities are treated as built-in loss property. Specifically, Treas. Reg. § 1.704-3(a)(12) provides that contingent liabilities are section 704(c) property (built-in loss property that at the time of contribution has a section 704(b) book value that differs from the contributing partner's adjusted tax basis) for purposes of applying Treas. Reg. § 1.704-3, except as otherwise provided in Treas. Reg. § 1.752-7.[49]

Notably, the Code treats a liability as "property" for other purposes of section 704(c). For example, under section 704(c)(3) and Treas. Reg. § 1.704-3(a)(4), accounts payable and other accrued but unpaid items contributed by a partner using the cash method of accounting are treated as section 704(c) property. This provision was added when section 704(c) was amended in 1984[50] because Congress was "concerned that the transfer to a partnership of accounts receivable, accounts payable, or other accrued but unpaid items of a partner who uses the cash method of accounting should not result in effectively transferring some or all of the transferor partner's tax benefits or burdens (attributable to the future deduction or income) to other partners."[51]

(b) Section 704(c)(1)(C)

Under section 704(c)(1)(C), which was enacted in 2004,[52] if "built-in loss" property is contributed to a partnership, the built-in loss is taken into account only in determining

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47 *See* Treas. Reg. § 1.704-3(a)(1).

48 Treas. Reg. § 1.704-3(a)(12).

49 To the extent that the built-in loss associated with a contingent liability exceeds the cost of satisfying the contingent liability, the excess creates a "ceiling rule" limitation. Treas. Reg. § 1.704-3(a)(12). Further, to the extent that a partnership properly capitalizes all or a portion of an item as described in Treas. Reg. § 1.704-3(a)(12), then the item or items to which such cost is properly capitalized is treated as section 704(c) property with the same amount of built-in loss as corresponds to the amount capitalized. Treas. Reg. § 1.704-3(a)(8)(iv).

50 Deficit Reduction Act of 1984, P.L. 98-369, §71(a).

51 Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84 (Dec. 31, 1984). For the same reasons discussed in this report, it appears that these items should attract a section 743(b) adjustment if a partner from whom the partnership assumed or took property subject to these types of items sells its interest when the partnership has a section 754 election in effect or has a "substantial built-in loss."

52 American Jobs Creation Act of 2004, P.L. 108-357.

the items allocated to the contributing partner, and, except as provided in regulations, in determining the amount of items allocated to the other partners, the basis of the contributed property is treated as being equal to its fair market value at the time of contribution. For this purpose, a "built-in loss" means the excess of the adjusted basis of the property in the hands of the contributing partner over its fair market value at the time of its contribution to the partnership. As discussed above, section 704(c)(1)(C), along with section 743(d) and section 734(d), was added to limit the ability to transfer losses among partners.[53]

In that regard, Treas. Reg. § 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner.[54] Thus, a purchaser of a partnership interest "steps into the shoes" of the transferor with respect to any section 704(c) amounts associated with the transferred partnership interest. This regulation, however, has not been amended to take into account the subsequent enactment of section 704(c)(1)(C). Notwithstanding the text of the regulation, therefore, if a partner contributes built-in loss property to a partnership and later transfers its partnership interest to another person, section 704(c)(1)(C) will generally prohibit the transferee from stepping into the shoes of the contributing partner with respect to that built-in loss.[55]

Significantly, however, Treas. Reg. § 1.752-7(c)(1)(i), which provides that sections 704(c)(1)(A) and (B),[56] section 737, and the regulations thereunder, apply to contingent liabilities, does *not* mention section 704(c)(1)(C). The preamble to the final Contingent Liability Regulations makes clear that this omission was deliberate. Indeed, in the preamble to those regulations, Treasury and the IRS specifically acknowledged the potential overlap between the

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53 H.R. Rep. No. 108-548, at 283(2004). For examples of transactions in which taxpayers attempted, unsuccessfully, to transfer losses in this fashion, see *Southgate Master Fund, LLC v. United States*, 659 F.3d 466 (5th Cir. 2011); *Long-Term Capital Holdings LP v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd 150 F. Appx. 40 (2d Cir. 2005); *Santa Monica Pictures, LLC v. Comm'r*, T.C. Memo 2005-104. *See also* Coordinated Issue Paper – Distressed Asset/Debt Tax Shelters, LMSB-04-0407-031 (Apr. 18, 2007) (describing a transaction involving contributions of distressed assets to a partnership to shift economic losses from a tax indifferent party to a U.S. taxpayer).

54 The last sentence of Treas. Reg. § 1.704-3(a)(7) contains an exception for liabilities described in Treas. Reg. § 1.752-7(e). As noted above, however, trade or business contingent liabilities are not subject to Treas. Reg. § 1.752-7(e).

55 The legislative history of section 704(c)(1)(C), however, indicates that in at least one situation – a transaction subject to section 381 (*e.g.*, a nontaxable liquidation under section 332) – the transferee of a contributing partner's interest in a partnership should be treated as if it were the contributor for purposes of section 704(c)(1)(C). *See* H.R. Rep. No. 108-755, at 402, note 546 (2004). The legislative history does not discuss other nontaxable transfers. In PLR 201127004 (Dec. 17, 2010), the IRS effectively allowed a corporate parent to be treated as the contributor after the original contributor, the parent's corporate subsidiary, distributed a partnership interest to the parent in a nontaxable liquidation under section 332.

56 Under section 704(c)(1)(B), if property described in section 704(c)(1)(A) is distributed, directly or indirectly, by the partnership (other than to the contributing partner) within seven years of the original contribution, the contributing partner must recognize the gain or loss it would have recognized under section 704(c)(1)(A) if the partnership had sold the property for its fair market value at the time of the distribution.

treatment of contingent liabilities in the regulations and the treatment of built-in losses under sections 704(c)(1)(C), 734, and 743:

> The IRS and the Treasury Department are aware of certain similarities between the treatment of § 1.752-7 liabilities in these regulations and the treatment of built-in losses under sections 704(c)(1)(C), 734, and 743 of the Code, as added by the Act. For example, it is possible to view the contribution of property with an adjusted tax basis equal to the fair market value of the property, determined without regard to any § 1.752-7 liabilities, as "built-in loss" property after the § 1.752-7 liability is taken into account in those cases where the § 1.752-7 liability is related to the contributed property. Although a partnership's assumption of a § 1.752-7 liability as part of the contribution of property to the partnership can be analogized to a property with an adjusted tax basis greater than fair market value, the purposes of section 704(c)(1)(C) and § 1.752-7 are different in certain respects. Section 704(c)(1)(C) and the other changes in section 833 of the Act [*i.e.*, the enactment of sections 734(d) and 743(d)] are directed toward loss duplication whereas § 1.752-7 is directed at both loss duplication and loss acceleration. Therefore, to the extent of any built-in loss attributable to a § 1.752-7 liability, § 1.752-7 shall be applied without regard to the amendments made by the Act, unless future guidance provides to the contrary. Any such guidance would be prospective in application.[57]

As of the date of this report, regulations under sections 704(c)(1)(C), 734(d), and 743(d) have not been issued. Accordingly, section 704(c)(1)(C) does not apply to contributed contingent liabilities.

III. Detailed Discussion

Based on the discussion above, it is clear that contingent liabilities qualify as property for purposes of section 704(c). It is also clear that sections 704(c), 743(b), and 755 are inextricably linked. In spite of this linkage, however, the regulations under sections 743 and 755 do not expressly provide that contingent liabilities also qualify as property for purposes of sections 743 and 755.[58] Nevertheless, we believe that contingent liabilities qualify as property

57 T.D. 9207, 70 Fed. Reg. 30334, 30336 (May 26, 2005).

58 For discussions of this issue, see Monte Jackel and Jerred Blanchard, *Reflections on Liabilities: Extension of New Law to Partnership Formations*, 91 Tax Notes 1579 (May 28, 2001) (suggesting that section 358(h) liabilities should be ignored in computing section 743(b) adjustments and alternatively proposing a basis reduction account for partners who contribute assets subject to section 358(h) liabilities to determine whether the basis of the partnership interest must be reduced when the interest is disposed of, and a basis reduction account for buyers of partnership interests to allow the buyers to claim future expense deductions attributable to the section 358(h) liability contributed by the seller); Monte Jackel & Suzanne Walsh, *Disguised Sales Revisited*, 114 Tax Notes 179

for these purposes as well. First, the policies underlying section 704(c) and section 743 are best served by treating contingent liabilities as property. Second, such treatment tends to harmonize the treatment of contingent liabilities with respect to a buyer of a partnership interest with the treatment of contingent liabilities with respect to a buyer in a direct purchase of assets. Third, such treatment is consistent with many of the other rules under subchapter K discussed above, including (i) section 751(a), which concerns the character of a partner's gain or loss from the sale of a partnership interest, (ii) section 752(d), which concerns the treatment of liabilities when a partnership interest is sold, and (iii) section 743(b), which generally gives the purchaser of a partnership interest a cost basis in its share of partnership assets.

The following discussion compares an asset purchase to the purchase of a partnership interest in detail. As discussed below, when the partnership has contingent liabilities, there may be significant timing differences depending on whether a purchaser acquires assets or an interest in a partnership. These differences are explored in three examples illustrating (i) the purchase of assets encumbered by a contingent liability, (ii) the purchase of a partnership interest from a partner who contributed a trade or business and an associated contingent liability to the partnership, and (iii) the purchase of a partnership interest after the partnership incurs (rather than assumes from a partner) a contingent liability.

A. Purchase of Assets

The following example discusses the treatment of an actual purchase of assets.

> ***Example 1. Purchase of Assets Encumbered by a Contingent Liability.*** E owned a trade or business with a gross fair market value of $5 million and adjusted basis of $3 million (nondepreciable capital assets with an aggregate adjusted basis and fair market value of $3 million and goodwill with a value of $2 million and an adjusted basis of zero) that was subject to a contingent liability of $2 million. The satisfaction of the contingent liability by E would have given rise to a deductible expense to E.
>
> In 2006, E sold the entire trade or business to F for $3 million. In 2007, F paid $2.25 million to satisfy the liability.

Under the approach to asset purchases discussed above, E's amount realized is $5 million, and E would recognize capital gain of $2 million. In addition, E is entitled to an

(Jan. 15, 2007) (asking whether basis adjustments should be allocated to contingent liabilities); Matthew Lay, *Can (or Must) Basis Adjustments Under Code Sec. 743(b) Be Allocated to Contingent Liabilities?*, 14 J. Passthrough Entities 7 (Nov.-Dec. 2011) (better view is that basis adjustments are allocated to contingent liabilities). Similar issues arise with respect to the allocation and recovery of basis adjustments under section 734(b).

immediate ordinary deduction of $2 million, resulting in no net income or loss.[59] F's initial cost basis is $3 million, which is then increased to $5.25 million when F pays the contingent liability.[60]

B. Purchase of Partnership Interest – Trade or Business Exception Applies

1. Facts

The following example illustrates the potential application of sections 743(b) and 755 to a contingent liability that is assumed by a partnership from a partner in connection with the transfer of a trade or business with which the contingent liability is associated.

> ***Example 2. Purchase of Partnership Interest from Partner Who Contributed Trade or Business and Associated Contingent Liability to Partnership.*** In 2004, X, Y, and Z formed LLC, which is classified as a partnership for federal income tax purposes. X contributed capital assets consisting of an entire trade or business with an aggregate fair market value of $5 million subject to a contingent liability of $2 million in exchange for a 25% interest in LLC. (The satisfaction of the contingent liability by X would have given rise to a deductible expense to X.) The assets contributed by X consisted of nondepreciable capital assets with an aggregate adjusted basis and fair market value of $3 million and goodwill with a value of $2 million and an adjusted basis of zero.[61] LLC continues to carry on the trade or business contributed by X. Y contributed $3 million cash in exchange for a 25% interest in LLC, and Z contributed $6 million cash in exchange for a 50% interest in LLC.
>
> In 2006, when LLC had a section 754 election in effect, X sold its interest in LLC to W, an unrelated person, for $3 million. At the time of the sale, the basis of X's LLC interest was $3 million, the remaining built-in loss associated with the contingent liability was $2 million, and LLC had no liabilities (as defined in Treas. Reg. § 1.752-1(a)(4)(i)).

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[59] *See James M. Pierce Corp. v. Comm'r*, 326 F.2d 67 (8th Cir. 1964); *see generally* Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶304.02 (2012); Glenn R. Carrington, *Tax Accounting in Mergers and Acquisitions*, ¶403.3.2.2 (2010).

[60] *See David R. Webb Co., Inc. v. Comm'r*, 708 F.2d 1254 (7th Cir. 1983); *Pacific Transport Company v. Comm'r*, 483 F. 2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974). Under the alternate approach proposed in the 1990 NYSBA Report, E's amount realized would be $3 million and F would be able to deduct the $2.25 million that F pays to satisfy the liability when it satisfies that liability.

[61] For purposes of Example 2, assume that the goodwill is not amortizable by LLC.

In 2007, LLC paid $3 million to satisfy the contingent liability.

2. Consequences to Seller

Because X contributed the entire trade or business with which the contingent liability was associated to LLC, and LLC carried on that trade or business, the trade or business exception in Treas. Reg. § 1.752-7(d)(2)(i) applies. Therefore, the special rules relating to transfers of partnership interests in Treas. Reg. § 1.752-7(e) do not apply, and X's basis in the LLC interest is *not* reduced by the contingent liability reduction described in Treas. Reg. § 1.752-7(b)(7). As a result, X recognizes no net gain or loss on the sale of its LLC interest to W (*i.e.*, the excess of X's adjusted basis, $3 million, over X's amount realized, $3 million). If, immediately before X sold its interest to W, LLC sold all of its assets for their fair market values and satisfied the contingent liability, LLC would be entitled to claim a $2 million deduction, all of which would be allocated to X under section 704(c) principles. Therefore, although there is no authority directly on point, it follows that, under Treas. Reg. § 1.751-1(a)(2), X would recognize a $2 million ordinary loss on the sale of X's interest to W, as well as $2 million of capital gain (*i.e.*, X's net income or loss before taking section 751(a) into account, $0, minus X's ordinary loss under section 751(a), <$2 million>).

3. Amount of Purchaser's Section 743(b) Adjustment

W's initial adjusted basis in the LLC interest is $3 million. Under Treas. Reg. § 1.704-3(a)(7), W steps into X's shoes with respect to the built-in gain in the goodwill ($2 million) and the built-in loss in the contingent liability ($2 million). Until further guidance is issued, the contingent liability is not treated as built-in loss property for purposes of section 704(c)(1)(C).

Because LLC has a section 754 election in effect, LLC must adjust the basis of its assets with respect to W.[62] In the hypothetical transaction described in Treas. Reg. § 1.743-1(d), W would receive $3 million in liquidation of LLC and be allocated all of the $2 million gain

[62] Treasury and the IRS should consider clarifying that contingent liabilities are taken into account when determining if a partnership has a substantial built-in loss under section 743(d). As noted above, section 743(d) determines whether a partnership has a substantial built-in loss based on the difference between the partnership's adjusted basis in partnership property and the fair market value of such property. Because contingent liabilities generally have no basis and a negative value, it may not be apparent how to account for contingent liabilities under section 743(d). Not treating contingent liabilities as built-in loss properties for purposes of section 743(d) would undermine the purpose of section 743(d), which generally is to limit the ability to transfer losses among partners once a threshold (*i.e.*, a built-in loss in partnership property of more than $250,000) is met. For example, assume that a partnership owns land with a fair market value and adjusted basis of $5 million and has a contingent liability of $1 million. Assume further that if the partnership satisfied the contingent liability for $1 million, the partnership would be entitled to claim a $1 million deduction and that deduction would be properly allocated in part to a transferee partner. If the partnership were not required to adjust the basis of partnership property after the transfer of an interest in the partnership, the existing partners would be able to transfer a portion of the built-in deduction in the contingent liability to a transferee partner. In such a situation, the partnership should be treated as having a substantial built-in loss (and thus be required to adjust the basis of its property) because, after the contingent liability is taken into account, the partnership's adjusted basis in partnership property ($5 million) would exceed the fair market value of that property ($4 million) by more than $250,000.

resulting from the disposition of the goodwill and a $2 million deduction resulting from the deemed satisfaction of the contingent liability.[63] Therefore, W's share of the adjusted basis of partnership property, as determined under Treas. Reg. § 1.743-1(d), would equal W's interest in the partnership's previously taxed capital of $3 million (the amount of cash that W would receive on a liquidation of LLC, $3 million, increased by the amount of tax loss that would be allocated to W in the hypothetical transaction, $2 million, and reduced by the amount of tax gain that would be allocated to W in the hypothetical transaction, $2 million). Therefore, LLC would make a net basis adjustment under section 743(b) of $0 (the difference between W's basis in its LLC interest, $3 million, and W's interests in LLC's previously taxed capital, $3 million).[64]

4. Allocation of Purchaser's Section 743(b) Adjustment Among LLC's Assets

W's net section 743(b) adjustment of $0 must be allocated among LLC's assets under Treas. Reg. § 1.755-1.[65] Under Treas. Reg. § 1.755-1(b)(2), the amount of W's section 743(b) adjustment that is allocated to *ordinary income property* is equal to the total amount of income or loss that would be allocated to W from the sale of all ordinary income property in a hypothetical transaction. If the contingent liability is treated as property for this purpose, presumably it would be treated as ordinary income property, because the contingent liability is

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63 Under Treas. Reg. § 1.743-1(d), the starting point for determining the transferee's share of the adjusted basis of partnership property is the amount of cash that the transferee would receive on a liquidation of the partnership following the hypothetical transaction described in that paragraph of the regulation. The regulation clearly provides that partnership liabilities reduce the amount of cash received by the transferee. *See* Treas. Reg. § 1.743-1(d)(3), Example 1. Further, the regulation also clearly provides that the partnership distributes the cash in "liquidation of the partnership" (as opposed to in liquidation of only the transferee's interest in the partnership). In the course of liquidating, a partnership normally would satisfy its known obligations. As a result, the partnership should be deemed to satisfy any contingent liability that the partnership is aware of at the time of the hypothetical liquidation. Any loss or expense that would be recognized from the deemed satisfaction of a contingent liability should be taken into account in determining a transferee's share of the adjusted basis of partnership property because, as discussed above, we believe that contingent liabilities are treated as partnership property for purposes of section 743. The general purpose of section 743 reinforces this interpretation of Treas. Reg. § 1.743-1(d). Specifically, section 743(b) effectively gives the transferee a "cost basis" in its allocable share of the partnership's assets. Example 2 of this report demonstrates that this result generally is not achieved if a transferee's share of the partnership's contingent liabilities are not taken into account in computing and allocating the transferee's section 743(b) adjustment.

64 The amount of W's section 743(b) adjustment, and the properties to which that adjustment must be allocated, generally must be determined based on the fair market values of LLC's assets and the amounts of LLC's fixed and contingent liabilities, rather than the amounts at which those assets and liabilities are reflected on LLC's books for purposes of the section 704(b) regulations. Therefore, these calculations would be the same regardless of whether LLC revalued its property under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) before W's purchase of X's interest in LLC.

65 To determine the value of LLC's goodwill, LLC must determine "partnership gross value" under Treas. Reg. § 1.755-1(a)(4) (*i.e.*, the amount that, if assigned to all partnership property, would result in a liquidating distribution to W of $3 million, W's outside basis). This amount would be $14 million (the amount that the partnership would need to sell its assets for in order to distribute $3 million to W, a 25% partner, after settling the contingent liability for $2 million). The deemed value of the goodwill would be $2 million (the amount by which partnership gross value, $14 million, exceeds the value of LLC's cash and other assets ($12 million)).

neither a capital asset nor a section 1231 asset. Thus, a negative $2 million basis adjustment would be allocated to the contingent liability.

Under Treas. Reg. § 1.755-1(b)(2), the amount of the basis adjustment that is allocated to *capital gain property* generally is the amount of the basis adjustment, less the amount allocated to ordinary income property. Here, W's net section 743(b) adjustment is $0, and a <$2 million> basis adjustment was allocated to ordinary income property. Therefore, a positive $2 million basis adjustment would be allocated to capital gain property ($0 minus <$2 million>). This amount would be allocated entirely to the goodwill under Treas. Reg. § 1.755-1(b)(3)(ii). W would therefore be treated as acquiring an amortizable section 197 intangible for $2 million at the time of W's purchase of X's interest, and the basis adjustment would be amortized over 180 months.[66]

In contrast, if the contingent liability is ***not*** treated as property for purposes of section 755, then no adjustment would be made to the contingent liability, nor would any adjustment be made to LLC's capital gain property. In that event, if all of LLC's assets were sold immediately after W's purchase for their aggregate fair market value and the contingent liability were settled, W would be allocated $2 million of gain from LLC's sale of goodwill and a $2 million ordinary deduction.[67]

5. Satisfaction of the Contingent Liability

LLC is entitled to a deduction of $3 million upon the satisfaction of the contingent liability. This deduction must be allocated to W to the extent of the remaining built-in loss associated with the contingent liability ($2 million). The $1 million amount by which the cost of satisfying the contingent liability ($3 million) exceeds the remaining built-in loss associated with the contingent liability ($2 million) is shared among the partners under section 704(b) ($250,000 to Y, $500,000 to Z, and $250,000 to W). W's share of the deduction, however, would be offset by any negative basis adjustment that was allocated to the contingent liability.[68] Thus, if a negative basis adjustment of $2 million is allocated to the contingent liability, then the net deduction allocated to W would be $250,000 ($2,250,000 minus $2 million). In contrast, if no

[66] *See* Treas. Reg. § 1.197-2(g)(3). Similarly, if the positive basis adjustment had been allocated to depreciable property under section 168, the additional basis would have been taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs. Treas. Reg. § 1.743-1(j)(4)(B)(*1*).

[67] If, however, the contingent liability were not taken into account for purposes of determining the amount of the section 743(b) adjustment *and* not treated as property for purposes of section 755, W would have a $2 million positive section 743(b) adjustment allocable to the goodwill. The positive basis adjustment results from the decrease in W's share of LLC's inside basis (*i.e*., W's share of previously taxed capital). Specifically, if the contingent liability does not give rise to a loss, W's share of previously taxed capital would be $1 million (the amount of cash that W would receive on a liquidation of LLC, $3 million, reduced by the amount of tax gain that would be allocated to W in the hypothetical transaction, $2 million). This share of inside basis would result in a $2 million positive section 743(b) adjustment (the difference between W's outside basis in its LLC interest, $3 million, and W's share of LLC's inside basis, $1 million). That adjustment would be allocated to the goodwill under the rules discussed above.

[68] Treas. Reg. § 1.743-1(j)(4)(ii)(A).

basis adjustment is allocated to the contingent liability, then W's distributive share of LLC's deduction would be $2,250,000.

C. Purchase of Partnership Interest After Partnership Incurs a Contingent Liability

1. Facts

The following example illustrates the potential application of sections 743(b) and 755 to a contingent liability in the context of the purchase of a partnership interest that occurs after the contingent liability is incurred by the partnership.[69]

> ***Example 3. Purchase of Partnership Interest after Partnership Incurs a Contingent Liability.*** In 2004, X, Y, and Z formed LLC, which is classified as a partnership for federal income tax purposes. X and Y each contributed $3 million cash in exchange for a 25% interest in LLC, and Z contributed $6 million cash in exchange for a 50% interest in LLC.
>
> In 2006, when LLC had a section 754 election in effect, X sold its interest in LLC to W, an unrelated person, for $3 million. At the time of the sale, the basis of X's LLC interest was $3 million, and LLC had no liabilities (as defined in Treas. Reg. § 1.752-1(a)(4)(i)). LLC's assets consisted of nondepreciable capital assets with an aggregate adjusted basis and fair market value of $12 million and goodwill with a fair market value of $8 million and an adjusted basis of zero. LLC also had a contingent liability of $8 million, the satisfaction of which would have given rise to a deductible expense to LLC.
>
> In 2007, LLC paid $9 million to satisfy the contingent liability.

2. Consequences to Seller

LLC's contingent liability was not assumed by LLC in connection with a contribution of property under section 721(a). Therefore, the special rules relating to transfers of partnership interests in Treas. Reg. § 1.752-7(e) do not apply. X recognizes no net gain or loss on the sale of the LLC interest to W (because X's adjusted basis, $3 million, is equal to X's amount realized). If, immediately before X sold its interest to W, LLC sold all of its assets for their fair market values and satisfied the contingent liability, LLC would be entitled to claim an $8 million deduction, $2 million of which would be allocated to X under section 704(b). Therefore, although there is no authority directly on point, under Treas. Reg. § 1.751-1(a)(2), we believe X should recognize a $2 million ordinary loss on the sale of X's interest to W, as well as

[69] For purposes of Example 3, assume that the goodwill is not amortizable by LLC.

$2 million of capital gain (*i.e.*, X's net income or loss before taking section 751 into account, $0, minus X's ordinary loss under section 751, <$2 million>).

3. Amount of Purchaser's Section 743(b) Adjustment

W's initial adjusted basis in the LLC interest acquired from X is $3 million. In the hypothetical transaction described in Treas. Reg. § 1.743-1(d), W would receive $3 million in liquidation of LLC and be allocated $2 million of gain resulting from the disposition of the goodwill. In addition, the LLC should also be treated as satisfying the contingent liability, giving rise to an $8 million deduction, $2 million of which would be allocated to W under section 704(b). Just as in Example 2, therefore, W's share of the adjusted basis of partnership property would equal W's interest in the LLC's previously taxed capital of $3 million, resulting in a net basis adjustment under section 743(b) of $0.[70]

4. Allocation of Purchaser's Section 743(b) Adjustment Among LLC's Assets

W's net section 743(b) basis adjustment of $0 would be allocated among LLC's assets under Treas. Reg. § 1.755-1 in the same manner as W's net basis adjustment in Example 2.

As in Example 2, if the contingent liability is *not* treated as property for purposes of section 755, then no adjustment would be made to the contingent liability or to LLC's capital gain property. Accordingly, if all of LLC's assets were sold immediately after W's purchase for their aggregate fair market value and the contingent liability were settled, W would be allocated $2 million of gain from LLC's sale of goodwill and a $2 million ordinary deduction.[71]

5. Satisfaction of the Contingent Liability

LLC is entitled to a deduction of $9 million upon the satisfaction of the contingent liability. This deduction is shared among the partners under section 704(b) ($2.25 million to W, $2.25 million to Y, and $4.5 million to Z). W's share of the deduction, however, would be offset by any negative basis adjustment that was allocated to the contingent liability.[72] Thus, if a negative basis adjustment of $2 million is allocated to the contingent liability, the net deduction allocated to W would be $250,000 ($2.25 million minus $2 million). In contrast, if no basis adjustment is allocated to the contingent liability, then W's distributive share of LLC's deduction would be $2,250,000.

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[70] *See* Treas. Reg. § 1.743-1(d); *see also* note 64, *supra*.

[71] For a discussion of the consequences if the contingent liability were also not treated as property for purposes of section 755, see *supra* note 67.

[72] Treas. Reg. § 1.743-1(j)(4)(ii)(A).

D. Additional Observations Regarding Examples 2 and 3

1. Purchaser's Share of the Partnership's Built-In Loss

Allocating (or not allocating) a basis adjustment under section 743(b) to a contingent liability has a significant impact on the transferee. Examples 2 and 3 illustrate that for every dollar of negative adjustment that is allocated to the contingent liability, the transferee partner receives an offsetting positive adjustment to other partnership assets. Specifically, if $2 million of W's section 743(b) adjustment is allocated to LLC's contingent liability, then W's distributive share of LLC's deduction for satisfying that liability would be reduced by $2 million, resulting in a *positive* basis adjustment of $2 million to LLC's capital gain assets. W would not be permitted to receive the benefit of X's built-in loss in the contingent liability and would not be subject to X's share of built-in gain in the partnership's goodwill at the time of the purchase. In contrast, if none of W's section 743(b) adjustment is allocated to LLC's contingent liability, then W's distributive share of LLC's deduction for satisfying that liability would be $2.25 million, and LLC would not adjust the basis of LLC's other assets. Not only would this permit W to receive the benefit of X's built-in loss in the contingent liability, but it also would subject W to X's share of built-in gain in the partnership's goodwill.

In Examples 2 and 3, allowing W to be allocated any part of the built-in deduction would undermine the purposes of section 743(b) as well as sections 743(d) and 704(c)(1)(C), both of which were enacted to prevent taxpayers from shifting built-in losses from one partner to another by transferring partnership interests. Allowing W to be allocated any part of the built-in deduction also would undermine the purposes of section 358(h) and Treas. Reg. § 1.752-7, which were designed to prevent the acceleration and duplication of losses. We believe that these reasons alone are sufficient to support the recommendations in this report. Moreover, allocating part of W's section 743(b) adjustment to the contingent liabilities in these examples approximates the tax consequences of purchasing assets and purchasing a partnership interest. If part of W's section 743(b) adjustment is allocated to the contingent liabilities, then W will not be entitled to claim its share of the built-in deduction existing at the time of W's purchase, just as a buyer in a purchase of assets would not be entitled to deduct payments of contingent liabilities assumed from the seller.

We believe that in both Example 2 and Example 3, a portion of W's section 743(b) adjustment is properly allocable to the contingent liability. We therefore recommend that Treasury and IRS issue guidance confirming that contingent liabilities qualify as built-in loss property for purposes of computing basis adjustments under section 743(b) following the sale of a partnership interest and allocating those adjustments among partnership assets under section 755, regardless of whether the partnership has revalued its property and regardless of whether (i) the partnership previously assumed (or took property subject to) those contingent liabilities from a partner, or (ii) the contingent liabilities originated in the partnership before the sale.[73]

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73 We note that the applicable rules are very complicated, and there has been no administrative guidance directly addressing this issue. Because some taxpayers may not be aware that section 743(b) adjustments should be allocated to contingent liabilities, Treasury and the IRS should consider whether this guidance should be prospective

2. Timing of Resulting Basis Adjustments

Unlike the consequences in a direct asset purchase, however, the corresponding basis step up with respect to LLC's other assets occurs *before* LLC actually satisfies the contingent liability. Specifically, because W in Examples 2 and 3 is allocated a positive adjustment to goodwill, W is permitted under current law to amortize that positive adjustment over the 180-month period that begins on the date of W's purchase of X's interest in ***2006***. We believe this treatment is unwarranted because W would not have been permitted an immediate basis step up in a direct purchase of assets. We note that in Example 1 above, F's initial cost basis was $3 million. F's basis was increased by the additional $2.25 million in ***2007,*** when the assumed contingent liability was satisfied for this amount.[74]

Thus, under current law, the partnership rules governing the calculation of basis adjustments under section 743(b) and the allocation of those adjustments among partnership assets allow the purchaser of a partnership interest to benefit from an immediate basis step up attributable to contingent liabilities before those liabilities are even satisfied. To address this issue, we recommend that Treasury and the IRS issue guidance that would disregard contingent liabilities in the calculation of basis adjustments under section 743(b) and the allocation of those adjustments among the partnership's assets under section 755 until the contingent liabilities are satisfied, either in whole or in part (the "Suspended Adjustment Recommendation").[75]

In Examples 2 and 3, if the Suspended Adjustment Recommendation is adopted, W's initial section 743(b) adjustment still would be $0. For purposes of allocating this basis adjustment among LLC's assets under section 755, however, W's positive basis adjustment would be suspended until the basis adjustment to the contingent liability is recovered. When the

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only. If guidance is prospective only, however, we believe that taxpayers should be permitted to rely on that guidance for periods before the effective date of the guidance.

[74] Because of this difference, taxpayers have a tax preference for acquiring a partnership interest rather than acquiring assets. For example, a taxpayer otherwise contemplating an asset purchase may propose that the seller first contribute the assets to a newly formed partnership (the other partner in which may be a person related to the seller) and then sell the partnership interest (or, in concert with an affiliate of the purchaser, both partnership interests) to the taxpayer.

[75] Note that this recommendation would prevent transferees from claiming the benefit of a built-in loss only in situations in which the partnership either has an election under section 754 in effect or has a substantial built-in loss. If neither of these conditions is satisfied, the transferee would be entitled to claim its distributive share of any resulting deductions. In this regard, contingent liabilities are treated in the same manner as other property having a built-in gain or a built-in loss following the transfer of a partnership interest. For example, a partnership might hold inventory with a basis in excess of value when a partnership interest is purchased. If that partnership does not have an election under section 754 in effect and does not have a substantial built-in loss, then the transferee partner would be entitled to claim its distributive share of any ordinary loss resulting from the sale of such inventory.

contingent liability is satisfied in 2007, W would be entitled to increase its adjusted basis in the LLC's assets by the amount of the negative basis recovered at that time.[76]

To the extent that an increase in basis is allocated to depreciable or amortizable property when the contingent liability is satisfied, the increase generally would be amortized or depreciated over the recovery period that would have remained if that increase had been placed in service at the time of the original transfer.[77] Assume, for example, that the contingent liability is satisfied 12 months after the interest was purchased. Since a positive adjustment that was allocated to goodwill would have been amortized over 180 months if it had been placed in service at the time of the purchase, a suspended adjustment that is allocated to goodwill under the Suspended Adjustment Recommendation would be amortized over 168 months (180 months less 12 months).[78]

3. Alternatives for Addressing How and When to Calculate Transferee's Basis Adjustment under the Suspended Adjustment Recommendation

Another significant difference between a purchase of assets and a purchase of a partnership interest is that the current partnership rules allow the purchaser of a partnership interest to deduct payments made to satisfy contingent liabilities to the extent that (i) the amount necessary to satisfy the liability is greater than the amount of the contingent liability when the interest was purchased and (ii) the deduction attributable to that payment is allocated to the purchaser of the partnership interest. In Examples 2 and 3, the contingent liability was satisfied for more than the amount of the built-in loss attributable to the contingent liability on the date of the purchase. LLC was therefore permitted to allocate part of the "excess" deduction to W, the transferee partner, under section 704(b). If W had instead purchased all of the LLC's assets, W would have been required to capitalize any excess payments. Conversely, under current law, if the contingent liability had been satisfied for *less* than the amount of the built-in loss attributable to the contingent liability on the date of the purchase, W would have been required to report the difference as current income. If W had instead purchased all of the partnership's assets, W would have claimed a smaller basis step up in the purchased assets.

If the Suspended Adjustment Recommendation is accepted, we believe that future guidance should provide rules for determining how and when the transferee's basis adjustment is calculated and allocated among the partnership's assets. We discuss below three possible alternatives.

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76 The following section discusses three alternative approaches to addressing how and when to calculate and allocate the transferee's basis adjustment if the Suspended Adjustment Recommendation is adopted.

77 As noted above, the rules for determining the recovery period of a basis adjustment under section 743(b) are in Treas. Reg. § 1.743-1(j)(4).

78 Treas. Reg. § 1.197-2(f)(2) (any amount that is properly included in the basis of an amortizable section 197 intangible after the first month of the 15-year period described in Treas. Reg. § 1.197-2(f)(1)(i) and before the expiration of that period is amortized ratably over the remainder of the 15-year period).

(a) Purchase Date Approach

Under one possible approach, the amount of a purchaser's basis adjustment would be determined on the date of purchase, but would not be adjusted if the contingent liability is later satisfied for a different amount (the "Purchase Date Approach"). If this approach were adopted, in the facts of Examples 2 and 3, W's basis adjustment would be calculated on the date of purchase regardless of the ultimate settlement amount.

For example, assume in Example 2 that LLC satisfied the entire liability for $750,000 rather than $2 million, and that W's distributive share of the resulting deduction was $750,000. Under the Purchase Date Approach, W would be allocated a $750,000 deduction, and $750,000 of W's negative basis adjustment allocated to the contingent liability would offset that amount. The remaining $1.25 million of W's original basis adjustment would result in current income to W.

(b) Hold Open Approaches

Because W would not be permitted under the Suspended Adjustment Recommendation to increase the basis of its assets until the contingent liability is settled, it seems inappropriate (and unnecessary) to require a fixed and irrevocable determination of those future adjustments as of the purchase date, as is the case under current law. Indeed, as noted above, the Purchase Date Approach could be potentially punitive to the transferee partner if the contingent liability is ultimately settled for less than was anticipated when the transferee acquired its interest. For these reasons, we believe the amount of the basis adjustment should be "held open" until the contingent liability becomes fixed.[79] When the contingent liability becomes fixed, a negative basis adjustment would arise at that time, and the amount of that adjustment would be determined by the amount of the contingent liability that becomes fixed.

Under one version of this approach (the "Hold Open With Cap Approach"), the amount of the adjustment that would arise when the contingent liability becomes fixed would be "capped" by the transferee's share of the built-in loss in the contingent liability when the interest is purchased. Under another version of this approach (the "Hold Open Without Cap Approach"), the amount of the adjustment that would arise when the contingent liability becomes fixed would *not* be "capped" by the transferee's share of the built-in loss in the contingent liability when the interest is purchased but instead would equal the deduction that the transferee would be allocated if the liability was satisfied on the date it becomes fixed.

For example, assume in Example 2 that LLC satisfied the entire liability for $750,000 and that W's distributive share of the resulting deduction was $750,000. If the amount of the basis adjustment was held open until the contingent liability became fixed, then LLC

[79] *Cf.* PLR 9715008 (Dec. 4, 1996) (the transferee's basis in its partnership interest, and thus the transferee's basis adjustment under section 743(b) with respect to the transferred interest, was adjusted when the transferee made purchase price payments that were based on the net profits of the partnership for a certain number of years following the transfer).

would allocate a negative basis adjustment of $750,000 to the contingent liability at that time, as well as a positive $750,000 adjustment to LLC's goodwill. Although W would be allocated a $750,000 deduction, W's $750,000 negative basis adjustment allocated to the contingent liability would offset that amount. To the extent that W's positive basis adjustment of $750,000 is allocated to depreciable or amortizable property, W would recover the adjustment over the recovery period that would have remained if the increase had been placed in service at the time of the original transfer.[80] Because the amount of the adjustment that would arise when the contingent liability becomes fixed is less than the transferee's share of the built-in loss in the contingent liability when the interest was purchased, these results would be the same under both "Hold Open" approaches.

In contrast, if LLC satisfied the entire liability for $3 million, W's distributive share of the resulting deduction would be $2.25 million. Under the Hold Open With Cap Approach, LLC would allocate a negative basis adjustment of $2 million (the lesser of W's distributive share of the resulting deduction or the amount of W's share of built-in loss in the contingent liability on the date of W's purchase of X's interest) to the contingent liability at that time, as well as a positive $2 million adjustment to LLC's goodwill. Although W would be allocated a $2.25 million deduction, W's $2 million negative basis adjustment that was allocated to the contingent liability would partially offset that amount. The net effect to W would be a $250,000 deduction. To the extent that W's positive basis adjustment of $2 million is allocated to depreciable or amortizable property, W would recover the adjustment over the property's recovery period that would have remained if that increase had been placed in service at the time of the original transfer.[81]

Under the Hold Open Without Cap Approach, LLC would allocate a negative basis adjustment of $2.25 million to the contingent liability at that time, as well as a positive $2.25 million adjustment to LLC's goodwill. Although W would be allocated a $2.25 million deduction, W's $2.25 million negative basis adjustment allocated to the contingent liability would entirely offset that amount. To the extent that W's positive basis adjustment of $2.25 million is allocated to depreciable or amortizable property, W would recover the adjustment over the property's recovery period that would have remained if that increase had been placed in service at the time of the original transfer.[82]

The Hold Open Without Cap Approach most closely approximates the tax consequences that result from the purchase of assets because the purchaser is not permitted to

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80 If, at the time the adjustment arises, that period has ended or the property has been disposed of, the adjustment otherwise allocable to that property would be recovered immediately.

81 As noted above, if at the time the adjustment arises, that period has ended or the property has been disposed of, the adjustment otherwise allocable to that property would be recovered immediately.

82 Under both "Hold Open" approaches, the basis adjustments that arise when a contingent liability becomes fixed would be allocated only to the property owned by the partnership at the time of the transfer that gave rise to the basis adjustments. If, after the transfer but before the contingent liability becomes fixed, the partnership disposes of property to which a basis adjustment would have been allocated when the contingent liability became fixed, then, when the contingent liability becomes fixed, the transferee would recognize a loss, the character of which would be determined under the principles of *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952).

deduct any part of the contingent liability, and the amount of any increase to basis in partnership assets is tied both in time and amount to the satisfaction of that liability. This approach, however, would represent a change from the manner in which contingent liabilities are treated under the Contingent Liability Regulations. Under those regulations, as described above, any deduction in excess of the built-in loss when a contingent liability is assumed (or taken subject to) by the partnership from a partner generally may be allocated among the partners under section 704(b).

It should be noted that the purchaser of a partnership interest (W in Examples 2 and 3) is not the only partner to receive the benefit of the excess deduction to the partnership (*i.e.*, the excess of the cost of satisfying the liability over its built-in loss on the date of the purchase of a partnership interest). For example, in Examples 2 and 3, existing partners Y and Z would also be allocated a share of the deduction. Similar issues would arise if a new investor ("V") acquired an interest in LLC by contributing cash or property in exchange for an interest.[83] In such a case, a portion of the excess deduction also could be allocated to V. In principle, none of W, Y, Z, or V should be entitled to the excess deduction. However, the rules that would be necessary to prevent anyone other than the original contributor from claiming the excess deduction would be very complicated.[84] If the Hold Open Without Cap Approach were applied to deny purchasers of partnership interests from being allocated any deduction attributable to the contingent liabilities of the partnership, we would expect similar rules to be drafted that would ensure that only the contributor of the contingent liability would be permitted to claim a current deduction when the contingent liability becomes fixed and would require that any amounts allocable to other partners would be capitalized, with any resulting amortization allocable to those partners under section 704(c) principles. If the treatment of these types of partners is not conformed, then taxpayers would have an incentive to invest in a partnership by contribution rather than by purchase from an existing partner solely to achieve more favorable tax treatment.[85]

The Hold Open With Cap Approach would preserve the distinction that the Contingent Liability Regulations have drawn between the amount of built-in loss in a contingent liability when it is assumed or taken subject to by a partnership, which are allocated under section 704(c), and any increases in that amount, which are allocated under section 704(b). If future guidance adopts this approach, no additional guidance would be necessary to ensure that partners who acquire their interests by contribution and by purchase are treated in the same manner.

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83 A contribution to an existing partnership is economically very similar to acquiring part of each existing partner's interest. *Cf*. Treas. Reg. § 1.197-2(h)(12)(v)(B).

84 In addition, the notion that the purchaser never should be able to deduct payments for contingent liabilities arguably is not correct, as we explained in the 1990 NYSBA Report.

85 If different rules apply depending upon whether a partner acquires its interest in the partnership by contribution or transfer, then the interests in the partnership would also not be fungible even if the partnership adopts the remedial method for curing ceiling limitations under section 704(c) and makes a section 754 election. As Treasury and the IRS are already aware, lack of fungibility raises serious compliance issues for publicly traded partnerships.