NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

APPLICATION OF TREAS. REG. § 1.267(B)-1(B)

TO

RELATED PARTY LOSS TRANSACTIONS

August 29, 2012

Report No. 1271

New York State Bar Association Tax Section

Report on the Application of Treas. Reg. § 1.267(b)-1(b) to Related Party Loss Transactions

This report (the "Report")[1] addresses whether the loss disallowance rule in Treas. Reg. § 1.267(b)-1(b) (the "267(b) Regulations") should be withdrawn in light of subsequent amendments to Sections 267(b) and 707(b) of the Code.[2]

The 267(b) Regulations treat a partnership as an aggregate of its partners for purposes of Section 267(a) and provide that any transaction between a partnership and a person other than a partner (a "non-partner") will be considered as occurring between the non-partner and the members of the partnership separately. If the non-partner and any member of the partnership fall into any of the categories of related parties described in Section 267(b), the portion of any loss on the sale or exchange that is deemed to occur between the non-partner and the related member of the partnership is either disallowed or deferred under Section 267.

The Report begins with a short history of the statutory provisions and case law governing related party loss transactions that first led the Treasury Department ("Treasury") and Internal Revenue Service ("IRS") to issue the 267(b) Regulations in 1958 and then led Congress to amend Sections 267(b) and 707(b) to apply to certain related party loss transactions involving partnerships. The second part of the Report

---

1 The principal author of this Report is Peter F.G. Schuur. Substantial contributions were made by Crosby A. Sommers. Helpful comments were received from Kimberly S. Blanchard, Michael S. Farber, Lawrence Garrett, Stephen B. Land, Matthew Lay, Andrew W. Needham, Amanda H. Nussbaum, Elliot Pisem, Yaron Z. Reich, David H. Schnabel, Eric B. Sloan and Michael L. Schler. The Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

2 References in the Report to "Section(s)", unless otherwise stated or the context otherwise indicates, are to sections of the Internal Revenue Code of 1986, as amended (the "Code") and the regulations thereunder.

discusses the subsequent amendments to Sections 267(b) and 707(b) that codified the entity treatment of partnerships under Section 267 and that expanded the statutory loss disallowance rules to cover many of the same transactions that led to the issuance of the 267(b) Regulations. The third part of the Report discusses the application of the 267(b) Regulations following these amendments to two categories of loss transactions involving partnerships: loss transactions to which these conflicting sets of rules overlap and loss transactions to which only the 267(b) Regulations apply. In both cases, we believe that loss disallowance under the Section 267(b) Regulations is inconsistent with the entity approach of the statutory amendments to Sections 267(a)(1) and 707(b) that followed their promulgation. We therefore recommend that Treasury withdraw the 267(b) Regulations.[3]

1. The 267(b) Regulations: Background and Subsequent Developments

Early statutory provisions. In 1934, Congress enacted Section 24(a)(6), the statutory predecessor to Section 267, to close a "loophole of tax avoidance" involving loss transactions between members of a family and loss transactions between shareholders and their closely-held corporations.[4] Section 24(a)(6) disallowed deductions for losses on the sale or exchange of property between family members or between an individual and a corporation in which the individual owned, directly or indirectly, more than 50% by value of the outstanding stock. The constructive ownership rules then in effect attributed to an individual any stock owned, directly or indirectly, by the individual's family members.[5]

---

[3] One commentator recently argued that the 267(b) Regulations have been invalid ever since the amendments to Sections 267(b) and 707(b) described in this Report. *See* D. Kahn, *Sales Between a Partnership and Non-Partners*, 136 Tax Notes 827 (2012) (concluding that the 267(b) Regulations have been invalid since 1986 to the extent they apply to Section 267(a)(1)). This Report expresses no view on whether the 267(b) Regulations are valid under current law.

[4] *See* H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934); S. Rep. No. 558, 73d Cong., 2d Sess. (1934).

[5] § 24(a)(6) (1934).

In 1937, Congress moved the related party loss disallowance rules to Section 24(b) and expanded the category of related parties to include two corporations if more than 50% of the value of the outstanding stock of each corporation was owned by or for the same individual.[6] Congress also expanded the constructive ownership rules to provide, among other things, that an individual owning stock in a corporation was attributed stock owned in the same corporation, directly or indirectly, by his or her partner and that stock owned, directly or indirectly, by or for a corporation or partnership was attributed proportionately to its shareholders or partners.[7] Section 24(b) did not treat a partnership and a corporation as related parties. The legislative history, however, noted that the amendment to Section 24 did not imply any legislative sanction for claiming losses in a transaction not subject to the express statutory language of Section 24(b) if the transaction lacked the elements of good faith or finality.[8]

<u>Case law treating partnerships as aggregates for purposes of loss disallowance rules</u>. In 1948, the Second Circuit ruled in *Commissioner v. Whitney* that the loss disallowance provisions of Section 24(b) applied to transactions between a partnership and a corporation.[9] In *Whitney*, J.P. Morgan & Co. Incorporated purchased all of the assets and assumed all of the liabilities of the J.P. Morgan & Co. partnership, including assets with built-in losses. The corporation was controlled by the thirteen partners of the partnership. The court rejected the taxpayers' contention that a partnership should be treated as an entity for purposes of Section 24(b), concluding instead that a partnership should be treated as an aggregate of its partners for this purpose. The court found that it was necessary to treat a partnership as an aggregate in order to prevent the types of tax avoidance transactions that Section 24(b) sought to prohibit:

---

6 *See* Revenue Act of 1937, § 301.

7 *Id*.

8 *See* S. Rep. No. 1242, 75th Cong., 1st Sess. (1937).

9 169 F.2d 562 (2d Cir. 1948).

> We cannot feel that there can be any serious doubt as to the legislative intent or any substantial ground for believing that Congress intended to leave so large a loophole—almost as large as the one it was trying to close—from its prohibition against deductible losses upon transfers between closely related persons or groups.[10]

In *Busche v. Commissioner*, the Tax Court followed *Whitney*, disallowing a loss on a sale of assets by a partnership to a corporation with overlapping ownership.[11] The court, citing *Whitney*, stated that for purposes of Section 24(b) a "partnership is treated as an aggregate of individuals who are co-owners of partnership property and to whom, in proportionate shares, the income of the partnership is taxed."[12] As a result, the court held, the sale by the partnership to the corporation should be treated as a sale "made by the individual partners and not by the partnership entity."[13] Since the taxpayer in *Busche* owned (directly and by attribution) more than 50% of the outstanding stock of the corporation, the court disallowed the taxpayer's distributive share of the loss recognized by the partnership under Section 24(b).

<u>Enactment of Sections 267 and 707</u>. In 1954, Congress again relocated the related party loss disallowance rules from Section 24(b) to where they are found today in Section 267(a)(1).[14] Section 267(a)(1) disallows any loss from the sale or exchange of property, directly or indirectly, between related persons specified in Section 267(b). As enacted in 1954, the relationships described in Section 267(b) included: (1) family members and (2) an individual and a corporation owned more than 50%, directly or indirectly, by or for such individual. Rules for treating partnerships as related persons

---

10 *Id.* at 565.

11 23 T.C. 709 (1955).

12 *Id.* at 714.

13 *Id.* at 715.

14 *See* P.L. 83-591 (1954).

were not included in Section 267(b). Section 267(c) carried over the constructive ownership rules of Section 24(b), treating an individual as owning stock owned, directly or indirectly, by or for his or her family and as owning the stock owned by his or her partners if he or she owned stock in such corporation (other than by family attribution). In addition, stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust was treated as being owned proportionately by or for its shareholders, partners or beneficiaries.[15]

Congress also added a new rule in Section 267(d) providing that, if a loss sustained by a transferor is disallowed on the sale or exchange of property to a taxpayer, and the taxpayer subsequently sold or disposed of the property at a gain, then the gain was recognized only to the extent that the gain exceeded the loss that was properly allocable to the property sold or disposed of by the taxpayer. Section 267(d) also excluded gain attributable to the sale by the taxpayer of property other than the transferred property if the taxpayer's basis in the other property was determined directly or indirectly by reference to the property with respect to which the loss was disallowed.[16]

In 1954, Congress also enacted Section 707(b)(1), a new related party loss provision specifically applicable to partnerships. Section 707(b)(1) was intended to prevent tax avoidance through the recognition of artificial losses.[17] The legislative history to Section 707(b) states that Congress intended to apply an entity theory of partnerships to loss transactions between a partner and a controlled partnership, although no inference was intended that a partnership should be viewed as a separate entity when applying other provisions of the Code.[18]

---

15 *See* § 267(c).

16 § 267(d)(2).

17 *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954).

18 Conf. Rep. 2543, 83d Cong., 2d Sess. (1954).

As enacted in 1954, Section 707(b)(1) disallowed a deduction in respect of a loss from the sale or exchange of property between: (1) a partnership and a partner owning more than 50% of the capital or profits interests in such partnership or (2) two partnerships in which the same persons owned more than 50% of the capital or profits interests. Section 707(b)(3) generally carried over the attribution rules applicable to stock ownership in Section 267(c), other than partner-to-partner attribution under Section 267(c)(3), to the attribution of a capital or profits interest in a partnership. In addition, Section 707(b)(1) carried over the gain exclusion rule of Section 267(d) on a subsequent sale by a transferee.

Issuance of the 267(b) Regulations. Treasury and the IRS issued the 267(b) Regulations in 1958.[19] The 267(b) Regulations provide that a sale at a loss between a partnership and a person other than a partner is treated as occurring between the other person and the members of the partnership separately. The first sentence of the regulation explains why the 267(b) Regulations do not apply to transactions between partners and partnerships: "Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267." It appears that Treasury and the IRS issued the 267(b) Regulations to confirm that a partnership would be treated as an aggregate for purposes of Section 267(a)(1), disallowing losses on transactions between a partnership and a related non-partner that were not subject to either Section 267(a)(1) or Section 707(b) as originally enacted, including transactions similar to the ones at issue in *Whitney* and *Busche*.

In *Casel v. Commissioner*, the Tax Court upheld the 267(b) Regulations as a valid exercise of regulatory authority.[20] The taxpayer had argued that the regulations were invalid because they treated a partnership as an aggregate of its partners, which was

---

19 *See* T.D. 6312, 1958-2 C.B. 126.

20 *See Casel v. Commissioner*, 79 T.C. 424 (1982).

inconsistent with the entity theory of partnerships adopted by Congress for loss transactions under the 1954 Code. The Tax Court cited *Whitney* and *Busche* for the authority that an aggregate theory applies to determine the tax consequences of loss transactions between a partnership and a corporation controlled by the partners of the partnership. The court also cited the statement in the legislative history to Section 707(b) to the effect that, despite the adoption of an entity theory of partnerships under Section 707, no inference was intended that a partnership should be treated as an entity under other provisions of the Code if treating the partnership as an aggregate of its partners is more appropriate. The court noted that treating a partnership as an entity in certain situations would create a loophole where a person interposed a partnership between himself and his related corporation in transactions that would otherwise be governed by Section 267(a).

<u>Subsequent amendments to Sections 267(b) and 707(b)</u>. In 1982, Congress enacted Section 267(b)(10), which treated an S corporation and a partnership as related parties if the same persons own more than 50% in value of the outstanding stock of the S corporation and more than 50% of the capital or profits interests in the partnership.[21] Two years later, Congress amended Section 267(b)(10) to apply to all corporations, not just S corporations.[22]

In 1984, Congress also amended Section 267 to defer any loss on the sale or exchange of property between members of a "controlled group."[23] Under Section 267(f), the loss on a sale or exchange of property between members of the same controlled group is not disallowed under Section 267(a)(1), but rather deferred until such time as the loss property is transferred outside of the controlled group in a transaction in which the loss

---

21 P.L. 97-354, § 3(h) (1982).

22 P.L. 98-369, § 174(b)(3) (1984).

23 P.L. 98-369, § 174(b)(2)(B) (1984). Section 267(f)(1) defines "controlled group" by reference to the definition in Section 1563(a), but substituting "more than 50%" for "at least 80%" in each place it appears.

would be recognized under consolidated return principles or until such other time as may be prescribed by future regulations.

Finally, in 1986, Congress amended Section 707(b) to apply to transactions between a partnership and a person who owns, directly or indirectly, more than 50% of the capital or profits interests of the partnership, *whether or not* such person is a partner.[24] The 1986 amendment to Section 707(b) also added the final sentence of the flush language to Section 707(b)(1), which treats two partnerships with more than 50% common ownership as related parties under Section 267(b) for purposes of applying the matching rule in Section 267(a)(2).[25] The statement by the Joint Committee on the 1986 amendment indicates that this flush language was intended to replace the aggregate approach of the rule in Temp. Treas. Reg. § 1.267(a)-2T(c), Questions 2 and 3, which was promulgated in 1984 and treated transactions between two partnerships with one or more common partners as transactions between the partners and the partnership subject to Sections 267(a)(1) and (a)(2), respectively.[26] The legislative histories to the amendments to Sections 267 and 707(b)(1) do not mention the application of the aggregate approach in the 267(b) Regulations.

2. The 267(b) Regulations Conflict with Subsequent Amendments to Sections 267 and 707(b) that Treat Partnerships as Entities Rather than Aggregates

As described above, the 267(b) Regulations provide that transactions between a partnership and a non-partner are considered as occurring between the non-partner and the members of the partnership separately. As a result, in the case of a sale or exchange of loss property between a partnership and a non-partner, Section 267(a)(1) applies to the

[24] P.L. 99-514, § 1812(c)(3)(A) (1986).

[25] *Id*. at § 1812(c)(3)(B).

[26] *See* Joint Comm. on Taxation, 99th Cong., Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, at 76-77 (1987). With this statement, Temp. Treas. Reg. § 1.267(a)-2T(c), Questions 2 and 3 presumably become deadwood.

extent the sale or exchange would have been subject to loss disallowance under Section 267 (in whole or in part) if the sale or exchange had been effected directly between the partners of the partnership and the non-partner.

The 267(b) Regulations reflect the same aggregate approach to partnerships articulated in *Whitney* which, in interpreting the statutory predecessor to Section 267, reasoned that Congress could not have intended to adopt a pure entity theory of partnerships because doing so would leave "so large a loophole—almost as large as the one that it was trying to close—from its prohibition against deductible losses upon transfers between closely related persons or groups."[27] Although Section 707(b) treats partnerships as entities for purposes of disallowing losses on sales or exchanges of property between a partnership and a related partner or between related partnerships, the legislative history to Section 707(b) did not prohibit the treatment of partnerships as aggregates for purposes of other Code sections, if such treatment was more appropriate.[28] In 1958, Treasury issued the 267(b) Regulations, which as described above treat a partnership as an aggregate for purposes of Section 267(a) and therefore disallow otherwise allowable losses in transactions similar to those at issue in *Whitney* and *Busche.*

Although the original enactment of Section 707(b) in 1954 did not foreclose aggregate treatment of partnerships under Section 267(b), Section 707(b) significantly expanded the application of the loss disallowance rules with respect to transactions involving partnerships. Under Section 707(b), a transfer of loss property between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests (*i.e.*, the partnership to partnership analogue to the transactions at issue in *Whitney* and *Busche*) is now subject to complete loss disallowance. As enacted, Section 707(b) also applied to a sale or exchange between a partnership and a

---

[27] 169 F.2d 562, 565 (2d Cir. 1948).

[28] Conf. Rep. 2543, 83d Cong., 2d Sess. (1954) (discussed above, at n. 18).

partner owning, directly or indirectly, more than 50% of the capital or profits interests in the partnership.

Following the issuance of the 267(b) Regulations, Congress expanded the application of the related party rules of Sections 707(b) and 267(b) to cover transactions between partnerships and non-partners (*i.e.*, the area formerly the sole province of the 267(b) Regulations). Although the amendments to Section 707(b) and Section 267(b) do not reach every loss transaction within the scope of the 267(b) Regulations, the amendments substantially alter the aggregate/entity dynamics of Section 267(a)(1). By extending Section 267 to sales or exchanges of loss property between partnerships and corporations under common control, Section 267(b)(10) treats a partnership as an entity, not an aggregate. Section 267(b)(10) also closed the loophole identified by the courts in *Whitney* and *Busche*, each of which involved a sale or exchange between a partnership and a corporation under common control.[29]

The 1986 amendments to Section 707(b) further extended the application of the loss disallowance rule of Section 707(b)(1) to cover transactions between a partnership and any person that owns, directly or indirectly, more than 50% of the capital or profits interests in the partnership, *whether or not* such person is a partner.[30] As a result, Section 707(b) now covers a category of loss transactions previously within the sole jurisdiction

[29] The IRS also issued regulations under Section 267(f) that adopt an entity approach to related party loss transactions among members of controlled groups. The stated rationale for the regulations is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer between a selling member and a buying member. Treas. Reg. § 1.267(f)-1(a)(1). Under Treas. Reg. § 1.267(f)-1(c)(1), the matching and acceleration rules of Treas. Reg. § 1.1502-13 apply such that a selling member's losses and deductions are not taken into account until the buying member transfers the property outside the controlled group or the selling and buying members are no longer part of the same controlled group.

[30] The Joint Committee explanation to the amendments to Section 707(b) states that the flush language added to Section 707(b)(1) at the same time, which treats two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests as related persons for purposes of the matching rule of Section 267(a)(1), is intended to replace the aggregate approach of Temp. Treas. Reg. § 1.267(a)-2T(c), Questions 2 and 3. *See* Joint Comm. on Taxation, 99th Cong., Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, at 76-77 (1987).

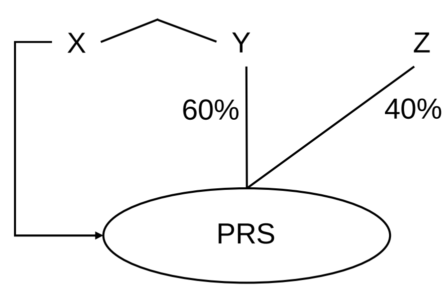
of the 267(b) Regulations. For example, prior to these amendments, a sale or exchange of loss property by a partnership to a related family member of a partner would have been partially disallowed under the 267(b) Regulations. Section 707(b) would not have applied to the transaction because before 1986, Section 707(b) did not apply to transactions between partnerships and non-partners. Following the 1986 amendments, Section 707(b) would disallow the same loss in its entirety if the non-partner is attributed more than 50% of the capital or profits interests in the partnership from the related partner (or from another person).

As discussed above, the amendments to Section 267(b) and Section 707(b) following the issuance of the 267(b) Regulations are inconsistent with the aggregate approach of the 267(b) Regulations. Indeed, with the enactment of Section 267(b)(10), the basic premise of the 267(b) Regulations that "section 267(b) does not include members of a partnership and the partnership as related persons" is no longer true, if the partner is a related corporation. The amendments to Sections 267(b) and 707(b) also close the original loophole identified by the courts in *Whitney* and *Busche,* applying to loss transactions formerly subject only to the 267(b) Regulations. As a result, the expansion of Sections 267(b) and 707(b) to cover such cases eliminates much of the underlying rationale of the 267(b) Regulations.

3. Differences Between the 267(b) Regulations and the Statutory Loss Disallowance Rules of Sections 267(a)(1) and 707(b) in Overlap and Non-Overlap Cases

As discussed below, differences between the scope of the 267(b) Regulations and the statutory loss disallowance rules of Section 267(a)(1) and Section 707(b) result in loss disallowance rules that produce inconsistent results, both in cases where they overlap and in cases where they do not.

(a) Example 1 – Rules Overlap: X is Y's child. Y owns a 60% interest in partnership PRS. The remainder of PRS is owned by Z, an unrelated

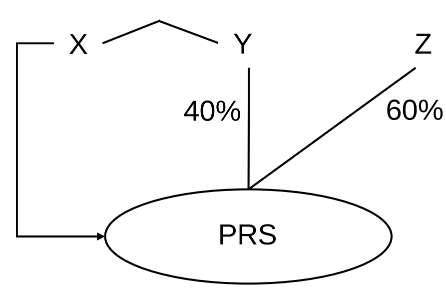


partner. X sells loss property to
PRS.

Result: Section 707(a)(1) applies to disallow 100% of the loss (Section 267(a) does not apply because an individual and a partnership are not related persons under Section 267(b)).[31] In contrast, under the 267(b) Regulations, the sale is bifurcated into a deemed sale between X and Y and a deemed sale between X and Z. As a result, only 60% of the loss is disallowed under the 267(b) Regulations.

In the overlap case illustrated by Example 1, Section 707(b) disallows the loss in its entirety whereas the 267(b) Regulations disallow only a portion of the loss, based on the related partner's relative interest in the partnership. Presumably, this conflict exists only because the amendments to Section 707(b) occurred decades after the issuance of the 267(b) Regulations in 1958, which Treasury never withdrew or modified to reflect the change in law.

(b) Example 2 – Rules Do Not Overlap: Same facts as Example 1, except Y owns only a 40% interest in PRS.



Result: Section 707(b) does not apply to the sale because X does not own, directly or by attribution, more than 50% of PRS (Section 267(a) does not apply because an individual and a partnership are not related persons under Section 267(b)). Under the 267(b) Regulations, the sale is bifurcated into a deemed sale between X and Y and a deemed sale

[31] Example 4 below illustrates the overlap between Section 267(a) and the 267(b) Regulations under analogous facts involving a related corporation.

between X and Z, just as in Example 1. As a result, 40% of the loss is disallowed under the 267(b) Regulations.

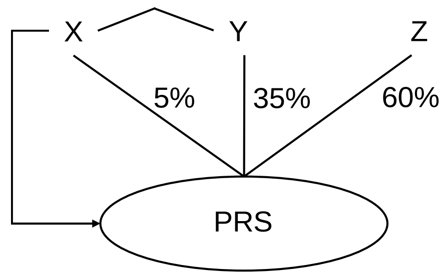
As illustrated by Example 2, the 267(b) Regulations are also inconsistent with Section 707(b) in the non-overlap cases. Section 707(b) does not apply because X is not related to the partnership. The 267(b) Regulations nevertheless disallow a portion of the loss, based on the related partner's relative interest in the partnership. This is so even though Y could have claimed the entire loss in a direct sale of the same property to PRS because the 267(b) Regulations do not apply to transactions between a partner and a partnership.

Although it is possible that Congress, in enacting the later amendments to Sections 707(b) and 267(b), intended to override the 267(b) Regulations only in overlap cases and to preserve its application of an aggregate approach in non-overlap cases, the structure of the amendments and the legislative history do not evidence any such intention. In fact, as illustrated by Example 3 below, even the 267(b) Regulations do *not* follow a pure aggregate approach: by their terms, they cede jurisdiction over all loss transactions between a partner and a partnership to Section 707(b) even though they could have applied an aggregate approach whenever the level of relatedness fell below 50%. The 267(b) Regulations instead apply an aggregate approach only to transactions between non-partners and partnerships.[32]

---

[32] As a result of the entity approach of Sections 267(a)(1) and 707(b), if the non-partner is not related to the partnership, loss disallowance does not apply to losses that are allocated to a partner that *is* a related person to the non-partner, including losses allocated to the related partner under Section 704(c). We believe this result is appropriate in light of the entity approach adopted by the amendments to Section 267(b) and Section 707(b) following the issuance of the 267(b) Regulations. We note, however, that in the case of a tax free contribution of loss property by a partner to a partnership subject to Section 704(c) that is followed by a sale of the loss property to a non-partner affiliate of the contributing partner, the transaction would need to run the gamut of judicial, statutory and regulatory anti-abuse rules, including the step transaction doctrine, Section 7701(o) and Treas. Reg. § 1.701-2 before the contributing partner could claim the loss.

(c) Example 3 – Sale between Partner and Partnership: Same facts as Example 2, but Y transfers a 5% interest in PRS to his child immediately before the sale.

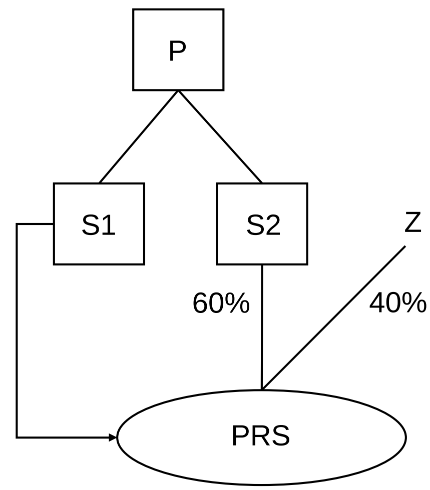


Result: Section 707(b) does not apply because X does not own, directly or by attribution, more than 50% of PRS (Section 267(a) does not apply because an individual and a partnership cannot be related persons under Section 267(b)). Unlike Example 2, nor do the 267(b) Regulations apply because X is a partner of PRS at the time of the sale.

As illustrated by Examples 2 and 3, by excluding transactions between partners and partnerships but not transactions between related non-partners and partnerships, the 267(b) Regulations impose different tax treatment on economically similar transactions. X in Example 3 is able to claim the loss merely because it acquired a small interest in PRS immediately before the sale, taking the transaction out of the jurisdiction of the 267(b) Regulations. We are not aware of any policy rationale that would support the allowance of full loss recognition when the seller is a partner of the purchasing partnership but not when the seller is merely related to the partner.

Section 267(f) loss deferral rules – overlap and non-overlap cases. The 267(b) Regulations also give rise to additional complexity and possible inconsistent treatment, in comparison to the statutory rules in Sections 267(a)(1) and 707(b), when the controlled group loss deferral rules of Section 267(f) apply.

(d) Example 4 – Rules Overlap: P owns 100% of S1 and S2. S2 owns a 60% interest in partnership PRS. The remainder of PRS is owned by Z, an unrelated partner. S1 sells loss property to PRS.



Result: Section 707(b) does not apply because S2's ownership of PRS is not attributed to S1 under Section 707(b). However, Section 267(a)(1) does apply because S1 and PRS are related under Section 267(b)(10) (P owns 100% of S1 and is treated as owning 60% of PRS by attribution under Section 267(e)(3)).[33] As a result, under Section 267(a)(1), 100% of the loss is disallowed.

In contrast, under the 267(b) Regulations, the analysis is substantially more complex and uncertain. Under the 267(b) Regulations, the sale is treated as a deemed sale between S1 and S2 and a deemed sale between S1 and Z. Since S1 and S2 are members of the same controlled group under Section 267(f), the loss on the deemed sale should be deferred pursuant to Section 267(f) until the property is transferred outside of the controlled

[33] The constructive ownership rules of Section 267(c) by their terms only apply for purposes of determining the ownership of stock. Nevertheless, P is treated as owning S2's 60% interest in PRS pursuant to Section 267(e)(3), which provides that the principles of Section 267(c) apply for purposes of determining ownership of a capital or profits interest in a partnership. P should also be attributed S2's 60% interest in PRS for purposes of Section 707(b), pursuant to Section 707(b)(3), which provides that the ownership of a partnership interest generally will be determined in accordance with the rules for constructive ownership of stock provided in Section 267(c). However, as Section 267(c) does not provide for downward attribution, P's ownership of PRS is not reattributed to S1 for purposes of Section 707(b)(1).

group and there would be recognition of loss under consolidated return principles.[34] If the loss property is then deemed to be contributed to PRS, which holds the property following the sale, the loss should be recognized under consolidated return principles.[35] It appears, however, that under Treas. Reg. § 1.267(f)-1(c)(1)(i), 60% of the loss would be disallowed (rather than deferred) because PRS is related to S1 and S2 under Section 267(b).[36]

Consistent with the other overlap examples above, we believe that in the overlap case described in Example 4, entity treatment and full loss disallowance under Section 267(a)(1) is the appropriate result. The aggregate approach of the 267(b) Regulations and its uncertain application cannot be justified in the wake of the subsequent legislative changes to Section 267(b).

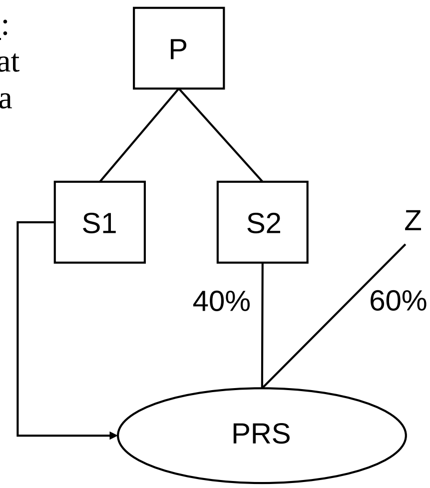
---

[34] § 267(f)(2).

[35] *See* Treas. Reg. § 1.1502-13(c)(7)(i) (deferred intercompany gain on sale from S to B taken into account upon a Section 351 contribution to X, a non-member, under the acceleration rule).

[36] In the future, PRS may be able shelter gain from the sale of the asset under Section 267(d). One commentator has speculated that, since Section 267(f) post-dates the 267(b) Regulations, the deemed sale from S1 to S2 pursuant to the 267(b) Regulations may not benefit from the Section 267(f) deferral regime. If that were the case, 60% of S1's loss would be disallowed under Section 267(a)(1) and Section 267(d) would potentially be available to exclude gain attributable to the sale of S2's interest in PRS because S2's basis in the partnership interest is determined directly or indirectly by reference to the property with respect to which the loss was disallowed. *See* J. Alexander and C. McHugh, *Sections 267 and 707: Are Related Party Transactions Leaving You at A Loss?*, New York University Annual Institute on Federal Taxation, Vol. 68 (2010). Alternatively, consistent with the IRS's approach in Private Letter Ruling 9114016, the deemed sale from S1 to S2 could be viewed as a sale between members of a controlled group that benefit from Section 267(f), but S2 could be deemed to continue to hold the loss property, with the result that the loss remains deferred. *Id*. at 17. Notwithstanding the conclusion of Private Letter Ruling 9114016, it is not clear why S2 would be deemed to own property that is actually owned by PRS. In addition, Private Letter Ruling 9114016 does not discuss Section 267(b)(10), which should have been applicable under the facts of the ruling, and therefore the legal reasoning of the ruling is questionable.

(e) Example 5 – Rules Do Not Overlap: Same facts as Example 4, except that S2 owns a 40% interest rather than a 60% interest in PRS.



Result: Section 267(a)(1) (but for the 267(b) Regulations) and Section 707(b) do not apply because PRS and S1 are not related under Section 267(b) or Section 707(b). Under the 267(b) Regulations, however, the deemed transactions described in Example 4 would disallow 40% of the loss.[37]

As discussed above in the non-overlap examples, it is not clear why the 267(b) Regulations should apply when full loss recognition generally would be permitted under Section 267(a)(1) and 707(b). Nor is it clear why the 207(b) Regulations should apply when full loss recognition would be permitted if (i) S1 merged into S2; (ii) P liquidated S2 and then transferred a portion of the 40% interest in PRS to S1; or (iii) PRS admitted S1 as a partner.

The facts of Example 5 also illustrate how a taxpayer that has no ability to take advantage of losses may seek to affirmatively use the 267(b) Regulations to transfer a tax asset to an unrelated party in the form of a future Section 267(d) exclusion. If the loss on the sale by S1 to PRS in Example 5 is disallowed, the other partners of PRS may benefit

[37] Note that the result in this example would be the same even if P owned all of S2 but only 50.01% of S1. This is so even though a sale of the loss property by the partner that actually owned the attributed 40% interest in the acquiring partnership would not result in any loss disallowance.

from the loss under Section 267(d) if PRS later sells the loss property at a gain.[38] In contrast, if S1 wishes to recognize the loss, S1 could be issued a small partnership interest before the sale, in which case the 267(b) Regulations would not apply. We believe this type of electivity, which is afforded because the 267(b) Regulations apply to loss transactions with related non-partners but not to loss transactions with related partners, is undesirable as a policy matter.

4. Conclusion

Under current law, the entity approach of Sections 267(b) and 707(b) conflict with the aggregate approach of the 267(b) Regulations. Since subsequent amendments to these Code provisions decades after the promulgation of the 267(b) Regulations in 1958 have expanded the statutory loss disallowance rules to cover transactions once targeted solely by the 267(b) Regulations, two conflicting sets of rules now apply to many of the same loss transactions.

For those transactions subject to both sets of rules, the statutory rules clearly preempt the rules under the 267(b) Regulations by disallowing the entire loss. At a minimum, therefore, Treasury should narrow the scope of the 267(b) Regulations to eliminate the existing overlap.

For the remaining loss transactions, we believe that the 267(b) Regulations produce results that are inconsistent with the entity approach that generally applies to other loss transactions subject to disallowance under Section 267(a)(1) or Section 707(b). Although it is possible that Congress intended to override the 267(b) Regulations only to the extent the statutory amendments to Sections 707(b) and 267(b) applied to the same

38 If the loss indifferent taxpayer is related to the partnership under Section 267(b)(10) or Section 707(b), the full benefit of the Section 267(d) exclusion will be transferred to the partnership. However, this result follows from the general entity approach of Section 267(d) and is consistent with the application of Section 267(d) to related corporations. As discussed above, the 267(b) Regulations extend this result to scenarios in which the loss indifferent taxpayer (by attribution) owns 50% or less of the partnership.

transactions, neither the structure of the amendments nor the legislative history evidence any such intention. Moreover, the failure of the 267(b) Regulations to follow a pure aggregate approach in the partnership context subjects very similar transactions to different tax treatment. By ceding all jurisdiction over loss transactions between partners and partnerships to Section 707(b), the 267(b) Regulations disallow losses in sales between a partnership and an affiliate of a partner even though the same loss would not be disallowed if realized in a direct sale between the partner and the partnership. We therefore recommend that Treasury withdraw the 267(b) Regulations.