

TAXATION SECTION OF THE DISTRICT OF COLUMBIA BAR
EXECUTIVE SUMMARY OF COMMENTS ON PROPOSED REGULATION SECTION 1.704-3
PERTAINING TO ALLOCATIONS IN CONNECTION WITH BUILT-IN GAIN OR
LOSS PROPERTY CONTRIBUTED TO PARTNERSHIPS

I. GENERAL

The Taxation Section of the District of Columbia Bar applauds the short length and simplicity of the proposed regulations. We also applaud the flexibility provided in the proposed regulations by permitting taxpayers to use curative allocations or the deferred sale method to offset distortions caused by the ceiling rule.

II. SAFE HARBOR

The proposed regulations detail three methods for making section 704(c) allocations, but do not mandate the use of any one method. The proposed regulations are backed-up by a broad and vague anti-abuse rule. We are concerned that the anti-abuse rule may be read by Service personnel to disallow any allocation that does not maximize tax liabilities. Taxpayers need more certainty in dealing with the distortions caused by the ceiling rule (but not at the expense of making the proposed regulations overly complex). Therefore, we propose that the final regulations contain a safe harbor for allocations made under the "curative gain allocation" method. This method was suggested by the legislative history to the 1984 Act, and is simple to explain and apply. The final regulations should also state that an allocation method is not unreasonable solely because more income (or fewer deductions or losses) are allocated to a zero bracket partner than under the traditional method.

III. TECHNICAL COMMENTS

A. With respect to the traditional method with curative allocations, we recommend that the final regulations provide more guidance as to what items are considered to be the same "type" and revise the example of the unreasonable use of this method.

B. We are concerned that under the proposed regulations, partners of partnerships that elect the deferred sale method would be treated less favorably than partners of partnerships that elect other reasonable methods. To ameliorate these concerns, we recommend that: deferred losses that would otherwise be disallowed under section 707(b)(1)(A) be treated the same as deferred losses of controlled groups under Treas. Reg. § 1.267(f)-1T; the final regulations clarify that "section 704(c) minimum gain" includes deferred gain for purposes of Treas. Reg. § 1.752-3(a)(2); section 708(b)(1)(B) deemed terminations not constitute a trigger event; and because a transfer of a partnership interest at death is not a trigger event under the proposed regulations, in such a case certain deferred gain or loss should be eliminated.

C. With respect to the deferred sale method, we also recommend that final regulations: provide that a deferred loss that is taken into account shall be treated as a distributive share of partnership loss for purposes of section 704(d); add complete liquidations of partnership interests as trigger events; prevent the duplication of deferred gain on partnership distributions; and include an anti-stuffing rule.

D. Additionally, we recommend that the cap in the de minimis rule be raised to \$50,000 and that more consideration be given to relaxing the aggregation rule, including permitting the aggregation of assets with no remaining recovery period.

¹ The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and do not represent those of the District of Columbia Bar or its Board of Governors.

The comments expressed have been approved by the Tax Policy Task Force of the Section of Taxation of the District of Columbia Bar, which Section has approximately 1,500 members. The Section of Taxation is chaired by Patricia G. Lewis and Celia Rody. The Section's Tax Policy Task Force is chaired by Roderick A. DeArment and William J. Wilkins. The Pass-Through Entities and Real Estate Committee is chaired by Blake D. Rubin. The Task Force on Partnership Contributions and Distributions is chaired by Christian M. McBurney.

TAXATION SECTION



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April 12, 1993

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COMMENTS ON PROPOSED REGULATION SECTION 1.704-3 PERTAINING TO ALLOCATIONS IN CONNECTION WITH BUILT-IN GAIN OR LOSS PROPERTY CONTRIBUTED TO PARTNERSHIPS

Committees:

Corporation Tax
Employee Benefits
Estate Planning/Death Related Taxes
Exempt Organizations
International Tax
Pass-Through Entities and Real Estate
Tax Audits and Litigation

The following comments represent the views of the Taxation Section of the District of Columbia Bar (the "Section"). Primary drafting responsibility for this report was exercised by Christian M. McBurney, Seth Green and Charles C. Hwang of the Task Force on Partnership Contributions and Distributions of the Pass-Through Entities and Real Estate Committee.¹ The authors received many key insights from Blake D. Rubin, and helpful assistance from Charles B. Temkin and Daniel M. Davidson. The contact person for this report is Christian M. McBurney (202) 457-5358.

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OUTLINE OF COMMENTS

I. GENERAL

The Section applauds the short length and simplicity of the proposed regulations. We also applaud the flexibility provided in the proposed regulations by permitting taxpayers to use curative allocations or the deferred sale method to offset distortions caused by the ceiling rule.

II. SAFE HARBOR

A. The proposed regulations detail three methods for making section 704(c) allocations, but do not mandate the use of any one method. The proposed regulations are backed-up by a broad and vague anti-abuse rule. We are concerned that the anti-abuse rule may be read by Service personnel to disallow any allocation that does not maximize tax liabilities. Taxpayers need more certainty in dealing with the distortions caused by the ceiling rule (but not at the expense of making the proposed regulations overly complex). Therefore, we propose that the final regulations contain a safe harbor for allocations made under the "curative gain allocation" method. This method was suggested by the legislative history of the 1984 Act, and is simple to explain and apply.

B. The final regulations should also state that an allocation method is not unreasonable solely because more income (or fewer deductions or losses) are allocated to a zero bracket partner than under the traditional method.

III. TECHNICAL COMMENTS

A. With respect to the traditional method with curative allocations, we recommend the following:

1. The final regulations should provide more guidance as to what items are considered to be the same "type".
2. The example of the unreasonable use of this method should be revised.

B. We are concerned that under the proposed regulations, partners of partnerships that elect the deferred sale method will be treated less favorably than partners of partnerships that elect other reasonable methods. To ameliorate these concerns, we recommend the following:

1. Deferred losses that would otherwise be disallowed under section 707(b)(1)(A) should be treated the same as deferred losses of controlled groups under Treas. Reg. § 1.267(f)-1T.
2. The final regulations should clarify that "section 704(c) minimum gain" includes deferred gain for purposes of Treas. Reg. § 1.752-3(a)(2).
3. Section 708(b)(1)(B) deemed terminations should not constitute a trigger event.
4. Certain deferred gain or loss be should eliminated upon a transfer of a partnership interest at death.

C. With respect to the deferred sale method, we also recommend the following:

1. Deferred loss that is taken into account should be treated as a distributive share of partnership loss for purposes of section 704(d).
2. Complete liquidations of partnership interests should be added as trigger events.
3. The duplication of deferred gain on partnership distributions should be prevented.
4. An anti-stuffing rule should be added.

D. Additionally, we recommend that the cap in the de minimis rule be raised to \$50,000.

E. Consideration should be given to a further relaxation of the aggregation rule. For example, the Treasury and Service should consider permitting the aggregation of section 1231 assets with no remaining recovery period and permitting the aggregation of assets that have been expensed under section 162(a) or treated as expensed under section 179(a).

I. Introduction

Section 704(c) of the Internal Revenue Code of 1954 was amended by the Deficit Reduction Act of 1984 (the "1984 Act") on July 18, 1984. The amendment mandates that items of income, gain, loss and deduction with respect to property contributed to a partnership must be allocated among the partners to take into

account any built-in gain or loss inherent in the property at the time of contribution. On December 23, 1992, the proposed regulations under section 704(c)² (the "proposed regulations") were published in the Federal Register.

The Section applauds the short length and the simplicity of the proposed regulations. The proposed regulations are in a form that can be easily understood by general tax practitioners. Our comments in this report are generally designed to clarify the application of the proposed regulations without materially adding to the length or complexity of the proposed regulations.

We also applaud the flexibility for taxpayers provided in the proposed regulations. Permitting taxpayers to elect to provide for curative allocations to offset distortions caused by the ceiling rule will reduce the number of inequities caused by the ceiling rule. Permitting taxpayers to elect to use the deferred sale method is another welcome alternative, although it may be too complicated for unsophisticated partnerships.

Most of the comments contained in this report are technical in nature. However, in Part II immediately below, we do recommend that the Treasury Department and Service consider adopting as a safe harbor a curative "gain" allocation rule as suggested in the legislative history of the 1984 Act.

²Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended.

II. General Principles

A. The Proposed Regulations

The proposed regulations state the general rule that any "reasonable" allocation under section 704(c) is permitted, and describe three generally reasonable methods: the traditional method, the traditional method with curative allocations ("curative allocation method"), and the deferred sale method. Prop. Treas. Reg. § 1.704-3(a)(1). (Each of the three methods is discussed in some detail below.) These three methods are not safe harbors, since the use of any of them will be found to be unreasonable if the contribution of property and the allocation of tax items are "made with a view to reducing substantially the partners' aggregate overall tax liability without substantially affecting the amounts to which each partner is economically entitled on the partnership's books." Prop. Treas. Reg. § 1.704-3(a)(5) (the "anti-abuse rule"). The partnership may apply a different method for each item of contributed property, but must apply the same method to any particular item, provided that the overall method or combination of methods is reasonable based on the facts and circumstances. Prop. Treas. Reg. § 1.704-3(a)(1).

The proposed regulations generally apply whenever built-in gain or loss property is contributed to a partnership. Prop. Treas. Reg. § 1.704-3(a)(2)(i). "Built-in gain" and "built-in loss" are defined by reference to the difference between book value (adjusted for book depreciation) and tax basis (adjusted for tax depreciation). Prop. Treas. Reg. § 1.704-3(a)(2)(ii).

Revaluations pursuant to Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(f) ("reverse section 704(c) allocations") also

trigger the application of section 704(c) principles. Prop. Treas. Reg. § 1.704-3(a)(4). Reverse section 704(c) allocations for an item of property need not rely on the same method governing section 704(c) allocations for that item. A partnership may use different methods for successive reverse section 704(c) allocations. As with section 704(c) allocations, reverse section 704(c) allocations are subject to an overriding requirement of reasonableness. Id.

B. Safe Harbor: Traditional Method with Curative Gain Allocation

1. **Need for safe harbor.** The absence of a safe harbor method under the proposed regulations is troubling in the context of the statement in Prop. Treas. Reg. § 1.704-3(a)(5), the anti-abuse rule, that an allocation is unreasonable if made with a view to reducing the partners' aggregate tax liability without substantially affecting the amounts to which the partners are economically entitled. In the absence of a safe harbor, the anti-abuse rule may effectively cause any allocation that does not maximize tax liabilities to be viewed as unreasonable. Such a result is plainly unfair.

Many taxpayers, including ordinary taxpayers that do not understand all of the intricacies of section 704(c), desire certainty that allocations of taxable income and loss from their partnerships will be respected for Federal income tax purposes. Many taxpayers also desire an allocation method which minimizes distortions caused by the ceiling rule.

Furthermore, some partners insist on certainty because of the disastrous consequences (apart from partnership tax rules) that can befall them if their allocations of taxable income and

loss under section 704(c) are not respected. For example, such a partner could include a tax-exempt entity that wants to avoid the risk of UBIT on income attributable to real property subject to acquisition indebtedness a threat to its tax-exempt status. See section 514(c)(9)(E); Prop. Treas. Reg. § 1.514(c)-2. Similarly, a partner insisting on certainty could include a REIT that wants to determine its income in order to avoid the risk of the excise tax imposed under section 4981 by reason of the minimum distribution rules applicable to REITS and possibly a threat to its REIT status. See sections 4981; 857(a).

For the above reasons, particularly to aid ordinary taxpayers, the Section believes that the final regulations should contain a safe harbor method that will be deemed reasonable under all circumstances and not be subject to the anti-abuse rule. We recommend that the traditional method with the curative gain allocation ("curative gain allocation method") suggested in the legislative history of the 1984 Act be adopted as a safe harbor.

Under the curative gain allocation method, an allocation of gain from the taxable disposition of the contributed property would be permitted to offset the distortions caused by the ceiling rule. No other curative allocations would fall within the safe harbor. Accordingly, the rule is simple to explain and apply and therefore will not sacrifice the simplicity of the proposed regulations.

2. Legislative history of 1984 Act and analysis of the curative gain allocation rule. The only "curative allocation" mentioned in the legislative history is a suggestion that "it may be appropriate" to amend Treas. Reg. § 1.704-1(c)(2), Ex. 2 to require that a curative allocation of depreciation frustrated by the ceiling rule be supplemented by an

allocation of gain on disposition of the contributed property ("curative gain allocation rule").³ We believe that the curative gain allocation method is in fact mandated by the accounting logic of the built-in gain or loss concept.

Treas. Reg. § 1.704-1(c)(2) Ex. 2 involves the following facts:

C and D form an equal partnership. D contributes \$10,000 cash and C contributes property having an adjusted tax basis of \$4,000, a fair market value of \$10,000, and a ten-year depreciable life to the partnership. C's built-in gain is \$6,000. The book-tax disparity is as follows:

	<u>tax</u>	<u>book</u>
C	\$4,000	\$10,000
D	\$10,000	\$10,000

In the first year, the contributed property generates a tax depreciation deduction of \$400, which reduces the adjusted tax basis of the property to \$3,600. The \$400 depreciation deduction must be allocated entirely to D under the traditional method, because D's book depreciation with respect to the property is \$500. The ceiling rule limits the tax depreciation deduction allocable to D to the tax depreciation actually available from the property. At the beginning of the second year, the property is sold.

When the property is sold, C's built-in gain under the proposed regulations is \$5,400, the difference between the adjusted book value of the property (\$9,000) and the adjusted tax

³H.R. Rep. No. 43, Pt.2, 98th Cong., 2d Sess, 1209 n.3 (1984); S. Prt. No. 169, Vol. I, 98th Cong., 2d Sess. 215 n.2 (1984); Staff of Joint Comm. on Taxation, General Explanation of H.R. 4170, 98th Cong., 2d Sess. 213 n.4 (Comm. Print 1984).

basis of the property (\$3,600). The proposed regulations' definition of built-in gain or loss thus implies that the book-tax disparity (initially \$6,000) will be reduced on a straight-line basis to zero over the recovery period, 10 years. As the example makes clear, such an assumption is unwarranted when the ceiling rule applies. After 10 years, the book-tax disparities in the example would not be zero, but rather the following:

	<u>tax</u>	<u>book</u>
C	\$4,000	\$5,000
D	\$6,000	\$5,000

Thus, the proposed regulations' definition of built-in gain or loss is deficient when the ceiling rule applies. This deficiency can be corrected by requiring a curative allocation of gain on the disposition of the contributed property.

Returning to the example, after one year of depreciation, the book-tax disparities can be summarized as follows:

	<u>tax</u>	<u>book</u>
C	\$4,000	\$9,500
D	\$9,600	\$9,500

If the property is sold for \$9,200, the partnership has a \$200 book gain (\$9,200 proceeds less \$9,000 adjusted book value) and a \$5,600 tax gain (\$9,200 proceeds less \$3,600 adjusted tax basis). The book gain is allocated \$100 each to C and D. Pursuant to the traditional rule, \$5,400 of the tax gain is allocated to C, and pursuant to the curative gain allocation rule the remaining \$200 is allocated to C. The book-tax accounts would then look as follows:

	<u>tax</u>	<u>book</u>
C	\$9,600	\$9,600
D	\$9,600	\$9,600

As is evident, such an allocation eliminates all book-tax disparities. This is the point of the curative gain allocation rule that Congress suggested in the legislative history. This result is accomplished by looking only to the specific property contributed by C to the partnership, and not to any other property held by the partnership. Thus, the curative gain allocation rule is not only supported by legislative history but also by the accounting logic of the built-in gain or loss concept.

3. Safe harbor may benefit some taxpayers. It is inherent in the notion of a safe harbor that it redound to the benefit of the taxpayer in certain situations. Thus, in the example discussed above, the curative gain allocation rule would help C if C has expiring NOLs. The fact that some taxpayers may benefit is not an argument against the method we propose, but an inevitable consequence of having any safe harbor. As noted above, the existence of a broadly worded anti-abuse rule makes the provision of at least one safe harbor necessary for equitable results. Moreover, rather than contributing the property to the partnership and in effect ceding one-half of the property to D, C instead could have sold one-half of its property to an unrelated party and recognized gain which would have been sheltered by C's NOLs.

4. Amendment to the anti-abuse provision. The proposed regulations contain an anti-abuse rule which provides that an allocation method is not reasonable if the contribution of property and the allocation of tax items are made with a view

to reducing substantially the partners' aggregate overall tax liability without substantially affecting the amounts to which each partner is economically entitled on the partnership's books. The proposed regulations provide two examples of allocations which would be deemed to be unreasonable under this anti-abuse method -- one example using the traditional method and one example using the traditional method with curative allocations. As noted below, the example of an unreasonable use of the traditional method with curative allocations is troubling in that it could be read to imply that any curative allocation is unreasonable if it results in the allocation of more income to a zero bracket partner (a tax-exempt partner or a partner with expiring net operating loss carryforwards) than would occur under the traditional method.

We are concerned that, in a partnership involving a zero bracket partner, the anti-abuse rule of the proposed regulations may effectively cause any allocation that does not maximize tax liabilities to be viewed as unreasonable. Such a result is unwarranted. We propose, therefore, that the anti-abuse rule be amended to explicitly state that an allocation method is not unreasonable solely because more income (or fewer deductions or losses) are allocated to a zero bracket partner than would occur under the traditional method.

III. The Traditional Method

A. The Proposed Regulations

The proposed regulations provide that, in general, it will be reasonable for a partnership to make allocations with respect to contributed property using the "traditional method" described in Treas. Reg. § 1.704-1(c)(2) (issued under former

section 704(c)(2) which was elective). Under the traditional method, when a partnership disposes of section 704(c) property in a transaction in which gain or loss is recognized, any built-in gain or loss is allocated to the contributing partner. If the contributed property is subject to depreciation or depletion, cost recovery deductions are allocated to the non-contributing partners to the extent that book allocations are made to such to such partners. However, the total depreciation, depletion, or gain or loss allocated to the partners is limited to the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it (the "ceiling rule").

The proposed regulations provide guidance which was lacking under Treas. Reg. § 1.704-1(c)(2) with respect to the traditional method in certain situations. Under the proposed regulations, if only a portion of section 704(c) property is disposed of, only a proportionate part of the built-in gain or loss is allocated to the contributing partner. If the section 704(c) property is disposed of in a non-recognition transaction, any property received by the partnership whose basis is determined with reference to the section 704(c) property is treated as section 704(c) property with the same amount of built-in gain or built-in loss property as the section 704(c) property disposed of in the transaction.

As discussed above, in the legislative history of the 1984 Act, Congress suggested that the ceiling rule be changed to include the curative gain allocation rule.⁴ The preamble to the proposed regulations explains that this modification was not

⁴H.R. Rep. No. 4170, 98th Cong., 2d Sess. 1209 n.3 (1984); S. Rep. No. 169, 98th Cong., 2d Sess. 215 n.2 (1984); Staff of Joint Comm. on Taxation, General Explanation of H.R. 4170, 98th Cong., 2d Sess. 213 n.4 (Comm. Print 1984).

incorporated into the traditional method because the same result would be permissible under proposed regulations using the traditional method with curative allocations.⁵

B. Use of the Traditional Method in the Proposed Regulations

The Section agrees with the Treasury Department and the Service that use of the traditional method should be allowed by the proposed regulations. We believe that the legislative history of the 1984 Act evidences satisfaction by Congress with the general approach of Treas. Reg. § 1.704-1(c)(2), and that regulations which completely reject this approach would be contrary to congressional intent.

C. Technical Comments

1. **Less complicated example.** The only example of the traditional method contained in the proposed regulations illustrates the operation of the ceiling rule in the case of built-in gain property which is depreciated and subsequently sold. Although the example does provide a necessary illustration of the interaction of depreciation and the ceiling rule, we believe that many practitioners would benefit from an additional, less complicated example. For example, the final regulations could contain an example of property which is contributed with a basis of \$1000 and a value of \$500 which is subsequently sold for \$600, with all \$400 of loss being allocated to the contributing partner.

⁵7 Fed. Reg. at 61,346 (1992).

2. Unreasonable use of the traditional method. The proposed regulations contain an example of the unreasonable use of the traditional method.⁶ The use is deemed to be abusive because it was made with a view to shifting income to a partner who is indifferent to receiving the income.

It should be noted that the shifting of income in this example would be entirely avoided if the curative gain allocation method were applied. As stated above, we believe that the final regulations should provide that use of the traditional method, as modified by the curative gain allocation rule, will be deemed a reasonable method under all circumstances. If the curative gain allocation method were applied, the \$10,000 tax gain would be allocated \$9,000 to C and \$1,000 to D, thus eliminating the

⁶Prop. Treas. Reg. § 1.704-3(b)(3), Ex. 2. The example is substantially as follows: C and D form partnership CD. C contributes equipment with a basis of \$1,000 and a book value of \$10,000 with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. D contributes \$10,000 of cash. C and D agree that CD will make allocations with respect to section 704(c) property using the traditional method. D has substantial net operating loss carryforwards that D otherwise anticipates will expire unused.

CD holds the property for one year, claiming \$1,000 of depreciation and reducing the basis of the property to zero, and in the second year sells the equipment for \$10,000. The entire first year's tax depreciation is allocated to D, the noncontributing partner. After taking into account the depreciation deduction, there is no remaining built-in gain with respect to the contributed equipment, and the \$10,000 of gain on the sale of the equipment is therefore allocated to the partners equally under the traditional method.

As a result of these allocations, there has been a shift of the pre-contribution gain in the equipment from C to D in the amount of \$4,000 (the \$5,000 share of tax gain on sale less the \$1,000 of tax depreciation allocated to D).

distortion created when the ceiling rule limits D's tax depreciation to \$1,000 (rather than D's \$5,000 share of book depreciation). Thus, the shifting of income which the proposed regulations find objectionable would be entirely avoided if the curative gain allocation method were applied.

IV. Curative Allocations

A. The Proposed Regulations

The proposed regulations also describe a method of making allocations which is based on the traditional method, but allows for "curative allocations" to counteract the effects of the ceiling rule. Curative allocations are allocations of partnership tax items of income, gain, loss, or deduction (other than cost recovery deductions attributable to the section 704(c) property or gain or loss on the sale of the section 704(c) property) that tend to equalize the allocation of book and tax items to the noncontributing partner. A curative allocation affects the recipient partner's taxable income, but does not affect the partners book capital account. A partnership may choose to make curative allocations only of particular tax items (e.g., only depreciation from a specific property or properties). The preamble to the proposed regulations indicates that a partnership may elect to make curative allocations only from the sales proceeds of the contributed property -- i.e., it may elect to follow the traditional method for purposes of depreciation, but may correct the distortion of the ceiling rule upon disposition. A curative allocation is reasonable only if made using items of the same "type," i.e., tax items that would have the same effect on the partners as the tax items affected by the ceiling rule.

B. Use of Curative Allocations in the Proposed Regulations

The Section agrees that use of the traditional method with curative allocations is an appropriate method of making allocations with respect to section 704(c) property. We believe, however, that the method as it is outlined in the proposed regulations provides insufficient guidance as to the operation of the method as envisioned by Treasury and the Service, especially with regard to what items will be considered to be of the same "type." The lack of clear guidance may result in a reluctance among taxpayers and practitioners to use the method, if they cannot be sure that their curative allocations will be respected by the Service.

C. Technical Comments

1. Additional guidance as to "type" of items. As noted above, the proposed regulations contain inadequate guidance as to what items are considered to be of the same "type," and how that determination is to be made. Significantly, the proposed regulations contain an example which permits a curative allocation of gain from the sale of inventory to correct a ceiling rule limitation of depreciation on equipment.⁷ This example may violate the "type" requirement. If the taxpayer is subject to the alternative minimum tax, an increase in depreciation deductions and a decrease in inventory gain may not give rise to identical tax consequences.⁸

⁷Prop. Treas. Reg. § 1.704-3(c)(4), Ex. 1.

⁸See section 56(a)(1).

Furthermore, it is unclear whether or not the determination of which items are of the same "type" is to be made in light of the taxpayer's individual situation. For example, if the taxpayer in the example contained in the proposed regulations was not subject to the alternative minimum tax, then it may be appropriate to consider inventory gain to be of the same "type" as depreciation deductions. Similarly, if a taxpayer claims a deduction for foreign taxes under section 164(a), it may be appropriate to consider foreign source income to be of the same "type" as deductions from a U.S. trade or business -- yet this conclusion would appear to be explicitly prohibited by the proposed regulations.

The final regulations should provide significantly more guidance regarding when items may be considered to be of the same "type." Guidance will be especially helpful regarding those items the treatment of which routinely depends on the particular tax posture of the partner, such as passive losses.

Finally, it appears that a curative allocation of gain from a sale of contributed property may violate the "type" requirement, if the sale gain is capital or section 1231 gain and the ceiling rule previously operated to disallow depreciation deductions. Consistent with our position that the curative gain allocation method in the legislative history of the 1984 Act should always be considered a reasonable method of making allocations, we believe that the final regulations should provide that the "type" requirement will not apply to a curative allocation of gain on the sale of the contributed property.

2. Unreasonable use of curative allocations. The proposed regulations contain an example of the unreasonable use

of the traditional method with curative allocations.⁹ The proposed regulations conclude that the use of the traditional method with curative allocations in the example is unreasonable because it results in the shifting of gain to a partner who is indifferent to receiving the income, and because the contribution and election of the traditional method with curative allocations are made "with a view to shifting a significant amount of partnership taxable income to a partner who is indifferent to receiving that income." Except for the fact that this example results in tax consequences more favorable to the taxpayers than would occur under the traditional method, it is unclear what makes this example abusive or unreasonable. For example, assuming an economic life of 3 years for the equipment and straight line depreciation, more income would have been "shifted" to the noncontributing partner in the first year under the

⁹Prop. Treas. Reg. § 1.704-3(c)(4), Ex. 2. The example is substantially as follows: G and H form partnership GH. G contributes equipment with a basis of \$1,000 and a book value of \$10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. G also has substantial net operating loss carryforwards that G anticipates will otherwise expire unused. H contributes \$10,000 of cash which GH uses to purchase inventory for resale. G and H agree that GH will make allocations with respect to section 704(c) property using the traditional method with curative allocations.

During its first year, GH claims depreciation of \$1,000 with respect to the contributed equipment and sells all of the inventory for \$11,500, generating \$1,500 of gain. All \$1,000 of depreciation is allocated to H under the traditional method. In addition, GH makes a curative allocation of \$750 of inventory gain to G, so that G is allocated all \$1,500 of inventory gain for tax purposes. If the curative allocation had not been made, G and H would each have been allocated \$750 of inventory gain for tax purposes.

deferred sale method than under the example in the proposed regulations.¹⁰

Perhaps the most perplexing aspect of this example is that it attacks a transaction which results in income acceleration. Although the contributing partner in the example is in a situation where income acceleration results in a lower tax burden, by and large the Code is not designed to prevent income acceleration. In fact, the contributing partner could have accelerated \$4,500 of the gain inherent in the equipment through a taxable sale of a one-half interest in the equipment to the partnership. Such a sale has similar economic results to a contribution of the equipment to an equal partnership, where the

¹⁰Assume the same facts as in Prop. Treas. Reg. § 1.704-3(c)(4), Ex. 2, except that G and H agree that GH will make allocations with respect to the contributed property using the deferred sale method. Further assume that the equipment, if purchased, would be depreciable on a straight-line method over 3 years and that if G sold the equipment, the first \$2,000 of gain would give rise to ordinary income under section 1245. Upon contribution of the property G has deferred gain of \$9,000. GH has an overall basis in the property of \$10,000 that is bifurcated into two components -- \$1,000 of the basis is depreciable over one year (under section 168(i)(7)), \$9,000 of the basis is depreciable over three years (under section 168(c)).

For the first year of the partnership, GH's depreciation deduction is \$4,000 (\$1,000 plus one-third of \$9,000). G and H share this deduction equally. The \$1,500 of gain from the sale of inventory is also shared equally by G and H. In addition, \$3,000 of G's deferred gain is triggered and must be recognized. Accordingly, as the overall result of the operation of the partnership, G has a depreciation deduction of \$2,000, \$750 of gain from the sale of inventory, and \$3,000 of triggered deferred gain (\$2,000 of which is ordinary income and \$1,000 of which is capital gain), for a net income of \$1,750. This is a greater amount of net income than resulted from the use of curative allocations that "abusively" accelerated income to G. H has a depreciation deduction of \$2,000 and \$750 of gain from the sale of inventory, for a net loss of \$1,250.

other partner would be treated as cross-purchasing one-half of the equipment. It is unclear, therefore, why it is viewed as inappropriate for G to accelerate \$750 of gain through a curative allocation.

This example should be significantly altered, if not abandoned altogether, in the final regulations.

3. Example of curative allocation only of sale proceeds. In order to further aid practitioners, we believe that the final regulations should contain an example of the use of curative allocations using only the proceeds of the contributed property.

Example: A and B form partnership AB. A contributes \$100, and B contributes property with a tax basis of \$120 and a value of \$100. A and B agree that AB will make allocations with respect to the contributed property using the traditional method with curative allocations.

AB subsequently sells the property for \$150. The \$50 of book gain is allocated \$25 each to A and B. Under the traditional method, the \$30 of tax gain would be allocated \$15 each to A and B. Because the ceiling rule causes a disparity of \$10 between A's book and tax capital accounts, under Prop. Treas. Reg. § 1.704-3(c), A and B may properly allocate to A an additional \$10 of tax gain from the sale of the property. As a result of this curative allocation, A is allocated \$25 of tax gain from the sale of the property and B is allocated \$5 of tax gain from the sale of the property.

The final regulations should also incorporate an example illustrating the effect of the curative gain allocation rule upon Prop. Treas. Reg. § 1.704-3(b)(3), Ex. 1.

4. Curative allocations using only certain items.

The proposed regulations provide that a partnership may choose to limit its curative allocations to a particular tax item or items. However, proposed regulations also state that:

A curative allocation is reasonable only to the extent that it does not exceed the amount necessary to offset the effect of the ceiling rule either for the taxable year, or for a prior year in which there were insufficient other partnership items to make the curative allocation. Prop. Treas. Reg. § 1.704-3(c)(3)(i) (emphasis added).

This language could be read to prohibit a curative allocation where the effect of the ceiling rule could have been offset in an earlier year, but only by using items which the partnership has elected to not to use for curative allocations. The final regulations should make clear that this result is not intended, by amending Prop. Treas. Reg. § 1.704-3(c)(3)(i) to read as follows:

A curative allocation is reasonable only to the extent that it does not exceed the amount necessary to offset the effect of the ceiling rule either for the taxable year, or for a prior year in which there were insufficient other partnership items (other than items which the partnership has chosen to not to use for curative allocations) to make the curative allocation.

A similar amendment should be made to the final sentence of Prop. Treas. Reg. § 1.704-3(c)(1).

5. Contributions by multiple partners. The legislative history of the 1984 Act suggests that regulations under section 704 should provide guidance in the situation where

more than one partner contributes property with built-in gain or built-in loss. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 857 (1984). The proposed regulations provide no such guidance.

Under the proposed regulations, the traditional method and the ceiling rule appear to apply on a property by property basis. This rule can lead to anomalous, even nonsensical, results. We believe that the final regulations should include an example of a permissible curative allocation involving multiple section 704(c) properties, which illustrates how these results may be corrected.

Example: A and B form partnership AB. A contributes property with a basis of \$50 and a value of \$100 ("P1"). B contributes property with a basis of \$10 and a value of \$100 ("P2"). Each property is depreciable, with one year of cost recovery remaining. A and B agree that AB will make allocations with respect to section 704(c) property using the traditional method with curative allocations.

For the first year of operation, AB has a total of \$60 of depreciation for tax purposes and \$200 of depreciation for book purposes. When the traditional method is applied on a property by property basis, A is allocated all \$10 of depreciation on P2 and B is allocated all \$50 of depreciation on P1. Rather than eliminating the book-tax disparity, this allocation has in fact created a new disparity; originally both A and B had capital accounts in excess of their basis, now A has a basis in excess of B's capital account. The partnership may, however, make a curative allocation of \$40 of depreciation on P2 to A. As a result of this allocation, A is allocated a total of \$50 of depreciation and B is allocated \$10 of depreciation, and all book-tax disparity has been eliminated.

V. The Deferred Sale Method

A. The Proposed Regulations

The third reasonable method for making allocations under section 704(c) that is detailed in the proposed regulations is the deferred sale method. Under this method, a contribution of property to a partnership is treated as a sale of the property to the partnership at its fair market value, except that the recognition of any gain or loss realized by the partner is deferred. The partnership is treated as having a tax basis in the property, at the time of contribution, equal to its fair market value. The partner's basis in its partnership interest is increased by the partner's tax basis in the property at the time of its contribution to the partnership, and is increased or decreased by the amount of deferred gain or loss recognized by the partner each year.

Under the proposed regulations, deferred gain or loss is generally triggered upon the following partnership-level events: (i) when the partnership takes deductions for amortization, depletion, depreciation, or other cost recovery that differ from the deductions it would have been allowed had it taken a transferred basis in the contributed property under section 723, and (ii) when the partnership disposes of the contributed asset (other than by a distribution to the contributing partner and by a contribution to a controlled partnership). Under the proposed regulations, deferred gain or loss is also generally triggered upon the following partner-level events: (i) when the partner disposes of any portion of the partnership interest (other than by death), and (ii) when the partnership makes a distribution to the contributing partner, and the amount of cash and the fair market value of the property

distributed exceeds the tax basis of the partner's interest in the partnership immediately before the distribution.

The deferred sale method effectively repeals the ceiling rule. Under the deferred sale method, the amount of deferred gain or loss recognized by the contributing partner is not limited to the gain or loss from the contributed property recognized by the partnership. In addition, the amount of depreciation or other cost recovery deduction allowable to the partnership is not limited to the partnership's carryover tax basis in the property. Accordingly, shifts of precontribution gain and loss from the contributing partner to the non-contributing partner that can result from application of the ceiling rule are avoided. This result advances the purpose of section 704(c) to prevent such shifts of income.

On the other hand, the deferred sale approach appears to conflict with sections 721 and 723. Section 721 provides that the contribution of built-in gain or built-in loss property to a partnership is a nonrecognition event. Instead, the contributing partner's tax basis in such property carries over to the partnership pursuant to section 723. Additionally, the partner's basis in its partnership interest is increased by the tax basis of the contributed property pursuant to section 722. Thus, the built-in gain or loss in the property is deferred until the partnership sells or exchanges the contributed property or the contributing partner's partnership interest is liquidated.

The deferred sale method, however, undermines this deferral regime by requiring that deferred gain or loss be triggered by events that do not include the partnership selling or exchanging the contributed property or by the partner selling or exchanging its partnership interest. For example, under the

proposed regulations, deferred gain or loss is triggered upon a contribution of deferred sale property to a noncontrolled partnership or to a wholly-owned corporation.

H.R. 11, the 1992 tax bill that was vetoed by President Bush on November 4, 1992, included a new section 774(b), which would have required the use of the deferred sale method for certain "large partnerships".¹¹ "Large partnerships" were generally defined as partnerships with 250 or more partners. In the case of partnerships with 100 or more partners, section 774(b) would have permitted such partnerships to elect to apply the deferred sale method. The deferred sale method rules adopted in section 774(b) were substantially similar to those adopted in the proposed regulations. H.R. 13, a tax bill which is currently pending in the House, also includes the new section 774(b) provision.¹²

B. Use of Deferred Sale Method in the Proposed Regulations

The Section agrees with the Treasury Department and the Service that the deferred sale method should not be made mandatory in the proposed regulations. We believe that such a requirement would not be authorized by the legislative history of the 1984 Act and would be inconsistent with sections 721 and 723. Moreover, we believe that the deferred sale method is far too complex and full of traps for the unwary to be required for use by all partnerships.

¹¹ H.R. 11, 102d Cong., 2d Sess. § 4301(a) (1992).

¹² H.R. 13, 103d Cong., 1st Sess. § 301 (1993).

Nonetheless, we applaud the Treasury Department and the Service for making the deferred sale method an optional method in the proposed regulations. We believe that sophisticated partnerships counselled by competent tax attorneys should have the flexibility of using the deferred sale method as a way of avoiding unwanted shifts of built-in gain and loss by reason of the application of the ceiling rule.

This position is consistent with past considerations of the deferred sale approach. The American Law Institute ("ALI") in a 1954 report considered and rejected a deferred sale approach for adoption as the standard statutory rule covering all partnerships. The deferred sale approach was criticized for its complexity and for inappropriately accelerating income.¹³ However, the ALI proposed the adoption of an elective deferred sale method for partnerships willing to accept the added complexities.¹⁴ In a 1984 report, the ALI also rejected adopting a deferred sale approach as the standard statutory rule, in part on grounds of complexity (especially upon the admission of a new partner to an existing partnership).¹⁵ Nevertheless, the ALI noted that "many" partnerships were "more sophisticated" than the partnerships that existed in 1954 and would therefore "be better able to handle the complexities of a deferred sale approach."¹⁶

¹³ See American Law Institute, Federal Income Tax Statute -- February 1954 Draft, Volume II 354-356 (1954).

¹⁴ Id. at 354.

¹⁵ See American Law Institute, Federal Income Tax Project Subchapter K -- Proposals on the Taxation of partners 136-38 (1982). The ALI report also noted the potential abuses involving the valuation of contributed property. Id. at 131-36.

¹⁶ Id. at 138.

C. Technical Comments Regarding the Deferred Sale Method

Many of our comments in connection with the deferred sale method are intended to insure that partners of partnerships that elect the deferred sale method are not treated less favorably than partners of partnerships that elect other reasonable methods. The Section is concerned that if our concerns are not addressed in the final regulations, because of the disparity in treatment, many partnerships will not elect to apply the deferred sale method.

1. Loss disallowance rule. The last sentence of Prop. Treas. Reg. § 1.704-3(d)(2)(i) provides that deferred gain or loss is not recognized if some other Internal Revenue Code provision limits or disallows recognition. Section 707(b)(1)(A) disallows losses on sales or exchanges of property between a partnership and a partner having more than 50 percent of the capital or profits interest in the partnership. It would appear that if a partner having the requisite interest contributes built-in loss property to the partnership and the partnership elects the deferred sale method, the portion of the deferred loss that would otherwise be triggered under Prop. Treas. Reg. § 1.704-3(d)(2)(i) would be disallowed, making the deferred sale method effectively not an option for such a partner.

We believe that this result does not serve the purpose of section 707(b)(1)(A). Section 707(b)(1)(A) addresses the acceleration of a loss by a partner by means of a sale or exchange to his controlled partnership. No net acceleration of loss is entailed by the use of the deferred sale method to comply with section 704(c). Under the ordinary deferred sale rules, the contributing partner would recognize loss just as and to the extent that the partnership's depreciation deductions are

decreased by the reduction in basis. This is the case with intercompany sales of built-in loss property within a consolidated group or a section 267(f) controlled group; in these cases, deferred loss is triggered just as and to the extent depreciation is claimed with respect to the property pursuant to regulations under section 267(f).¹⁷ As with consolidated groups and section 267(f) controlled groups, the tax equipoise of the system is maintained because the recognition of deferred loss by one partner matches the diminution of depreciation deductions claimed by other partners. Thus, the application of section 707(b)(1)(A) to disallow loss recognition under the deferred sale method makes no more sense than the disallowance of the additional depreciation deductions that such a contributing partner would be entitled to under the traditional method.

We recommend that the final regulations treat deferred losses that would otherwise be disallowed under section 707(b)(1)(A) consistent with the treatment of deferred losses with respect to section 267(f) controlled groups in Treas. Reg. § 1.267(f)-1T. Accordingly, the usual trigger events generally should apply to such deferred losses, except that (i) if the contributing partner ceases to be a partner of the partnership, the deferred loss should not be triggered, but the amount of the loss should be added to the basis of the contributed property held by the partnership (see Treas. Reg. § 1.267(f)-1T(c)(6), (7)), and (ii) if the property for which loss was deferred is sold to any person having a relationship to the contributing partner specified in section 267(b), the remaining deferred loss, to the extent it is in excess of the amount of gain (if any) recognized on the sale, should not be triggered and should be

¹⁷ See Treas. Reg. §§ 1.267(f)-2T(b), 1.1502-13(d), and 1.267-1T(d).

treated as loss referred to in section 267(d)(1) (see Treas. Reg. § 1.267(f)-1T(c)(8)).

2. Sharing of nonrecourse liabilities. We understand that the Service is aware of the ambiguity regarding how partner's shares of nonrecourse liabilities are allocated under the section 752 regulations when the partnership has elected to apply the deferred sale method. Pursuant to Treas. Reg. § 1.752-3(a)(2), a partner's share of nonrecourse liabilities includes the partner's "section 704(c) minimum gain," which is

[t]he amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.

Arguably, section 704(c) minimum gain would include deferred gain since if the partnership disposed of its property subject to nonrecourse liabilities in a taxable transaction, the deferred gain would be triggered under Prop. Treas. Reg. § 1.704-3(d)(2)(iii)(A) (which is a regulation issued under section 704(c)) and allocated to the contributing partner. Some ambiguity exists, however, since taking into account the deferred gain may not constitute "taxable gain that would be allocated under section 704(c)" within the meaning of Treas. Reg. § 1.752-3(a)(2). Accordingly, the final regulations should clarify that section 704(c) minimum gain includes deferred gain for purposes of Treas. Reg. § 1.752-3(a)(2).

Of course, the section 704(c) minimum gain basis rule was adopted by the Service in 1988 in order to permit a partner to contribute encumbered and appreciated property to a partnership without recognizing immediate gain under the section 752 deemed distribution rules. The rule also permits an existing group of partners to admit a new partner and avoid immediate gain recognition under the section 752 deemed distribution rules by "booking-up" the existing partner's capital accounts to at least the amount of the non-recourse liability pursuant to a revaluation of partnership property under Treas. Reg. § 1.704-1(b)(2)(iv)(f). These policies apply with equal force to a partnership electing the deferred sale method as to partnerships electing other reasonable allocation methods. We believe that the failure to make the clarification that we recommend may result in many partnerships electing not to use the deferred sale method.

3. Application of section 704(d). Section 704(d) provides that a partner's distributive share of partnership loss shall be allowed only to the extent of the tax basis of such partner's partnership interest at the end of the partnership's taxable year in which the loss occurred. Under the deferred sale method, the contribution of property is treated "as a sale of the property to the partnership at fair market value, except that any gain or loss that would have been recognized by the partner on the sale . . . is deferred." Thus, technically a deferred loss is attributable to a sale by the partner and is not a distributive share of loss of the partnership that is subject to section 704(d).

Accordingly, the proposed regulations leave open the possibility of a partner having a negative basis in the partner's partnership interest.

Example. A contributes asset X to ABC partnership. Asset X has a tax basis of \$100 and a fair market value of \$50. ABC partnership elects to apply the deferred sale method. A is treated as selling asset X to ABC partnership, creating a \$50 deferred loss. Pursuant to Prop. Treas. Reg. § 1.704-3(d)(1), A has a basis in its partnership interest of \$100.

In Year 1, A is allocated \$100 of partnership loss from normal partnership operations. A's basis in its partnership interest is reduced to \$0. In Year 2, ABC partnership sells asset X, which triggers the recognition of A's \$50 deferred loss. The partnership's income and loss items offset each other for the year. Pursuant to Prop. Treas. Reg. § 1.704-3(d)(1), A must reduce the basis of its partnership interest by the amount of the deferred loss recognized in Year 2. Presumably, A's basis in its partnership interest is reduced to negative \$50.

The partnership regime assiduously avoids negative basis.¹⁸ Moreover, permitting the partner to recognize the loss and take a negative basis would put the partner in a better position than if the partnership had elected the traditional method (with or without curative allocations). Accordingly, the final regulations should provide that a deferred loss that is

¹⁸ For example, in the case of a nonliquidating distribution the distributee partner takes the distributed property with a basis equal to the partnership's basis in the property immediately before the distribution. Section 732(a)(1). Pursuant to Section 733, the basis of the distributee partner's partnership interest is reduced by the basis of the property. However, where the basis of the property in the hands of the partnership immediately before the distribution exceeds the partner's basis in its partnership interest, these rules would result in the distributee partner having a negative basis in its partnership interest. To avoid such a result, in such cases the property takes a basis equal to the partner's basis in its partnership interest. Section 732(a)(2).

taken into account shall be treated as a distributive share of partnership loss for purposes of section 704(d).

4. **Transfers at death.** A transfer of a partnership interest as a result of death is not a trigger event under the proposed regulations. Pursuant to section 1016, a recipient of a partnership interest transferred as a result of a partner's death takes the interest with a basis equal to its fair market value. Assume, however, that at the time of the partner's death, the partner's partnership interest was subject to deferred gain. How is the deferred gain treated after the step-up in the basis of the partnership interest in the hands of the transferee partner? If the partnership had elected the traditional method (with or without curative allocations) and had a section 754 election in effect or if section 732(d) applied, the resulting basis increase to the distributee partner's share of partnership assets pursuant to section 743(b) or 732(d) generally would reduce or eliminate the precontribution gain in the contributed property. Accordingly, we recommend that deferred gain or loss be eliminated to the extent precontribution gain or loss would be eliminated by reason of adjustments pursuant to sections 1016 and section 743(b) or 732(d) had the partnership elected a reasonable method other than the deferred sale method. Such a rule would mirror the results of a transfer of a partnership interest at death and a section 743(b) or 732(d) adjustment in the case where the partnership has elected to apply the traditional method (with or without curative allocations) or some other reasonable method.

D. **Partnership Distributions**

1. **Background.** Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) provides that if a partnership distributes to the contributing partner cash or property other than the contributed

property, the contributing partner recognizes any remaining deferred gain or loss with respect to any contributed property to the extent the cash and the fair market value of the other property exceed the adjusted basis of the contributing partner's partnership interest immediately before the distribution. This provision is similar to new section 737, which was enacted in H.R. 776, the Energy Policy Act of 1992 (the "Energy Act").¹⁹ Section 737, however, is only triggered by a distribution made within five years of the original property contribution.

Section 737 was aimed at the avoidance of section 704(c)(1)(B). Under section 704(c)(1)(B), if a partner contributes built-in gain or loss property to a partnership, and the partnership distributes the property to another partner within five years of the contribution, the contributing partner must recognize gain as if the property had been sold at its fair market value at the time of distribution. Congress became concerned that section 704(c)(1)(B) could be easily avoided by not distributing the contributed property and by redeeming the contributing partner out of the partnership with a distribution of other property.

¹⁹ Section 737 provides that if a partner contributes built-in gain property to a partnership and within five years distributes other property to that partner, the contributing partner must recognize gain to the extent that the fair market value of the distributed property (other than money) exceeds the partner's adjusted basis in the partnership interest (reduced by the amount of money in the distribution). Section 737(a) limits the gain recognition to the contributing partner's "net precontribution gain." Under section 737(b), that is the net gain that would have been recognized by the contributing partner under section 704(c)(1)(B) if all property that had been contributed by that partner to the partnership during the previous five years and that was held by the partnership immediately before the distribution had been distributed to another partner.

2. Section 737 and section 704(c)(1)(B) references.

Presumably, sections 704(c)(1)(B) and 737 would not affect a partner who contributes property which is subject to the deferred sale method, since such property would obtain a tax basis equal to its fair market value in the hands of the partnership. To avoid possible confusion among practitioners over the possibility of duplicating gain that is taken into account under the deferred sale rules, however, Prop. Treas. Reg. 1.704-3(d)(2)(ii)(B) should provide that section 737 does not apply and Prop. Treas. Reg. § 1.704-3(d)(2)(iii)(B) should provide that section 704(c)(1)(B) does not apply.

We note that proposed section 774(b) provides that sections 704(c) and 737 shall not apply to contributions of property to large partnerships. Proposed section 774(b) would apply distribution rules similar to those in Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B).

3. Duplication of deferred gain. The interaction of a distribution which triggers Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) and the trigger event caused by a taxable disposition of all or part of the contributing partner's partnership interest in Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A) should be addressed in the proposed regulations.

Example. A and B form AB partnership. A contributes property with a \$100 value and \$20 basis and B contributes property with a \$100 value and \$100 basis to the partnership in exchange for 50 percent interests in the partnership. AB partnership elects to apply the deferred sale method. A is treated as selling its property to AB, creating an \$80 deferred gain.

Three years later, AB distributes to A \$50 in cash in exchange for one-half of A's 50 percent

interest in AB. Assume that AB's profits and losses offset each other each of the first three years and that no deferred gain has yet been triggered. Presumably, A has disposed of one-half of its interest in a taxable disposition under Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A), and \$40 of A's deferred gain is triggered ($\frac{1}{2}$ times \$80). Additionally, under Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) the distribution triggers \$30 of A's deferred gain (\$50 cash received less \$20 basis in A's partnership interest).

In the above example, it would be inappropriate to trigger \$70 of A's \$80 deferred gain. We recommend that the final regulations provide that Prop. Treas. § 1.704-3(d)(2)(ii)(A) does not apply to distributions by the partnership with respect to a partner's interest in the partnership. If it is determined that Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A) should apply to partnership distributions, then in order to prevent the duplication of deferred gain, we recommend that at the end of Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B), the following sentence be added:

If a distribution to a contributing partner triggers a recognition of deferred gain or loss under paragraph (d)(2)(ii)(A) of this section, such deferred gain or loss shall be taken into account and the basis in the contributing partner's interest in the partnership shall be increased or reduced accordingly before the determination is made whether any deferred gain is triggered pursuant to this paragraph (d)(2)(ii)(B).

Additionally, a rule should be adopted to insure that deferred gain is taken into account and adjustments to the basis in the partner's interest in the partnership are made pursuant to Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) (and Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A) if it is determined that it applies to

partnership distribitons) prior to the determination of whether a distribution of cash results in gain under section 731(a).

4. Reduction in contributing partner's interest in the partnership. Prop. Treas. Reg. § 1.704-3(d)(2)(i) provides that "[a]s a general rule," deferred gain or loss is triggered "when the contributing partner's interest in the partnership is reduced." However, Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) only refers to the value of the distribution and the basis of the partner's interest in the partnership immediately before the distribution; no reference is made to a reduction in the contributing partner's interest in the partnership. Additionally, Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A) triggers deferred gain upon a taxable disposition of a contributing partner's interest in the partnership; as noted above, we recommend that this provision not apply to partnership distributions, and in any case, the provision is not triggered by a nontaxable disposition.

We assume that Prop. Treas. Reg. § 1.704-3(d)(2)(i) does not provide operative rules for triggering deferred gain and loss. If this assumption is accurate, it should be clarified in the final regulations.

A complete liquidating distribution of property (other than the contributed property) in complete reduction of the contributing partner's interest in the partnership will not necessarily trigger deferred gain or loss under the proposed regulations. For example, assume that partner X contributes property with a \$100 value and \$50 basis to a partnership with many other partners and properties. The partnership elects to apply the deferred sale method. After three years, the property contributed by X continues to have a \$100 value, but the

partnership's other property has declined in value. X is completely redeemed out of the partnership in exchange for a distribution of property (other than the property contributed by X) worth \$50. X's \$50 of deferred gain is not triggered under either Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) (because the \$50 value of the distributed property does not exceed the \$50 basis of X's partnership interest) or Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A) (because a distribution of property other than cash is a nonrecognition event under section 731(a)). This result is inconsistent with the general precepts of Prop. Treas. Reg. § 1.704-3(d)(2)(i). Moreover, the partnership will enjoy a full step-up in basis of the property contributed by X even though X has completely disposed of its interest in the partnership and has never been taxed on the built-in gain in the contributed property. To resolve this problem, we recommend that a complete liquidating distribution be added as a trigger event.

A partial liquidating distribution of property (other than the contributed property) in reduction of a partner's interest in the partnership also will not necessarily trigger deferred gain or loss under the proposed regulations. For example, assume instead that one-half of X's partnership interest is redeemed in exchange for property (other than the contributed property) with a \$50 value. Again, X's \$50 of deferred gain is not triggered under either Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(B) or § 1.704-3(d)(2)(ii)(A). This result is also apparently inconsistent with the general precepts in Prop. Treas. Reg. § 1.704-3(d)(2)(i).

An argument can be made that a partial liquidating distribution should trigger a proportionate share of deferred gain or loss. However, we believe that for a number of reasons this should not be the case. First, the contributing partner

will remain a partner of the partnership and eventually will recognize the deferred gain or loss under the usual trigger rules (i.e., when the contributed property is sold, when the contributing partner's interest in the partnership is sold, etc...). Second, in the partnership area, partial liquidating distributions generally are treated differently than complete liquidating distributions. See, e.g., sections 731(a), 732(a), 732(b), and 736; Treas. Reg. § 1.761-1(d). Third, a partial liquidating distribution in many cases has the same economic effect as a "flip" provision in a partnership agreement. For example, assume that a partnership agreement provides that when the contributing partner receives distributions in an aggregate amount equal to the value of the property it contributed to the partnership, its percentage interest will decline from 50 percent to 25 percent. Such a "flip" provision in substance is indistinguishable from a partial liquidating distribution, and "flip" provisions should not constitute trigger events in the final regulations.

5. Anti-stuffing rule. Proposed section 774(b)(2)(C)(ii)(II) provides that if the contributing partner contributes an interest in an entity to the partnership, and later that interest is distributed to the contributing partner, the rule that no gain or loss is to be recognized does not apply to the extent that the value of such interest is attributable to property contributed to such entity after such interest had been contributed to the partnership. Section 737(d) contains a similar exception. Prop. Treas. Reg. § 1.704-3(d)(6)(i) should contain a similar anti-stuffing rule.

6. Section 708(b)(1)(B) deemed terminations. Upon the sale or exchange of 50 percent or more of the capital and profits interests in a partnership within a twelve-month period,

the partnership is deemed to terminate pursuant to section 708(b)(1)(B). As a result, Treas. Reg.

§ 1.708-1(b)(1)(iv) treats the partnership as distributing its properties in liquidation of the interests of the new partner and the remaining partners in proportion to their respective interests in the partnership. Immediately thereafter, the new partner and the remaining partners are treated as contributing the properties to a newly reconstituted partnership for continuation of the business.

The proposed regulations do not refer to the effects of a section 708(b)(1)(B) deemed termination of a partnership on a remaining partner which has yet to recognize all of the deferred gain or loss with respect to deferred sale property. As a technical matter, it would appear that deferred gain or loss with respect to such property would be triggered by a deemed distribution of the partnership's properties (including any deferred sale property) as a result of a section 708(b)(1)(B) deemed termination pursuant to Prop. Treas. Reg. 1.704-3(d)(2)(ii)(B).

We believe that a deemed termination of a partnership under section 708(b)(1)(B) should not constitute a trigger event under the deferred sale method. We note that the legislative history to section 737 indicates that precontribution gain under section 737 is not triggered by a deemed termination under section 708(b)(1)(B).²⁰ Moreover, section 774(d) in H.R. 13

²⁰ Conference Report, H.R. 776, 102d Cong. 2d Sess. 46 (1992).

provides that section 708(b)(1)(B) would not apply to a large partnership.²¹

Any such exception in the final regulations will have to provide a special rule for the computation of basis following the deemed termination. If deferred gain is not triggered upon a deemed distribution under Treas. Reg. § 1.708-1, then the contributing partner's basis in the partnership is not increased. The tax consequences of the deemed distribution are covered by sections 731 and 732, with the result that the basis of the partnership's assets in the hands of the contributing partner will be equal to the contributing partner's basis in the partnership immediately prior to the deemed distribution. Upon the deemed recontribution, such basis will carryover and be the partnership's new basis in its assets. Section 723. As a result of this deemed distribution and recontribution, therefore, the partnership's basis in its assets will have been reduced by the amount of deferred gain. Any rule triggering deferred gain or loss will therefore need to contain a provision which restores the amount of deferred gain or loss to the partnership's basis in the contributed property immediately following the termination.

If Treasury and the Service determine that deferred gain or loss can be triggered upon a deemed termination under

²¹ Additionally, to the extent a deferred loss is triggered because a partner's interest in the partnership is reduced, a deemed termination under section 708(b)(1)(B) may inappropriately trigger a deferred loss. Indeed, a contributing partner could be in a position to trigger a section 708(b)(1)(B) deemed termination intentionally in order to recognize a deferred loss by transferring its partnership interest pursuant to sections 721, 731, 332, 351, or 368(a)(1)(A), (C) or (D). Such transfers constitute "sales or exchanges" within the meaning of section 708(b)(1)(B), but would not trigger deferred gain or loss pursuant to Prop. Treas. Reg. § 1.704-3(d)(2)(ii)(A).

section 708(b)(1)(B), it should so state in the final regulations. We feel that many partnerships would refuse to elect the deferred sale method if deferred gain or loss is triggered upon a deemed termination under section 708(b)(1)(B).

VI. Exceptions and Special Rules

A. De Minimis Exception

We believe that the de minimis exception in the proposed regulations is far too strict and would impose significant record keeping costs on many small partnerships.

The legislative history clearly expresses Congress' concern that small partnerships would be unduly burdened. The Senate Report suggests that disparities of less than 15 percent (but not to exceed \$10,000) in aggregated properties could be subjected to the prior law rule of elective elimination of book-tax differences.²² This apparently is the source of the present de minimis rule. However, the Conference Committee and Bluebook call attention to this suggestion, and direct the Treasury to treat such suggestion as an illustration of an appropriate provision for flexibility rather than a limitation on such provisions.²³

We recommend that the dollar amount of the cap on aggregate disparities be raised to \$50,000.

²²S. Prt. No. 169, Vol. I, 98th Cong., 2d Sess. 215 (1984).

²³H.R. Conf. Rep. 861, 98th Cong., 2d Sess. 857 (1984); Staff of Joint Comm. on Taxation, General Explanation of H.R. 4170, 98th Cong., 2d Sess. 214 (Comm. Print 1984).

B. Aggregation

The "general asset account" aggregation rule limits aggregation to assets that are in the same asset class, that have the same depreciation method, first-year convention, and recovery period, and that are placed in service by the taxpayer in the same taxable year.²⁴ This aggregation rule is unduly restrictive, and in particular is of limited use to a partner who contributes all the operating assets of a small business to a partnership. Such partners are especially burdened by the cost of record keeping and appraisals for separate assets. We hope that the Service and the Treasury Department will consider a further relaxation of the aggregation rule. For example, we believe it would be helpful to permit aggregation of all section 1231 assets with no remaining recovery period and assets that have been expensed under section 162(a) or treated as expensed under section 179(a). Permitting the aggregation of such assets presents few (if any) opportunities for abuse.

Further consideration should also be given to a suggestion in the Senate Report that built-in gain items contributed by a single partner be electively aggregated and that built-in loss items contributed by a single partner also be electively aggregated.²⁵ Such an aggregation rule would further Congress' desire to avoid needless computational complexity.

²⁴See Prop. Treas. Reg. § 1.168(i)-1(c)(2).

²⁵S. Rpt. No. 169, Vol. I, 98th Cong., 2d Sess. 215 (1984).