



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-138759-14]

RIN 1545-BM48

Aggregation of Basis for Partnership Distributions Involving Equity Interests of a Partner

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would allow consolidated group members that are partners in the same partnership to aggregate their bases in stock distributed by the partnership for the purpose of limiting the application of rules that might otherwise cause basis reduction or gain recognition. The proposed regulations would also require certain corporations that engage in gain elimination transactions to reduce the basis of corporate assets or to recognize gain. The proposed regulations affect partnerships and their partners.

DATES: Comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-138759-14), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours

of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-138759-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-138759-14).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kevin I. Babitz, (202) 317-6852; concerning submission of comments or to request a public hearing, Oluwafunmilayo Taylor at (202) 317-6901.

SUPPLEMENTARY INFORMATION:

Background

1. Section 337(d) and the Repeal of the General Utilities Doctrine

In General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), the Supreme Court held that corporations generally could distribute appreciated property to their shareholders without the recognition of any corporate level gain (the General Utilities doctrine). Beginning in 1969 and ending with the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, (the Act), Congress enacted a series of statutory changes that limited and ultimately repealed the General Utilities doctrine. Under current law, sections 311(b) and 336(a) of the Internal Revenue Code (Code) require a corporation that distributes appreciated property to its shareholders to recognize gain determined as if the property were sold to the shareholders for its fair market value. Additionally, section 631 of the Act added section 337(d) to the Code to permit the Secretary to prescribe regulations that are necessary or appropriate to carry out the purposes of the General Utilities repeal, "including regulations to ensure that [the repeal

of the General Utilities doctrine] may not be circumvented through the use of any provision of law or regulations.”

2. Section 732(f)

Section 538 of the Ticket to Work and Work Incentives Improvement Act of 1999, Public Law 106-170, 113 Stat. 1860, (the Ticket to Work Act), enacted section 732(f) on December 17, 1999. Section 732(f) provides that if: (1) a corporate partner receives a distribution from a partnership of stock in another corporation (distributed corporation), (2) the corporate partner has control of the distributed corporation (ownership of stock meeting the requirements of section 1504(a)(2)) immediately after the distribution or at any time thereafter (the “control requirement”), and (3) the partnership’s basis in the stock immediately before the distribution exceeded the corporate partner’s basis in the stock immediately after the distribution, then the basis of the distributed corporation’s property must be reduced by this excess. The amount of this reduction is limited to the amount by which the sum of the aggregate adjusted basis of property and the amount of money of the distributed corporation exceeds the corporate partner’s adjusted basis in the stock of the distributed corporation. The corporate partner must recognize gain to the extent that the basis of the distributed corporation’s property cannot be reduced.

Congress enacted section 732(f) due to concerns that a corporate partner could otherwise negate the effects of a basis step-down to distributed property required under section 732(b) by applying the step-down against the basis of distributed stock of a corporation (distributed corporation). The Senate Finance Committee stated that:

The Committee is concerned that the downward adjustment to the basis of property distributed by a partnership may be nullified if the distributed

property is corporate stock. The distributed corporation can be liquidated by the corporate partner, so that the stock basis adjustment has no effect. Similarly, if the corporations file a consolidated return, their taxable income may be computed without reference to the downward adjustment to the basis of the stock. These results can occur either if the partnership has contributed property to the distributed corporation, or if the property was held by the corporation before the distribution. Therefore, the provision requires a basis reduction to the property of the distributed corporation.

S. Rep. No. 106-201, 106th Cong., 1st Sess. 50 (1999).

For example, assume a corporate partner has a partnership interest with zero basis and receives a partnership distribution of high-basis stock in a corporation. The corporate partner's basis in the distributed corporation's stock is reduced to zero under section 732(a) or section 732(b). If the partnership has elected under section 754, then the basis of other partnership property is increased by an equal amount under section 734(b). The effects of the section 732 basis decrease and the section 734(b) basis increase generally offset each other. However, if the corporate partner owned stock in the distributed corporation that satisfied the control requirement, the corporate partner could liquidate the distributed corporation under section 332, and section 334(b) would generally provide for a carryover basis in the distributed corporation's property received by the corporate partner in the liquidation. Taken together, these rules could permit the partnership to increase the basis of its retained property without an equivalent basis reduction following the liquidation of the distributed corporation. Section 732(f) generally precludes this result by requiring that either the distributed corporation must

reduce the basis of its property or the corporate partner must recognize gain (to the extent the distributed corporation is unable to reduce the basis of its property). Thus, section 732(f) generally ensures that any basis increase under section 734(b) is ultimately offset.

Section 732(f) applies if the corporate partner either has control of the distributed corporation following the distribution or if the corporate partner subsequently acquires control of the distributed corporation at any time thereafter. Section 732(f) does not apply if the corporate partner does not have control of the distributed corporation immediately following the distribution and the corporate partner establishes to the satisfaction of the Secretary that the distribution was not part of a plan or arrangement to acquire control of the distributed corporation.

In its discussion of the control requirement of section 732(f)(1)(B), the Conference Report to the Ticket to Work Act explains that “[t]his provision also calls for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of this provision.” H. R. Conf. Rep. No. 106-478, 106th Cong., 1st Sess. 174 (1999). This grant of regulatory authority is codified at section 732(f)(8), which provides that “[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations to avoid double counting and to prevent the abuse of such purposes.”

Simultaneous with this notice of proposed rulemaking, the Treasury Department and the IRS are issuing final and temporary regulations under section 337(d) (§1.337(d)-3T) that prevent a corporate partner from using a partnership to avoid corporate-level gain required to be recognized under section 311(b) or section 336(a)

following the repeal of the General Utilities doctrine. Those final and temporary regulations address partnership acquisitions, ownership, and distributions of stock and other equity interests in a corporate partner. Sections 732(f) and 337(d) share a common purpose of preserving corporate-level gains. Given this shared purpose, these proposed regulations are issued under the combined authority of sections 337(d) and 732(f).

Explanation of Provisions

As described in this preamble, Congress provided the Treasury Department and the IRS with a broad grant of statutory authority to carry out the purposes of sections 337(d) and 732(f). The Treasury Department and the IRS believe that as currently applied, section 732(f) may be too broad in some circumstances and too narrow in others. Specifically, section 732(f) may require basis reduction or gain recognition even though that basis reduction or gain recognition does not further the purposes of section 732(f). In other circumstances, corporate partners may inappropriately avoid the purposes of section 732(f) by engaging in transactions that allow corporate partners to receive property held by a distributed corporation without reducing the basis of that property to account for basis reductions under section 732(b) made when the partnership distributed stock of the distributed corporation to the corporate partner. These proposed regulations add rules to conform the application of section 732(f) with Congress's identified purposes for enacting sections 337(d) and 732(f) in these situations.

1. Aggregation of Section 732(b) Basis Adjustments

Section 732(f) generally applies on a partner-by-partner basis. However, the Treasury Department and the IRS believe that in certain circumstances, it is appropriate

to aggregate the bases of consolidated group members in a partnership for purposes of applying section 732(f). For example, basis aggregation may be appropriate when two or more corporate partners in the same consolidated group (member-partners) receive a deemed distribution of stock in a distributed corporation either because (a) the partnership elects to be treated as an association taxable as a corporation under §301.7701-3 or (b) one corporate partner acquires all of the interests in the partnership causing the partnership to liquidate. In these instances, section 732(b) may cause one member-partner to increase the basis of distributed stock while another member-partner reduces the basis of distributed stock by an equivalent amount. Under current law, section 732(f) may require the member-partner whose basis is reduced to recognize gain or to reduce the basis of the distributed corporation's property, with no offsetting loss or increase to the basis of the distributed corporation's property with respect to the member-partner whose basis is increased. The Treasury Department and the IRS do not believe that prohibiting member-partners from consolidating their bases in a partnership for purposes of applying section 732(f) in these situations furthers Congress's intent to sustain the effect of the basis reduction to distributed property.

These proposed regulations provide for the aggregation of basis within the same consolidated group (as defined in §1.1502-1(h)), for purposes of section 732(f), when two conditions are met. First, two or more of the corporate partners receive a distribution of stock in a distributed corporation. Second, the distributed corporation is or becomes a member of the distributee partners' consolidated group following the distribution.

Under this rule, section 732(f) only applies to the extent that the partnership's adjusted basis in the distributed stock immediately before the distribution exceeds the aggregate basis of the distributed stock in the hands of all members of the distributee corporate partner's consolidated group immediately after the distribution. The requirement that the distributed corporation be a member of the consolidated group is intended to avoid unintended consequences that could result if that corporation was a controlled foreign corporation. However, the Treasury Department and the IRS request comments on whether this proposed rule should apply more broadly.

2. Gain Elimination Transactions

As described in the Background section of this Preamble, Congress enacted section 732(f) to address concerns that a corporate partner could otherwise negate the effects of a basis step-down to distributed property required under section 732(b) by applying the step-down against stock of a distributed corporation. Congress indicated that it intended for the control requirement to apply expansively by requiring corporate partners to apply section 732(f) whenever the corporate partner acquires control (as defined in section 732(f)(5)) of the distributed corporation as part of a plan or arrangement. The formalistic definition of control, however, fails to anticipate other scenarios in which a corporate partner's acquisition of the property of a distributed corporation has the same effect. To address these scenarios, Congress granted the Secretary authority to promulgate regulations necessary to carry out the purposes of section 732(f).

The Treasury Department and the IRS are concerned that some corporate partners might eliminate gain in the stock of a distributed corporation while avoiding the

effects of a basis step-down in transactions in which the corporate partner's ownership of the distributed corporation does not satisfy the control requirement. For example, a distributed corporation not controlled by a corporate partner might subsequently merge into the corporate partner in a reorganization under section 368(a) in which gain is not recognized as part of a plan or arrangement. In this situation, the gain inherent in the stock of the distributed corporation is eliminated, but the basis of the distributed corporation's property is not reduced. If section 732(f) does not apply to this transaction, then the basis step-down is negated, contravening the purposes of section 732(f) and General Utilities repeal.

Accordingly, these proposed regulations provide that, in the event of a gain elimination transaction, section 732(f) shall apply as though the corporate partner acquired control (as defined in section 732(f)(5)) of the distributed corporation immediately before the gain elimination transaction.

The proposed regulations define several terms for purposes of applying this rule. The term "Corporate Partner" means a person that is classified as a corporation for federal income tax purposes and that holds or acquires an interest in a partnership. The term "Stock" includes other equity interests, including options, warrants and similar interests. The term "Distributed Stock" means Stock distributed by a partnership to a Corporate Partner, or Stock the basis of which is determined by reference to the basis of such Stock. Distributed Stock also includes Stock owned directly or indirectly by a Distributed Corporation if the basis of such Stock has been reduced pursuant to section 732(f)(7). The term "Distributed Corporation" means the issuer of Distributed Stock (or, in the case of an option, the issuer of the Stock into which the option is exercisable).

The term “Gain Elimination Transaction” means a transaction in which Distributed Stock is disposed of and less than all of the gain is recognized, unless (1) the transferor of the Distributed Stock receives in exchange Stock or a partnership interest that is exchanged basis property (as defined in section 7701(a)(44)) with respect to the Distributed Stock, or (2) a transferee corporation holds the Distributed Stock as transferred basis property (as defined in section 7701(a)(43)) with respect to a transferor corporation’s gain.

Examples of Gain Elimination Transactions include (without limitation) a reorganization under section 368(a) in which the Corporate Partner and the Distributed Corporation combine, and a distribution of the Distributed Stock by the Corporate Partner to which section 355(c)(1) or 361(c)(1) applies.

3. Tiered Partnerships

The IRS and the Treasury Department are concerned that taxpayers could use tiered partnerships to circumvent these regulations and section 732(f) generally.

Congress specified in the Conference Report to the Ticket to Work Act that taxpayers should not be permitted to avoid the purposes of section 732(f) through the use of tiered partnerships. H. R. Conf. Rep. No. 106-478, 106th Cong., 1st Sess. 174 (1999).

Therefore, these regulations require taxpayers to apply these regulations to tiered partnerships in a manner consistent with the purpose of section 732(f).

Effective/Applicability Date

The rules governing aggregation of basis apply to distributions occurring on or after the date these regulations are published as final regulations in the **Federal Register**. The rules governing gain elimination transactions apply to transactions occurring on or after the date these regulations are published as final regulations in the

Federal Register. The rules governing tiered partnerships apply to distributions and transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**. No inference is expressed or implied with respect to distributions or transactions occurring before the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. These proposed regulations do not impose a collection of information on small entities. Further, pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these proposed regulations would primarily affect sophisticated ownership structures with interlocking ownership of corporations, partnerships and corporate stock. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will

be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Kevin I. Babitz and Joseph R. Worst, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.732-3 also issued under 26 U.S.C. 337(d), 732(f), and 1502. * * *

Par. 2. Section 1.732-3 is revised to read as follows:

§1.732-3 Corresponding adjustment to basis of assets of a distributed corporation controlled by a corporate partner.

(a) Determination of control. The determination of whether a corporate partner that is a member of a consolidated group has control of a distributed corporation for

purposes of section 732(f) shall be made by applying the special aggregate stock ownership rules of §1.1502-34.

(b) Aggregation of basis within consolidated group. With respect to distributed stock of a corporation, if the following two conditions are met, then section 732(f) shall apply only to the extent that the partnership's adjusted basis in the distributed stock immediately before the distribution exceeds the aggregate basis of the distributed stock of the corporation in the hands of corporate partners that are members of the same consolidated group (as defined in §1.1502-1(h)) immediately after the distribution:

(1) Two or more of the corporate partners receive a distribution of stock in another corporation; and

(2) The corporation, the stock of which was distributed by the partnership, is or becomes a member of the distributee partners' consolidated group following the distribution.

(c) Application of section 732(f) to Gain Elimination Transactions– (1) General rule. In the event of a Gain Elimination Transaction, section 732(f) shall apply as though the Corporate Partner acquired control (as defined in section 732(f)(5)) of the Distributed Corporation immediately before the Gain Elimination Transaction.

(2) Definitions. The following definitions apply for purposes of this paragraph (c):

(i) Corporate Partner. The term Corporate Partner means a person that is classified a corporation for federal income tax purposes and that holds or acquires an interest in a partnership.

(ii) Stock. The term Stock includes other equity interests, including options, warrants and similar interests.

(iii) Distributed Stock. The term Distributed Stock means Stock distributed by a partnership to a Corporate Partner, or Stock the basis of which is determined by reference to the basis of such Stock. Distributed Stock also includes Stock owned directly or indirectly by a Distributed Corporation if the basis of such Stock has been reduced pursuant to section 732(f).

(iv) Distributed Corporation. The term Distributed Corporation means the issuer of Distributed Stock (or, in the case of an option, the issuer of the Stock into which the option is exercisable).

(v) Gain Elimination Transaction. The term Gain Elimination Transaction means a transaction in which Distributed Stock is disposed of and less than all of the gain is recognized unless—

(A) The transferor of the Distributed Stock receives in exchange Stock or a partnership interest that is exchanged basis property (as defined in section 7701(a)(44)) with respect to the Distributed Stock, or

(B) A transferee corporation holds the Distributed Stock as transferred basis property (as defined in section 7701(a)(43)) with respect to the transferor corporation's gain. A Gain Elimination Transaction includes (without limitation) a reorganization under section 368(a) in which the Corporate Partner and the Distributed Corporation combine, and a distribution of the Distributed Stock by the Corporate Partner to which section 355(c)(1) or 361(c)(1) applies.

(d) Tiered partnerships. The rules of this section shall apply to tiered partnerships in a manner that is consistent with the purposes of section 732(f).

(e) Effective/applicability date. The rules governing aggregation of basis in paragraph (b) of these regulations apply to distributions occurring on or after the date these regulations are published as final regulations in the **Federal Register**. The rules governing gain elimination transactions in paragraph (c) of this section apply to transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**. The rules governing tiered partnerships in paragraph (d) of this section apply to distributions and transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

John Dalrymple

Deputy Commissioner for Services and Enforcement.