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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9722]

RIN 1545-BM35

Partnership Transactions Involving Equity Interests of a Partner

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that prevent a corporate partner from avoiding corporate-level gain through transactions with a partnership involving equity interests of the partner. These regulations affect partnerships and their partners. The text of these temporary regulations serves as the text of proposed regulations (REG-149518-03) published in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §§1.337(d)-3T(i) and 1.732-1T(c)(5).

FOR FURTHER INFORMATION CONTACT: Concerning the final and temporary regulations, Kevin I. Babitz, (202) 317-6852.

SUPPLEMENTARY INFORMATION:

Background

The General Utilities Doctrine and Its Repeal

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, Congress enacted a series of exceptions to the General Utilities doctrine, starting with certain non-liquidating distributions of depreciable property. In the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248, 96 Stat. 324, Congress enacted current section 311(b) (originally designated as section 311(d)), which required a corporation to recognize gain on appreciated property distributed to a shareholder in redemption of shares. In 1984, Congress enacted legislation that required gain recognition for all non-liquidating distributions. Finally, as part of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, (the Act), Congress repealed what remained of the General Utilities doctrine by enacting section 336(a) of the Internal Revenue Code (Code) to apply gain and loss recognition to liquidating distributions. Under current law, sections 311(b) and 336(a) of the 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.”

1992 Proposed Regulations

After the enactment of sections 311(b) and 337(d), the Treasury Department and the IRS became aware of transactions in which taxpayers used a partnership to postpone or avoid completely gain generally required to be recognized under section 311(b). In one example of this transaction, a corporation entered into a partnership and contributed appreciated property. The partnership then acquired stock of that corporate partner, and later made a liquidating distribution of this stock to the corporate partner. Under section 731(a), the corporate partner did not recognize gain on the partnership's distribution of its stock. By means of this transaction, the corporation had disposed of the appreciated property it formerly held and had acquired its own stock, permanently avoiding its gain in the appreciated property. If the corporation had directly exchanged the appreciated property for its own stock, section 311(b) would have required the corporation to recognize gain upon the exchange.

In response to this type of transaction, the Treasury Department and the IRS issued Notice 89-37, 1989-1 CB 679, on March 9, 1989. Notice 89-37 announced that future regulations under section 337(d) would address the use of partnerships to avoid the repeal of the General Utilities doctrine. Specifically, the Treasury Department and the IRS determined that, in certain circumstances, the acquisition (or ownership) by a partnership of stock in one of its corporate partners (or stock of any member of the affiliated group of which the partner is a member) results in avoidance of the repeal of the General Utilities doctrine. Such avoidance occurs to the extent that a corporate

partner, in substance, relinquishes an interest in appreciated property in exchange for an interest in its stock (or the stock of an affiliate). The Notice provided that section 311(b), rather than section 731(a), would apply when a partner received a distribution of its own stock, and that the partner would recognize gain whenever a pre-distribution transaction has the economic effect of an exchange of appreciated property for the partner's own stock.

On December 15, 1992, the Treasury Department and the IRS published a notice of proposed rulemaking under section 337(d) (PS-91-90, REG-208989-90, 1993-1 CB 919) in the **Federal Register** (57 FR 59324) addressing partnership transactions involving stock of a partner (the 1992 proposed regulations). The 1992 proposed regulations adopted two rules to protect the repeal of the General Utilities doctrine: the deemed redemption rule (the 1992 deemed redemption rule) and the distribution rule (the 1992 distribution rule). The 1992 proposed regulations also provided de minimis and inadvertence exceptions to these two rules.

The 1992 deemed redemption rule addressed pre-distribution transactions involving corporate partner stock owned or acquired by the partnership. The Treasury Department and the IRS believed that certain of these transactions created the economic effect of an exchange of appreciated property for corporate partner stock. The 1992 deemed redemption rule provided that a corporate partner recognizes gain at the time of, and to the extent that, any transaction (or series of transactions) has the economic effect of an exchange by the partner of its interest in appreciated property for an interest in its stock (or the stock of any member of the affiliated group of which such partner is a member) owned, acquired, or distributed by the partnership.

The 1992 distribution rule provided that a partnership's distribution to a partner of the partner's stock is treated as a redemption or an exchange of the stock of the partner for a portion of the partner's partnership interest with a value equal to the distributed stock. Thus, the 1992 distribution rule applied section 311(b) principles to the distribution to trigger gain to the corporate partner, rather than applying section 731, which would not have required gain recognition. The 1992 distribution rule ensured that section 311(b) would apply to any acquisition by the corporate partner of its own stock where the 1992 deemed redemption rule had not applied. The preamble to the 1992 proposed regulations indicated that commenters on the Notice raised concerns that the 1992 distribution rule could duplicate gain recognition and suggested a modified approach. However, the 1992 proposed regulations rejected the modified approach as overly complex.

As noted previously, the 1992 proposed regulations applied to stock of a partner, to stock of a partner's affiliate, and to other equity interests in the partner or affiliate. The 1992 proposed regulations used a modified affiliation standard to determine whether a partner and another corporation were affiliates. The 1992 proposed regulations treated a corporation as an affiliate of a partner at the time of a deemed redemption or distribution by the partnership if, immediately thereafter, the partner and corporation were members of an affiliated group as defined in section 1504(a) without regard to section 1504(b) (section 337(d) affiliation). On January 19, 1993, the Treasury Department and the IRS issued Notice 93-2, 1993-1 CB 292, which stated that the 1992 proposed regulations would be amended to limit the application of the regulations to transactions in which section 337(d) affiliation existed immediately before

the deemed redemption or distribution. The Treasury Department and the IRS indicated that further study was required for cases in which section 337(d) affiliation did not exist prior to a distribution of stock by a partnership to a corporate partner, but resulted from the distribution.

The Treasury Department and the IRS received several written comments in response to Notice 89-37, the 1992 proposed regulations, and Notice 93-2. Commenters largely supported the 1992 deemed redemption rule, though some suggested modifications. Some commenters, however, opposed the 1992 distribution rule, asserting that the rule is overly broad and inconsistent with the deemed redemption rule. These comments are discussed in detail in the Explanation of Provisions section of this preamble.

After considering these comment letters, and taking into account subsequent changes in relevant law as described in part 1 of this preamble, the Treasury Department and the IRS are withdrawing the 1992 proposed regulations and simultaneously issuing temporary and final regulations that also serve as the text of new proposed regulations published in the Proposed Rules section of this issue of the **Federal Register**.

Explanation of Provisions

The purpose of these regulations authorized under section 337(d) is to prevent corporate taxpayers from using a partnership to circumvent gain required to be recognized under section 311(b) or section 336(a). These regulations, including the rules governing the amount and timing of recognized gain, must be applied in a manner consistent with, and which reasonably carries out, this purpose.

These regulations apply when a partnership, either directly or indirectly, owns, acquires, or distributes Stock of the Corporate Partner (as defined in part 1 of this preamble). Under these regulations, a Corporate Partner (as defined in part 1 of this preamble) may recognize gain when it is treated as acquiring or increasing its interest in Stock of the Corporate Partner held by a partnership in exchange for appreciated property in a manner that avoids gain recognition under section 311(b) or section 336(a). The regulations also provide exceptions under which a Corporate Partner is not required to recognize gain.

These regulations retain the 1992 deemed redemption rule with the modifications described in part 2 of this preamble. However, these regulations remove the 1992 distribution rule in response to comments. In its place, these regulations apply the deemed redemption rule to partnership distributions of Stock of the Corporate Partner to the Corporate Partner as though the partnership amended its agreement, immediately before the distribution, to allocate 100 percent of the distributed stock to the Corporate Partner.

1. Scope and Definitions

These regulations apply to certain partnerships that hold stock of a Corporate Partner. For this purpose, a “Corporate Partner” is defined as a person that holds or acquires an interest in a partnership and that is classified as a corporation for federal income tax purposes. The regulations define “Stock of the Corporate Partner” expansively to include the Corporate Partner's stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls (within the meaning of section 304(c)) the Corporate Partner. Stock of the

Corporate Partner also includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner.

These definitions of Corporate Partner and Stock of the Corporate Partner are consistent with those set forth in the 1992 proposed regulations except for two changes. First, these regulations modify the definition of Stock of the Corporate Partner. Based on changes in the law and comments received, the Treasury Department and the IRS have determined that the scope of the definition of “Stock of a Partner” in the 1992 proposed regulations was too narrow in certain instances and too broad in others. These regulations broaden the definition of Stock of a Corporate Partner to include stock or other equity interests of any corporation that controls the Corporate Partner within the meaning of section 304(c) (section 304(c) control), whereas the 1992 proposed regulations’ definition was limited to stock or other equity interests issued by the Corporate Partner and its section 337(d) affiliates. Section 304(c) control generally exists when there is ownership of stock of a corporation possessing at least 50 percent of the total combined voting power of all classes of the corporation’s stock that is entitled to vote or at least 50 percent of the value of the shares of all classes of stock of the corporation, while control of a corporation under section 1504(a)(2) requires ownership of stock of the corporation possessing at least 80 percent of the total voting power of the stock of the corporation and at least 80 percent of the total value of the stock of the corporation. The Treasury Department and the IRS believe the lower threshold for control set forth in section 304(c) is the more appropriate standard for this purpose because General Utilities repeal could be avoided by acquiring stock of a corporation that owns less than 80 percent of the vote and value of the Corporate

Partner's stock. In addition, these regulations narrow the definition of Stock of a Corporate Partner to exclude stock of any corporation that does not possess section 304(c) control of the Corporate Partner, even if the corporation is a section 337(d) affiliate or a member of the same consolidated group as the Corporate Partner. The enactment of sections 732(f) and 755(c) subsequent to the issuance of the 1992 proposed regulations generally have served to prevent abusive transactions involving partnerships that own stock of lower tier section 337(d) affiliates of the Corporate Partner. Accordingly, these regulations do not apply to a partnership that owns, acquires, or distributes stock of any section 337(d) affiliate of the Corporate Partner unless that affiliate possesses section 304(c) control of the Corporate Partner. The Treasury Department and the IRS continue to study the application of these provisions and plan to issue additional guidance as needed to address further abuses in this area. Comments are requested regarding such guidance.

Second, these regulations add an exception for certain related-party partners. Under this exception, Stock of the Corporate Partner does not include any stock or other equity interest held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group defined in section 1504(a) that includes the Corporate Partner. Thus, these regulations do not apply if, for example, a domestic corporation and its wholly owned domestic subsidiary (each of which is an includible corporation under section 1504(b)) are the only partners in a partnership and either corporation contributes stock of another affiliate. The Treasury Department and the IRS have determined that this additional exception is appropriate because the purpose of these regulations is not implicated if a partnership is owned

entirely by affiliated corporations. The Treasury Department and the IRS invite comments on whether this exception should be extended, for example, to partnerships owned by controlled foreign corporations that are owned entirely by a single affiliated group.

For partnerships that hold Stock of the Corporate Partner, these regulations apply to a transaction (or series of transactions) that is a “Section 337(d) Transaction.” These regulations define a Section 337(d) Transaction as a transaction that has the effect of an exchange by a Corporate Partner of its interest in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by a partnership. For example, a Section 337(d) Transaction may occur if: (i) a Corporate Partner contributes appreciated property to a partnership that owns Stock of the Corporate Partner; (ii) a partnership acquires Stock of the Corporate Partner; (iii) a partnership that owns Stock of the Corporate Partner distributes appreciated property to a partner other than the Corporate Partner; (iv) a partnership distributes stock of the Corporate Partner to the Corporate Partner; or (v) a partnership agreement is amended in a manner that increases a Corporate Partner’s interest in the Stock of the Corporate Partner (including in connection with a contribution to, or distribution from, a partnership).

If a partnership engages in a Section 337(d) Transaction, the Corporate Partner must recognize gain. The regulations define a “Gain Percentage” that the partnership uses to quantify the amount of gain recognized. The computation of the Gain Percentage is set forth in part 2 of this preamble.

2. Deemed Redemption Rule

These regulations largely retain the 1992 deemed redemption rule. If a transaction is a Section 337(d) Transaction described in part 1 of this preamble, a Corporate Partner must recognize gain under the deemed redemption rule. To determine the amount of gain, the Corporate Partner must first determine the amount of appreciated property (other than Stock of the Corporate Partner) effectively exchanged for Stock of the Corporate Partner (by value) and then calculate the amount of taxable gain recognized.

These regulations set forth general principles that apply in determining the amount of appreciated property effectively exchanged for Stock of the Corporate Partner. These general principles require that the Corporate Partner's economic interest with respect to both Stock of the Corporate Partner and all other appreciated property of the partnership be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The deemed redemption rule applies only to the extent that the transaction has the effect of an exchange by the Corporate Partner of its interest in appreciated property for Stock of the Corporate Partner. Thus, these regulations do not apply to the extent a transaction has the effect of an exchange by a Corporate Partner of non-appreciated property for Stock of the Corporate Partner or has the effect of an exchange by a Corporate Partner of appreciated property for property other than Stock of the Corporate Partner.

A Corporate Partner must recognize gain under these regulations even if the Section 337(d) Transaction would not otherwise change the Corporate Partner's allocable share of gain under section 704(c). For example, if a Corporate Partner contributes appreciated property to a newly-formed partnership and an individual contributes cash that the partnership subsequently uses to purchase Stock of the Corporate Partner, then the purchase of the stock is a Section 337(d) Transaction even though the Corporate Partner's allocable share of gain in the appreciated property under section 704(c) is the same before and after the purchase. The Treasury Department and the IRS believe that this gain recognition is appropriate because a Section 337(d) Transaction may create an immediate benefit to the Corporate Partner equivalent to the benefit associated with the redemption of corporate stock in exchange for appreciated property. See Example 4 of §1.337(d)-3T(h) in these regulations.

If the Corporate Partner has an existing interest in the partnership's Stock of the Corporate Partner prior to the Section 337(d) Transaction, the deemed redemption rule applies only with respect to the Corporate Partner's incremental increase in the Stock of the Corporate Partner. For example, changing allocations to increase a Corporate Partner's interest in the Stock of the Corporate Partner from 50 percent to 80 percent and to decrease the Corporate Partner's interest in other appreciated property from 80 percent to 50 percent would have the effect of an exchange by the Corporate Partner of the 30-percent incremental decrease in its interest in the appreciated property for the 30-percent incremental increase in the Stock of the Corporate Partner. See Example 5 of §1.337(d)-3T(h) in these regulations.

For purposes of recognizing gain under the deemed redemption rule, the Corporate Partner's interest in an identified share of Stock of the Corporate Partner will never be less than the Corporate Partner's largest interest (by value) in that share of Stock of the Corporate Partner that was taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction (regardless of whether the Corporate Partner recognized gain in the earlier transaction). See Example 6 of §1.337(d)-3T(h) in these regulations. This rule ensures that alternating increases and decreases in a Corporate Partner's interest in Stock of the Corporate Partner do not cause duplicate gain recognition. This limitation does not apply if any reduction in the Corporate Partner's interest in the identified share of Stock of the Corporate Partner occurred as part of a plan or arrangement to circumvent the purpose of these regulations. See Example 7 of §1.337(d)-3T(h) in these regulations.

In certain limited circumstances, a partnership's acquisition of Stock of the Corporate Partner does not have the effect of an exchange of appreciated property for that stock. For example, as one commenter asserted, if a partnership with an operating business uses the cash generated in that business to purchase Stock of the Corporate Partner, the deemed redemption rule should not apply to the stock purchase because the Corporate Partner's share in appreciated property has not been reduced, and thus no exchange has occurred. The Treasury Department and the IRS acknowledge that such stock acquisitions would not contravene the purposes of these regulations. Accordingly, these regulations adopt this comment and do not apply to stock purchases or other transactions that do not have the effect of an exchange of appreciated property for Stock of the Corporate Partner.

If a transaction is a Section 337(d) Transaction, the deemed redemption rule requires the Corporate Partner to recognize a percentage of its total gain in partnership appreciated property equal to a fraction, the numerator of which is the Corporate Partner's interest (by value) in appreciated property effectively exchanged for Stock of the Corporate Partner under the deemed redemption rule, and the denominator of which is the Corporate Partner's interest (by value) in appreciated property immediately before the Section 337(d) Transaction. This fraction is defined in these regulations as the "Gain Percentage." The Corporate Partner's gain under the deemed redemption rule equals the product of (i) the Corporate Partner's Gain Percentage and (ii) the gain from the appreciated property that is the subject of the exchange that the Corporate Partner would recognize if, immediately before the Section 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the section 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)), reduced, but not below zero, by any gain the Corporate Partner is required to recognize with respect to the appreciated property in the Section 337(d) Transaction under any other section of the Code. For example, if a Corporate Partner would be allocated \$100x of tax gain on a sale of appreciated partnership property (other than Stock of the Corporate Partner) and the Corporate Partner's interest in that appreciated partnership property (determined under all facts and circumstances) is \$500x, and if the partnership engages in a Section 337(d) Transaction that reduces the Corporate Partner's interest in appreciated partnership property by \$200x and increases the Corporate Partner's interest in Stock of the Corporate Partner by \$200x, then the Corporate Partner's Gain

Percentage equals 40% (200x/500x), and the Corporate Partner's gain under the deemed redemption rule is \$40x (40% of \$100x).

The gain from the hypothetical sale used to compute gain under the deemed redemption rule is determined by applying the principles of section 704(c), which generally requires the partnership to take into account variations between the adjusted tax basis and fair market value of partnership property at the time it is contributed to the partnership and upon certain other events that allow or require the value of partnership property to be redetermined under §1.704-1(b)(2)(iv)(f). See Examples 3 and 5 of §1.337(d)-3T(h) in these regulations. A partner's share of gain under section 704(c) for this purpose includes any remedial allocations under §1.704-3(d) for a partnership that has elected under section 704(c) to report notional items of offsetting tax gain and loss to its partners to eliminate distortions that may arise when the partnership's total tax gain or loss on the sale of partnership property is less than all partners' aggregate share of gain or loss from the property.

These regulations also contain two rules related to the effect of the deemed redemption rule on partner and partnership basis. First, these regulations require the Corporate Partner to increase its basis in its partnership interest by an amount equal to the gain that the Corporate Partner recognizes in a Section 337(d) Transaction. This basis increase is necessary to prevent the Corporate Partner from recognizing gain a second time when the partnership liquidates (or, if property is distributed to the Corporate Partner, when that property is sold).

Second, the regulations require the partnership to increase its adjusted tax basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction

by the amount of gain that the Corporate Partner recognized with respect to that property as a result of the Section 337(d) Transaction. This basis increase applies regardless of whether the partnership has elected under section 754 to adjust the basis of partnership property. This rule prevents the Corporate Partner from recognizing gain a second time when the partnership sells the property that was effectively exchanged under the deemed redemption rule.

One commenter suggested that when a partnership owns or acquires stock in a Corporate Partner's subsidiary or a sister of the Corporate Partner and the stock is not issued as part of the transaction, the deemed redemption rule should not apply unless and until a subsequent transaction relating to the stock creates tax consequences that are inconsistent with General Utilities repeal. As discussed in part 1 of this preamble, these regulations only apply to Stock of a Corporate Partner, which under these regulations, does not include stock in a Corporate Partner's sister corporation or subsidiary unless such corporation possesses section 304(c) control of the Corporate Partner. Such control could exist, if, for example, a Corporate Partner's subsidiary were to own so-called "hook stock" in the Corporate Partner. If such control of the Corporate Partner does exist, then it is appropriate to treat stock of a Corporate Partner's subsidiary or sister corporation as Stock of the Corporate Partner because the value of that sister or subsidiary corporation's stock owned or acquired by the partnership is in part attributable to the Corporate Partner's stock.

Another commenter suggested that the deemed redemption rule is no longer necessary. The commenter explained that the acquisition of Stock of the Corporate Partner is not the appropriate time to impose tax and that the 1992 distribution rule and

changes in the law since 1989 make it more difficult to exit a partnership tax-free. The Treasury Department and the IRS do not adopt this comment because a Section 337(d) Transaction may create an immediate benefit to the Corporate Partner equivalent to the benefit associated with the redemption of corporate stock in exchange for appreciated property. If the deemed redemption rule does not apply at the time of this exchange, the Corporate Partner can defer paying tax on this economic benefit in a manner that is inconsistent with section 311(b).

3. Partnership Distributions of Stock of the Corporate Partner

The 1992 distribution rule required a Corporate Partner to recognize gain when the partnership distributes Stock of the Corporate Partner to the Corporate Partner. Commenters noted a number of concerns with this rule and recommended eliminating it.

Several commenters noted that the rule was overly broad because it could cause the Corporate Partner to recognize gain in an amount that exceeded the appreciation in property effectively exchanged for the stock. For example, the rule could require a Corporate Partner to recognize gain upon a partnership's distribution of appreciated Stock of the Corporate Partner even though the partnership held no other appreciated property. One commenter stated that the 1992 distribution rule would therefore require the Corporate Partner to recognize gain on appreciation inherent in its partnership interest, even though the distribution does not implicate the repeal of the General Utilities doctrine and even though section 1032 provides for nonrecognition of gain on the distribution. The commenter maintained that the 1992 distribution rule should not

apply when a Corporate Partner merely exchanges an indirect interest in its own stock for a direct interest in its own stock.

The Treasury Department and the IRS agree with these comments and adopt new rules governing the tax consequences of a distribution of Stock of the Corporate Partner to that Corporate Partner. Instead of adopting the 1992 distribution rule, these regulations extend the deemed redemption rule to certain distributions to the Corporate Partner of Stock of the Corporate Partner. These new rules governing distributions apply only if the distributed stock has previously been the subject of a Section 337(d) Transaction or becomes the subject of a Section 337(d) Transaction as a result of the distribution (a section 337(d) distribution). Additionally, these regulations do not apply to a distribution to the Corporate Partner of the Stock of the Corporate Partner to which section 732(f) applies at the time of the distribution. If the deemed redemption rule applies to a distribution, these regulations deem the partnership to amend its agreement immediately before the distribution to allocate 100 percent of the distributed stock to the Corporate Partner and to allocate an appropriately reduced interest in other partnership property away from the Corporate Partner. This deemed allocation is solely for purposes of recognizing gain under these regulations, and no inference is intended with regard to the treatment of such allocations generally.

If a distribution is a section 337(d) distribution, then in addition to any gain recognized under the deemed redemption rule upon the distribution of Stock of the Corporate Partner to the Corporate Partner, these regulations also require the Corporate Partner to recognize gain to the extent that the partnership's basis in the distributed Stock of the Corporate Partner exceeds the Corporate Partner's basis in its

partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution. Recognition of gain in this circumstance is necessary to prevent the Corporate Partner from shifting basis away from its own stock onto other property of the partnership. The regulations provide an exception to this additional gain recognition rule if the gain recognition or basis reduction rules of section 732(f) apply at the time of the distribution. Although this exception generally ensures that gain recognized as a result of these regulations will not be duplicated as a result of section 732(f), duplication may still result in certain circumstances. For example, if a Corporate Partner recognizes gain under section 337(d) on a partnership distribution and section 732(f) does not apply to the distribution because the section 732(f) control requirement is not satisfied at the time of the distribution, but the control requirement is subsequently satisfied triggering section 732(f), then the Corporate Partner could recognize gain under both provisions. The Treasury Department and the IRS invite comments on how the rules in these regulations should be coordinated with section 732(f).

These regulations set forth two rules under sections 337 and 732 to coordinate the effects of the rule requiring gain recognition when the Stock of the Corporate Partner is stepped down on a section 337(d) distribution with existing rules for determining the basis of property upon partnership distributions. The first rule applies for purposes of determining the basis of property distributed to the Corporate Partner (other than the basis of the Corporate Partner in its own stock), the basis of the Corporate Partner's remaining partnership interest, and the partnership's basis in undistributed Stock of the Corporate Partner, and for purposes of computing gain on the distribution. For these purposes, the basis of Stock of the Corporate Partner distributed

to the Corporate Partner equals the greater of: (i) the partnership's basis of that distributed Stock of the Corporate Partner immediately before the distribution, or (ii) the fair market value of that distributed Stock of the Corporate Partner immediately before the distribution less the Corporate Partner's allocable share of gain from all of the Stock of the Corporate Partner if the partnership sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately before the distribution. See Examples 2 and 3 of §1.337(d)-3T(h) in these regulations. This special rule is necessary to prevent basis from shifting away from distributed Stock of the Corporate Partner to other property. This basis shift could occur, for example, upon a distribution of less than all of the partnership's Stock of the Corporate Partner to the Corporate Partner. The Treasury Department and the IRS request comments on this rule, including comments on whether its objectives would be better achieved through guidance under section 732 providing that on a distribution of a partial interest in partnership property, the basis of the distributed property in the hands of the distributee partner is determined by taking the principles of section 704(c) into account.

A second rule applies when a Corporate Partner receives both Stock of the Corporate Partner and other property in a section 337(d) distribution. Under this rule, the basis to be allocated to the properties distributed under section 732(a) or (b) is allocated first to the Stock of the Corporate Partner before taking into account the distribution of any other property (other than cash). Therefore, before taking into account the distribution of other property, the Corporate Partner will reduce its basis in its partnership interest by the Corporate Partner's basis in the distributed Stock of the

Corporate Partner (but not below zero). The Corporate Partner will determine its basis in other distributed partnership property and in its remaining partnership interest after giving effect to this reduction. This rule, which governs the application of sections 732(a) and 732(b), is being promulgated pursuant to the specific statutory grant of authority in section 337(d)(1) to ensure that the purposes of the repeal of the General Utilities doctrine are not circumvented through the use of any provision of law or regulations.

When a Corporate Partner receives a partnership distribution of its own stock, it is unclear under existing law whether the Corporate Partner has basis in that stock. (See, for example, Rev. Rul. 2006-2, 2006-1 CB 261.) The resolution of this question is beyond the scope of these regulations. However, because the distribution to a Corporate Partner of its own stock affects the Corporate Partner's basis in other distributed property and any retained partnership interest, these regulations require the partnership and the Corporate Partner to determine the basis of other distributed property and any retained partnership interest by reference to the partnership's basis in the distributed Stock of the Corporate Partner. That is, the Corporate Partner determines its basis in other distributed property and in any retained partnership interest as though the distributed stock was stock other than Stock of the Corporate Partner. Similarly, the regulations compute any gain recognition on the distribution by comparing the Corporate Partner's basis in its partnership interest to the basis of that Stock of the Corporate Partner in the hands of the partnership (without regard to whether the Corporate Partner can have basis in the distributed stock). No inference is intended

with respect to the question of whether a corporation has or does not have basis in its own stock.

4. De Minimis and Inadvertence Exceptions

These regulations retain the de minimis and inadvertence exceptions from the 1992 proposed regulations, but make small modifications to the de minimis rule to reduce burden. As set forth in these regulations, the de minimis rule provides that these regulations do not apply to a Corporate Partner if three conditions are satisfied. These conditions are tested upon the occurrence of a Section 337(d) Transaction and upon any subsequent revaluation event described in §1.704-1(b)(2)(iv)(f).

The first condition requires that both the Corporate Partner and any persons related to the Corporate Partner under section 267(b) or section 707(b) own, in the aggregate, less than five percent of the partnership. The second condition requires that the partnership hold Stock of the Corporate Partner worth less than two percent of the value of the partnership's gross assets, including Stock of the Corporate Partner. The third condition requires that the partnership has never, at any point in time, held more than \$1,000,000 in Stock of the Corporate Partner or more than two percent of any particular class of Stock of the Corporate Partner. The 1992 proposed regulations contained similar conditions, but capped the permissible value of the partnership's Stock of the Corporate Partner at \$250,000.

These regulations provide a special rule that applies if the conditions of the de minimis rule are satisfied at the time of a Section 337(d) Transaction, but are not satisfied at the time of a subsequent Section 337(d) Transaction or revaluation event described in §1.704-1(b)(2)(iv)(f). This rule provides that, solely for purposes of the

deemed redemption rule, a Corporate Partner may determine its gain on the subsequent acquisition or revaluation event as if it had already recognized gain at the previous event. Accordingly, the Corporate Partner would only recognize gain with respect to appreciation arising between the earlier acquisition or revaluation event and the subsequent event. Neither the Corporate Partner nor the partnership increases its basis by the gain the Corporate Partner would have recognized if the de minimis rule did not apply to the prior acquisition or revaluation event.

These regulations also contain an inadvertence exception. The inadvertence exception provides that these regulations do not apply to Section 337(d) Transactions in which the partnership satisfies two requirements. First, the partnership must dispose of, by sale or distribution, the Stock of the Corporate Partner before the due date (including extensions) of its federal income tax return for the taxable year in which the partnership acquired the stock (or in which the Corporate Partner joined the partnership, if applicable). Second, the partnership must not have distributed the Stock of the Corporate Partner to the Corporate Partner or a person possessing section 304(c) control of the Corporate Partner. Other than broadening and narrowing the scope of related distributees as a result of the modified definition of Stock of the Corporate Partner, this inadvertence exception is generally unchanged from the 1992 proposed regulations. However, the Treasury Department and the IRS will consider comments with respect to removing the prohibition against distributions of Stock of the Corporate Partner to the Corporate Partner in light of the enactment of section 737, which requires a partner to recognize gain on property with built-in gain contributed to a partnership

when the partnership distributes other property to the partner within seven years of the contribution.

5. Tiered Partnerships

The Treasury Department and the IRS are concerned that taxpayers could use tiered partnerships to circumvent these regulations. Therefore, these regulations require taxpayers to apply these regulations to tiered partnerships in a manner consistent with the regulations' purpose. See Example 8 of §1.337(d)-3T(h) in these regulations.

Effective/Applicability Date

These regulations apply to transactions occurring on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Special Analyses

It has been determined that this Treasury Decision 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. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-referenced notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. 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.

Drafting Information

The principal authors of these regulations are Joseph R. Worst and Kevin I. Babitz, 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.

Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

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

Section 1.337(d)-3T also issued under 26 U.S.C. 337(d). * * *

Par. 2. Section 1.337(d)-3T is added to read as follows:

§1.337(d)-3T Gain recognition upon certain partnership transactions involving a partner's stock (temporary).

(a) Purpose. The purpose of this section is to prevent corporate taxpayers from using a partnership to circumvent gain required to be recognized under section 311(b) or section 336(a). The rules of this section, including the determination of the amount of gain, must be applied in a manner that is consistent with and that reasonably carries out this purpose.

(b) In general. This section applies when a partnership, either directly or indirectly, owns, acquires, or distributes Stock of the Corporate Partner (within the meaning of paragraph (c)(2) of this section). Under paragraphs (d) or (e) of this section, a Corporate Partner (within the meaning of paragraph (c)(1) of this section) is required to recognize gain when a transaction has the effect of the Corporate Partner acquiring or increasing an interest in its own stock in exchange for appreciated property in a manner that contravenes the purpose of this section as set forth in paragraph (a) of this section. Paragraph (f) of this section sets forth exceptions under which a Corporate Partner does not recognize gain.

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

(1) Corporate Partner. A Corporate Partner is a person that is classified as a corporation for federal income tax purposes and holds or acquires an interest in a partnership.

(2) Stock of the Corporate Partner--(i) In general. With respect to a Corporate Partner, Stock of the Corporate Partner includes the Corporate Partner's stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls (within the meaning of section 304(c)) the Corporate Partner. Stock of the Corporate Partner also includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner.

(ii) Affiliated partner exception. Stock of the Corporate Partner does not include any stock or other equity interests held or acquired by a partnership if all interests in the

partnership's capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner.

(3) Section 337(d) Transaction. A Section 337(d) Transaction is a transaction (or series of transactions) that has the effect of an exchange by a Corporate Partner of its interest in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by a partnership. For example, a Section 337(d) Transaction may occur when--

(i) A Corporate Partner contributes appreciated property to a partnership that owns Stock of the Corporate Partner;

(ii) A partnership acquires Stock of the Corporate Partner;

(iii) A partnership that owns Stock of the Corporate Partner distributes appreciated property to a partner other than a Corporate Partner;

(iv) A partnership distributes Stock of the Corporate Partner to the Corporate Partner; or

(v) A partnership agreement is amended in a manner that increases a Corporate Partner's interest in Stock of the Corporate Partner (including in connection with a contribution to, or distribution from, a partnership).

(4) Gain Percentage. A Corporate Partner's Gain Percentage equals a fraction, the numerator of which is the Corporate Partner's interest (by value) in appreciated property effectively exchanged for Stock of the Corporate Partner under the test described in paragraphs (d)(1) and (2) of this section, and the denominator of which is the Corporate Partner's interest (by value) in that appreciated property immediately before the Section 337(d) Transaction. Paragraph (d) of this section requires a

partnership to multiply the Gain Percentage by the Corporate Partner's aggregate gain in appreciated property to determine gain recognized under this section.

(d) Deemed redemption rule--(1) In general. A Corporate Partner in a partnership that engages in a Section 337(d) Transaction recognizes gain at the time, and to the extent, that the Corporate Partner's interest in appreciated property (other than Stock of the Corporate Partner) is reduced in exchange for an increased interest in Stock of the Corporate Partner, as determined under paragraph (d)(2) of this section. This section does not apply to the extent a transaction has the effect of an exchange by a Corporate Partner of non-appreciated property for Stock of the Corporate Partner or has the effect of an exchange by a Corporate Partner for property other than Stock of the Corporate Partner.

(2) Corporate Partner's Interest in Partnership Property. The Corporate Partner's interest with respect to both Stock of the Corporate Partner and the appreciated property that is the subject of the exchange is determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The Corporate Partner's interest in an identified share of Stock of the Corporate Partner will never be less than the Corporate Partner's largest interest (by value) in that share of Stock of the Corporate Partner that was taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction with respect to such share (regardless of whether the Corporate Partner recognized gain in the earlier transaction). See Example 6 of paragraph (h) of this section. However, this limitation will not apply if any reduction in the Corporate Partner's interest in the identified share of Stock of the Corporate Partner occurred as

part of a plan or arrangement to circumvent the purpose of this section. See Example 7 of paragraph (h) of this section.

(3) Amount of gain recognized on the exchange. The amount of gain the Corporate Partner recognizes under paragraph (d)(1) of this section equals the product of the Corporate Partner's Gain Percentage and the gain from the appreciated property that is the subject of the exchange that the Corporate Partner would recognize if, immediately before the Section 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the Section 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)), reduced, but not below zero, by any gain the Corporate Partner is required to recognize with respect to the appreciated property in the Section 337(d) Transaction under any other provision of this chapter. This gain is computed taking into account allocations of tax items applying the principles of section 704(c), including any remedial allocations under §1.704-3(d).

(4) Basis adjustments--(i) Corporate Partner's basis in the partnership interest. The basis of the Corporate Partner's interest in the partnership is increased by the amount of gain that the Corporate Partner recognizes under this paragraph (d).

(ii) Partnership's basis in partnership property. The partnership's adjusted tax basis in the appreciated property that is treated as the subject of the exchange under this paragraph (d) is increased by the amount of gain recognized with respect to that property by the Corporate Partner as a result of that exchange, regardless of whether the partnership has an election in effect under section 754.

(e) Distribution of Stock of the Corporate Partner--(1) In general. This paragraph (e) applies to distributions to the Corporate Partner of Stock of the Corporate Partner to which section 732(f) does not apply and that have previously been the subject of a Section 337(d) Transaction or become the subject of a Section 337(d) Transaction as a result of the distribution. Upon the distribution of Stock of the Corporate Partner to the Corporate Partner, paragraph (d) of this section will apply as though immediately before the distribution the partners amended the partnership agreement to allocate to the Corporate Partner a 100 percent interest in that portion of the Stock of the Corporate Partner that is distributed and to allocate an appropriately reduced interest in other partnership property away from the Corporate Partner.

(2) Basis rules--(i) Basis allocation on distributions of stock and other property. If, as part of the same transaction, a partnership distributes Stock of the Corporate Partner and other property (other than cash) to the Corporate Partner, see §1.732-1T(c)(1)(iii) for a rule allocating basis first to the Stock of the Corporate Partner before the distribution of the other property.

(ii) Computation of Basis. For purposes of determining the basis of property distributed to the Corporate Partner (other than the basis of the Corporate Partner in its own stock), the basis of the Corporate Partner's remaining partnership interest, and the partnership's basis in undistributed Stock of the Corporate Partner, and for purposes of computing gain under paragraph (e)(3) of this section, the partnership's basis of Stock of the Corporate Partner distributed to the Corporate Partner equals the greater of--

(A) The partnership's basis of that distributed Stock of the Corporate Partner immediately before the distribution, or

(B) The fair market value of that distributed Stock of the Corporate Partner immediately before the distribution less the Corporate Partner's allocable share of gain from all of the Stock of the Corporate Partner if the partnership sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately before the distribution.

(3) Gain recognition. The Corporate Partner will recognize gain on a distribution of Stock of the Corporate Partner to the Corporate Partner to the extent that the partnership's basis in the distributed Stock of the Corporate Partner (as determined under paragraph (e)(2)(ii) of this section) exceeds the Corporate Partner's basis in its partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution.

(f) Exceptions--(1) De minimis rule--(i) In general. This section does not apply to a Corporate Partner if at the time that the partnership acquires Stock of the Corporate Partner or at the time of a revaluation event as described in §1.704-1(b)(2)(iv)(f) (without regard to whether or not the partnership revalues its assets) —

(A) The Corporate Partner and any persons related to the Corporate Partner under section 267(b) or section 707(b) own in the aggregate less than five percent of the partnership;

(B) The partnership holds Stock of the Corporate Partner with a value of less than two percent of the partnership's gross assets (including the Stock of the Corporate Partner); and

(C) The partnership has never, at any point in time, held in the aggregate--

(1) Stock of the Corporate Partner with a fair market value greater than \$1,000,000; or

(2) More than two percent of any particular class of Stock of the Corporate Partner.

(ii) De minimis rule ceases to apply. If a partnership satisfies the conditions of the de minimis rule of paragraph (f)(1) of this section upon an acquisition of Stock of the Corporate Partner or revaluation event as described in §1.704-1(b)(2)(iv)(f), but later fails to satisfy the conditions of the de minimis rule upon a subsequent acquisition or revaluation event, then solely for purposes of paragraph (d) of this section, the Corporate Partner may compute its gain on the subsequent acquisition or revaluation event as if it had already recognized gain at the previous event. Neither the Corporate Partner nor the partnership increases its basis by the gain the Corporate Partner would have recognized if the de minimis rule of paragraph (f)(1) of this section did not apply to the prior acquisition or revaluation event.

(2) Inadvertence rule. Unless acquired as part of a plan to circumvent the purpose of this section, this section does not apply to Stock of the Corporate Partner that --

(i) Is disposed of (by sale or distribution) by the partnership before the due date (including extensions) of its federal income tax return for the taxable year during which the Stock of the Corporate Partner is acquired (or for the taxable year in which the Corporate Partner becomes a partner, whichever is applicable); and

(ii) Is not distributed to the Corporate Partner or a corporation possessing section 304(c) control of the Corporate Partner.

(g) Tiered partnerships. The rules of this section shall apply to tiered partnerships in a manner that is consistent with the purpose set forth in paragraph (a) of this section.

(h) Examples. The following examples illustrate the principles of this section. All amounts in the following examples are reported in millions of dollars:

Example 1. Deemed redemption rule – contribution of Stock of a Corporate Partner. (i) In Year 1, X, a corporation, and A, an individual, form partnership AX as equal partners in all respects. X contributes Asset 1 with a fair market value of \$100 and a basis of \$20. A contributes X stock, which is Stock of the Corporate Partner, with a basis and fair market value of \$100.

(ii) Because A and X are equal partners in AX in all respects, the partnership formation causes X's interest in X stock to increase from \$0 to \$50 and its interest in Asset 1 to decrease from \$100 to \$50. Thus, the partnership formation is a Section 337(d) Transaction because the formation has the effect of an exchange by X of \$50 of Asset 1 for \$50 of X stock.

(iii) X must recognize gain under paragraph (d) of this section with respect to Asset 1 to prevent the circumvention of section 311(b) principles. X's gain equals the product of X's Gain Percentage and the gain from Asset 1 that X would recognize (decreased, but not below zero, by any gain that X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, all assets were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If Asset 1 had been sold in a fully taxable transaction immediately before the formation of partnership AX, X's allocable share of gain would have been \$80. X's Gain Percentage is 50% (equal to a fraction, the numerator of which is X's \$50 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$40 of gain (\$80 multiplied by 50%) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$20 to \$60. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$20 to \$60 because Asset 1 is the appreciated property treated as the subject of the exchange.

Example 2. Distribution of Stock of the Corporate Partner – pro rata distribution. (i) The facts are the same as in Example 1(i). AX liquidates in Year 9, when Asset 1 and the X stock each have a fair market value of \$200. X and A each receive 50% of Asset 1 and 50% of the X stock in the liquidation. At the time AX liquidates, X's basis in its AX partnership interest is \$60 and A's basis in its AX partnership interest is \$100.

(ii) When AX liquidates, X's interests in its stock and in Asset 1 do not change. Thus, the liquidation is not a Section 337(d) Transaction because it does not have the effect of an exchange by X of appreciated property for Stock of the Corporate Partner.

(iii) Paragraph (e) of this section applies because the distributed X stock was the subject of a previous Section 337(d) Transaction and because section 732(f) does not apply. Under §1.732-1T(c)(1)(iii), the distribution to X of X stock is deemed to immediately precede the distribution of 50% of Asset 1 to X for purposes of determining X's basis in the distributed property. For purposes of determining X's basis in Asset 1 and X's gain on distribution, the basis of the distributed X stock is treated as \$50, the greater of \$50 (50% of the stock's \$100 basis in the hands of the partnership), or \$50, the fair market value of that distributed X stock (\$100) less X's allocable share of gain from the distributed X stock if AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately before the distribution (\$50). Thus, X reduces its basis in its partnership interest by \$50 prior to the distribution of Asset 1. Accordingly, X's basis in the distributed portion of Asset 1 is \$10. Because AX's basis in the distributed X stock immediately before the distribution (\$50) does not exceed X's basis in its AX partnership interest immediately before the distribution (\$60), X recognizes no gain under paragraph (e)(3) of this section.

Example 3. Distribution of Stock of the Corporate Partner – non pro rata distribution. (i) The facts are the same as Example 2(i), except that when AX liquidates, X receives 75% of the X stock and 25% of Asset 1 and A receives 25% of the X stock and 75% of Asset 1.

(ii) The liquidation of AX causes X's interest in X stock to increase from \$100 to \$150 and its interest in Asset 1 to decrease from \$100 to \$50. Thus, AX's liquidating distributions of X stock and Asset 1 to X are a Section 337(d) Transaction because the distributions have the effect of an exchange by X of \$50 of Asset 1 for \$50 of X stock.

(iii) X must recognize gain with respect to Asset 1 to prevent the circumvention of section 311(b) principles. Under paragraph (e)(1) of this section, paragraph (d) of this section is applied as if X and A amended the AX partnership agreement to allocate to X a 100% interest in the distributed portion of the X stock. X must recognize gain equal to the product of X's Gain Percentage and the gain from Asset 1 that X would have recognized (decreased, but not below zero, by any gain X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property.

(iv) If Asset 1 had been sold in a fully taxable transaction immediately before the amendment of the AX partnership agreement, X's allocable share of gain would have been \$90, or the sum of X's \$40 remaining gain under section 704(c) and \$50 of the \$100 post-contribution appreciation. X's Gain Percentage is 50% (equal to a fraction, the numerator of which is X's \$50 interest in Asset 1 effectively exchanged for X stock,

and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$45 of gain (\$90 multiplied by 50%) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$60 to \$105. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$60 to \$105 because Asset 1 is the appreciated property treated as the subject of the exchange.

(v) Paragraph (e) of this section applies because the distributed X stock was the subject of a previous Section 337(d) Transaction and because section 732(f) does not apply. Under §1.732-1T(c)(1)(iii), AX is treated as first distributing the X stock to X before the distribution of 25% of Asset 1. For purposes of determining X's basis in Asset 1 and X's gain on distribution, the basis of the distributed X stock is treated as \$100, the greater of \$75 (75% of the stock's \$100 basis in the hands of the partnership) or \$100, the fair market value of the distributed X stock (\$150) less X's allocable share of gain if the partnership had sold all of the X stock immediately before the distribution for cash in an amount equal to its fair market value (\$50). Thus, X will reduce its basis in its partnership interest by \$100 prior to the distribution of Asset 1. Accordingly, X's basis in the distributed portion of Asset 1 is \$5. Because AX's basis in the distributed X stock immediately before the distribution as computed for purposes of this section (\$100) does not exceed X's basis in its AX partnership interest immediately before the distribution (\$105), X recognizes no additional gain under paragraph (e)(3) of this section.

Example 4. Deemed redemption rule – subsequent purchase of Stock of the Corporate Partner. The facts are the same as Example 1(i), except that A contributes cash of \$100 instead of X stock. In a later year, when the value of Asset 1 has not changed, AX uses the contributed cash to purchase X stock for \$100. AX's purchase of X stock has the effect of an exchange by X of appreciated property for X stock, and thus, is a Section 337(d) Transaction. X must recognize gain at the time, and to the extent, that X's share of appreciated property (other than X stock) is reduced in exchange for X stock. Thus, the consequences of the partnership's purchase of X stock are the same as those described in Example 1(ii) and (iii), resulting in X recognizing \$40 of gain.

Example 5. Change in allocation ratios – amendment of partnership agreement.
(i) The facts are the same as Example 2(i), except that in Year 9, AX does not liquidate, and the AX partnership agreement is amended to allocate to X 80% of the income, gain, loss, and deduction from the X stock and to allocate to A 80% of the income, gain, loss, and deduction from Asset 1. If AX had sold the partnership assets immediately before the change to the partnership agreement, X would have been allocated \$90 of gain from Asset 1 and \$50 of gain from the X stock.

(ii) The amendment to the AX partnership agreement causes X's interest in its stock to increase from \$100 (50% of the stock value immediately before the amendment of the agreement) to \$160 (80% of stock value immediately following amendment of

agreement) and its interest in Asset 1 to decrease from \$100 to \$40. Thus, the amendment of the partnership agreement is a Section 337(d) Transaction because the amendment has the effect of an exchange by X of \$60 of Asset 1 for \$60 of its stock.

(iii) X must recognize gain equal to the product of X's Gain Percentage and the gain from Asset 1 that X would have recognized (decreased, but not below zero, by any gain X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If Asset 1 had been sold in a fully taxable transaction immediately before the amendment of the AX partnership agreement, X's allocable share of gain would have been \$90, or the sum of X's \$40 remaining gain under section 704(c) and 50% of the \$100 post-contribution appreciation. X's Gain Percentage is 60% (equal to a fraction, the numerator of which is X's \$60 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$54 of gain (\$90 multiplied by 60%) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$60 to \$114. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$60 to \$114 because Asset 1 is the appreciated property treated as the subject of the exchange.

Example 6. Change in allocation ratios – admission and exit of a partner. (i) The facts are the same as Example 1(i). In addition, in Year 2, when the values of Asset 1 and the X stock have not changed, B contributes \$100 of cash to AX in exchange for a one-third interest in the partnership. Upon the admission of B as a partner, X's interest in Asset 1 decreases from \$50 to \$33.33, and its interest in B's contributed cash increases. B's admission is not a Section 337(d) Transaction because it does not have the effect of an exchange by X of its interest in Asset 1 for X stock. Accordingly, X does not recognize gain under paragraph (d) of this section.

(ii) In Year 9, when the values of Asset 1 and the X stock have not changed, the partnership distributes \$50 of cash and 50% of Asset 1 (valued at \$50) to B in liquidation of B's interest. X and A are equal partners in all respects after the distribution. Upon the liquidation of B's interest, X's interest in Asset 1 decreases from \$33.33 to \$25, and its interest in X stock increases from \$33.33 to \$50. AX's liquidation of B's interest has the effect of an exchange by X of appreciated property for X stock, and thus, is a Section 337(d) Transaction.

(iii) Pursuant to paragraph (d)(2) of this section, X's interest in X stock and other appreciated property held by the partnership is determined based on all facts and circumstances, including allocation and distribution rights in the partnership agreement. However, paragraph (d)(2) of this section also requires that X's interest in its stock for purposes of paragraph (d) will never be less than the Corporate Partner's largest interest (by value) in those shares of Stock of the Corporate Partner taken into account when the partnership previously determined whether there had been a Section 337(d)

Transaction (regardless of whether the Corporate Partner recognized gain in the earlier transaction). Although X's interest in X stock increases to \$50 upon AX's liquidation of B's interest, X's largest interest previously taken into account under paragraph (d)(1) of this section was \$50. Thus, X's interest in its stock is not considered to be increased, and X therefore recognizes no gain under paragraph (d) of this section, provided that the transactions did not occur as part of a plan or arrangement to circumvent the purpose of this section.

Example 7. Change in allocation ratios – plan to circumvent purpose of this section. (i) In Year 1, X, a corporation, and A, an individual, contribute a small amount of capital to newly-formed partnership AX, with X receiving a 99% interest in AX and A receiving a 1% interest in AX. AX borrows \$100 from a third-party lender and uses the proceeds to purchase X stock, which is Stock of the Corporate Partner. Later, as part of a plan or arrangement to circumvent the purposes of this section, A contributes \$100 of cash, which AX uses to repay the loan, and X contributes Asset 1 with a fair market value of \$100 and basis of \$20. After these contributions, A and X are equal partners in AX in all respects.

(ii) Pursuant to paragraph (d)(2) of this section, X's interest in X stock and other appreciated property held by the partnership is determined based on all facts and circumstances, including allocation and distribution rights in the partnership agreement. Generally pursuant to paragraph (d)(2) of this section, X's interest in X stock for purposes of paragraph (d) will never be less than the Corporate Partner's largest interest (by value) in those shares of Stock of the Corporate Partner taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction (regardless of whether the Corporate Partner recognized gain in the earlier transaction). This limitation does not apply, however, if the reduction in X's interest in X's stock occurred as part of a plan or arrangement to circumvent the purpose of this section. Because the transactions described in this example are part of a plan or arrangement to circumvent the purpose of this section, the limitation in paragraph (d)(2) of this section does not apply. Accordingly, the deemed redemption rule under paragraph (d) of this section applies to the transactions with the consequences described in Example 1(iii) of this section, resulting in X recognizing \$40 of gain.

Example 8. Tiered partnership. (i) In Year 1, X, a corporation, and A, an individual, form partnership UTP. X contributes Asset 1 with a fair market value of \$80 and a basis of \$0 in exchange for an 80% interest in UTP. A contributes \$20 of cash in exchange for a 20% interest in UTP. UTP and B, an individual, form partnership LTP as equal partners. UTP contributes Asset 1 and \$20 of cash. B contributes X stock, which is Stock of the Corporate Partner, with a basis and fair market value of \$100.

(ii) Pursuant to paragraph (g) of this section, the rules of this section shall apply to tiered partnerships in a manner that is consistent with the purpose set forth in paragraph (a) of this section. Pursuant to paragraph (d)(1) of this section, if X is in a partnership that engages in a Section 337(d) Transaction, X must recognize gain at the time, and to the extent, that X's share of appreciated property is reduced in exchange

for X stock. The formation of LTP causes X's interest in X stock to increase from \$0 to \$40 and its interest in Asset 1 to decrease from \$64 to \$32. Thus, LTP's formation is a Section 337(d) Transaction because the formation has the effect of an exchange by X of \$32 of Asset 1 for \$32 of X stock.

(iii) X must recognize gain with respect to Asset 1 to prevent the circumvention of section 311(b) principles. X must recognize gain equal to the product of X's Gain Percentage and the gain from Asset 1 (decreased, but not below zero, by any gain X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) that X would recognize if, immediately before the Section 337(d) Transaction, all assets were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If Asset 1 had been sold in a fully taxable transaction immediately before LTP's formation, X's allocable share of gain would have been \$80 pursuant to section 704(c). X's Gain Percentage is 50% (equal to a fraction, the numerator of which is X's \$32 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$64 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$40 of gain (\$80 multiplied by 50%) under the deemed redemption rule in paragraph (d) of this section. Under paragraphs (d)(4)(i) and (d)(4)(ii) of this section, X's basis in its UTP partnership interest increases from \$0 to \$40, UTP's basis in its LTP partnership interest increases from \$20 to \$60, and LTP's basis in Asset 1 increases from \$0 to \$40 pursuant to paragraph (g) of this section.

(i) Effective/applicability date. This section applies to transactions occurring on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(j) Expiration date. This section expires on June 11, 2018.

Par. 3. Section 1.732-1 is amended by revising paragraphs (c)(1) and (5) to read as follows:

§1.732-1 Basis of distributed property other than money.

* * * * *

(c) * * * (1) [Reserved]. For further guidance, see §1.732-1T(c)(1).

* * * * *

(5) Effective/applicability date—(i) In general. This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(ii) [Reserved]. For further guidance, see §1.732-1T(c)(5)(ii).

* * * * *

Par. 4. Section 1.732-1T is added to read as follows:

§1.732-1T Basis of distributed property other than money (temporary).

(a) and (b) [Reserved]. For further guidance, see §1.732-1(a) and (b).

(c) Allocation of basis among properties distributed to a partner--(1) General rule-

(i) Unrealized receivables and inventory items. Except as provided in paragraph

(c)(1)(iii) of this section, the basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in §1.732-1(c)(2)(i). See §1.460-4(k)(2)(iv)(D) for a rule determining the partnership's basis in long-term contract accounted for under a long-term contract method of accounting.

(ii) Other distributed property. Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section or to stock of persons that control the corporate partner or to the corporate partner's stock under paragraph (c)(1)(iii) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed

property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in §1.732-1(c)(2).

(iii) Stock distributed to the corporate partner. If a partnership makes a distribution described in §1.337(d)-3T(e)(1), then for purposes of this section, the basis to be allocated to properties distributed under section 732(a)(2) or (b) is allocated first to the Stock of the Corporate Partner, as defined in §1.337(d)-3T(c)(2), before the distribution of any other property (other than cash). The amount allocated to the Stock of the Corporate Partner is as provided in §1.337(d)-3T(e)(2).

(2) through (5)(i) [Reserved]. For further guidance, see §1.732-1(c)(2) through (c)(5)(i).

(ii) Exception. Notwithstanding paragraph (c)(5)(i), the first sentence of each of paragraphs (c)(1)(i) and (c)(1)(ii) of this section, and paragraph (c)(1)(iii) of this section in its entirety, apply to distributions of Stock of the Corporate Partner, as defined in §1.337(d)-3T(c)(2), that occur on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(d) and (e) [Reserved]. For further guidance, see §1.732-1(d) and (e).

(f) Expiration date. This section expires on June 11, 2018.

John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: June 1, 2015

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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