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Gimme Fiction: Rev. Rul. 99-6

Don Leatherman

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*By Don A. Leatherman**

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I. Introduction

In form, if a partner buys all remaining interests in a partnership, the sellers transfer partnership interests, the partnership terminates on the sale, and the buyer ends up with partnership assets. It is not intuitively obvious, however, how the buyer, sellers, and partnership should be treated for tax purposes. There are at least three possibilities:

1. The sellers and buyer could be treated as if the sellers sold partnership interests to the buyer, and the partnership could be deemed to liquidate after the sale, distributing its assets to the buyer (the "interest-over" approach).
2. The partnership could be deemed to liquidate before the sale, and the sellers could be deemed to sell their interests in former partnership assets to the buyer (the "asset-up" approach).[1]
3. The sellers could be treated as selling partnership interests while the buyer could be treated as buying partnership assets (the "asymmetric" approach).[2]

It is the last approach that the IRS adopted in Rev. Rul. 99-6.[3] In this article, I explore whether the IRS made the right choice for taxable purchases of partnership interests.[4]

Even without Rev. Rul. 99-6, the partnership regime tolerates substantial asymmetry on sales of partnership interests.[5] Code Sec. 754 allows buyers to simulate an asset purchase in important ways while still allowing sellers to be treated as selling partnership interests. However, Code Sec. 751 substantially narrows the potential scope of this asymmetry by using an aggregate approach for certain "ordinary income" assets of the partnership. Code Sec. 751 operates with equal force when Rev. Rul. 99-6 applies.

Rev. Rul. 99-6 is also not unique in adopting an asymmetric approach. Sometimes, the Code and the IRS expressly sanction the asymmetric treatment of a buyer and seller in an acquisitive transaction. As a prosaic example, if I buy bread from a grocery store for my personal use, I cannot deduct that cost, although the grocer must account for the payment in computing its gross income. Thus, not all asymmetry is bad; in fact, it may reflect a fundamental choice in a healthy income tax system.

In gauging whether asymmetric treatment is problematic, context is vitally important. It may be a problem if it creates a meaningful risk that the IRS will be whipsawed, violates express Congressional policy, or creates significant interpretive issues. Further, concerns with asymmetry may be heightened when the buyer or seller acts as a tax surrogate for another or when the buyer and seller can easily re-structure the acquisition, effectively electing their tax treatment. In different contexts, Rev. Rul 99-6 may raise each of those problems or concerns.

Don A. Leatherman is the W. Allen Separk Distinguished Professor of Law at the University of Tennessee College of Law.

II. An Overview of Rev. Rul. 99-6

When a person buys a partnership interest or interests and, as a result, owns all partnership interests, Rev. Rul. 99-6, treats the buyer and sellers asymmetrically: The buyer is deemed to buy partnership *assets* while the sellers are deemed to sell partnership *interests.*

Rev. Rul. 99-6 examines two situations, both involving an equal two-member partnership. In the first situation, one partner sells his or her partnership interest to the other partner. In the second situation, each partner sells his or her partnership interest to a third person. In each case, the selling partner (or partners) are treated as selling partnership interests, reporting gain or loss under Code Sec. 741.[6] However, the buyer is treated as if the partnership first made liquidating distributions to each partner of the assets "attributable to" his or her interest. Thus, in the first situation, the buyer is deemed to buy the selling partner's attributable share of each partnership asset from the seller and to receive the remaining interest in each asset in a liquidating distribution. In the second situation, the buyer is treated as buying all partnership assets.

To support those results, the IRS relied primarily on *E.E. McCauslen.*[7] In *McCauslen,* one member of a two-member partnership bought the other member's interest and the partnership terminated. Within a few months, the buyer sold a former partnership asset, recognizing capital gain. At issue was the holding period of the asset and, correspondingly, the character of the gain as long- or short-term capital gain.

The buying partner argued that the gain on the asset's sale was entirely long-term capital gain. In effect, he asserted that he should be treated as if he bought the partnership interest and the partnership liquidated immediately after the purchase (*i.e.,* that the interest-over approach should apply). Then, he would (i) acquire all interests in the asset in a liquidating distribution from the partnership, (ii) tack the partnership's holding period for the asset under Code Sec. 735(b), and (iii) recognize long-term capital gain in full on its sale.

The IRS conceded that the buying partner received an undivided 50-percent interest in the asset in a liquidating distribution,[8] but it asserted that he purchased the remaining interest in the asset. With little analysis the court agreed, also concluding that the buying partner's holding period for that remaining interest began on the day after the purchase so that he recognized short-term capital gain on the remaining interest's sale.[9]

The court's conclusions are consistent with either of two characterizations of the transaction. First, under the asset-up approach, the following steps would be deemed to have occurred:

1. The partnership liquidated *immediately before* the buying partner's purchase of the partnership interest.
2. Each partner received a liquidating distribution of partnership assets attributable to his or her partnership interest.
3. The selling partner sold its interests in those assets to the buying partner.[10]

Second, under the asymmetric approach adopted by Rev. Rul. 99-6, the following steps would be deemed to have occurred:

1. The partnership liquidated *at the time of* the buying partner's purchase.
2. The selling partner sold its partnership interest.
3. The buyer partner purchased the selling partner's attributable share of partnership assets and received and the remaining interest in each partnership asset in a liquidating distribution.

The *McCauslen* court hinted that it favored the asymmetric approach by referring to Code Sec. 741, a section dealing with the sale of partnership interests. The reference seems relevant only under the asymmetric approach, since it involves the sale of a partnership interest while the asset-up approach does not. Reg. §1.741-1(b) also treats the selling partner under the *McCauslen* facts as selling a partnership interest, precluding the asset-up approach.[11]

The asymmetric approach has some appeal, because in form the partnership terminates at the instant of the sale, existing immediately before, but not immediately after, the sale. Only the asymmetric approach is consistent with that form. With the asset-up approach, the partnership would be deemed to terminate before the sale. With the interest-over approach, it would be deemed to exist after the sale.

Moreover, the asymmetric approach has a famous corporate analogue, the *Kimbell-Diamond* doctrine. That doctrine applied when, as part of a plan, a corporation purchased all target stock and then liquidated the target. Under the doctrine, the target shareholders were treated as selling target stock, following form,[12] but the buyer was treated as buying the target's assets,[13] an asymmetry comparable to Rev. Rul. 99-6. Under the doctrine, the buyer also took a cost basis in the target assets. Achieving that cost basis, in fact, was the doctrine's impetus.[14]

Today, however, the doctrine offers thin gruel to sustain Rev. Rul. 99-6 because it is no longer backstopped by the *General Utilities* doctrine. Under the latter doctrine, a liquidating corporation recognized no gain or loss on its distribution of assets, even though the shareholders took fair market value bases in those assets.[15] Thus, an early 1950s court could disregard the target corporation in a *Kimbell-Diamond* transaction. The consequences were the same whether the court deemed the transaction (i) a stock sale by target shareholders and a asset purchase by the buyer (*i.e.*, the asymmetric approach under the *Kimbell-Diamond* doctrine); or (ii) a liquidation by the target and an asset sale by the target shareholders (an asset-up approach). In either case, the target shareholders recognized gain or loss on their target stock,[16] the buyer took a cost basis in the target assets, and the target recognized no gain or loss.

Once Congress repealed the *General Utilities* doctrine in 1986 (if not before), the target could no longer be disregarded in a *Kimbell-Diamond* transaction. Under the repeal, when a buyer takes a cost basis in an appreciated asset acquired from a corporation, Congress intends that the corporation recognize gain.[17] Today, therefore, in a *Kimbell-Diamond* transaction, the target should not avoid gain recognition if the buyer acquires the target assets with a cost basis. Although Code Sec. 338 now makes the *Kimbell-Diamond* doctrine largely irrelevant,[18] if the doctrine were to apply, it should be refined so that the target recognizes gain or, if appropriate, loss. In other words, if the doctrine applied to a taxable transaction today, it could not employ an asymmetric approach like in Rev. Rul. 99-6.

Thus, Rev. Rul. 99-6 cannot lean on the *Kimbell-Diamond* doctrine for support. Instead, it should be justified, if at all, by how it furthers the purposes of the Code and aids tax administration, a deteriminataion that depends critically on context. Thus, in the remainder of the article, I discuss how Rev. Rul. 99-6 and alternative approaches apply in several contexts, first considering a significant interpretive issue under the ruling.

III. Interpreting Rev. Rul. 99-6

In Rev. Rul. 99-6, when the buying partner buys the other partner's partnership interests, the buyer's tax consequences are determined by assuming the following: (i) The partnership distributed its assets to both partners; and (ii) the buyer purchased the share of assets deemed distributed to the other partner. The assets deemed distributed to each partner are those "attributable to" that partner's interest, but it is unclear how to determine that attributable share.

At a minimum, the net value of assets deemed distributed to each partner should correspond to the partner's economic interest in the partnership. That standard, however, does not define which partnership assets any partner is deemed to receive.[19] Following are among the options to determine a partner's attributable share of partnership assets:

- The deemed distributions could be guided by the partnership agreement.[20]
- Partners could be deemed to receive a pro rata interest in each partnership asset.
- The assets could be deemed distributed in a manner that minimizes the impact of Code Secs. 704(c), 737 and 751(b).[21]
- The buying partner could choose which assets were deemed distributed to each partner.[22]

The last option, in particular, seems problematic. It would allow the buying partner to elect a deemed distribution that minimized his or her tax without affecting the sellers' tax.[23] It could also present a complex matrix of choices that are costly to analyze. Further, it would likely favor the more tax-savvy buyers, including those who more readily could afford sophisticated advice. For those reasons, the last option should be rejected.[24]

The first option, following the partnership agreement, has the some appeal, but the agreement may not always specify which assets a partner may receive on a partnership's liquidation. Thus, the first option is at best incomplete.

The second option, deeming a *pro rata* distribution of assets, offers the lure of certainty, but it may result in the buying partner recognizing gain or loss under Code Sec. 704(c) or 737.

Example 1. *Code Sec. 704(c) Gain.* A and B are equal partners in partnership AB and have $0 and $100 bases in their AB interests, respectively. The partnership owns Asset 1 and Asset 2; Asset 1 has a $0 basis and $100 value; and Asset 2 has a $100 basis and $100 value.[25] If AB distributed Asset 1 to B, A would recognize a $100 gain under Code Sec. 704(c)(1)(B). If, however, AB distributed that asset to A, A would recognize no gain.[26] B sells her AB interest to A for $100. Under the *pro rata* approach, A is treated as if AB distributed an undivided 50-percent interest in Asset 1 to B, and A therefore recognizes a $50 gain (one half of $100).[27] Further, A increases his basis in his AB interest by $50,[28] a basis benefit that increases his basis in the AB assets by $50.[29] Overall, A takes a $50 basis in Asset 1 and a $100 basis in Asset 2.[30] Assume instead that A has a $200 basis in his AB interest and that Asset 1 instead has a $200 basis, reflecting a $100 Code Sec. 704(c) loss. Then on B's sale, A recognizes a $50 loss on the deemed distribution of half of Asset 1 to B, and A decreases his basis in his AB interest and in the AB assets by $50.

A's recognition of this gain or loss is troubling for at least three reasons. First, it does not further Congressional intent. Congress enacted Code Sec. 704(c)(1)(B) to prevent a partnership distribution from shifting pre-contribution gain or loss on contributed property to a non-contributing partner.[31] Since B actually receives no partnership distribution, no such shift can occur. Second, recognition may harm the fisc, since it is functionally elective: A may avoid recognition merely by purchasing B's interest through a related person, such as a spouse or controlled corporation.[32] Finally, recognition seems unfair, because it most likely hurts the poorly advised or the unfortunate whose circumstances prevent a "functional" election.

Thus, A's recognition of Code Sec. 704(c)(1)(B) gain or loss raises some concern, but nonrecognition may as well. In Example 1, if A did not recognize the $50 gain, his basis in his AB interest would remain at $0, and A would take $50 bases in Assets 1 and 2.[33] Accordingly, through the purchase, A would shift basis from one asset (Asset 2) to another (Asset 1), a shift that is functionally elective: A could often avoid the shift by purchasing B's interest through a related person.

The third option offers an alternative to nonrecognition—deeming the assets distributed in a manner that minimizes the impact of Code Secs. 704(c), 737 and 751(b). No matter how this option is implemented, however, the partner may recognize gain. For instance, if Asset 2 in Example 1 had a $10 basis and was a Code Sec. 751 asset, A would recognize gain regardless of which AB assets were deemed distributed. Further, the amount of his gain may depend on the assets deemed distributed, forcing A to navigate the twists and turns of Code Secs. 704(c)(1)(B), 737 and 751(b). Without tremendous study, it may be unclear how to minimize the impact of those provisions, often making the third option uncertain and far from simple to implement.

Thus, none of the four options may offer a suitable anodyne to the "attributable interest" headache, a real concern with the asymmetric approach of Rev. Rul. 99-6. This concern is even more pronounced under the asset-up approach, since its resolution affects all partners, not just the buyer.[34] The concern disappears, however, with an interest-over approach, because the buyer is deemed to receive a liquidating distribution of all partnership assets,[35] resolving the "attributable interest" headache.

IV. Testing the Various Approaches

Although the interest-over approach sidesteps the definitional concern raised by the asymmetric or asset-up approach, the enduring measure of each of those approaches should be the extent to which, in operation, it violates Congressional intent or creates a meaningful risk that the IRS will be whipsawed. In the ensuing discussion, I test each approach in various settings.

A. Attributes of Partnership Assets

The chosen approach may affect the holding period and basis of the acquired partnership assets and the timing and amount of subsequent depreciation deductions on those assets.[36] Under either the asymmetric or asset-up approach, the buyer is treated as buying the selling partners' attributable share of partnership assets. Consequently, the buyer takes a cost basis in that share of assets,[37] and his or her holding period for those assets begins on the day following the purchase.[38] Further, the buyer treats those assets as newly purchased property in computing depreciation deductions.[39]

In addition, if the buyer is also a partner in the partnership, he or she is deemed to receive the remaining share of partnership assets in a liquidating distribution from the partnership. The buyer's basis in those assets generally equals his or her outside basis,[40] and the buyer succeeds to the partnership's holding periods for those assets.[41] To the extent that the buyer's basis in any depreciable asset does not exceed the partnership's basis, the buyer steps into the partnership's shoes in computing any depreciation deduction.[42]

Thus, under either the asymmetric or asset-up approach, if the buyer is not a partner, he or she is treated simply as buying partnership assets. If the buyer is also a partner, however, he or she is treated both as buying assets and as receiving assets in a liquidating distribution. In the latter case, the buyer likely takes split holding periods and split bases in partnership assets and may depreciate an acquired asset using multiple recovery periods.

In contrast, under the interest-over approach, the buyer is treated as receiving all partnership assets in liquidation of the partnership, with consequences consistent with those noted above for liquidating distributions.[43] Accordingly, the interest-over approach likely avoids split holding periods and split bases, a distinct advantage of that approach.

Nonetheless, the interest-over approach would allow the buyer to succeed, in total, to the partnership's holding period for an asset, a consequence that prompted the IRS to litigate *McCauslen* and perhaps issue Rev. Rul. 99-6.[44] The IRS was concerned that a buyer may actually hold the portion of an asset attributable to a selling partner for just a short time, sell that portion, and still recognize long-term capital gain.

The IRS's concern seems misplaced, because a buyer often may structure the acquisition to achieve a result like under the interest-over approach: The buyer may use a related party (*e.g.*, a spouse or corporate affiliate) to buy some of the partnership interests.[45] With the related-party purchase, the partnership remains in existence, and the holding periods of the partnership's assets are unaffected by the purchase.[46] Thus, if the partnership sells the asset a short time after the purchase, it recognizes long-term capital gain, all of which is allocated between the partners.[47]

Further, depreciation deductions under the interest-over approach are comparable to a related-party purchase, particularly if the partnership has a Code Sec. 754 election in effect. Generally, in either case, the recovery methods and periods for any asset are the same.[48] In addition, to the extent that the basis of an asset increases because of the purchase,[49] the excess is accounted for using the recovery method and period for newly purchased property.[50]

Finally, the relevant asset bases should also be comparable, at least if the buying partner's outside basis comports with his or her share of partnership inside basis, the partnership has a Code Sec. 754 election in effect, and the buyer makes a fair market value purchase.[51]

Example 2. *Comparable Asset Bases.* A and B are equal partners in partnership AB, and A has a $125 basis in his AB interest. The partnership owns Asset 1 with a $50 basis and $100 value, and Asset 2 with a $150 basis and $100 value, and Asset 3 with a $50 basis and $200 value.[52] Each asset is depreciable, and AB has a Code Sec. 754 election in effect. Assume first that A buys B's AB interest for $200 and the interest-over approach applies. Under that approach, A is deemed to purchase B's AB interest and AB is then deemed to liquidate. Because of the deemed purchase, A would have the following special adjustments under Code Sec. 743 and 754: a $25 positive adjustment for Asset 1, a $25 negative adjustment for Asset 2, and a $75 positive adjustment for Asset 3.[53] In applying Code Sec. 732 on the deemed liquidation, AB takes those adjustments into account,[54] and A therefore takes $75, $125 and $125 bases, respectively, in Assets 1, 2 and 3.[55] Assume, instead, that C, A's spouse, buys B's AB interest for $200. Under Code Secs. 743 and 754, C would have special basis adjustments like those for A in the preceding paragraph. Thus, overall for A and C, the partnership would take into account $75, $125, and $125 bases, respectively, in Assets 1, 2 and 3.

Finally, in either case in Example 2, the depreciation deductions for each asset would be the same. The historic recovery periods and methods would be used for $50, $125 and $50 of bases on Assets 1, 2 and 3, respectively. The excess basis ($25 for Asset 1 and $75 for Asset 3) would be accounted for using the recovery methods and periods for newly purchased property.

Under the asymmetric or asset-up approach, A would be deemed to purchase B's attributable share of AB assets and receive the remaining interests in AB assets in a liquidating distribution. A's aggregate basis in Assets 1, 2 and 3 would be the same as in Example 2.[56] However, A would use the historic recovery periods and methods for only $25, $75 and $25 of basis on Assets 1, 2 and 3, respectively (*i.e.*, the portion of the basis inherited in the deemed liquidation). He would recover the remaining bases for the assets ($50 for Asset 1, $50 for Asset 2 and $100 for Asset 3) using the recovery methods and periods for newly purchased property.

Thus, with the asymmetric or asset-up approach, A might purchase B's AB interest or choose to have C purchase B's interest, basing the choice on the more favorable depreciation schedule. That functional election may hurt the fisc and seems less readily available with the interest-over approach, lending support to that approach.[57]

B. Code Sec. 1239

The case for the interest-over approach is less strong in other circumstances, such as in situations involving Code Sec. 1239, a section considered in Rev. Rul. 72-172.[58] In that ruling, a husband and wife, the sole partners in a partnership, sold their partnership interests at a gain to their wholly owned corporation. The partnership owned land and a depreciable apartment building, each of which were Code Sec. 1231 assets.[59] The IRS concluded that (i) in effect, the partnership assets were transferred to the corporation in the transaction;[60] and (ii) a portion of the partners' gain was ordinary income under Code Sec. 1239.

Under Code Sec. 1239(a), a transferor recognizes ordinary income on "a sale or exchange of [depreciable] property, directly or indirectly, between related persons."[61] If, unlike the facts in Rev. Rul. 72-172, the partnership had sold its assets directly to the corporation, the partnership's gain on the apartment building would have been ordinary under Code Sec. 1239. That section would have applied to the sale, because the partnership sold depreciable property to the corporation and the partnership and corporation were related persons.

A technical case may be made, however, that Code Sec. 1239 should *not* apply to the sale in Rev. Rul. 72-172, at least under the asymmetric approach. Although the corporation *buys* a depreciable asset in that transaction, the husband and wife *sell* partnership interests, assets that are not depreciable. Thus, arguably, there is no "sale" to which Code Sec. 1239 could apply.[62]

However, Code Sec. 1239 is better read to apply in Rev. Rul. 72-172, a reading more consistent with the section's purpose. The section is intended to require a person to treat any gain as ordinary income when a related person buys a depreciable asset from the person and takes a cost basis in the asset.[63] In Rev. Rul. 72-172, the corporation takes a cost basis in depreciable property that it acquires as part of a sale where related persons (the husband and wife) are the transferors. Thus, to fulfill its purpose, Code Sec. 1239 should apply under the facts of the revenue ruling.

Still, its application raises several concerns. First, the revenue ruling recharacterizes the partners' gain on their sale of partnership interests only to the extent "attributable to" Code Sec. 1239 gain. It is not clear how that attributable amount would be determined if the partnership has gain and loss assets, and only a portion of the gain is potential Code Sec. 1239 gain.[64]

Second, Rev. Rul. 72-172 recharacterizes only the gain a partner recognizes under Code Sec. 741 on its sale of a partnership interest.[65] If the partner has no such gain, Code Sec. 1239 does not apply to the sale.[66]

Example 3. *No Gain on Partnership Interest.* The facts are the same as in Rev. Rul. 72-172, except that each partner's partnership interest has a basis equal to its value. Assume that the partnership also owns stock held as an investment with a built-in loss equal to the built-in gain on its apartment building and that the land has a basis equal to its value.[67] Each partner sells his or her partnership interest to the related corporation recognizing no gain or loss, and Code Sec. 1239 does not apply to the sales. The corporation takes a fair market value basis in each asset, eliminating the built-in loss on the stock and the built-in gain on the apartment building.

Note that if the partnership had sold those assets to the corporation, it would have recognized a capital loss and ordinary Code Sec. 1239 gain. Thus, the transaction in Example 3 effectively allows a capital loss to offset ordinary income.

Like under the asymmetric approach, a seller is treated as selling a partnership interest under the interest-over approach. Because Code Sec. 1239 applies to sellers, the concerns raised by the asymmetric approach under that section are raised as well by the interest-over approach.[68]

In contrast, under the asset-up approach, a seller is deemed to sell partnership assets. As a consequence, the asset-up approach could avoid the concerns raised by the other approaches, including the one illustrated by Example 3. Under the asset-up approach, the partnership would be treated as liquidating immediately before the sale, and the husband and wife would be treated as selling the former partnership assets to the related corporation. To the extent that either partner recognized gain on his or her sale of the apartment building, the gain should be ordinary income under Code Sec. 1239.[69] Further, to the extent either recognized loss on the stock sale, the loss would be capital loss.

However, no matter the approach, the selling partners may avoid Code Sec. 1239 by selling their interests to the corporation and its subsidiary. With this related-party purchase, the partnership would not terminate, and Code Sec. 1239 would not apply because the buyers would acquire non-depreciable partnership interests.[70] Then, if the partnership has made a Code

Sec. 754 election, the buyers could enjoy, in effect, a stepped-up basis in the apartment building, eliminating the potential Code Sec. 1239 gain.

The related-party purchase suggests a much broader concern. Because the Code Sec. 754 election simulates an asset purchase for the buyer, it may eliminate Code Sec. 1239 gain on many sales of partnership interests. To address both the related-party purchase and the broader concern, Congress could amend Code Sec. 751 to treat an asset as Code Sec. 751 property to the extent of its Code Sec. 1239 gain.

C. Gain and Loss Disallowance and Deferral

It is also not always clear how the various approaches apply to loss disallowance and deferral under Code Sec. 267 and gain and loss deferral under Reg. §1.1502-13. I discuss those issues in this part of the article.

1. Code Sec. 267

Under Code Sec. 267(a)(1), a taxpayer cannot deduct a loss sustained on a sale or exchange of property to a related person.[71] If the related person later sells the property at a gain, under Code Sec. 267(d), the person's recognized gain equals his or her realized gain, reduced by the portion of the disallowed loss "properly allocable" to the property.[72]

Example 4. *Code Sec. 751 Amount Recognized.* Fred and his daughter Mary are equal 50-percent partners in partnership FM, and each has a $75 basis in his or her FM interest. FM owns two assets, Asset 1 with a $50 basis and $100 value and Asset 2 with a $100 basis and $50 value. Assume that Asset 1, but not Asset 2, is a Code Sec. 751 asset, that neither asset is a Code Sec. 704(c) asset, and that FM does not have a Code Sec. 754 election in effect. Fred sells his FM interest to Mary for $75, and under the asymmetric approach, he is treating as selling that interest for federal income tax purposes. Under Code Sec. 751, he recognizes $25 of ordinary income and under Code Sec. 741 he recognizes a $25 capital loss. Fred's loss is disallowed under Code Sec. 267(a)(1), because it results from his sale of property to a related person (his daughter). Mary is treated as if the partnership liquidated, distributing undivided 50-percent interests in each asset to Mary and Fred and as if Fred sold his undivided interests to Mary for $75. On the deemed liquidation, Mary recognizes no gain or loss,[73] receives undivided 50-percent interests in Assets 1 and 2,[74] and takes $25 and $50 bases, respectively, in those interests.[75] Mary is treated as buying the remaining interests in those assets from Fred. Thus, she takes an aggregate $75 basis in each asset.[76]

Assume that Mary later sells Asset 2 to an unrelated person for $100.[77] She realizes a $25 gain,[78] none of which should be recognized under Code Sec. 267(d), although that section's application is not free from doubt. The doubt arises because of the asymmetric treatment of Fred and Mary: Fred recognized his $25 loss on his deemed transfer of his FM interest, while Mary was deemed to purchase interests in FM assets. For Code Sec. 267(d) to apply:

- a transferor's loss on a transfer of property to a related person must be disallowed under Code Sec. 267(a)(1);
- the related person must later sell property at a gain; and
- the disallowed loss must be "properly allocable" to the property sold by the related person.

The relevant regulation suggests that the transferor must recognize loss on the transfer of property and that the related person must later sell *the same* property at a gain.[79] That suggestion is echoed by applicable legislative history.[80] Because Fred sold a partnership interest but Mary sold Asset 2, Code Sec. 267(d) arguably does not apply to Mary's sale.[81]

The better view, however, is that it should apply. First, the statute does not literally require that the transferor transfer the asset sold by the transferee. It requires only that the asset be transferred to the transferee and that the transferor sustain a loss in the transaction disallowed by Code Sec. 267(a)(1).[82] Under the asymmetric approach of Rev. Rul. 99-6, in the same transaction, an asset is deemed transferred to Mary and Fred sustains such a disallowed loss. More cogently, the revenue ruling provides that in determining Mary's tax treatment, Fred is deemed to sell the asset to Mary. Because Code Sec. 267(d) applies to Mary, not Fred, in applying that provision, Fred should be deemed to have sold Asset 2 to Mary, meeting even the narrow reading of Code Sec. 267(d) suggested in the preceding paragraph. Second, even accepting that narrow reading, Frank could be considered to have sold the same asset as Mary (*i.e.*, Asset

2) under an aggregate approach. The IRS has asserted that Code Sec. 267(d) should be applied using an aggregate approach,[83] and it uses that approach to apply Code Sec. 1239 in a similar context.[84] Finally, if Code Sec. 267(d) did not apply, the loss would be permanently disallowed, contrary to the provision's apparent purpose. For all of these reasons, Code Sec. 267(d) should apply to Mary's sale.

Under Code Sec. 751(a), Fred's $25 gain is entirely attributable to Asset 1, and consequently under Code Sec. 741, his $25 loss is entirely attributable to Asset 2. Further, under the fiction that applies to determine Mary's tax consequences, Fred would be deemed to recognize the same gain and loss amounts on those assets.[85] Thus, the $25 loss should be "properly allocable" to Asset 2, and under Code Sec. 267(d), Mary should recognize none of her $25 realized gain on her sale of Asset 2.[86]

The analysis changes if the facts are the same as in Example 4, except that neither Asset 1 nor Asset 2 is a Code Sec. 751 asset. Then, on Fred's sale of his FM interest to Mary, he recognizes no gain or loss. When Mary later sells Asset 2 for $100, she realizes a $25 gain, but all of that gain should be recognized. Under the asymmetric approach, in applying Code Sec. 267(d) to Mary, Fred would be deemed to sell his interest in Asset 2 at a $25 loss, but Fred did not actually sustain a loss that was disallowed by Code Sec. 267(a)(1).[87] Thus, Code Sec. 267(d) should not apply to Mary on her sale of Asset 2, and she should recognize her full $25 realized gain.

It is less clear how Code Sec. 267(d) applies under the asymmetric approach when the partnership has multiple built-in gain and loss assets, since Rev. Rul. 99-6 does not definitively tie a partner's loss on a partnership interest to particular partnership assets.

Example 5. *Multiple Built-in Gain and Loss Assets.* Fred and his daughter Mary each own equal 50-percent interests in partnership FM, and each has a $125 basis in his or her FM interest. FM owns three assets, Asset 1 with a $50 basis and $100 value, Asset 2 with a $100 basis and $50 value, and Asset 3 with a $100 basis and $50 value. Assume that none of FM's assets are Code Sec. 704(c) or 751 assets, that loss on the sale of Asset 2 or 3 could offset gain on the sale of Asset 1, and that FM has no Code Sec. 754 election in effect. Fred sells his FM interest to Mary for $100, and under the asymmetric approach, he is treating as selling that interest for federal income tax purposes. Under Code Sec. 741, he recognizes a $25 capital loss. Under Code Sec. 267(a)(1), Fred's $25 loss is disallowed. Mary is treated as if the partnership liquidated, distributing undivided 50-percent interests in each asset to Mary and Fred and as if Fred sold his undivided interests to Mary for $100. Mary recognizes no gain or loss on the deemed liquidation,[88] and takes a $25 basis in her interest in Asset 1 and a $50 basis in each of her interests in Asset 2 and 3.[89] Mary is treated as buying the remaining interests in Assets 1, 2 and 3 from Fred for $50, $25 and $25, respectively. Thus she takes an aggregate $75 basis in each FM asset.[90]

Assume that Mary later sells Asset 2 to an unrelated person for $100, thereby realizing a $25 gain. Although it is not altogether clear how Code Sec. 267(d) works in this case, Mary should recognize either $12.50 of that gain or none of it.

Fred's $25 loss seems equally attributable to the built-in losses in Assets 2 and 3, suggesting that the Code Sec. 267(d) amount should be split between them.[91] Under the asymmetric approach, in applying Code Sec. 267(d) to Mary, Fred would be deemed to receive a liquidating distribution of his share of all FM assets and then deemed to sell that share to Mary. On that deemed sale, Fred would have a $25 loss on each of the Asset 2 and 3 interests and a $25 gain on the Asset 1 interest.[92] Because the loss on either asset could offset the gain, Fred's actual $25 loss sensibly could be allocated between Assets 2 and 3 in proportion to their built-in losses (*i.e.*, half to each). Then, Mary would recognize a $12.50 gain on her sale of Asset 2, her realized $25 gain minus $12.50, the share of the Code Sec. 267(d) amount allocable to that asset.

However, it may also be reasonable to allocate the Code Sec. 267(d) amount entirely to Asset 2. While that asset was held by Mary, it appreciated in value by $50, matching the net built-in loss in the FM assets when Mary purchased Fred's FM interest. Because Asset 2's appreciation completely offsets that net built-in loss, the Code Sec. 267(d) amount arguably should be assigned fully to Asset 2.[93] Then, Mary would recognize no gain on her sale of Asset 2, since her realized $25 gain would be reduced by $25, the share of the Code Sec. 267(d) amount allocable to the asset.

The analysis changes if, in Example 5, Asset 2 (but not Asset 3) was a Code Sec. 751 asset. Then, under

Code Sec. 751, Fred's $25 loss on the sale would be ordinary, and the loss would be entirely attributable to Asset 2. Further, under the fiction that applies to determine Mary's tax consequences, Fred would be deemed to recognize the same loss amounts on his sale of his interest in Asset 2.[94] Thus, the $25 loss should be "properly allocable" to Asset 2, and under Code Sec. 267(d), Mary should recognize none of her $25 realized gain on her sale of Asset 2.

If, however, Asset 3, rather than Asset 2, was the Code Sec. 751 asset, Fred's ordinary loss on the sale would be entirely attributable to *Asset 3*. Under the fiction that applies to determine Mary's tax consequences, Fred would be deemed to recognize the same loss amount on his sale of his interest in Asset 3. Thus, under these facts, the $25 loss should be "properly allocable" to Asset 3, Code Sec. 267(d) should not reduce Mary's recognized gain on her sale of Asset 2, and she should recognize all of her $25 realized gain.

Taken in total, these Code Sec. 267 examples illustrate that the interaction of that section and the asymmetric approach of Rev. Rul. 99-6 often creates uncertainty, because the revenue ruling does not securely tie a partner's loss to specific partnership assets. Moreover, Code Sec. 267 often must be applied on an *ad hoc* basis, creating an administrative headache for partnerships and the IRS.

The asset-up approach eliminates the potential uncertainty of the asymmetric approach. For instance, if the asset-up approach had applied in Example 4, both Fred and Mary would be treated as if Fred received a share of Assets 1 and 2 in FM's liquidation and as if he sold those assets to Mary for $75. Fred's $25 disallowed loss and Mary's Code Sec. 267(d) benefit would be securely moored to Asset 2.[95]

However, the asset-up approach potentially increases the seller's recognized gain and disallowed loss, a distinct disadvantage. For instance, in Example 5, Fred would be deemed to receive a share of the partnership assets in FM's liquidation and to sell those assets to Mary for $100. On the sale, he would recognize a $25 gain, $25 loss, and $25 loss on Assets 1, 2 and 3, respectively.[96] Because Fred's losses would be disallowed under Code Sec. 267(a)(1), Fred would have $50 of disallowed loss and a $25 recognized gain, compared with just a $25 disallowed loss under the asymmetric approach.

Because of those harsh results, Fred might restructure the sale to avoid the asset-up approach. For example, suppose Mary owned all stock in S Inc. Fred could sell his FM interest to S Inc for $100, recognizing a $25 loss. Because the partnership would not terminate on the sale, the asset-up approach would not apply. Code Sec. 267(a)(1) would still apply to the sale, and Fred's $25 loss would be disallowed.[97]

Thus, through such a related-party sale, Fred could "functionally" elect a result like a direct sale to Mary under the asymmetric approach. Nevertheless, the asset-up approach and election might be a poor substitute for the asymmetric approach for at least two reasons. First, the functional election might entail added costs, for example if Mary had to set up S Inc. for Fred to "exercise" the election. Second, the election may be unfair, unavailable to the poorly advised or the unfortunate whose circumstances prevent such an election.[98] Thus, the asset-up approach raises some concerns.

The interest-over approach also seems problematic. Under that approach, the buyer is treated as buying a partnership interest from the seller (or sellers) and then receiving the partnership assets in liquidation of the partnership. If a seller's loss is disallowed under Code Sec. 267(a)(1), the buyer apparently applies Code Sec. 267(d) by looking to the partnership assets, as successor assets to the purchased partnership interest.[99]

It is not clear how the Code Sec. 267(d) amount would be allocated among the partnership assets, but it may be allocated by comparing (i) the buyer's basis in each partnership asset following the deemed liquidation, with (ii) the buyer's basis in each such asset, computed by assuming that his or her outside basis is increased by the seller's disallowed loss.[100]

In some cases, that allocation would allow the buyer to sell quickly a former partnership asset and eliminate built-in gain.

Example 6. *Eliminating Built-in Gain.* Fred and his daughter Mary each own equal 50-percent interests in partnership FM. Fred and Mary have $100 and $50 bases, respectively, in their FM interests. FM owns two assets, each with a $50 basis and $75 value. Assume that neither FM asset is a Code Sec. 704(c) or 751 asset and that FM has no Code Sec. 754 election in effect. Fred sells his FM interest to Mary for $75, recognizing a $25 loss that is disallowed under Code Sec. 267(a)(1). Under the interest-over approach, Mary would take a $62.50 basis in each asset.[101] Further, $12.50 of Fred's $25 loss should be allocated to each asset under Code Sec. 267(d), since Mary would have take a $75 basis in each asset if her FM basis had been increased by Fred's $25 disallowed loss.[102] Then, Mary would recognize no gain on her sale of either asset for $75. Although she would realize a $12.50 gain, her recognized gain would be $0, her realized gain less the $12.50 Code Sec. 267(d) amount.[103]

The other approaches would avoid this result if Mary took split bases in the assets with the Code Sec. 267(d) amount associated with the portion of the assets deemed sold by Fred.

Although no approach perfectly accounts for all issues raised by Code Sec. 267(a)(1) and (d), the asset-up approach appears to be the best of an imperfect lot. In this context, imperfection may be tolerable, because a seller may often avoid the adopted approach through a related-party sale.[104]

As an aside, note that some related-party sales avoid Code Sec. 267 entirely. In the examples above, if Fred had sold his FM interest to Mary's spouse, that section would not have applied to Fred's sale, because Mary's spouse and Fred would not be related persons.[105] Fred could take his loss into account on the sale, and assuming that no anti-abuse rule applied,[106] Mary and her spouse could take a corresponding loss into account when the partnership sold the loss assets.[107] If the spouses filed joint returns, Mary could directly benefit from the entire partnership loss, even though Mary and Fred are related persons. Those results seem inconsistent with Code Sec. 267, and they present issues not resolved by a choice among the asymmetric, asset-up, and interest-over approaches.

2. Consolidated Group Issues

That choice is relevant when a member of a consolidated group transfers a partnership interest to another member and, as a result, the partnership terminates. In two private letter rulings, the IRS considered how the matching and acceleration rules of Reg. §1.1502-13 applied to those transactions.[108]

The facts of each ruling could be represented by the following example:

Example 7. *Intercompany Transfer.* P owns all stock of S1 and S2, and P, S1, and S2 are members of a consolidated group. S1 and S2 are equal partners in a two-member partnership. S1 sells its partnership interest to S2 and the partnership terminates.[109] Under the asymmetric approach of Rev. Rul. 99-6, S1 is treated as selling a partnership interest, but S2 is treated as if the following occurred: (i) The partnership liquidated, distributing its assets to S1 and S2; and (ii) S2 purchased S1's interests in the former partnership assets.[110] On its sale of the partnership interest, S1 recognizes gain or loss under Code Sec. 741 and Code Sec. 751(a), while S2 takes a cost basis in the share of the former partnership assets deemed purchased from S1.

In each private letter ruling, the IRS properly concluded that the sale of the partnership interest was an intercompany transaction. An intercompany transaction is defined as "a transaction between corporations that are members of the group immediately after the transaction."[111] S1's sale to S2 was an intercompany transaction, because the sale was a transaction between S1 and S2, members of the P group immediately after the sale.

Thus, S1's gain or loss on the sale was accounted for under Reg. §1.1502-13. Under that regulatory section, the P group accounts for the selling member's (*i.e.*, S1's) intercompany items and the buying member's (*i.e.*, S2's) corresponding items from an intercompany transaction under matching and acceleration rules.[112] S1's intercompany items are its gain or loss from its sale of its *partnership interest.*[113] S2's corresponding items include its income, gain, loss or deduction from the *partnership assets* purchased in the transaction.[114]

Under the matching rule, the timing, holding period and attributes of the S1 and S2's items from an intercompany transaction are accounted for using a single-entity approach.[115] However, the location and amount of those items are determined by treating those members as separate corporations.[116]

To the extent the matching rule applies, S1 defers its gain or loss until S2 takes a corresponding item into account.[117] S1 takes the deferred amount into account to reflect the difference between S2's corresponding item and its "recomputed" corresponding item.[118] S2's "recomputed" corresponding item is the amount it would take into account if S1 and S2 were divisions of a single corporation and the intercompany transaction had occurred between those divisions.[119]

The acceleration rule applies once the matching rule can no longer apply. Under the acceleration rule, S1 must take its intercompany items into account immediately before it is impossible to treat S1 and S2 as divisions of a single corporation.[120]

In applying the matching and acceleration rules to S1's sale, the IRS might have concluded that S1 took its gain or loss into account immediately, because S2 was not deemed to acquire a partnership interest.[121] Instead, it concluded that the matching rule could apply, implicitly concluding that S1's share of the partnership assets were successor assets to S1's partnership interest.[122] In applying the matching rule, S2's "recomputed" corresponding items were determined as if the assets deemed purchased by S2 were received by S1 in a liquidating distribution from the partnership and then sold by S1 to S2.[123]

The asymmetric approach works well for a one-asset partnership. Suppose, for example, that, in Example 7, the partnership's only asset was land with a $50 basis and $100 value and that S1 and S2 each had $25 bases in their partnership interests. If S1 sold its partnership interest to S2 for $50, it would recognize a $25 gain, an amount precisely reflected in S2's corresponding and recomputed corresponding items.[124] Then, for example, if S2 later sold the land to a nonmember, S1 would take its gain into account under the matching rule.[125]

The asymmetric approach should also work well for multiple-asset partnerships if the selling partner recognizes gain (or loss) on the intercompany sale and each of the selling partner's recomputed corresponding items reflect built-in gain (or loss). However, the approach may reach unexpected results, at least to those unfamiliar with the partnership rules, as the following examples illustrate:[126]

Example 8. *Gain Triggered on Intercompany Sale.* The facts are the same as in Example 7, except that the partnership has $100 cash and owns land with a $50 basis and $100 value and S1 has a $25 basis in its partnership interest.[127] S1 sells that interest to S2 for $100, recognizing a $75 gain. Only $50 of that amount is reflected in S2's corresponding and recomputed corresponding items.[128] Because only $50 of S1's $75 gain could be taken into account under the matching rule, only $50 of that gain may be deferred. Thus, S1 takes into account the remaining $25 gain in the year of the intercompany sale under the acceleration rule.[129] That result makes sense, because if the partnership had actually liquidated, S1 would have recognized a $25 gain.[130]

Example 9. *Loss Triggered on Intercompany Sale.* The facts are the same as in Example 8, except that the partnership has two inventory assets (as defined in Code Sec. 751(d)), each with a $50 basis and value, and S1 and S2 each have $100 bases in their partnership interests. S1 sells its partnership interest to S2 for $50, recognizing a $50 loss. None of that loss is reflected in S2's corresponding and recomputed corresponding items.[131] Because none of S1's $50 loss could be taken into account under the matching rule, none of it can be deferred. Thus, S1 takes into account its $50 loss in the year of the intercompany sale under the acceleration rule.[132] That result makes sense, because if the partnership had actually liquidated, S1 would have recognized a $50 loss.[133]

It is unclear, however, how the asymmetric approach works in many cases when the partnership has multiple built-in gain and loss assets.

Example 10. *Multiple Built-in Gain and Loss Assets; Asymmetric Approach.* The facts are the same as in Example 9, except that the partnership has three parcels of land, Tract 1 with a $50 basis and $150 value, Tract 2 with a $50 basis and $150 value, and Tract 3 with a $200 basis and $100 value. None of these assets is a Code Sec. 704(c) or 751 asset. S1 has a $150 basis in its partnership interest and sells that interest to S2 for $200, recognizing a $50 gain. Under the asymmetric approach, S2's corresponding and recomputed corresponding items in the aggregate exactly reflect S1's $50 gain.[134] However, they also reflect a $50 "corresponding" gain each in Tracts 1 and 2 and a $50 "corresponding" loss in Tract 3.[135] Thus, it is unclear how much of S1's gain is tied to any one asset and how the gain should be taken into account. Among other possibilities, the $50 amount could be allocated between the gain assets in proportion to their corresponding gains or it could be taken into account to the extent S2 recognizes a difference between its corresponding and recomputed corresponding items for any gain asset.[136]

The same sorts of issues may arise if S1 sells its partnership interest to S2 at a loss and the partnership's assets have a net built-in loss.[137] The IRS might address these issues by defining how a corporation like S1 takes its deferred gain or loss into account.

However, the asset-up approach avoids those issues by treating the buyer and sellers consistently. If that approach applied in the examples above, both S1 and S2 would be treated as if S1 received a liquidating distribution of assets from the partnership and as if it sold those assets to S2. On the deemed sale, S1 would recognize gain or loss separately on each asset, and S2's recomputed corresponding item for each asset would precisely match that gain or loss, thus dodging the concern raised by Example 10.[138]

The interest-over approach may raise that and other concerns. Under this approach, the selling partners are treated as selling partnership interests, and the buyer is treated as acquiring those interests and then receiving the partnership assets in liquidation of the partnership. Because the buyer's basis in those assets is determined by looking to its basis in its partnership interest,[139] the partnership assets should be successor assets to the partnership interest in applying the matching rule.[140]

Thus, the buyer's corresponding items include its income, gain, loss, or deduction from the *partnership assets* acquired in the partnership's deemed liquidation.[141] Its recomputed corresponding items include those same amounts, determined as if the buyer and sellers were divisions of a single corporation and the intercompany transaction had occurred between divisions.[142]

As one possible concern with the interest-over approach, its results may depend on the basis that the buyer has in its partnership interest, because that basis is taken into account in the partnership's deemed liquidation. For instance, if that approach applied in Example 8, S1's $75 gain would be deferred if *S2's* outside basis was at least $75 but it would be immediately taken into account to the extent that outside basis was less than $75.[143] That result seems odd.

Further, like the asymmetric approach, it is often unclear how the interest-over approach works when the partnership has assets with built-in gain and loss.

Example 11. *Multiple Built-in Gain and Loss Assets; Interest-Over Approach.* S1 and S2 are members of a consolidated group and equal partners in a two-member partnership, which has a Code Sec. 754 election in effect. Each partner has a $150 basis in its partnership interest, and the partnership has three parcels of land, Tract 1 with a $50 basis and $150 value, Tract 2 with a $50 basis and $150 value, and Tract 3 with a $200 basis and $100 value. None of these assets are a Code Sec. 704(c) or 751 asset. S1 sells its partnership interest to S2 for $200, recognizing a $50 gain. Under the interest-over approach, S1 is deemed to sell that interest to S2, and the partnership is then deemed to liquidate, distributing all assets to S2 in liquidation. Because of the deemed purchase, S2 would have the following special adjustments under Code Secs. 743 and 755: a $50 positive adjustment for each of Assets 1 and 2 and a $50 negative adjustment for Asset 3.[144] In applying Code Sec. 732 on the deemed liquidation, the partnership takes those adjustments into account,[145] and S2 therefore takes $100, $100, and $150 bases, respectively, in Assets 1, 2 and 3.[146]

In computing S2's recomputed corresponding bases, S1 and S2 are treated as divisions of a single corporation.[147] Because a corporation cannot sell property to itself, one division of a corporation cannot transfer property to another division *by sale or exchange*. Further, because Code Sec. 743 requires such a transfer, the section cannot apply to a transfer between divisions. Hence, in computing S2's recomputed corresponding bases, because S1 and S2 are treated as divisions, no adjustments are made under Code Sec. 743 and 755. Thus, in computing S2's recomputed corresponding bases, S2 is deemed to take S1's $150 basis in the acquired partnership interest. Overall, therefore, S2 is deemed to have a $300 basis in the partnership interest, and on the deemed partnership liquidation, S2 takes a $50, $50 and $200 basis, respectively, in Assets 1, 2 and 3.[148] S2's corresponding and recomputed corresponding items in the aggregate exactly reflect S1's $50 gain. However, they also reflect a $50 "corresponding" gain each in Tracts 1 and 2 and a $50 "corresponding" loss in Tract 3.[149] Thus, it is unclear how much of S1's gain is tied to any one asset and how the gain should be taken into account.[150]

Under the interest-over approach, a group could also accelerate when it takes into account the selling member's gain and a corresponding loss (or loss and corresponding gain) under Code Sec. 741 and 751.

Example 12. *Accelerating Gain and Loss.* S1 and S2 are members of a consolidated group and equal partners in a two-member partnership. Each partner has a $75 basis in its partnership interest, and the partnership owns two assets. Asset 1 has a $100 basis and $50 value, while Asset 2 has a $50 basis and $100 value. Asset 1, but not Asset 2, is a Code Sec. 751 asset.[151] The partnership does not have a Code Sec. 754 election in effect. S1 sells its partnership interest to S2 for $75. Under Code Secs. 741 and 751(a), S1 recognizes a $25 capital gain and $25 of ordinary loss. Because S2 pays S1 an amount equal to its outside basis, it will take into account the same basis amounts in computing its corresponding and recomputed corresponding items.[152] Because those amounts are equal, none of S1's gain or loss can ever be taken into account under the matching rule.[153] Accordingly, under the acceleration rule, S1 would take those amounts into account at the time of the sale.[154]

The result in Example 12 would be the same if S1 sold its partnership interest to a member other than S2, because the buyer's basis in the interest would be the same as S1's. Note that this result would not depend on the approach applied. Thus, under asymmetric or asset-up approach, the group could defer or accelerate S1's gain and loss by choosing to have S1 sell its partnership interest to S2 (for deferral) or to another member (for acceleration).

However, this functional election under the asymmetric or asset-up approach lends little support to the interest-over approach. Even under the interest-over approach, the group could elect to defer S1's gain and loss in Example 12 by having the partnership make a Code Sec. 754 election.[155] Thus, under any approach, the group could elect to defer or accelerate S1's gain or loss.[156]

In the consolidated setting, the interest-over approach seems flawed. The least flawed approach to account for deferred gain or loss on intercompany transactions appears to be the asset-up approach, unless the asymmetric approach is refined as discussed above.

3. Controlled Group Issues

If a member of a controlled, nonconsolidated, group sells an asset at a loss to another member, the seller's loss is deferred under the principles of Reg. §1.1502-13.[157] Gain, however, is not deferred. Thus, controlled groups may raise concerns like those noted in the sections above discussing Code Sec. 265(a)(1) and consolidated groups. For example, the asset-up approach may result in greater gain than with either other approach. On the other hand, under the asymmetric or interest-over approach, it may be unclear how the approach works if the partnership has built-in gain and loss assets, although the asymmetric approach may be refined to avoid that issue. If refined, the asymmetric approach seems like the best approach to account for loss deferred by controlled, non-consolidated groups.

D. Partner Debt

The chosen approach will also be relevant when a partnership holds partner debt. The tax consequences to the partners (and partnership) depend on whether or not the debt arose because of a loan between the partnership and partner.

If the debt arose because of such a loan and the partnership cancels the debt,[158] the partner is deemed to receive a distribution of money at the time of the loan.[159] Although the regulations do not specify how much money is deemed distributed, a noted commentator suggests (and this article assumes) that the amount of the distribution should equal the debt's fair market value.[160] Then, if the debt's value is less than its adjusted issue price, the partnership may be entitled to a bad-debt deduction under Code Sec. 165 or 166 and the debtor partner should have cancellation of indebtedness income ("COD").[161] If the debt's value exceeds its adjusted issue price, the partnership should recognize gain and the debtor partner should be entitled to a corresponding deduction.[162]

The IRS employs a different regime if the partnership acquired the partner debt from a third person, a position laid out in Rev. Rul. 93-7.[163] In that case, the IRS concluded that if a partnership distributes a partner's debt to the partner, the partnership is treated as distributing property and recognizes no gain or loss.[164] The debtor partner determines its basis in the distributed debt under Code Sec. 732 and recognizes gain or loss to the extent the debt's fair market value differs from that basis.[165] Further, the partner is treated as satisfying the distributed debt for its adjusted issue price, recognizing COD or benefitting from a deduction, as appropriate, measured by the difference between the debt's fair market value and adjusted issue price.[166]

In each example in this section, A and B, unrelated individuals, own 50-percent interests in the capital and profits of partnership AB, which does not have a Code Sec. 754 election in effect. AB owns B debt and the debt has a $100 basis, $100 adjusted issue price, and $100 stated redemption price at maturity.[167] AB also owns land with a $100 basis and $100 value. Neither AB asset is a Code Sec. 704(c) or 751 asset. Finally, each partner has a $100 basis in his or her AB interest.[168]

In the examples below, either A buys B's AB interest or B buys A's AB interest.[169] Further, either the B debt is worth $80 or $120. Finally, AB purchased the B debt from either B or a third party. I consider the eight permutations of those facts below, beginning with a set of four that consider A buying B's AB interest.

1. Sales by the Debtor Member

Examples 13 through 16 consider B's sale of his AB interest to A. The sale terminates the partnership, and the examples explore the tax consequences of the sale under the asymmetric, asset-up and interest-over approaches. In each example, B, the debtor and selling partner, is treated consistently under the asymmetric and interest-over approaches, while A, the buying partner, is treated consistently under the asymmetric and asset-up approaches. In considering the four examples together, however, A and B are treated consistently only under the interest-over approach.

Example 13. *A buys B's AB interest; AB bought B debt from a third party; debt worth $80.* Sometime ago, bought B debt from a third party.[170] The B debt is worth $80 and B sells his AB interest to A for $90. Under the asymmetric approach of Rev. Rul. 99-6, B is treated as selling his AB interest to A and recognizes a $10 capital loss.[171] A is treated as if AB liquidated, distributing its assets to A and B and then as if A purchased B's share of those assets from B for $90. Thus, A and B are each deemed to receive a 50-percent interest in each AB asset, taking a $50 basis in each interest under Code Sec. 732(c).[172] A is then treated as if she purchased B's interest in the land for $50 and, presumably, an interest in "newly issued" B debt for $40. Thus, A may take $10 into account over time as original issue discount on the B debt,[173] and she will have aggregate $90 and $100 bases in the B debt and land, respectively.

Under the interest-over approach, the results to A and B would be essentially the same, except that A should not have original issue discount in the B debt, because she would not acquire the debt from B (instead acquiring it from the partnership in a liquidating distribution).[174]

Under the asset-up approach, the result to A but not B would be the same as in Example 13. B would be deemed to first receive a distribution from the partnership and then to make a sale to A. On the distribution, B would be deemed to take $50 bases in 50-percent interests in the land and B debt.[175] Because that portion of the B debt would be worth only $40, B would recognize a $10 loss, equal to that difference, and also take $10 of COD into account.[176] B would then be deemed to sell A his interest in land for $50 and, presumably, newly issued B debt for $40. Over time, B would be entitled to $10 of additional deductions (in addition to stated interest) on that B debt.[177]

Example 14. *A buys B's AB interest; AB bought B debt from a third party; debt worth $120.* The facts are the same as in Example 13, except that the B debt is worth $120 and B sells his AB interest to A for $110. Following the analysis set out in the previous example, under the asymmetric approach, B recognizes a $10 capital gain, while A takes an aggregate basis in the B debt of $110 ($60 from her deemed purchase from B plus $50 on the deemed partnership distribution) and a $100 basis in the land. Further she should be entitled to a $10 deduction when the debt is satisfied or, in appropriate cases. over time as amortizable bond premium.[178]

Under the interest-over approach, the results to A and B would be the same, except that A could not deduct $10 as amortizable bond premium over time (but instead would have a loss when the debt was satisfied).[179] Under the asset-up approach, the result to A would be the same as in Example 14, but B would be deemed to first receive a distribution from the partnership and then to make a sale to A. On the distribution, B would be deemed to take a $50 bases in its 50-percent interests in the land and B debt.[180] Because that portion of the B debt would be worth $60, B would recognize a $10 gain, equal to that difference, and also be entitled to a $10 deduction.[181] B would then be deemed to sell A his interest in land for $50 and, presumably, newly issued B debt for $60. Over time, B would reduce his interest deduction on the debt by $10.[182]

Example 15. *A buys B's AB interest; AB bought B debt from B; debt worth $80.* The facts are the same as in Example 13, except that AB bought the B debt from B. Thus, the B debt is worth $80 and B sells his AB interest to A for $90. Under the asymmetric approach of Rev. Rul. 99-6, B is treated as selling his AB interest to A and recognizes a $10 capital loss. A is treated as if AB liquidated, distributing its assets to A and B and then as if A purchased B's share of those assets from B for $90. Thus, to determine A's tax treatment, the following should be considered:

- In the deemed liquidating distribution to B, B is treated as receiving a 50-percent interest in the land. He is also treated as if his 50-percent interest in B debt was cancelled.[183] Assuming that AB is deemed to have receive consideration equal to the $40 value of that debt,[184] AB would have a $10 bad debt deduction,[185] half of which would be allocated to A, reducing her AB basis by $5, from $100 to $95.[186]
- In the deemed liquidating distribution to A, A would take a $50 basis in its interest in the land and a $45 basis in its interest in the B debt.[187] A's interest in that portion of the B debt therefore reflects a $5 market discount.[188]
- On the deemed purchase, A should be deemed to pay $50 for a 50-percent interest in the land and $40 for an interest in, presumably, newly issued B debt. Thus, A may take $10 into account over time as original issue discount on the B debt.[189]

Overall, therefore, A is allocated a $5 bad debt deduction from the partnership, takes a $100 basis in the land, and takes an $85 basis in the B debt, which reflects $5 of market discount and $10 of original issue discount.

Under the asset-up approach, the result to A would be the same as in Example 15, but B's consequences would differ. B would be deemed first to receive a liquidating distribution from the partnership and then to make a sale to A. As discussed in Example 15, AB would be deemed to cancel a 50-percent interest in the B debt for $40 consideration, resulting in a $10 bad debt deduction for AB, half of which would be allocated to B, reducing his basis in AB by $5 to $95.[190] Because of that deemed payment, B would also have $10 of COD (the excess of the $50 adjusted issue price of the debt over the $40 deemed consideration). B would take a $55 basis in a 50-percent interest in the land[191] and would recognize a $5 loss on its deemed sale to A for $50. B would also be deemed to issue debt to A for $40 with a stated redemption price at maturity of $50. Thus, over time, B would be entitled to $10 of additional deductions (in addition to stated interest) on that B debt. In summary, B would enjoy a $5 bad debt deduction, a $5 loss on the land, and $10 of additional interest deductions over time but would recognize $10 of COD.

Under the interest-over approach, B would be deemed to sell his AB interest and would recognize a $10 capital loss on the sale. A would be deemed to acquire B's AB interest for $90 and receive all AB assets in deemed liquidation of AB. On the deemed liquidation, neither A nor AB would recognize income, gain, or loss, and A would take a $100 basis in the land and a $90 basis in the B debt, preserving $10 of market discount in that debt.[192]

Example 16. *A buys B's AB interest; AB bought B debt from B; debt worth $120.* The facts are the same as in Example 15, except that the B debt is worth $120. Following the analysis set out in the previous example, under the asymmetric approach, B recognizes a $10 capital gain on his sale of his AB interest to A. A is treated as if AB liquidated, distributing its assets to A and B and then as if A purchased B's share of those assets from B for $110. Thus, to determine A's tax treatment, the following should be considered:

- In the deemed liquidating distribution to B, B is treated as receiving a 50-percent interest in the land. He is also treated as if his 50-percent interest in B debt was cancelled. Assuming that AB is deemed to receive $60 to cancel that portion of B's debt,[193] AB would have $10 of income,[194] half of which would be allocated to A, increasing her AB basis by $5, from $100 to $105.[195]
- In the deemed liquidating distribution to A, A takes a $50 basis in its 50-percent interest in the land and a $55 basis in her 50-percent interest in the B debt.[196] A's interest in that portion of the B debt therefore reflects a $5 premium.
- On the deemed purchase, A should be deemed to pay $50 for a 50-percent interest in the land and $60 for an interest in, presumably, newly issued B debt.

Overall, therefore, A is allocated a $5 of income from the partnership, takes a $100 basis in the land, and takes an $115 basis in the B debt, which reflects a $15 premium. That premium may be deducted when the debt is satisfied or, in appropriate cases, $10 of that amount may be deductible over time as amortizable bond premium.[197]

Under the interest-over approach, the result to B would be the same. A would be deemed to acquire B's AB interest for $110, taking an aggregate $210 basis in AB. AB would then be deemed to liquidate, distributing the land and B debt to A. A would take a $100 basis in the land and a $110 basis in the B debt.[198] The $10 premium basis could be deducted only as the debt was satisfied.[199]

Under the asset-up approach, the result to A would be the same as in Example 16, but B would be deemed to first receive a distribution from the partnership and then to make a sale to A. As discussed in Example 16, AB would be deemed to cancel a 50-percent interest in the B debt for $60 consideration, resulting in $10 of income for AB, half of which would be allocated to B, increasing his basis in AB by $5 to $105.[200] Because of that deemed payment, B would also have a $10 deduction (the excess of the $60 deemed consideration over the $50 adjusted issue price of the debt). B would take a $45 basis in a 50-percent interest in the land[201] and would recognize a $5 gain on his deemed sale of that interest to A for $50. B would also be deemed to issue debt to A for $60 with a stated redemption price at maturity of $50. Thus, over time, B would reduce his interest deduction on the debt by $10.[202] In summary, B would have $5 of allocated partnership income, a $5 gain on the land and a $10 deduction, and, over time, would reduce his interest deduction on the B debt by $10.

In situations like Examples 13 through 16, the interest-over approach should be the favored approach. Unlike under the other approaches, A and B are treated consistently whether AB bought the B debt from B or a third party.

Further, the interest-over approach more closely matches a transaction in which B sells his AB interest to A's spouse or controlled corporation.[203] Under the asymmetric or interest-over approach, such a related-party sale may offer a functional election to A and B to choose their tax consequences, an election that would likely hurt the fisc and favor the more sophisticated.

Finally, the interest-over approach best follows the form and substance of the transaction. In each transaction, no portion of the B debt is cancelled and B issues no new debt. The only approach wholly consistent with those facts is the interest-over approach.[204] For those reasons, in situations like in Examples 13 through 16, the interest-over approach appears to be the best approach.

2. Sales to the Debtor Member

Examples 17 through 20, consider A's sale of her AB interest to B, the debtor partner. The sale terminates the partnership, and the examples explore the tax consequences of the sale under the asymmetric, asset-up, and interest-over approaches. In the first two examples, where AB bought the B debt from a third party, each approach reaches essentially the same results. However, in the last two examples, where AB bought the B debt from B, the results differ significantly.

Example 17. *B buys A's AB interest; AB bought B debt from a third party; debt worth $80.* Sometime ago, AB bought B debt from a third party. The B debt is worth $80 and A sells her AB interest to B for $90.[205] Under the asymmetric approach of Rev. Rul. 99-6, A is treated as selling her AB interest to B and recognizes a $10 capital loss. B is treated as if AB liquidated, distributing its assets to A and B and then as if B purchased A's share of those assets for $90. Thus, A and B are each deemed to receive a 50-percent interest in each AB asset, taking a $50 basis in each interest under Code Sec. 732(c). On the deemed distribution to B, B is deemed to take $50 bases in 50-percent interests in the land and B debt.[206] Because that portion of the B debt is worth only $40, B recognizes a $10 loss, equal to that difference, and also takes $10 of COD into account.[207] B is treated as if A sold him her 50-percent interest in the land for $50 and her 50-percent interest in B debt for $40. Because the debt has a $50 adjusted issue price, B has $10 of COD on that purchase. Overall, therefore, B has $20 of COD on the debt, a $10 capital loss, and a $100 basis in the land.

Under the interest-over approach and asset-up approach, the results to A and B are the same.[208]

Example 18. *B buys A's AB interest; AB bought B debt from a third party; debt worth $120.* The facts are the same as in Example 17, except that the B debt is worth $120. Following the analysis set out in the previous example, whether under asymmetric, the asset-up, or the interest over approach, A recognizes a $10 capital gain.[209] Under the asymmetric and asset-up approaches, B is deemed to purchase 50-percent interests in each AB asset from A and to receive the remaining AB interest in a liquidating distribution.

- B is deemed to pay $50 for the 50-percent interest in the land and $60 for a 50-percent interest in the B debt. Because that debt has an adjusted issue price of only $50, B is entitled to a $10 interest deduction.[210]

- B is deemed to receive the remaining interests in the AB assets in a liquidating distribution. On the distribution, B would first be deemed to take a $50 basis in each of the 50-percent interests in the land and the B debt.[211] Because that portion of the B debt would be worth $60, B would recognize a $10 capital gain and also be entitled to a $10 deduction.[212]

Thus, overall, B would recognize a $10 capital gain, enjoy a $20 deduction, and take a $100 basis in the land.

The results to B generally are the same under the interest-over approach, although the analysis is somewhat different. Under this approach, B is deemed to purchase A's AB interest for $110 and then receive a liquidating distribution of the entire interest in all AB assets. Because of the purchase, B has a $210 basis in its AB interest. Thus, B takes a $100 basis in the land and, temporarily, a $110 basis in the B debt.[213] B recognizes a $10 capital gain (the excess of the debt's value over its deemed basis) and is entitled to a $20 deduction (the excess of the debt's value over its adjusted issue price).[214]

Example 19. *B buys A's AB interest; AB bought B debt from B; debt worth $80.* The facts are the same as in Example 17, except that AB bought the B debt from B. Thus, the B debt is worth $80 and A sells her AB interest to B for $90. Under the asymmetric approach, A is treated as selling her AB interest to B and recognizes a $10 capital loss. B is treated as if AB liquidated, distributing its assets to A and B and then as if B purchased A's share of those assets for $90.

- On the deemed liquidating distribution to B, AB and B are first treated as if his 50-percent interest in the B debt is cancelled.[215] Assuming that AB is deemed to receive $40 for that portion of the debt (*i.e.*, its value),[216] AB has a $10 bad debt deduction,[217] half of which is allocated to B, reducing his AB basis by $5, from $100 to $95.[218] In addition, B has $10 of COD (equal to the excess of the $50 adjusted issue price for that portion of the debt over the $40 deemed payment).
- In the deemed liquidation, B takes a $55 basis in its interest in the land.[219]
- B is also deemed to purchase a 50-percent interest in the land from A for $50 and a 50-percent interest in the B debt for $40, recognizing an additional $10 COD.

Overall, therefore, B has $20 COD and a $5 allocable bad debt deduction, and he takes a $105 basis in the land.

Under the interest-over approach, the results to A would be the same. B would be deemed to acquire A's AB interest for $90 and therefore would take a $190 aggregate basis in his AB interest after the purchase. AB would then be deemed to liquidate, distributing the land to B and cancelling the B debt. Assuming that AB is deemed to receive $80 for the debt (*i.e.*, its value),[220] AB would have a $20 bad debt deduction, allocated entirely to B, reducing his AB basis by $20, from $190 to $170.[221] Further, B would have $20 of COD. Thus, in the deemed liquidation, B would take a $90 basis in its interest in the land.[222] Overall, therefore, B would have $20 COD and a $20 bad debt deduction, and he would take a $90 basis in the land.

Under the asset-up approach, the results to B would be the same as under the asymmetric approach. A, however, would be treated as a partner when AB takes a $10 bad debt deduction into account and would be allocated $5 of that deduction, reducing her basis in her AB interest by $5 to $95.[223] Then, A would be deemed to receive a 50-percent interest in each AB asset, taking a $50 basis in her interest in the land and a $45 basis in her interest in the B debt.[224] Finally, she would be deemed to sell those interests to B for $50 and $40, respectively, recognizing no gain or loss on the land and a $5 loss on the B debt. Thus, overall, A would enjoy a $5 bad debt deduction and a $5 loss on her deemed sale of the B debt.

Example 20. *B buys A's AB interest; AB bought B debt from B; debt worth $120.* The facts are the same as in Example 19, except that the B debt is worth $120. Under the asymmetric approach, A is deemed to sell her AB interest to B for $110 and recognizes a $10 capital gain. B is treated as if AB liquidated, distributing its assets to A and B and then as if B purchased A's share of those assets from B for $110.

On the deemed liquidating distribution to B, AB and B are first treated as if B's 50-percent interest in the B debt was cancelled.[225] Assuming that AB is deemed to receive $60 for that por-

> tion of the debt (*i.e.*, its value),[226] AB has $10 of income,[227] half of which would be allocated to B, increasing his AB basis by $5, from $100 to $105.[228] Further, B has a $10 deduction, equal to the excess of $60 (the amount deemed paid for that portion of the debt) over $50 (its adjusted issue price).
>
> In the deemed liquidation, B takes a $45 basis in his interest in the land.[229]
>
> B is also deemed to purchase a 50-percent interest in the land from A for $50 and a 50-percent interest in the B debt for $60, entitling him to an additional $10 deduction.
>
> Overall, therefore, B has a $20 deduction, he has a $5 of income, and he takes a $95 basis in the land.

Under the interest-over approach, the results to A would be the same. B would be deemed to acquire A's AB interest for $110 and therefore would take a $210 aggregate basis in his AB interest after the purchase. AB would then be deemed to liquidate, distributing the land to B and cancelling the B debt. Assuming that AB is deemed to receive $120 for the debt (*i.e.*, the debt's value),[230] AB would have a $20 of income, allocated entirely to B, increasing his AB basis by $20, from $210 to $230.[231] Further, B would have $20 deduction. Thus, in the deemed liquidation, B would take a $110 basis in the land.[232] Overall, therefore, B would have $20 of income and a $20 deduction, and he would take a $110 basis in the land.

Under the asset-up approach, the results to B would be the same as under the asymmetric approach. A, however, would be treated as a partner when AB takes $10 of income on the debt payment into account and would be allocated $5 of that income, increasing her basis in her AB interest by $5 to $105.[233] Then, A would be deemed to receive a 50-percent interest in each AB asset, taking $50 and $55 bases in her interests in the land and B debt.[234] Finally, on her deemed sale those interests for $50 and $60, respectively, A would recognize no gain or loss on the land and a $5 gain on the B debt. Thus, overall, A would be allocated $5 of partnership income and have a $5 gain on her deemed sale of the B debt.

In Examples 17 and 18, the asymmetric, asset-up, and interest-over approaches reach substantially similar and rationale results. However, in Examples 19 and 20, the results under each approach differ, almost haphazardly. In those examples, AB holds land with a fair market value basis, it has conforming inside and outside bases, and B makes a fair market value purchase of A's AB interest. Yet, under each approach, B's basis in the land after the purchase differs from its value, a perplexing result.[235] Thus, each approach in the latter two examples seems flawed.

As a viable alternative to those approaches, immediately before B purchases A's AB interest, he could be deemed to pay off his debt to the partnership for its fair market value.[236] In Examples 17 and 19, AB would have a $20 bad debt deduction,[237] while B would have $20 of COD.[238] Half of that deduction would be allocated to each partner, reducing the partner's basis in AB by $10, from $100 to $90.[239] In Examples 18 and 20, AB would have a $20 of income,[240] while B would have a $20 deduction.[241] Half of that income would be allocated to each partner, increasing the partner's basis in AB by $10, from $100 to $110.[242] In each case, B would take a $100 basis in the land, a rationale result.[243]

E. Code Sec. 1031

The asymmetric approach (and interest-over approach) may allow taxpayers effectively to elect nonrecognition under Code Sec. 1031, an election avoided by the asset-up approach.

> **Example 21.** *Code Sec. 1031 exchange; gain or loss recognized by selling partners.*[244] A and B are equal partners in partnership AB, and the partnership owns Tract 1. C, an unrelated person, transfers Tract 2 to A and B in exchange for their AB interests. Under the asymmetric approach of Rev. Rul. 99-6, A and B are deemed to exchange their AB interests for Tract 2. Because Code Sec. 1031 cannot apply to that exchange,[245] A and B recognize any realized gain or loss. C, however, is treated as exchanging Tract 2 solely for Tract 1, making a solely like-kind exchange. If the other requirements of Code Sec. 1031 are met, C recognizes no gain or loss on the exchange.
>
> **Example 22.** *Code Sec. 1031 exchange; gain or loss not recognized by selling partners.* The facts are the same as in Example 21, except that AB transfers Tract 1 to C in exchange for Tract 2. Thus, AB and C are each treated as exchanging like-kind property solely for like-kind property.

If the other requirements of Code Sec. 1031 are met, neither AB nor C recognize realized gain or loss.

Examples 21 and 22 illustrate that A and B, through a mere change in form, can defer gain or recognize loss on an effective exchange of Tract 1 for Tract 2, essentially making Code Sec. 1031 elective. The interest-over approach would also tolerate electivity,[246] while the asset-up approach arguably would eliminate it.[247]

V. Conclusion

In this article, I consider what should happen when a person buys a partnership interest or interests and ends up owning all of the partnership interests. I explore three possible approaches in various settings, the asymmetric approach of Rev. Rul. 99-6, the asset-up approach, and the interest-over approach, discussing how each approach may apply and suggesting some refinements to the asymmetric approach. I caution that my analysis considers only a few settings and is therefore only a start, not a comprehensive evaluation of all relevant issues that any approach is likely to raise. Still, it is clear that no approach comfortably accommodates every case.

The interest-over approach, an "entity" approach, seems to reach the best result when the partnership should be viewed as an entity. It also has the advantage of limiting split holding periods and bases and often avoiding functional electivity.

The asset-up approach, an "aggregate" approach, seems to reach the best result when the partnership should be viewed as an aggregate of its partners. For example, it can clearly tie deferred gain and loss amounts to partnership assets.

The asymmetric approach treats the partnership as an entity for the selling partners but as an aggregate of its partners for the buyer. It therefore may fall short when the partnership is better viewed either as an entity or as an aggregate of its partners. In many cases, however, it may be appropriate to view the partnership as an entity for some purposes but as an aggregate of its partners for others. That mix may require a practical compromise between an aggregate and entity approach, a second-best solution. In the final analysis, that solution may be the asymmetric approach.

ENDNOTES

* The author thanks Suresh Advani and Dana Trier for comments on an early draft of this article.

1 Reg. §1.741-1(b) treats the selling partners in this circumstance as selling partnership interests. Thus, for the IRS to adopt the asset-up approach, it would have to amend that regulation. In this article, unless otherwise stated, a reference to the "Code" is to the Internal Revenue Code of 1986, as amended, and a reference to the "IRS" is to the Internal Revenue Service.

2 The partnership could also be deemed to sell to the buying partner the interests in partnership assets attributable to the sellers and then to liquidate, distributing the sales proceeds to the sellers and the remaining interests in partnership assets to the buyer (an "asset-over" approach). If this approach were literally followed, the buying partner might be allocated gain or loss on the partnership's deemed asset sale and Code Sec. 751(b) might apply on the partnership's deemed liquidation, results that seem difficult to justify. For that reason, I generally do not discuss an asset-up approach.

3 Rev. Rul. 99-6, 1999-1 CB 432.

4 *Cf.* American Bar Association Section of Taxation, *Comments on the Final Regulations Defining the Term "Statutory Merger or Consolidation"* (June 11, 2007), *available at* 2007 TNT 113-21 ("ABA Report") (concluding that the interest-over approach should apply when a partnership terminates because of a tax-free merger); Howard E. Abrams, *The McCauslen Two-Step: Did the Government Get It Right in Revenue Ruling 99-6*, 656 PLI/TAX 85, 97 (2005) (arguing that Rev. Rul. 99-6 should not apply to a transfer of a partnership interest described in Code Sec. 351); Rev. Rul. 84-111, 1984-2 CB 88 (allowing form to control the tax consequences of partnership incorporations). *See also* Susan Kalinka, *Proposed Regulations Concerning Partnership Mergers and Divisions Provide Guidance and Some, But Not Enough, Flexibility*, TAXES, Aug. 2000, at 15 (describing the asset-over, asset-up, and interest-over forms of merger).

5 In fact, this asymmetry is far more common than the Rev. Rul. 99-6's asymmetry.

6 When appropriate, Code Sec. 751 applies as well. *See* LTR 200334037 (May 13, 2003).

7 *E.E. McCauslen*, 45 TC 588, Dec. 27,889 (1966). The IRS also cited Reg. §1.741-1(b), which states that if one partner of a two-person partnership sells his or her partnership interest to the other partner, Code Sec. 741 applies to the selling partner. Because Code Sec. 741 applies to the sale or exchange of a partnership interest, the selling partner under this regulatory section must be treated as selling a partnership interest.

That conclusion, however, does not mandate that the buyer be treated (asymmetrically) as buying partnership assets, the approach of *McCauslen*. Instead, consistent with the regulation, the interest-over approach could apply. In other words, the buyer could be deemed to receive all partnership assets in liquidating distributions from the partnership that follow the buyer's purchase of partnership interests. *Cf.* Rev. Rul. 84-111, 1984-2 CB 88 (Situation 3) (appearing to adopt this approach when the partners of partnership contribute their partnership interests to a corporation; because the corporation determines its basis in the partnership assets under Code Sec. 732(c), it is deemed to receive the assets in liquidation of the partnership).

8 Thus, the IRS conceded that the taxpayer recognized long-term capital gain on his sale of a 50-percent interest in the asset received in the deemed partnership liquidation, because the taxpayer tacked the partnership's holding period for that interest.

9 *See also* Rev. Rul. 67-65, 1967-1 CB 168 (reaching the same conclusion under similar facts but with little analysis).

10 *Cf.* Reg. §301.7701-3(g)(1)(iii) and (3) (providing that when an association electively converts to a disregarded entity, it is deemed to liquidate immediately before the close

of the day before the date that the election becomes effective).

[11] *See also* T.D. 6175, 1956-1 CB 211, 274 (introducing current Reg. §1.741-1(b)). Note that the asymmetric and interest-over approaches (*i.e.*, the IRS and taxpayer approaches) are each consistent with this regulatory provision. Perhaps for that reason, the court failed to cite it.

[12] *See Dallas Downtown Development Co.*, 12 TC 114, Dec. 16,777 (1949), *acq.* 1950-1 CB 2.

[13] *See Kimbell-Diamond Milling Co.*, 14 TC 74, Dec. 17,454, *aff'd per curium*, CA-5, 51-1 USTC ¶9201, 187 F2d 718, *cert. denied*, 342 US 827 (1951).

[14] To achieve that purpose, a court could not follow form in the *Kimbell-Diamond* transaction. If form were followed, the buying corporation would be treated as buying target stock and then liquidating the target corporation. If, as is likely, the liquidation met the requirements of Code Sec. 332's predecessor, the buyer would take a transferred or carryover basis in the target assets. *See* Code Sec. 113(a)(15) (1951) (providing for a carryover basis).

[15] *See General Utilities & Operating Co. v. Helvering*, SCt, 36-1 USTC ¶9012, 296 US 200.

[16] *See* Code Sec. 331 (1954) (providing that amounts distributed in complete liquidation of a corporation are treated as full payment in exchange for stock).

[17] *See* H.R. CONF. REP. NO. 99-841, at II-204 (1986) (providing that "[t]he repeal of the *General Utilities* doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context"); H.R. REP. NO. 99-425, 99th Cong., 2d Sess. 282 (1985) (stating that "[u]nder normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis in the transferred property"); 1990-1 CB 68 (in the preamble to the first version of the consolidated loss disallowance rule, stating that the principal purpose of the repeal of the *General Utilities* doctrine "was to require the payment of a corporate-level tax in a transaction that results in a stepped-up basis to the new owner").

[18] Code Sec. 338 is "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine." H.R. CONF. REP. NO. 760, 97th Cong., 2d Sess. 536 (1982). *See also* Rev. Rul. 90-95, 1990-2 CB 67 (concluding that the *Kimbell-Diamond* doctrine does not apply to a qualified stock purchase of a target followed by its planned liquidation; also stating that Code Sec. 338 "replaced" that doctrine and "governs whether a corporation's acquisition of stock is treated as an asset purchase"). Perhaps, despite Code Sec. 338, the *Kimbell-Diamond* doctrine, as appropriately modified, may still apply to a taxable transaction in the absence of a qualified stock purchase. *See* Code Sec. 338(a) (requiring a qualified stock purchase for a Code Sec. 338 election to be made); *id.*, at (d)(3) (defining a qualified stock purchase as the "purchase" of a sufficient quantity of target stock over a 12-month period); *id.*, at (h)(3) (providing that certain acquisitions of stock are not "purchases" for purposes of Code Sec. 338).

[19] *See* ABA Report, *supra* note 4. In certain cases, it may also be difficult to determine the partner's economic interest.

[20] Presumably, however, the partnership agreement could not be changed as part of the transaction. *Cf.* Code Sec. 761(c) (providing that the partnership agreement includes any modifications to the agreement made on or before the due date (without extensions) of the partnership tax return for the taxable year). If partners could freely amend the partnership agreement after the sale for this purpose, the buyer, with the sellers' consent, effectively could choose which assets were deemed distributed to each partner (*i.e.*, option (iv) below).

[21] Other issues include whether Code Sec. 731(c) or 732(f) should apply and how partnership liabilities should be accounted for, particularly if they are not allocated *pro rata*. *See* ABA Report, *supra* note 4 (raising these issues). *See also* Monte A. Jackal, *New Rulings Address One-to-Two and Two-to-One Entity Conversions*, 82 TAX NOTES 1167, 1172 (Feb. 22, 1999) (questioning whether Code Sec. 704(c)(1)(B) or Code Sec. 737 should apply to the deemed partnership liquidation).

[22] *See* ABA report, *supra* note 4 (suggesting some of these options).

[23] If form is followed, the buyer and sellers may achieve a similar result by having the partnership distribute assets to the sellers, which the sellers sell to the buyer in conjunction with their sale of partnership interests. If these distributions and sales are part of a plan, however, under the step-transaction doctrine, the asset distribution and asset sale may (and should) be disregarded and the sellers treated in substance as selling only partnership interests. *See E.K. Crenshaw*, CA-5, 71-2 USTC ¶9698, 450 F2d 472 (1971), *cert denied.*, 408 US 923 (1972) (where in form a partnership made a liquidating distribution of an asset, the distributee sold the asset, and the buyers contributed the asset to the partnership in exchange for a partnership interest, the court applied the step-transaction doctrine to disregard the distribution, asset sale, and contribution and treat the transaction in substance as the sale of a partnership interest); ILM 200224007 (Feb. 27, 2002) (arguing that a sale of assets by a partnership followed by its liquidation was properly treated as a sale of partnership interests under the step-transaction doctrine). *Cf. L.A. Harris, Jr.*, 61 TC 770, Dec. 32,500 (1974) (concluding that the step-transaction did not apply in a case where the distributed property was not recontributed to the partnership); Howard E. Abrams, *supra* note 4, at 97 (noting that there may be a substantial difference between the distribution and sale of partnership assets and the sale of a partnership interest because of liabilities that attach to the partnership assets).

If partnership assets were distributed and sold as a prelude to a Rev. Rul. 99-6 sale of partnership interests, the form likely would be respected if the assets were sold to a person other than the buyer. Then, in substance, the asset distribution and sale would differ from a mere sale of a partnership interest, even if the asset sale was to a person related to the buyer.

[24] *Cf.* Heather M. Field, *Fiction, Form, and Substance in Subchapter K: Taxing Partnership Mergers, Divisions, and Incorporations*, 44 SAN DIEGO L. REV. 259 (2007) (describing how the tax treatment of partnership mergers, divisions and incorporations depends on form, noting that for nontax reasons some taxpayers cannot structure their transactions to maximize their tax results, and arguing that the tax results should instead be elective and not tied to form). *See also* Rev. Rul. 84-111, 1984-2 CB 88 (allowing form to control the tax consequences of partnership incorporations).

[25] Assume that neither asset is a Code Sec. 751 asset.

[26] Code Sec. 704(c)(1)(B) (providing that if property is distributed to the contributing partner, Code Sec. 704(c)(1)(B) does not apply).

[27] *Cf.* Reg. §1.704-4(c)(6) (providing that Code Sec. 704(c)(1)(B) does not apply to a distribution of an undivided interest in property to a contributing partner, to the extent that the interest does not exceed the undivided interest contributed by that partner).

Code Sec. 737 does not apply to A's deemed distribution, because he has no net precontribution gain. That gain amount is determined after taking into account the gain recognized under Code Sec. 704(c)(1)(B) on the 50-percent Asset 1 interest deemed distributed to B and also by disregarding the 50-percent Asset 1 interest deemed distributed to A. *See* Reg. §1.737-1(c)(2)(iv) (disregarding Code Sec. 704(c)(1)(B) gain recognized in same transaction); Reg. §1.737-2(d)(1) (disregarding property previously contributed by the distributee partner and distributed in the transaction). Because Asset 1 is not taken into account, A has no precontribution gain, and thus Code Sec. 737 cannot apply.

[28] Reg. §1.704-4(e)(1) (providing that the contributing partner's basis in the partnership interest is increased by recognized gain or

decreased by recognized loss under Code Sec. 704(c)(1)(B)).

29 *See generally* Code Sec. 731(a)(2) (for loss) and Code Sec. 732(b) (for asset basis following liquidating distributions).

30 A purchases 50-percent interests in each asset for $50, taking $50 bases in those interests. Code Sec. 1012. He receives the other 50-percent interests in each asset in a deemed liquidating distribution from AB and under Code Sec. 732(b) takes a $0 and $50 bases in the 50-percent interests in Assets 1 and 2. Thus, overall, A has a $50 basis in Asset 1 and a $100 basis in Asset 2.

31 *See* H.R. Rep. No. 101-247, 101st Cong., 1st Sess. 1356 (1989).

32 Note that if AB has a Code Sec. 754 election in effect, B's sale of its AB interest to the related party may also result in a special basis adjustment in the AB assets for the related party.

33 A purchases 50-percent interests in each asset for $50, taking $50 bases in those interests. Code Sec. 1012. He receives the other 50-percent interests in each asset in a deemed liquidating distribution from AB and under Code Sec. 732(b) takes a $0 and basis in each 50-percent distributed interest. Thus, overall, A has a $50 basis in Asset 1 and a $50 basis in Asset 2. Note that this analysis also assumes that Code Sec. 737 does not apply to A.

34 Presumably, the buyer and sellers would have to account for their attributable interests in partnership assets consistently under an assets-up approach.

35 *See* Reg. §1.704-2(d)(2) (providing that the transferee of the partnership interest of a contributing partner is treated as the contributing partner for purposes of Code Sec. 704(c)(1)(B)).

36 *See also* McKee, Nelson, and Whitmire, Federal Taxation of Partnership and Partners (4th ed. 2007), at ¶16.02[3][b] ("McKee") (describing an issue under the anti-churning rule of Code Sec. 197(f)(9)); Monte A. Jackal, *supra* note 21, at 1171 (discussing the same issue).

37 Code Sec. 1012.

38 Rev. Rul. 99-6, 1999-1 CB 432 (citing Rev. Rul. 66-7, 1966-1 CB 188, concluding that the holding period of an asset is determined by excluding its purchase date).

39 *See* Code Sec. 168(c) (providing applicable recovery periods for purchased property, whether new or used); Howard E. Abrams, *supra* note 4 at 91 (stating that "[t]he natural implication of Revenue Ruling 99-6, though, is that section 168(i)(7) does not apply to that portion of the distributed assets attributable to the purchased partnership interest").

40 Code Sec. 732(b) (providing that the basis of noncash assets distributed to a partner in liquidation of his or her partnership interest equals the partner's basis in his or her partnership interest reduced by the money distributed in the same transaction); *id.*, at (c) (providing for the allocation of basis among the distributed assets, including that the amount allocated to unrealized receivables and inventory items cannot exceed the partnership's basis in those assets).

For convenience, I sometimes use the phrase "outside basis" to refer to a partner's basis in his or her partnership interest and the phrase "inside basis" to refer to the partnership's basis in its assets.

41 Code Sec. 735(b).

42 Code Sec. 168(i)(7) (stating that the transferor in a transaction described in Code Sec. 731 is treated as the transferee for purposes of computing the depreciation deduction). Any excess basis should be accounted for using the recovery period and method for newly purchased property. *See id. Cf.* Reg. §1.168(i)-6(d)(1)(i) (describing this rule for Code Sec. 1031 exchanges).

43 *See supra* notes 40 to 42 and accompanying text.

44 *See supra* notes 7 to 11 and accompanying text (for a discussion of *McCaulsen*).

45 As an alternative planning device, the sellers may sell most, but not all, of their partnership interests.

46 If more than 50 percent of the partnership capital and profits are sold, the partnership is deemed to terminate under Code Sec. 708(b)(1)(B). The partnership is deemed to transfer its assets to a new partnership in Code Sec. 721 exchange. *See* Reg. §1.708-1(b)(4). Under Code Sec. 723, the new partnership succeeds to the old partnership's asset bases, and thus under Code Sec. 1223(2), it also succeeds to the old partnership's holding periods for its assets.

47 The partners may also report that gain on the same return (*e.g.*, a joint or consolidated return). *See* Code Sec. 1501 (affording an affiliated group the privilege of making a consolidated return); Code Sec. 6013 (authorizing a husband and wife to file a joint return).

48 *See* Reg. §1.743-1(j)(4)(ii) (describing how to account for a negative basis adjustment on depreciable property).

49 In a related-party purchase, this basis increase would be a positive basis adjustment under Code Secs. 743 and 755.

50 *Id.*, at (j)(4)(i)(B)(*1*) (describing how the to account for positive basis adjustments on depreciable property). *See id.*, at (j)(4)(i)(B)(*2*) (for a special rule under the remedial allocation method).

51 Note that if the buying partner's outside basis does not comport with his or her share of partnership inside basis, the aggregate asset basis of the partnership assets in the related-party purchase may differ from the aggregate basis of those assets under the interest-over, asset-up, or asymmetric approach. Further, that aggregate basis may be allocated among the partnership assets under the interest-over approach differently than under the other two approaches.

52 Assume that none of these assets is a Code Sec. 704(c) or 751 asset. For convenience, when this article uses the phrase "Code Sec. 704(c) asset," it means a built-in gain or loss asset contributed by a partner to the partnership, and when it uses the phrase "Code Sec. 751 asset," it means an asset described in Code Sec. 751(c) or (d).

53 *See* Reg. §1.743-1(b); Reg. §1.755-1(b).

54 Reg. §1.732-2(b). Thus, AB is deemed to have a $75 basis in Asset 1 ($50 original basis plus $25 positive adjustment), a $125 basis in Asset 2 ($150 original basis minus $25 negative adjustment), and a $125 basis in Asset 3 ($50 original basis plus $75 positive adjustment).

55 Code Sec. 732(b).

56 This conclusion assumes that each partner's attributable interest in each AB asset is a 50-percent undivided interest. Then, A would be deemed to acquire a 50-percent interest in Asset 1, 2 and 3 for their values, taking $50, $50 and $100 bases, respectively, in those interests. He would be deemed to receive the remaining interests in those assets in a liquidating distribution, taking a $25, $75 and $25 basis in the remaining 50-percent interests in those assets. Code Sec. 732(b) and (c). Thus, overall, A would have $75, $125 and $125 bases in Assets 1, 2 and 3, respectively.

57 When a nonpartner buys all interests in a partnership, it may seem counterintuitive to support the interest-over approach, since the buyer never is a partner in the partnership. However, the same functional election applies in that circumstance, since the nonpartner and a related person could instead buy the partnership interests. The interest-over approach limits that functional election favoring that approach, even when a nonpartner buys all interests in a partnership.

58 Rev. Rul. 72-172, 1972-1 CB 265.

59 The revenue ruling implied that none of the partner's gain would be ordinary under Code Sec. 751. Thus, although the apartment building was Code Sec. 1250 property, the revenue ruling presumed that none of the gain on its sale would be characterized as ordinary income under Code Sec. 1250(a).

60 To support this conclusion, the revenue ruling cited *McCauslen* and therefore apparently applied the asymmetric approach. *See supra* notes 10 to 11 and accompanying text (explaining why *McCauslen* used the asymmetric approach).

61 Under Code Sec. 1239(b)(1), related persons include a person and all of that person's controlled entities. A corporation is a person's controlled entity if the person owns more than 50 percent by value of its outstanding stock. Code Sec. 1239(c)(1)(A). A partnership is a person's controlled entity if the person owns more than 50 percent of its capital and profits interests. Code Sec. 1239(c)(1)(A). Further, one spouse is considered to own any stock or partnership

interest owned by the other spouse. Code Sec. 1239(c)(2) (providing that ownership is determined under rules "similar to" Code Sec. 267(c)); Code Sec. 267(c)(2) and (4) (providing that an individual is considered to own stock owned by his or her family and that an individual's family includes his or her spouse).

In Rev. Rul. 72-172, a husband and wife together owned 100 percent of both the corporation and partnership. Thus, constructively, each spouse owned 100 percent of each entity, and each spouse, the corporation, and the partnership were related persons.

[62] Note that Code Sec. 751 did not apply to the sale by either partner, because the apartment building was not Code Sec. 751 property, even though the partnership would have recognized ordinary income if it had sold the building to the corporation. Property is Code Sec. 751 property only if it is an unrealized receivable or inventory item. Code Sec. 751(a). The apartment building was neither.

In relevant part, an unrealized receivable includes Code Sec. 1250 property, to the extent that gain from the sale of that property would be characterized as ordinary income under Code Sec. 1250(a). Code Sec. 751(c). Although the apartment building was Code Sec. 1250 property, the revenue ruling presumed that none of the gain on its sale would be characterized as ordinary income under Code Sec. 1250(a) and it was therefore not an unrealized receivable.

An inventory item is any property that is neither a capital asset nor Code Sec. 1231 asset (or would be neither a capital asset nor Code Sec. 1231 asset if held by the selling partner). Code Sec. 751(d). Although the partnership (and selling partners) would have recognized ordinary income on a direct sale of the apartment building under Code Sec. 1239, the building remained a Code Sec. 1231 asset, as Rev. Rul. 72-172 noted. Thus, the apartment building was also not an inventory item and Code Sec. 751 did not require the selling partners to recognize ordinary income on their sales of partnership interests.

The apartment building remained a Code Sec. 1231 asset despite Code Sec. 64. Under that section, ordinary income is characterized as "gain from the sale or exchange of property that is neither a capital asset nor property described in section 1231(b)." Because Code Sec. 64 characterizes the gain, but not the nature of the asset, an asset retains its character as a Code Sec. 1231 asset even if Code Sec. 1239 applies to its sale. Thus, even though the sale of the building by the partners (or partnership) would have resulted in ordinary income, the building remained a Code Sec. 1231 asset.

[63] Code Sec. 1239(a) applies to "a sale or exchange of property, directly or indirectly, between related persons" if the transferee holds the property as a depreciable asset. The words "directly or indirectly," situated between two adjective phrases—"of property" and "between related persons"—could be read to modify either phrase. If those words modify the phrase "of property," the provision should apply to an "indirect" sale of a depreciable asset to a related person if, as a result of the transaction, the related person holds the asset.

Those words should modify the phrase "of property," as is made clear by their placement in Code Sec. 1239(a)'s predecessor. The predecessor applied to "a sale or exchange, directly or indirectly, of property ... between [related persons]." Code Sec. 1239(a) (1975). In the predecessor, the words "directly or indirectly" modified the immediately succeeding phrase "of property," not the more distant succeeding phrase "between [related persons]."

The current version of Code Sec. 1239(a) has been in the Code since in 1976, when Congress amended its predecessor. Act Sec. 2129(c) of the Tax Reform Act of 1976 (P.L. 94-455). Because the amendment was non-substantive, current Code Sec. 1239(a) should be interpreted in the same way as its predecessor. *See* S. Rep. No. 938, 94th Cong., 2d Sess. 515 (1976) (stating that the purpose of the amendment was to strike out an obsolete effective date). Thus, it may apply to an "indirect" sale of a depreciable asset. In particular, it may apply to the sale of a partnership interest where the partnership owns a depreciable asset, at least if the buyer acquires the depreciable asset in the transaction.

[64] For example, the attributable Code Sec. 1239 gain could be determined proportionately, it could be reduced by any ordinary loss (not otherwise taken into account under Code Sec. 751), it could accounted for first, or it could be accounted for last.

[65] *See also* GCM 34711 (Dec. 10, 1971) (reviewing a draft of Rev. Rul. 72-172 and making clear that revenue ruling recharacterized gain otherwise recognized under Code Sec. 741).

[66] Applying the aggregate approach broadly, the partner may be deemed to sell a share of partnership assets and recognize ordinary income under Code Sec. 1239. That application should be rejected as an extra-statutory expansion of Code Sec. 751.

In certain cases, the aggregate approach may apply, as Congress suggested in crafting the modern partnership system as part of the 1954 Code. It stated:

> No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.

H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954) (making this statement as part of its discussion of Code Sec. 707). By way of illustration, Congress hinted that Code Sec. 543(a)(6) should be applied using the aggregate approach.

Under that section, a corporation's personal holding company income may include its rental income for tangible property used by its 25-percent shareholder. Under the aggregate approach, if a corporation rented tangible property to a partnership with a 25-percent shareholder/partner, the shareholder should be deemed to use the rental property. Then, the corporation's rental income may be personal holding company income, at least up to the shareholder's attributable share of the rent.

Accordingly, to interpret Code provisions outside of Subchapter K, "a partnership ... may be treated either as an aggregate of its partners or as an entity distinct from its partners," depending on the context. Rev. Rul. 89-85, 1989-2 CB 218 (applying the aggregate approach to account for deferred gain on an intercompany sale of a partnership interest). However, with one possible exception, courts and the IRS have not applied this aggregate approach to modify any provision of Subchapter K. *See, e.g., Holiday Village Shopping Center*, CA-FC, 85-2 ustc ¶9649, 773 F2d 276 (applying an aggregate approach to compute Code Sec. 1250 gain in a corporate liquidation to which Code Sec. 751 did *not* apply); *E. Casel*, 79 TC 424, Dec. 39,311 (1982) (concluding that Reg. §1.267(b)-1(b)(2) validly applied the aggregate approach); *George Edward Quick Trust*, 54 TC 1336, Dec. 30,187 (1970) (applying an aggregate approach under Code Sec. 1014(b) to deny a basis step-up for income in respect of a decedent); *C.H. Woodhall*, 28 TCM 1438, Dec. 29,884(M), TC Memo. 1969-279 (to the same effect); Rev. Rul. 91-32, 1991-1 CB 107 (using an aggregate approach to determine effectively connected income); Rev. Rul. 90-112, 1990-2 CB 186 (using an aggregate approach to determine if a controlled foreign corporation (a "CFC") held U.S. property); Rev. Rul. 89-108, 1989-2 CB 100 (concluding that ordinary income under Code Sec. 751 attributable to partnership inventory could not be reported under the installment method); Rev. Rul. 60-352, 1960-2 CB 208 (concluding that the transfer of a partnership interest was a disposition of the partnership's installment obligation under the predecessor to Code Sec. 453B). *Cf.* Rev. Rul. 89-72, 1989-1 CB 257 (applying Code Sec. 702(a)(7) and (b) to treat a CFC's allocable share of partnership income as subpart F income); *Brown Group,* *Inc.*, 104 TC 105, Dec. 50,436 (1995) (using the aggregate approach to reach the same conclusion, arguably expanding Code Sec. 702(a)(7)), *rev'd by* CA-8, 96-1 USTC ¶50,055, 77 F3d 217 (1996).

If a partner sold a partnership interest and applied Code Sec. 1239 using a broad aggregate approach, that approach may make the sale's tax consequences uncertain. For instance, it may be unclear whether Code Sec. 1239 should apply to such a sale if the partnership had no Code Sec. 754 election in effect. The better approach is to apply Code Sec. 1239 as in Rev. Rul. 72-172, because it eliminates that uncertainty and seems more consistent with both Code Sec. 751 and Congressional intent. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 99 (1954) (appearing to limit ordinary income to Code Sec. 751 amounts).

[67] Assume as well that if the partnership sold the apartment building and recognized gain, none of that gain would be treated as ordinary income under Code Sec. 1250. Additionally assume that neither partner is a dealer in real property. Thus, Code Sec. 751 would not apply to the sale.

[68] Note, however, that the buyer's bases in the partnership assets may differ under the two approaches. Under the asymmetric approach, the buyer determines his or her basis in partnership assets under Code Sec. 1012, to the extent the assets are deemed purchased, and under Code Sec. 732, to the extent the assets are deemed distributed in liquidation of the partnership. Under the interest-over approach, the buyer's basis in the partnership assets is determined entirely under Code Sec. 732.

[69] In implementing the asset-up approach, the property should not lose its character as depreciable property because of the deemed liquidation. Thus, the sellers should be deemed to sell depreciated property to a related person, and Code Sec. 1239 could apply to the sale.

[70] *See* Code Sec. 1239(a) (requiring the transferee to acquire a depreciable asset).

[71] Related persons include members of the same family, including parents and children, and members of the same controlled group of corporations. Code Sec. 267(b)(1) (members of the same family); *id.*, at (b)(3) (members of the same controlled group); *id.*, at (c)(4) (providing that the family of an individual includes only his or her siblings, spouse, ancestors and lineal descendants); *id.*, at (f) (defining a controlled group).

[72] *Id.*, at (d) (also providing that this gain limitation rule applies to property "the basis of which in [the person's] hands is determined directly or indirectly by reference to the basis of [the purchased] property").

[73] Code Sec. 731(a).

[74] In this and subsequent examples, I assume that a 50-percent partner's attributable share of partnership assets is an undivided 50-percent interest in each partnership asset.

[75] Code Sec. 732(b) and (c)(1). Mary takes the partnership's bases in these assets because her basis in her FM interest equals the sum of those bases.

[76] Her aggregate basis in Asset 1 equals $25 for the undivided interest deemed received in liquidation plus $50 for the undivided interest deemed purchased. Her aggregate basis in Asset 2 equals $50 for the undivided interest deemed received in liquidation plus $25 for the undivided interest deemed purchased. Her holding period for the undivided interests deemed received from the partnership includes the partnership's holding periods. Code Sec. 735(b). Her holding period for the interests deemed purchased begins on the day following the sale date. Rev. Rul. 99-6, 1999-1 CB 432 (citing Rev. Rul. 66-7, 1966-1 CB 188, concluding that the holding period of an asset is determined by excluding its purchase date). Although it is not altogether clear, the basis for the assets may also be similarly split.

[77] Thus, Asset 2 has appreciated in value to $100 while held by Mary.

[78] Code Sec. 1001(a). If Mary has a blended basis of $75 in Asset 2, she realizes a $25 gain on her sale of the asset ($100 amount realized minus $75 basis). If she has a split basis, she recognizes no gain or loss on her sale of the distributed interest ($50 amount realized minus $50 basis) and a $25 gain on her sale of the purchased interest ($50 amount realized minus $25 basis).

[79] *See* Reg. §1.267(d)-1(b)(2) (providing that gain realized by the related person on a sale of property is recognized only to the extent that the gain exceeds the loss not allowable to the transferor on "such" property).

[80] *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. A66 (1954) (stating that the rule applies of the disposition of property "if a loss was incurred by the transferor on the transfer of the property to the taxpayer"); S. REP. NO. 1622, 83d Cong., 2d Sess 227 (1954) (containing identical language).

[81] Note that the other requirements of Code Sec. 267(d) would be met: Frank would recognize a loss on his sale of property (the FM interest) to a related person (Mary, his daughter), that loss would be disallowed under Code Sec. 267(a)(1), and Mary would sell property (Asset 2) at a gain.

[82] *See also* Reg. §1.267(d)-1(a)(1) (providing that Code Sec. 267(d) may apply if a taxpayer acquires property by purchase from a transferor and the transferor sustains a loss "on the transaction").

[83] *See* Notice 2002-50, 2002-2 CB 98 (stating in a different context that "Code Sec. 267(d) must be applied under an aggregate approach, rather than an entity approach").

[84] *See* notes 60 to 63, *supra* (and accompanying text). In fact, the case to apply Code Sec. 267(d) is stronger, because it simply requires a sale to the taxpayer (which occurs under the fiction of Rev. Rul. 99-6). In contrast, Code Sec. 1239 requires a sale of the property "between" the taxpayer and related person. If Code Sec. 1239 can apply under the asymmetric approach, so should Code Sec. 267(d).

[85] Under that fiction, Fred would be deemed to receive undivided 50-percent interests in each asset in liquidation of his FM interest, taking a $25 basis and $50 basis, respectively, in the Asset 1 and 2 interests. Code Sec. 732(b). He would be deemed to sell those interests for their fair market values ($50 for the Asset 1 interest and $25 for the Asset 2 interest), recognizing a $25 gain on the Asset 1 interest and a $25 loss on the Asset 2 interest.

[86] If Asset 2, rather than Asset 1, were the Code Sec. 751 asset, Fred would recognize $25 of ordinary loss and $25 of capital gain on his sale of the partnership interest. Code Sec. 741; Code Sec. 751(a). The results and analysis for Mary should be the same as discussed above.

[87] *See* Code Sec. 267(d)(1) (requiring as a condition that the transferor (*e.g.*, Fred) sustain a loss not allowed by reason of Code Sec. 267(a)(1)). Note that if Fred's deemed loss were an actual loss, its deduction would be disallowed by Code Sec. 267(a)(1).

[88] Code Sec. 731(a).

[89] Code Sec. 732(b) and (c)(1). Mary takes the partnership's bases in these assets because her basis in her FM interest equals the sum of those bases.

[90] Her aggregate basis in Asset 1 equals $25 for the undivided interest deemed received in liquidation plus $50 for the undivided interest deemed purchased. Her aggregate basis in Asset 2 or 3 each equals $50 for the undivided interest deemed received in liquidation plus $25 for the undivided interest deemed purchased. Her holding period for the undivided interests deemed received from the partnership includes the partnership's holding periods. Code Sec. 735(b). Her holding period for the interests deemed purchased begins on the day following the sale date. Rev. Rul. 99-6, 1999-1 CB 432 (citing Rev. Rul. 66-7, 1966-1 CB 188, concluding that the holding period of an asset is determined by excluding its purchase date). Although it is not altogether clear, the basis for the assets may also be similarly split.

[91] *Cf.* Reg. §1.267(d)-1(b)(3)(i) (measuring loss on a "class" of property); *id.*, at (b)(3)(ii) (providing that when the taxpayer's basis for loss cannot be determined, it is allocated among all property purchased in proportion to value).

[92] Note that for this purpose it is more appropriate to consider a partner's deemed gains

and losses on this fictional sale, rather than his or her share of the net built-in loss in partnership assets immediately before the sale. If the partner's outside basis does not conform to the partnership's inside basis, the partner's share of net inside built-in loss may not equal his or her outside loss. The partner's net loss on the fictional sale, however, will also equal his or her outside loss. *See* Code Sec. 732(b) (providing that a partner's aggregate basis in property received in a liquidating distribution equals his or her outside basis).

Under Code Sec. 732(b) and (c), Fred would be deemed to take a $25 basis, $50 basis, and $50 basis, respectively, in his shares of Assets 1, 2 and 3. Because he would be deemed to sell those shares for their fair market values ($50, $25 and $25), he would be deemed to recognize a $25 gain, $25 loss and $25 loss, respectively, on Assets 1, 2 and 3. Code Sec. 1001(a) and (c).

93 Allocating the Code Sec. 267(d) amount fully to Asset 2 may also be supported by the following somewhat analogous case: Suppose that instead of Fred's selling his FM interest to Mary, he sold it to his son, Frank, so that the FM partnership would have two partners and not terminate. If Asset 2 appreciated in value by $50 and Frank sold his FM interest at a $25 realized gain, he arguably should recognize none of the gain because of Code Sec. 267(d).

The argument is as follows: Code Sec. 267(d) applies if a transferor transfers property to a related person, recognizing a loss disallowed by Code Sec. 267(a)(1), and the related person later sells that property at a gain. Because Fred sold the partnership interest to a related person (Frank, his son), he recognized a $25 loss disallowed under Code Sec. 267(a)(1). Further, because Frank sold the same partnership interest at a $25 gain, Code Sec. 267(d) should apply to Frank's sale, so that Frank recognizes none of his realized gain.

In essence, because of Asset 2's appreciation, Frank realizes gain, but that gain is fully offset by the Code Sec. 267(d) amount. By analogy, the full Code Sec. 267(d) amount should be assigned to Asset 2 in the text example. Note that force of the analogy is diminished by Notice 2002-50, 2002-2 CB 98, which muddles how Code Sec. 267(d) applies in a case like Frank's. The notice states that Code Sec. 267(d) is applied using an aggregate approach, although it is not clear how an aggregate approach would be applied (*e.g.*, it could be applied by allocating the Code Sec. 267(d) amount between Assets 2 and 3 or by allocating that amount solely to Asset 2). A prominent commentator has harshly criticized applying Code Sec. 267(d) using an aggregate approach, stating that it raises "dizzying" questions and "is unwarranted by the language of the statute, legislative history, and case law." *See* McKee, *supra* note 36, at ¶16.08[3][a].

94 Under that fiction, Fred would be deemed to receive undivided 50-percent interests in each asset in liquidation of his FM interest, taking $25, $50 and $50 bases in the Assets 1, 2 and 3 interests, respectively. He would be deemed to sell those interests for their fair market values ($50 for the Asset 1 interest and $25 each for the Asset 2 and 3 interests), recognizing a $25 gain on the Asset 1 interest and a $25 loss on each of the Asset 2 and 3 interests.

95 *See* note 85, *supra* (describing how Fred would recognize a $25 gain and $25 loss on his interests in Assets 1 and 2, respectively).

96 *See* note 92, *supra* (for the computation of those gain and loss amounts).

97 That provision would apply to Fred's sale, because he would be deemed to own all S Inc. stock and would therefore sell his partnership interest to a related person. Code Sec. 267(c)(2) (providing that an individual is deemed to own all stock owned by a family member); *id.*, at (c)(4) (providing that an individual's family members include his or her lineal descendants); *id.*, at (b)(2) (providing that an individual and more than 50 percent–owned corporation are related persons).

98 Note that if FM had no Code Sec. 754 election in effect and S Inc. was an S corporation, the restructuring might also benefit Mary, because each partnership's loss asset would retain its full $50 built-in loss. That benefit would arise with either the asset-up or asymmetric approach. Thus, either approach might encourage a functional election.

99 *See* Code Sec. 267(d); Reg. §1.267(d)-1(a)(2) (applying Code Sec. 267(d) to a disposition of property "when the basis of such property in the taxpayer's hands is determined directly or indirectly by reference to other property acquired by the taxpayer from the transferor through a sale or exchange in which a loss sustained by the transferor was not allowable"); Code Sec. 732(b) (providing that a partner takes an aggregate basis in noncash property distributed in a partnership liquidation equal to his or her outside basis less any money distributed).

100 The allocation might also be made using an aggregate approach.

101 She would have a $125 aggregate basis in the entire FM interest, and half of that amount would be allocated to each asset ($50, equal to the FM's basis, plus $12.50, since each asset has a $25 inside built-in gain). Code Sec. 732(b) and (c)(2).

102 She would have a $150 aggregate basis in the entire FM interest, and half of that amount would be allocated to each asset ($50, equal to FM's basis, plus $25, equal to each asset's $25 inside built-in gain). Code Sec. 732(b) and (c)(2).

103 If the Code Sec. 267(d) amount was allocated between the partnership assets using an aggregate approach, $12.50 would still be allocated to each asset. Thus, the results would be the same.

104 *See* note 98, *supra*, and accompanying text (describing some related-party sales).

105 *See* Code Sec. 267(c)(2) (providing that family members are related persons); *id.*, at (c)(4) (providing that an individual's family includes his or her spouse and any lineal descendant, but not the spouse of a lineal descendent). Rev. Rul. 71-50, 1971-1 CB 106 (concluding that a step-mother was not a related person); LTR 9017008 (Apr. 27, 1990) (concluding that loss on a property sale to a son-in-law was not disallowed under Code Sec. 267(a)(1)). *See also Van Valkenburgh*, 26 TCM 753, Dec. 28,562(M), TC Memo. 1967-162, at 774–75 (1967) (concluding that a loss on sale to a brother-in-law was not disallowed under Code Sec. 267(a)(1)).

106 *Cf.* Reg. §1.701-2(e) (providing that the IRS can use the aggregate approach when "appropriate to carry out the purpose of any provision of the Internal Revenue Code").

107 Note that in the examples above, the partnership did not have a Code Sec. 754 election in effect.

108 *See* LTR 200737006 (Sept. 27, 2006); LTR 200334037 (May 13, 2003).

109 Note that in the 2007 private letter ruling, the two partners sold their partnership interests to a third member.

110 Assume that S1's attributable interest in each partnership asset is a 50-percent undivided interest.

111 Reg. §1.1502-13(b)(1)(i).

112 *See generally id.*, at (c) (the matching rule) and (d) (the acceleration rule).

113 *Id.*, at (b)(2)(i) (defining intercompany items).

114 *Id.*, at (b)(3)(i) (defining corresponding items).

115 *Id.*, at (c)(1)(i) (providing that separate-entity attributes "are redetermined to the extent necessary to produce the same effect on consolidated taxable income ... as if [the selling and buying members] were divisions of a single corporation and the intercompany transaction were a transaction between divisions"); *id.*, at (c)(1)(ii) (providing for an aggregation of holding periods); *id.*, at (c)(2)(ii) (providing that the selling member takes its intercompany items into account as the buying member accounts for its corresponding items).

116 *Id.*, at (a)(2).

117 *See generally id.*, at (c)(2)(ii).

118 *Id.*

119 *Id.*, at (b)(4).

120 *Id.*, at (d)(1)(i).

121 *Cf. id.*, at (f)(4) (providing that when a member acquires its own stock from another member, the other member generally must take its intercompany items into account); *id.*, at (f)(7), *Example 4(b)* (illustrating that when parent redeemed its stock from a

subsidiary, the subsidiary took its gain on the stock into account under the acceleration rule) and *(c)* (the same result for a Code Sec. 301 distribution of the parent stock by the subsidiary to the parent).

[122] It is not clear that the successor-asset rule should apply. Under Reg. §1.1502-13(j)(1), for purposes of Reg. §1.1502-13—

> Any reference to an asset includes, as the context may require, any other asset, the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

Except by liberally applying an aggregate approach, it is hard to see how S1's share of the partnership assets could be successor assets to S1's partnership interest, because S1 is not deemed to acquire those assets and S2 is deemed to acquire them with a cost, not substituted, basis. Code Sec. 1012. *See also* Lawrence M. Axelrod, *Using Partnerships with Consolidated Groups*, 755 PLI/Tax 119, 124 (2007) (stating that the IRS "gave lip service to the application of Rev. Rul. 99-6 but effectively did not apply it); Terrill A. Hyde, Andrew J. Dubroff and Roger S. Wise, *The Use of Partnerships and LLCs in Structuring Consolidated Groups*, 738 PLI/Tax 885, 934 (2006) (noting the "successor-asset" issue).

[123] *See* LTR 200737006 (Sept. 27, 2006) (ruling 7); LTR 200334037 (May 13, 2003) (ruling 8).

[124] In computing S2's corresponding and recomputed corresponding items, S1 is deemed to receive a liquidating distribution from the partnership of an undivided 50-percent share in the land. Under Code Sec. 732(b), S1 is deemed to take a $25 basis in that share. S2 is then deemed to acquire that share for $50. Thus, S2's corresponding item takes into account its $50 basis in that share. Because S2 determines its recomputed corresponding item as if S1 and S2 were divisions of a single corporation, that item takes into account a $25 basis (*i.e.*, S1's basis) in that share. The $25 difference between S2's corresponding and recomputed corresponding bases precisely matches S1's $25 gain on its sale of the partnership interest.

[125] At the time of the sale, S2 would take its basis in the land into account, and its gain (or loss) and recomputed gain (or loss) would differ by $25. The character of S2's gain or loss should control the character of S1's gain. Reg. §1.1502-13(c)(4)(i).

[126] Each of these examples assume that each partner's attributable share of each partnership asset is an undivided 50-percent interest.

[127] Assume that the land is not a Code Sec. 704(c) or 751 asset.

[128] In computing S2's corresponding item for the land, S2 would be deemed to purchase a 50-percent undivided interest in the land for $50, taking a $50 basis in that interest. Code Sec. 1012. In computing S2's recomputed corresponding item for the land, S1 would be deemed to receive a liquidating distribution from the partnership of an undivided 50-percent interest in the land plus $50 in cash. Under Code Sec. 732(b), S1 would take a $0 basis in that land interest and S2's recomputed corresponding item would be determined by using that $0 basis, reflecting a $50 built-in gain, or $25 less than S1's $75 gain on the intercompany sale of its partnership interest to S2.

[129] Reg. §1.1502-13(d).

[130] Code Sec. 731(a)(1) (providing that a partner recognizes gain to the extent that any money distributed exceeds the adjusted basis of the partner's partnership interest immediately before the distribution).

[131] In computing S2's corresponding items for each asset, S2 would be deemed to purchase an undivided 50-percent interest in each asset for $25, taking a $25 basis in each interest. Code Sec. 1012. In computing its recomputed corresponding item for those interests, S1 would be deemed to receive a liquidating distribution from the partnership of an undivided 50-percent interest in each inventory asset. Under Code Sec. 732(c)(1)(A)(i), S1 would take a $25 basis in each interest and S2's recomputed corresponding item would be determined by using that $25 basis, reflecting no built-in gain or loss in either interest.

[132] Reg. §1.1502-13(d).

[133] Code Sec. 731(a)(2) (providing that if a partner receives nothing other than cash, unrealized receivables and inventory, the partner recognizes loss to the extent that the adjusted basis of the partner's partnership interest immediately before the distribution exceeds the money distributed plus the partner's aggregate basis under Code Sec. 732 of any distributed noncash property).

[134] As the next footnote spells out, those items would reflect a $50 gain on Tract 1, a $50 gain on Tract 2 and a $50 loss on Tract 3, or a net $50 gain.

[135] In computing S2's corresponding and recomputed corresponding items, S1 is deemed to receive a liquidating distribution from the partnership of an undivided 50-percent share in each tract. Under Code Sec. 732(b), S1 is deemed to take $25, $25 and $100 bases, respectively, in its shares of Tracts 1, 2 and 3. S2 is then deemed to pay $75, $75 and $50, respectively, for the shares of Tracts 1, 2 and 3, and those costs equal its bases in those shares. Code Sec. 1012. S2's corresponding items takes those bases into account. Because S2 determines its recomputed corresponding item as if S1 and S2 were divisions of a single corporation, its recomputed corresponding items for the shares of Tracts 1, 2 and 3 take into account a $25, $25 and $100 bases (*i.e.*, S1's bases) in those shares. Thus, S2 would have $50 "corresponding" gains for the Tract 1 and Tract 2 shares (*i.e.*, the excess of the corresponding basis for the share over its recomputed corresponding basis) and a $50 "corresponding" loss for the Tract 3 share (*i.e.*, the excess of the recomputed corresponding basis for the share over its corresponding basis).

[136] As a further refinement, if S2 were to first sell the loss asset, S1 could take its deferred gain into account only as S2's aggregate corresponding items for the former partnership assets exceeded their aggregate recomputed corresponding items.

[137] *See* Reg. §1.267(f)-1(a)(2) (applying the timing principles of Reg. §1.1502-13 in a sale of property between controlled group members). *See also* Andrew J. Dubroff, Jerred G. Blanchard, Jr., John Broadbent, and Kevin A. Duvall, Federal Income Taxation of Corporations Filing Consolidated Returns (2d. ed. 2007), at §31.05[2][b] (noting these problems with the asymmetric approach; also noting that similar problems may arise when a partner sells a partnership interest in an intercompany sale at a gain or loss, the partnership has a Code Sec. 754 election in effect, and the partnership makes both positive and negative adjustments to account for the sale).

[138] The results in Examples 8 and 9 under the asset-up approach would be the same as under the asymmetric approach, although the analysis would differ. Thus, in Example 8, S1 would defer a $50 gain and take into account a $25 gain, and in Example 9, it would recognize a $50 loss.

In Example 8, S1 would be treated as receiving $50 cash and a 50-percent undivided interest in the land in deemed liquidation of the partnership. S1 would recognize a $25 gain on the distribution, the excess of the $50 cash distributed over its $25 outside basis. Code Sec. 731(a)(1). S1 would be deemed to take a $0 basis in the land. Code Sec. 732(b) (providing that a partner takes an aggregate basis in noncash property distributed in a partnership liquidation equal to his or her outside basis less any money distributed). On S1's deemed sale of the land to S2 for $50, S1 would recognize a $50 gain, all of which would be deferred. *See* Reg. §1.1502-13(c)(2).

In Example 9, S1 would be deemed to receive undivided 50-percent interests in the two inventory assets of the partnership. Under Code Sec. 732(b) and (c)(1), it would take $25 bases in each of those assets. Because S1 would be deemed to receive only inventory assets and its $100 outside basis would exceed its aggregate $50 basis in those assets under Code Sec. 732, S1 would recognize a loss equal to that $50 excess. Code Sec. 731(a)(2). On its deemed sale of those assets to S2 for $25 each (*i.e.*, an amount equal to their bases), S1 would recognize no additional gain or loss.

[139] Code Sec. 732(b).

[140] Reg. §1.1502-13(j)(1) (providing that as the context may require, a reference to an asset

includes "a reference to any other asset the basis of which is determined ... by reference to the basis of the first asset").

[141] *Id.*, at (b)(3)(i) and (j)(1).

[142] *Id.*, at (b)(4) and (j)(1).

[143] In Example 8, S1 and S2 were equal partners in a two-member partnership that had two assets, $100 cash and land with a $100 value. The asset was not a Code Sec. 704(c) or 751 asset. S1 sold its partnership interest to S2 for $100. Because S1's basis in the interest was $25, it recognized a $75 gain.

Under the interest-over approach, S1 is deemed to sell its interest to S2 and the partnership is then deemed to liquidate. The matching rule applies by taking into account S2's basis and "recomputed" basis in the partnership's land.

Those basis amounts depend on S2's basis and recomputed basis in the partnership interest just before the deemed liquidation. S2's basis in the partnership interest equals $100 (the amount paid to S1) plus its original outside basis ("$X"). Its recomputed basis in that interest equals $25 (S2's outside basis) plus $X. S2 determines the basis (or recomputed basis) amount under Code Sec. 732(b). Its basis in the land equals its basis (or recomputed basis) in the partnership interest, reduced (but not below zero) by $100, the distributed cash. Thus, (i) S2's basis in the land equals (($100 + $X) – $100), which is $X; and (ii) S2's recomputed basis the greater of (A) $0 or (B) (($25 + $X) – $100), which is $X – $75. Thus, if $X equals at least $75, the recomputed basis is $X – $75, while if $X is less than $75, the recomputed basis is $0.

Thus, if $X equals at least $75, the difference between S2's basis and recomputed basis in the land is $75 ($X – ($X – $75)), and S1's full $75 gain is deferred, because it can be fully taken into account under the matching rule. *See* Reg. §1.1502-13(c)(2)(ii). If, however, $X is less than $75, that difference equals $X ($X – $0), which is the amount S1 can defer. S1 must take the excess ($75 – $X) into account at the time of the sale, because that amount cannot be taken into account under the matching rule. *See id.*, at (d).

[144] *See* Reg. §1.743-1(b)–(d) (providing for a net $50 positive adjustment, equal to (i) $200 (S2's cost for S1's interest) over (ii) the interest's share of cash that would be received if the partnership sold its assets in a fair market value sale ($200), reduced by the interest's share of gain on that sale ($100), and increased by its share of loss on that sale ($50)); Reg. §1.755-1(b) (in a fair market value sale, essentially providing for positive and negative adjustments for the purchased interest equal to the interest's share of built-in gain or loss on the partnership assets).

[145] Reg. §1.732-2(b). Thus, AB is deemed to have a $100 basis in Asset 1 ($50 original basis plus $50 positive adjustment), a $100 basis in Asset 2 ($50 original basis plus $50 negative adjustment), and a $150 basis in Asset 3 ($200 original basis minus $50 positive adjustment).

[146] Code Sec. 732(b).

[147] Reg. §1.1502-13(b)(4).

[148] Code Sec. 732(b).

[149] S2's $50 "corresponding" gains for Tract 1 and Tract 2 equal the excess of the corresponding basis for each tract over its recomputed corresponding basis. S2's $50 "corresponding" loss for Tract 3 equals the excess of its recomputed corresponding basis for the tract over its corresponding basis.

[150] Example 10 describes several ways S1's gain may be taken into account. *See* note 136, *supra*, and accompanying text.

[151] Neither asset is a Code Sec. 704(c) asset.

[152] S2's corresponding items are determined by looking to S2's bases in the partnership assets as if S2 purchased S1's partnership interest and the partnership then liquidated. In computing those asset bases, S2 will be deemed to have a $150 basis in its 100-percent partnership interest, its original $75 basis plus its $75 cost basis for the interest purchased from S1.

S2's recomputed corresponding items are determined by looking to what S2's bases in the partnership assets would have been if S1 and S2 had been divisions of a single corporation, S2 acquired the S1 interest, and the partnership then liquidated. In computing those asset bases, S2 would still be deemed to have a $150 basis in its 100-percent partnership interest, its original $75 basis plus its $75 transferred basis for the interest acquired from S1. Thus, in either case, S2 is deemed to have a $150 basis in the partnership interest immediately before its deemed liquidation. Accordingly, S2 would take the same bases in the partnership assets to determine its corresponding and recomputed corresponding items.

[153] *Cf.* Reg. §1.1502-13(c)(2)(ii).

[154] *Id.*, at (d).

[155] If the partnership had a Code Sec. 754 election in effect, S1's loss and gain would be deferred. The analysis is as follows:

Under the interest-over approach, S2 would be deemed to purchase S1's partnership interest and the partnership would then be deemed to liquidate. Because of the deemed purchase, S2 would have a $25 negative adjustment for Asset 1 and a $25 positive adjustment for Asset 2. *See* Reg. §1.743-1(b)-(d); Reg. §1.755-1(b). In applying Code Sec. 732 on the deemed liquidation, the partnership would take those adjustments into account, and S2 would therefore take $75 bases in Assets 1 and 2. Code Sec. 732(b); Reg. §1.732-2(b). S2 would use those bases in determining its corresponding items.

In computing S2's recomputed corresponding items, S1 and S2 would be treated as divisions of a single corporation. Reg. §1.1502-13(b)(4). Because Code Sec. 743 cannot apply to a transfer between divisions, no adjustments would be made under Code Sec. 743 and 755 in computing those items. Accordingly, for that purpose, S2 would be deemed to take $100 and $50 bases in Assets 1 and 2, respectively. Code Sec. 732(b). Thus, S2's corresponding and recomputed corresponding items would reflect a $25 loss in Asset 1 and a $25 gain in Asset 2, the differences between S2's basis and recomputed corresponding basis in each asset. Because those differences would exactly match S1's $25 loss and $25 gain, those amounts would be deferred under the matching rule. Reg. §1.1502-13(c)(2)(ii).

[156] Note that if S1 sold its partnership interest to a member other than S2 and the partnership had a Code Sec. 754 election in effect, S1 would defer its gain or loss because the special basis adjustments under Code Sec. 743 and 755 would allow the matching rule to apply. *See* Reg. §1.1502-13(c)(7)(ii), *Example 9(b)* and *(c)* (for an illustration of how the matching rule takes those special basis adjustments into account).

[157] Reg. §1.267(f)-1(a)(2). *See also* Code Sec. 267(f)(1) (providing that a controlled group has the same meaning as in Code Sec. 1563(a), except that "more than 50 percent" is substituted for "at least 80 percent) and certain parts of the section do not apply); Code §1563(a) (defining parent-subsidiary, brother-sister, and combined controlled groups).

[158] If the partnership distributes the debt to the debtor partner, the debt should be treated as cancelled. *See* Rev. Rul. 93-7, 1993-1 CB 125 (providing that when a partnership distributes a partner's debt to the partner, the debt is "extinguished"); 1996 WL 33107129 (IRS FSA), 1996 FSA Lexis 136 (stating that Rev. Rul. 93-7 treats debt distributed to the debtor partner as cancelled and, if Reg. §1.731-1(c)(2) applies, the distribution is treated as a distribution of money).

[159] Reg. §1.731-1(c)(2).

[160] *See* McKee, *supra* note 36, at ¶19.02[5][a].

[161] *Id.*

[162] *Id. See also* Reg. §1.163-4(c)(1) (providing that if a corporation repurchases its bond for an amount in excess of its adjusted issue price, the corporation may deduct the excess as interest in the tax year of the repurchase).

[163] Rev. Rul. 93-7, 1993-1 CB 125.

[164] *Id.* (citing Code Sec. 731(b)). The IRS also concluded that if the partnership has a Code Sec. 754 election, it may adjust the basis of undistributed property under Code Sec. 734. *Id.*

[165] *Id.* (also concluding that Reg. §1.731-1(c)(2) does not apply to a situation where the partnership purchased partner debt from a third person). *See also* McKee, *supra* note 36, at ¶19.02[5][b] (arguing forcefully that this conclusion of the revenue ruling is "conceptually suspect").

[166] Rev. Rul. 93-7, 1993-1 CB 125.

[167] Assume that B's debt is a business debt and that B can deduct the interest on the debt.

[168] Assume also that each partner's "attributable interest" in each AB asset is an undivided 50-percent interest.

[169] The examples assume that AB allocates its tax items between A and B using the interim closing of the books method. *See* Code Sec. 706(c)(2)(A); Reg. §1.706-1(c)(2)(ii).

[170] Code Sec. 108(e)(4) would not apply to this purchase because B and AB are not related persons. *Cf.* Code Sec. 108(e)(4)(A) (to determine COD, treating the acquisition of debt by a person related to the debtor under Code Sec. 267(b) or 707(b) as an acquisition by the debtor); Code Sec. 707(b) (treating a partner and partnership as related if the partner owns more than a 50-percent capital or profits interest in the partnership).

[171] Code Sec. 741.

[172] The partnership recognizes no gain or loss on the distribution. Code Sec. 731(b); Rev. Rul. 93-7, 1993-1 CB 125.

[173] *See* Code Sec. 1273(a) (defining "original issue discount" as the excess of the stated redemption price at maturity over issue price); Code Sec. 1272(a) (describing how a holder accounts for original issue discount). Code Sec. 1275(c) requires that certain legends be placed on the debt instrument and certain information be reported by the issuer. *See also* Reg. §1.1275-3 (describing the legends and reporting). It is not clear whether B is subject to those reporting requirements, however, because even though A is treated as purchasing debt from B, B is not treated issuing that debt under the asymmetric approach.

[174] Thus, the debt would have $10 of market discount. *See* Code Sec. 1276.

[175] Rev. Rul. 93-7, 1993-1 CB 125.

[176] *Id.* The $10 COD equals the excess of that portion of the debt's $50 adjusted issue price over its $40 fair market value.

[177] Note that in Examples 13 through 16, under the interest-over approach, A would succeed to AB's holding period for its entire interest in the land. *See* Code Sec. 735(b). Under the other approaches, A would succeed to AB's holding period for an undivided 50-percent interest in the land and its holding period for the remaining interest would begin on the day following its deemed purchase.

[178] *See* Code Sec. 171 (for amortizable bond premium); *id.*, at (c) (providing that amortization is permitted for taxable bonds only by election). *See also* Reg. §1.171-1(b) (defining "bond" for purposes of Code Sec. 171 as having the same meaning as "debt instrument" in Reg. §1.1275-1(d)); Reg. §1.1275-1(d) (defining "debt instrument" to mean "any instrument or contractual arrangement that constitutes debt under general principles of Federal income tax law").

[179] Code Sec. 171(b)(4) (providing that if a person acquires a bond in exchange for other property and determines its basis in that bond by reference to its basis in the other property, the basis of the bond is deemed not to exceed its fair market value in applying Code Sec. 171); Reg. §1.171-1(e)(1)(ii) (for a comparable rule); *id.*, at (f), *Example 1* (illustrating this rule for a distribution of a bond in liquidation of a partnership interest).

[180] Rev. Rul. 93-7, 1993-1 CB 125.

[181] *Id.* (citing Reg. §1.163-4(c)(1)). The $10 deduction equals the excess of that portion of the debt's $60 fair market value over its $50 adjusted issue price.

[182] Reg. §1.163-13(a) (providing that if a debt instrument is issued with a bond issuance premium, the issuer's interest deductions are reduced by that premium, with the premium being taken into account using a constant yield).

[183] *See* Reg. §1.731-1(c)(2).

[184] *See* McKee, *supra* note 36, at ¶19.02[5][a] (arguing for this result).

[185] That $10 deduction equals the $50 basis for the portion of the debt cancelled over the $40 payment.

[186] Code Sec. 705(a)(2)(A).

[187] Code Sec. 732(b) and (c).

[188] *See* Code Sec. 1276(a)(2).

[189] *See* Code Sec. 1273(a) (defining "original issue discount"); Code Sec. 1272(a) (describing how a holder accounts for original issue discount). Code Sec. 1275(c) requires that certain legends be placed on the debt instrument and certain information be reported by the issuer. *See also* Reg. §1.1275-3 (describing the legends and reporting). It is not clear whether B is subject to those reporting requirements, however, because even though A is treated as purchasing debt from B, B is not treated issuing that debt under the asymmetric approach.

[190] Code Sec. 705(a)(2)(A).

[191] That basis would equal $95 (B's basis in AB) minus $40, the cash deemed distributed to B. Code Sec. 732(b).

[192] A's basis in AB before the deemed liquidation would be $190, $100 original basis plus $90 to account for the purchase from B. Under Code Sec. 732(b) and (c), $100 of that amount would be allocated to the land and $90 to the B debt (which had a $20 built-in loss in AB's hands).

[193] *See* Reg. §1.731-1(c)(2).

[194] The $10 income would equal the $60 payment for the debt deemed cancelled over its $50 basis.

[195] Code Sec. 705(a)(2)(A).

[196] Code Sec. 732(b) and (c).

[197] *See* Code Sec. 171 (for amortizable bond premium); *id.*, at (c) (providing that amortization is permitted for taxable bonds only by election); Reg. §1.171-1(b) (defining "bond" for purposes of Code Sec. 171 as having the same meaning as "debt instrument" in Reg. §1.1275-1(d); Reg. §1.1275-1(d) (defining "debt instrument" to mean "any instrument or contractual arrangement that constitutes debt under general principles of Federal income tax law). *See also* Code Sec. 171(b)(4) (providing that if a person acquires a bond in exchange for other property and determines its basis in that bond by reference to its basis in the other property, the basis of the bond is deemed not to exceed its fair market value in applying Code Sec. 171); Reg. §1.171-1(e)(1)(ii) (for a comparable rule); *id.*, at (f), *Example 1* (illustrating this rule for a distribution of a bond in liquidation of a partnership interest).

[198] Code Sec. 732(b) and (c).

[199] Code Sec. 171(b)(4) (providing that if a person acquires a bond in exchange for other property and determines its basis in that bond by reference to its basis in the other property, the basis of the bond is deemed not to exceed its fair market value in applying Code Sec. 171); Reg. §1.171-1(e)(1)(ii) (for a comparable rule); *id.*, at (f), *Example 1* (illustrating this rule for a distribution of a bond in liquidation of a partnership interest).

[200] Code Sec. 705(a)(1)(A).

[201] That basis would equal $105 (B's basis in AB) minus $60, the cash deemed distributed to B. Code Sec. 732(b).

[202] Reg. §1.163-13(a) (providing that if a debt instrument is issued with a bond issuance premium, the issuer's interest deductions are reduced by that premium, with the premium being taken into account using a constant yield).

[203] The match is particularly close if AB has a Code Sec. 754 election in effect.

[204] Under the asymmetric approach, A may have original issue discount on the B debt, even though B does not actually issue debt in the transaction. Under the asset-up approach, B may have COD, even though none of his debt is actually cancelled.

[205] Thus, the facts are the same as in Example 13, except that A sells her AB interest to B for $90.

[206] Rev. Rul. 93-7, 1993-1 CB 125.

[207] *Id.* The $10 COD equals the excess of that portion of the debt's $50 adjusted issue price over its $40 fair market value.

[208] Although the results under the interest-over approach would be the same, the analysis for B would be somewhat different. B would take a $190 basis in his AB interest. On the deemed liquidation, B would take a $100 basis in the land and a $90 basis in the B debt. Under Rev. Rul. 93-7, B would recognize a $10 capital loss (equal to the excess of the $90 basis over the debt's $80 fair market value) and also have $20 of COD (equal to the excess of the $100 adjusted issue price of the debt over its $80 value).

Further, although the results under the asset-up approach would be the same for A and B, the analysis for A would be somewhat different. A would be deemed to receive a liquidating distribution of a 50-percent interest in both the land and B debt. She would take a $50 basis in each interest, recognizing no gain or loss on her deemed sale of the land for $50 but recognizing a $10 capital loss on her sale of the B debt for $40.

Note that in Examples 17 through 20, under the interest-over approach, B would succeed to AB's holding period for its entire interest in the land. *See* Code Sec. 735(b). Under the other approaches, B would succeed to AB's holding period for an undivided 50-percent interest in the land and its holding period for the remaining interest would begin on the day following its deemed purchase.

[209] Under the asymmetric and interest-over approaches, A is deemed to sell her AB interest for $110, recognizing a $10 capital gain. Under the asset-up approach, A is deemed to receive 50-percent interests in both the land and the B debt, taking $50 bases in those interests under Code Sec. 732(b) and (c). A is then deemed to sell those interests for $50 and $60, respectively, recognizing a $0 gain on the land interest and a $10 capital gain on the B debt interest. *See* Code Sec. 1271(a).

[210] Reg. §1.163-4(c). The $10 deduction equals the excess of the $60 payment for that portion of the debt over its $50 adjusted issue price.

[211] Rev. Rul. 93-7, 1993-1 CB 125.

[212] *Id.*

[213] Code Sec. 732(b) and (c).

[214] Rev. Rul. 93-7, 1993-1 CB 125.

[215] *See* Reg. §1.731-1(c)(2).

[216] *See* McKee, *supra* note 36, at ¶19.02[5][a] (arguing for this result).

[217] That $10 deduction equals the $50 basis for the portion of the debt cancelled over the $40 payment.

[218] Code Sec. 705(a)(2)(A).

[219] That basis equals $100 (his beginning basis in his AB interest) minus $5 (for his allocable share of the bad debt deduction) minus $40 (for the cash deemed distributed). Code Sec. 732(b) and (c).

[220] *See* McKee, *supra* note 36, at ¶19.02[5][a] (arguing for this result).

[221] Code Sec. 705(a)(2)(A).

[222] That basis would equal $190 (his beginning basis in his AB interest) minus $20 (for his allocable share of the bad debt deduction) minus $80 (for the cash deemed distributed). Code Sec. 732(b) and (c).

[223] Code Sec. 705(a)(2)(A).

[224] Code Sec. 732(b) and (c).

[225] *See* Reg. §1.731-1(c)(2).

[226] *See* McKee, *supra* note 36, at ¶19.02[5][a] (arguing for this result).

[227] The $10 income would equal the $60 payment for the debt deemed cancelled over its $50 basis.

[228] Code Sec. 705(a)(1)(A).

[229] That basis would equal $100 (his beginning basis in his AB interest) plus $5 (for his allocable share of the premium) minus $60 (for the cash deemed distributed). Code Sec. 732(b) and (c).

[230] *See* McKee, *supra* note 36, at ¶19.02[5][a] (arguing for this result).

[231] Code Sec. 705(a)(2)(A).

[232] That basis would equal $210 (his beginning basis in his AB interest) plus $20 (for his allocable share of the income) minus $120 (for the cash deemed distributed). Code Sec. 732(b) and (c).

[233] Code Sec. 705(a)(1)(A).

[234] Code Sec. 732(b) and (c).

[235] In Examples 17 and 18, under each approach, B takes a fair market value basis in the land.

[236] Note that implementing this alternative may require a statutory change.

[237] That $20 deduction would equal the excess of AB's $100 basis in the debt over $80, the debt's value and B's deemed payment.

[238] That $20 COD would equal the excess of the debt's $100 adjusted issue price over B's $80 deemed payment.

[239] Code Sec. 705(a)(2)(A). Thus, except for the $10 deduction allocated to A from AB, A would have no other income, loss, or deduction on the sale. Under the asymmetric and interest-over approaches, A would be deemed to sell her AB interest for $90, an amount equal to her basis in that interest, and would recognize no gain or loss. Code Sec. 1001(a) and (c). Under the asset-up approach, A would be deemed to receive $40 cash and a 50-percent undivided interest in the land, taking a $50 basis in that land interest ($90 outside basis minus $40 distributed cash). Code Sec. 732(b). On her deemed sale of that land interest to B for $50, she would recognize no gain or loss. Code Sec. 1001(a) and (c).

[240] That $20 income amount would equal the excess of $120, the debt's value and B's deemed payment, over AB's $100 basis in the debt.

[241] That $20 deduction would equal the excess of B's $120 deemed payment over the debt's $100 adjusted issue price.

[242] Code Sec. 705(a)(1)(A). Thus, except for the $10 of income allocated to A from AB, A would have no other income, loss, or deduction on the sale. Under the asymmetric and interest-over approaches, A would be deemed to sell her AB interest for $110, an amount equal to her basis in that interest, and would recognize no gain or loss. Code Sec. 1001(a) and (c). Under the asset-up approach, A would be deemed to receive $60 cash and a 50-percent undivided interest in the land, taking a $50 basis in that land interest ($110 outside basis minus $40 distributed cash). Code Sec. 732(b). On her deemed sale of that land interest to B for $50, she would recognize no gain or loss. Code Sec. 1001(a) and (c).

[243] In each case under the asymmetric or asset-up approach, B would be treated as buying a 50-percent interest in the land from A for $50. Further, he would be treated as receiving the remaining 50-percent interest in liquidation of his partnership interest. If the debt was worth $80, B would be deemed to receive the 50-percent interest in the land (with a $50 basis to AB) and $40 cash (*i.e.*, his share of the debt payment). Because he would have a $90 basis in his AB interest, he would take a $50 basis in the distributed land interest ($90 total basis minus $40 cash). Code Sec. 732(b). If the debt instead was worth $120, B would be deemed to receive the 50-percent interest in the land (with a $50 basis to AB) and $60 cash (*i.e.*, his share of the debt payment). Because he would have a $110 basis in his AB interest, he would take a $50 basis in the distributed land interest ($110 total basis minus $60 cash). Code Sec. 732(b). Thus, overall, he would have a $100 basis in the land.

In each case under the interest-over approach, B would be treated as buying A's AB interest and AB would then be deemed to liquidate. If the debt was worth $80, B would be deemed to pay $90 for A's interest and have an overall $180 basis in AB after the purchase. He would be deemed to receive the land (with a $100 basis to AB) and $80 cash (*i.e.*, the debt payment) in AB's liquidation. Thus, he would take a $100 basis in the land ($180 total basis minus $80 cash). Code Sec. 732(b). If the debt instead was worth $120, B would be deemed to pay A $110 for her AB interest and have an overall $220 basis in AB after the purchase. He would be deemed to receive the land (with a $100 basis to AB) and $120 cash (*i.e.*, the debt payment) in AB's liquidation. Thus, he would take a $100 basis in the land ($220 total basis minus $120 cash). Code Sec. 732(b).

[244] This example is found in McKee, *supra* note 36, at ¶16.02[3][b].

[245] *See* Code Sec. 1031(a)(2)(D) (providing that Code Sec. 1031 does not apply to any exchange of interests of a partnership).

[246] Under that approach, Code Sec. 1031 treatment would be unavailable if C exchanged Tract 2 for the AB interests, but it might be available for both sides tothe exchange if AB and C exchanged Tract 1 and Tract 2.

[247] Under that approach, if C exchanged Tract 2 for the AB interests, A and B would be deemed to receive Tract 1 in liquidation of AB and A, B and C would then be treated as if they exchanged Tract 1 for Tract 2. Thus, the parties arguably would not avoid Code Sec. 1031 by having A and B swap their AB interests for Tract 2. *See J.R. Bolker*, CA-9, 85-1 USTC ¶9400, 760 F2d 1039 (1985) (concluding that property received in a Code Sec. 333 liquidation in which the shareholder took a transferred basis was held for investment when the shareholder held it for three months and later transferred it in a purported Code Sec. 1031 exchange planned at the time of the liquidation); *B.B. Maloney*, 93 TC 89, 97, Dec. 45,863 (1989) (concluding that a corporation made a Code Sec. 1031 exchange when it exchanged like-kind property and 26 days later liquidated in a Code Sec. 333 liquidation). *Cf.* Rev. Rul. 77-337, 1997-2 CB 305 (concluding that Code Sec. 1031 did not apply to a taxpayer who acquired property in a Code Sec. 333 liquidation and immediately exchanged the property); Rev. Rul. 75-292, 1975-2 CB 333 (concluding that Code Sec. 1031 did not apply to a taxpayer who exchanged like-kind property and, as part of the same plan, transferred the property received to a newly formed, wholly owned corporation in a Code Sec. 351 transfer).