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Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year(s) Involved:

Dates of Conferences:

LEGEND:

A	=
X	=
Y	=
M	=
N	=
O	=
P	=
Q	=
R	=
S	=
	=
	=
<u>Year1</u>	=
<u>Year2</u>	=

<u>Year3</u>	=
<u>Year4</u>	=
<u>Year5</u>	=
<u>N1</u>	=
<u>N2</u>	=
<u>N3</u>	=
<u>N4</u>	=
<u>N5</u>	=
<u>N6</u>	=
<u>N7</u>	=
<u>N8</u>	=
<u>N9</u>	=
<u>N10</u>	=
<u>N11</u>	=
<u>N12</u>	=
<u>N13</u>	=
<u>N14</u>	=
<u>N15</u>	=
<u>N16</u>	=
<u>N17</u>	=

ISSUES:

1. Is a deemed distribution of a partnership interest in an assets-over merger of two partnerships under § 1.708-1(c)(3)(i) of the Income Tax Regulations (“regulations”) treated as an “exchange” pursuant to § 761(e) of the Internal Revenue Code (“Code”) that requires a mandatory downward inside-basis adjustment under § 743(b) when the resulting partnership has a substantial built-in loss?
2. If so, to what extent are the resulting partnership’s liabilities included in calculating a transferee partner’s adjusted basis in the transferred partnership interest and a transferee partner’s share of adjusted basis to the partnership of the resulting partnership’s property for purposes of § 1.743-1(c) and (d)(1)?
3. Is cancellation of indebtedness (“COD”) income that is deferred under § 108(i) included in calculating a transferee partner’s share of adjusted basis to the partnership of partnership property for purposes of § 1.743-1(d)(1)?

CONCLUSIONS:

1. Yes, a deemed distribution of a partnership interest in an assets-over merger of two partnerships under § 1.708-1(c)(3)(i) is treated as an “exchange” pursuant to

§ 761(e) that requires a mandatory downward inside-basis adjustment under § 743(b) when the resulting partnership has a substantial built-in loss.

2. In calculating a transferee partner's adjusted basis in the transferred partnership interest and a transferee partner's share of adjusted basis to the partnership of the resulting partnership's property for purposes of § 1.743-1(c) and (d)(1), the resulting partnership's liabilities are included in the transferee partner's basis in the transferred partnership interest and the transferee partner's share of the resulting partnership's liabilities to the extent of the amount of gain that the transferee partner would recognize under § 731 after Step 1 of the assets-over merger absent the rule in § 1.752-1(f).
3. No, deferred COD income under § 108(i) is not included in calculating a transferee partner's share of adjusted basis to the partnership of partnership property for purposes of § 1.743-1(d)(1) because such amount is not "tax gain" within the meaning and for purposes of § 1.743-1(d)(1)(iii).

FACTS:

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LAW:

A. Partnership Assets-Over Mergers and Section 761(e)

Section 708(b)(2)(A)⁴ provides that, in the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of § 708, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

Section 1.708-1(c)(1) provides that if two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership, the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a

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⁴ Statutory and regulatory references in this technical advice memorandum refer to the statute and regulations that were applicable at the time of the assets-over merger transaction in this case.

continuation of more than one of the merging or consolidating partnerships, it shall unless the Commissioner permits otherwise, be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated.

Section 1.708-1(c)(3)(i) provides that, when two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not described in § 1.708-1(c)(3)(ii), any merged or consolidated partnership that is considered terminated under § 1.708-1(c)(1) is treated as undertaking the assets-over form for Federal income tax purposes. Under the assets-over form of merger, the merged or consolidated partnership that is considered terminated under § 1.708-1(c)(1) contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.

Section 761(e) provides that, except as otherwise provided in regulations, for purposes of (1) § 708 (relating to continuation of partnership), (2) § 743 (relating to optional adjustment to basis of partnership property), and (3) any other provision of subchapter K specified in regulations prescribed by the Secretary, any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

B. Basis Adjustment to Partnership Property Upon Exchange of Partnership Interest

Section 743(a) provides that the basis of partnership property shall not be adjusted as a result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by § 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership or unless the partnership has a substantial built-in loss immediately after such transfer.⁵

Section 743(b) provides that in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with

⁵ In 2004, Congress amended § 743 to mandate a downward inside-basis adjustment to partnership property with respect to a transferee partner in cases where there is a substantial built-in loss in the partnership. Under prior law, these adjustments would only be required in cases where the partnership had an election under § 754 in effect. Congress was concerned that, under those rules, built-in loss at the partnership level could be transferred to a transferee partner who would then be allocated a share of the loss when the partnership disposes of (or depreciates) the property. See H.R. Rep. No. 108-755, at 622 (2004) (Conf. Rep.).

respect to which the election provided in § 754 is in effect or which has a substantial built-in loss immediately after such transfer shall --

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Section 743(b) further provides, in part, that, under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of property contributed to the partnership by a partner, § 704(c) (relating to contributed property) shall apply in determining such share.

Section 743(d) provides that, for purposes of § 743, a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than \$250,000 the fair market value of such property.

Section 1.743-1(a) provides that, generally, the basis of partnership property is adjusted as a result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner only if the election provided by § 754 (relating to optional adjustments to the basis of partnership property) is in effect with respect to the partnership. Whether or not the election provided in § 754 is in effect, the basis of partnership property is not adjusted as the result of a contribution of property, including money, to the partnership.

Section 1.743-1(b) provides that in the case of the transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership that has an election under § 754 in effect --

(1) increases the adjusted basis of partnership property by the excess of the transferee's basis for the transferred partnership interest over the transferee's share of the adjusted basis to the partnership of the partnership's property; or

(2) decreases the adjusted basis of partnership property by the excess of the transferee's share of the adjusted basis to the partnership of the partnership's property over the transferee's basis for the transferred partnership interest.

Section 1.743-1(c) provides that, in the case of a transfer of a partnership interest by sale or exchange or as a result of the death of a partner, the transferee's basis in the transferred partnership interest is determined under § 742 and § 1.742-1. See also § 752 and §§ 1.752-1 through 1.752-5.

Section 1.743-1(d)(1) provides that, generally, a transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to --

(i) the amount of cash that the transferee would receive on a liquidation of the partnership following the hypothetical transaction, as described in § 1.743-1(d)(2) (to the extent attributable to the acquired partnership interest); increased by

(ii) the amount of tax loss (including any remedial allocations under § 1.704-3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

(iii) the amount of tax gain (including any remedial allocations under § 1.704-3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

Section 1.743-1(d)(2) provides that, for purposes of § 1.743-1(d)(1), the hypothetical transaction means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.

C. Determination of Transferee Partner's Share of Partnership Liabilities

Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a

partnership of property subject to a liability or the termination of the partnership under § 708(b) will require that the increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction. When two or more partnerships merge or consolidate under § 708(b)(2)(A), as described in § 1.708-1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under § 752. Example 2 of § 1.752-1(g) illustrates the application of this rule to a merger of two partnerships holding property encumbered by liabilities.

Section 1.752-1(g), Example 2, provides as follows: (i) B owns a 70 percent interest in partnership T. Partnership T's sole asset is property X, which is encumbered by a \$900 liability. Partnership T's adjusted basis in property X is \$600, and the value of property X is \$1,000. B's adjusted basis in its partnership T interest is \$420. B also owns a 20 percent interest in partnership S. Partnership S's sole asset is property Y, which is encumbered by a \$100 liability. Partnership S's adjusted basis in property Y is \$200, the value of property Y is \$1,000, and B's adjusted basis in its partnership S interest is \$40.

(ii) Partnership T and partnership S merge under § 708(b)(2)(A). Under § 708(b)(2)(A) and § 1.708-1(c)(1), partnership T is considered terminated and the resulting partnership is considered a continuation of partnership S. Partnerships T and S undertake the form described in § 1.708-1(c)(3)(i) for the partnership merger. Under § 1.708-1(c)(3)(i), partnership T contributes property X and its \$900 liability to partnership S in exchange for an interest in partnership S. Immediately thereafter, partnership T distributes the interests in partnership S to its partners in liquidation of their interests in partnership T. B owns a 25 percent interest in partnership S after partnership T distributes the interests in partnership S to B.

(iii) Under § 1.752-1(f), B nets the increases and decreases in its share of partnership liabilities associated with the merger of partnership T and partnership S. Before the merger, B's share of partnership liabilities was \$650 (B had a \$630 share of partnership liabilities in partnership T and a \$20 share of partnership liabilities in partnership S immediately before the merger). B's share of S's partnership liabilities after the merger is \$250 (25 percent of S's total partnership liabilities of \$1,000). Accordingly, B has a \$400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a \$400 distribution from partnership S under § 752(b). Because B's adjusted basis in its partnership S interest before the deemed distribution under § 752(b) is \$460 (\$420 + \$40), B will not recognize gain under § 731. After the merger, B's adjusted basis in its partnership S interest is \$60.

Section 1.752-3(a) provides, generally, that a partner's share of nonrecourse liabilities of a partnership equals the sum of the following:

- (1) the partner's share of partnership minimum gain determined in accordance with the rules of § 704(b) and the regulations thereunder;

- (2) the amount of any taxable gain that would be allocated to the partner under § 704(c) (or in the same manner as § 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and
- (3) the partner's share of the excess nonrecourse liabilities (those not allocated under § 1.752-3(a)(1) and (2)) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.

D. Cancellation of Indebtedness (COD) Income and Deferral

Section 61(a)(12) provides generally that gross income includes income from discharge of indebtedness.

Section 108(i) allows taxpayers (including partnerships) to elect to defer the inclusion of COD income for debt discharged in 2009 and 2010. Under the deferral regime, the taxpayer must include COD income deferred in 2009 and 2010 ratably over a statutorily specified five-taxable-year period starting in the fourth or fifth taxable year following the discharge of debt, depending on whether the debt was discharged in 2009 or 2010.

Section 108(i)(6) provides that, in the case of a partnership, any income deferred under § 108(i) shall be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under § 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge shall not be taken into account for purposes of § 752 at the time of the discharge to the extent it would cause the partner to recognize gain under § 731. Any decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under § 108(i) is recognized.

Section 1.108(i)-2T(b)(3)(i) provides, in general, that an electing partnership shall determine, for each of its direct partners with a deferred amount, the partner's deferred § 752 amount, if any, with respect to an applicable debt instrument. A partner's deferred § 752 amount with respect to an applicable debt instrument equals the decrease in the partner's share of a partnership liability under § 752(b) resulting from the reacquisition of the applicable debt instrument that is not treated as a current distribution of money under § 752(b) by reason of § 108(i)(6) (deferred § 752 amount). A partner's deferred § 752 amount is treated as a distribution of money by the partnership to the partner under § 752(b) at the same time and, to the extent remaining,

in the same amount as the partner recognizes the deferred amount with respect to the applicable debt instrument.

Section 1.108(i)-2T(b)(6) requires a partnership to recognize all § 108(i) deferred COD income upon the occurrence of a number of events, including a liquidation of the partnership, a sale by the partnership of substantially all of its assets, or cessation of business by the partnership.

Section 1.108(i)-2T(b)(6)(iii)(D) provides that recognition of deferred COD income is not required if an electing partnership merges into another partnership. Instead, the resulting partnership becomes subject to § 108(i) including all reporting requirements under § 1.108(i)-2T.

ANALYSIS:

A. Section 761(e) Applies to a Deemed Distribution of a Partnership Interest in a Partnership Assets-Over Merger

Under § 1.708-1(c)(3)(i), X is deemed to contribute all of its assets and liabilities to Y in exchange for an interest in Y (Step 1), and immediately thereafter, X is deemed to distribute interests in Y to A and Q in liquidation of X (Step 2). Except as otherwise provided in regulations, any distribution of an interest in a partnership is treated as an exchange under § 761(e) for purposes of §§ 708 and 743. Neither the Code nor the regulations suggest that § 761(e) was only intended to apply to actual distributions and, therefore, not intended to apply to constructive distributions such as the one described in § 1.708-1(c)(3)(i). Under Subchapter K of the Code, partnership distributions that are “deemed” to occur as a result of the application of certain rules in the Code or regulations to specific facts (such as “deemed” distributions of cash or money under § 731(a) resulting from the forgiveness or shifting of liabilities among partners under § 752(b)) generally will have the same or similar tax effects as actual partnership distributions of money or other property. Accordingly, under the plain language of § 761(e), we conclude that X’s deemed distribution of interests in Y to A and Q in liquidation of X resulting from an assets-over merger under § 1.708-1(c)(3)(i) is treated as an exchange for purposes of § 743(b).

A argues that Congress did not intend § 761(e)(2) to apply to constructive distributions of partnership interests because when Congress amended § 743(b) to require mandatory basis adjustments for a partnership with a substantial built-in loss, it did not also amend the parenthetical language in § 761(e)(2) to reference a “substantial built-in loss.” Because the parenthetical language in § 761(e)(2) only references an “optional adjustment to basis of partnership property” when a § 754 election is in effect, A argues that § 761(e) was not meant to apply to constructive distributions of partnership interests when a partnership has a substantial built-in loss. A disconnect in A’s argument exists because if A’s argument is correct, then § 761(e) would not apply to

actual distributions of partnership interests when a partnership has a substantial built-in loss. Clearly, this was not what Congress intended when it amended § 743(b).

We disagree that the failure to amend the parenthetical language in § 761(e)(2) was meant to limit the application of § 743(b) to only actual distributions of partnership interests when a § 754 election is in effect for the partnership. The “relating to” parenthetical language is best read as a descriptive short-hand reference to § 743 and not as limiting language. We find support for our interpretation of § 761(e) in the fact that Congress also did not amend the parenthetical language in § 755(a) when it enacted the substantial built-in loss mandatory basis adjustment rule. Both parentheticals in § 755(a) only refer to optional basis adjustments to partnership property and not the mandatory basis adjustments that would apply when the partnership has a substantial built-in loss. Interpreting § 755(a) as only applying to optional basis adjustments would be erroneous given that § 755 and related regulations provide the exclusive rules for allocation of basis among specific partnership properties when §§ 734(b) and 743(b) adjustments apply. No other rules or methods outside of § 755 provide for allocation of basis among specific partnership properties for mandatory basis adjustments. Because it would be erroneous to limit the application of § 755 to optional basis adjustments based solely on the failure to amend the parenthetical language in § 755(a), it would be equally erroneous to interpret the failure to amend the parenthetical language in § 761(e)(2) as limiting § 761(e) to apply only to optional basis adjustments under § 743(b) and not to mandatory basis adjustments under § 743(b) as well. A’s argument regarding the parenthetical language in § 761(e) is unpersuasive and, thus, § 761(e) applies to actual and constructive distributions of partnership interests when either a § 754 election is in effect for the partnership or the partnership has a substantial built-in loss.

Alternatively, A argues that Y, the resulting partnership in this case, should be treated as a continuation of both X and Y under the literal language of § 708(b)(2)(A) and, as a result, § 761(e) should not apply to any constructive distributions that would result by treating X as a terminated partnership under the “tiebreaker rule” in § 1.708-1(c)(1). In A’s view, because the merger of two partnerships owned by the same majority partner in the same proportion represents a “mere change in form,” the deemed steps that occur under § 1.708-1(c)(3)(i) by treating X as a terminated partnership under § 1.708-1(c)(1) should have no substantive tax effects or consequences, including any potential § 743(b) adjustments. A cites language from the preamble to proposed regulations under § 704(c) to support A’s argument that because the majority ownership of X and Y was essentially unchanged after the merger, the transaction should result in no substantive tax consequences to the partners.⁶

We disagree with A’s argument that no substantive tax effects or consequences should result when X and Y merge. When a resulting partnership could be considered

⁶ See Preamble to Proposed § 1.704-4(c)(4) and § 1.737-2(b), 72 Fed. Reg. 46932, 46933 (Aug. 22, 2007).

the continuation of more than one of the merging or consolidating partnerships under § 708(b)(2)(A) (for example, because the same majority partner owns both partnerships), the “tiebreaker rule” in § 1.708-1(c)(1) mandates that only one of the merging or consolidating partnerships continues (based on fair market value of assets contributed) while any other merging or consolidating partnership terminates. This rule and the rule in § 1.708-1(c)(3)(i) describing the steps that are treated as occurring to effectuate the deemed termination of any merged or consolidated partnership as a result of the merger cannot be ignored. For tracking basis and capital accounts, determining partnership elections, and other administrative concerns, only one merging partnership can be treated as continuing. Additionally, A’s reliance on the preamble to the regulations under § 704(c) is misplaced. The “substantive tax consequences” described in that preamble concern the recognition of immediate gain and not the conformity of partnership basis under § 743(b). Finally, A’s assertion that the merger in this case represents a “mere change in form” ignores the fact that Federal tax law recognizes the existence of separate entities and the resulting tax consequences from transactions between those separate entities. The fact that two separate entities are owned by the same majority partner does not mean they are the same partnership or should be treated as one partnership for Federal income tax purposes. A chose the form of the transaction (in this case, a merger of X into Y) for A’s own reasons

. This indicates that the form of the transaction had real substantive legal effects, and therefore, the transaction was not a mere change in form. Accordingly, the transaction as carried out had substantive effects and consequences that are respected for Federal income tax purposes, and the transaction is of a type that falls within and is subject to § 1.708-1(c)(3)(i). The deemed steps that occur as a result of an assets-over merger under § 1.708-1(c)(3)(i) include the treatment of the constructive distribution by X of the partnership interest in Y as an exchange under § 761(e) for purposes of § 743(b).

A also argues that because Rev. Rul. 90-17, 1990-1 C.B. 119, holds that a deemed distribution resulting from an assets-over merger is not an exchange under § 761(e) for § 708(b)(1)(B) purposes, it should not be treated as an exchange for purposes of § 743(b). Even though A concedes that Rev. Rul. 90-17 does not address whether a deemed distribution resulting from an assets-over merger is an exchange for purposes of § 743, A argues that the conclusion that the deemed distribution in an asset-over merger is not an exchange for § 743 purposes necessarily follows from this ruling because § 761(e) applies to both §§ 708 and 743. Accordingly, not applying § 708 for purposes of § 761(e) means that § 743 cannot be applied for § 761(e) purposes either. We disagree. As discussed in Rev. Rul. 90-17, the § 708(b)(2)(A) merger rules take precedence over the § 708(b)(1)(B) termination rule in cases where both could theoretically apply. Therefore, even though deemed distributions resulting from assets-over mergers may not be properly treated as exchanges for purposes of applying § 708(b)(1)(B) to the resulting partnership, neither the Code nor the regulations prevent a deemed distribution resulting from an assets-over merger from being treated

as an exchange of the distributed interests in the resulting partnership under § 708(b)(2)(A), for purposes of applying § 743(b) to those distributed interests. The holding in Rev. Rul. 90-17 supports this position and does not alter our conclusion that a deemed distribution of a partnership interest in an assets-over merger is treated as an exchange under § 761(e) for purposes of § 743(b).

Finally, A asserts that the netting rule of § 1.752-1(f) reflects and implements a “single transaction/unitary basis” approach and that the application of § 743(b) to the assets-over merger under § 1.708-1(c)(3)(i) assumes a two-step transaction in which the interest acquired in Step 2 is disaggregated from all other interests previously held by the transferee partner in the resulting partnership. Accordingly, A argues that a single transaction approach cannot be reconciled with the separate interest/bifurcated approach that applies for § 743(b) purposes and, therefore, § 743(b) should not apply to an assets-over merger under § 1.708-1(c)(3)(i).

We disagree. The application of the netting rule in § 1.752-1(f) to an assets-over merger under § 1.708-1(c)(3)(i) also does not alter our conclusion. Even though the netting rule in § 1.752-1(f) treats an assets-over merger under § 1.708-1(c)(3)(i) as a single transaction for purposes of determining any net liability shifts under § 752, § 1.752-1(g) Example 2 (illustrating the application of the netting rule when two partnerships merge) demonstrates that an assets-over merger is a single transaction involving two steps, as described in § 1.708-1(c)(3)(i). Therefore, by respecting the deemed steps that occur in an assets-over merger, the single transaction approach can be reconciled with the separate/bifurcated approach that applies for § 743(b) purposes.⁷

B. Mandatory Basis Adjustment to Partnership Property Upon Exchange of Partnership Interests When Partnership Has a Substantial Built-in Loss

Because § 761(e) applies to deemed distributions of interests in a resulting partnership, X's deemed distribution of interests in Y to A in liquidation of X in Step 2 of the assets-over merger under § 1.708-1(c)(3)(i) is treated as an exchange for purposes of § 743(b). Because Y has a substantial built-in loss (within the meaning of § 743(d)(1)) at the time of the exchange, a downward basis adjustment to Y's partnership property with respect to A is required under § 743(b) under the facts of this case.

C. Determination of Transferee Partner's Share of Partnership Liabilities for Purposes of a § 743(b) Adjustment

Congress amended § 743(b) in 2004 to prevent the duplication or transfer of losses – first on the sale or exchange of a partnership interest, and then when the transferee partner is allocated a share of the loss when the partnership disposes of or

⁷ See footnote 14, *infra*, for additional detail.

depreciates partnership property. Upon the sale or exchange of a partnership interest when a substantial built-in loss exists, Congress provided a mandatory downward basis adjustment to the inside basis of partnership property (with respect to the transferee partner) following the sale or exchange of a partnership interest. The adjustments under § 743(b) are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner, so that the transferee partner “would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.”⁸ Where the transferee partner’s outside basis in the partnership is less than its share of the adjusted inside basis of the partnership property, the transferee partner’s share of inside basis of partnership property is decreased to match the transferee partner’s outside basis.⁹ Thus, the overall effect and intent of § 743(b) is to achieve parity between the inside basis of partnership property (with respect to the transferee partner) and the outside basis of the transferee partner’s interest in the partnership upon a sale or exchange of a partnership interest.

Section 1.743-1 sets forth a mathematical formula for calculating the mandatory downward basis adjustment to partnership property when § 743(b) applies to a transaction.¹⁰

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. Notwithstanding the complications, the formula can be applied to achieve the correct basis adjustment consistent with the purpose of § 743(b), § 752, and subchapter K generally.

In applying the formula to the facts of this case and for purposes of computing A’s adjusted basis in the transferred Y interest under § 1.743-1(c) and A’s share of the adjusted basis to the partnership of Y’s property under § 1.743-1(d)(1), any net decrease in A’s share of X’s liabilities that are assumed by Y in Step 1 of the assets-over merger under § 1.708-1(c)(3)(i) must be taken into account to carry out the mandatory basis adjustment of § 743(b). When X is deemed to contribute all of its assets and liabilities to Y in exchange for an interest in Y under § 1.708-1(c)(3)(i), X’s (and consequently A’s) share of those liabilities decreases under § 752(b) when Y assumes the liabilities. In addition, A, as a momentary indirect partner in Y, is allocated a share of Y’s liabilities under § 1.752-3(a)(3).¹² Because A’s profit share in Y with respect to its momentary indirect interest in Y is N15, A’s share of Y’s liabilities under

⁸ H.R. Rep. No. 108-755, at 622-625 (2004) (Conf. Rep.); S. Rep. No. 83-1622, at 396-397 (1954).

⁹ Section 743(b)(2).

¹⁰ When Congress amended § 743(b) in 2004 to mandatorily apply to substantial built-in loss cases, the mathematical formula was in § 1.743-1(d), which was amended in 1999 to apply to transfers of partnership interests occurring on or after December 15, 1999. Accordingly, Congress was aware that any basis adjustment under § 743(b) would not only take into account the transferee partner’s share of built-in gain and built-in loss in determining the partner’s share of previously taxed capital but would also take into account the partner’s share of partnership liabilities.

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¹² Section 1.752-3(a)(1) and (a)(2) do not apply to the facts of this case.

§ 1.752-3(a)(3) is \$N15. Because the decrease in A's share of X's liabilities of \$N14 exceeds A's share of Y's liabilities through X after Step 1 of the merger, A would be treated as receiving a distribution of money under § 752(b) after Step 1 of the merger absent the netting rule in § 1.752-1(f). Immediately before the deemed distribution under § 752(b), A's adjusted basis in X is \$N15. Therefore, without the netting rule in § 1.752-1(f), A would recognize gain under § 731 after Step 1 of the merger to the extent that the distribution under § 752(b) exceeds A's adjusted basis in X.

A's unrecognized gain under § 731 represents the net decrease in A's share of X's liabilities that are assumed by Y after Step 1 of the assets-over merger. To carry out the mandatory downward basis adjustment of § 743(b) when there is a disparity between a transferee partner's basis in a resulting partnership and the transferee's share of the adjusted basis to the partnership of the resulting partnership's property, we must account for this decrease in liabilities by respecting the steps of the assets-over merger in § 1.708-1(c)(3)(i) and by taking into account the effect of the netting rule under § 1.752-1(f) in determining the basis adjustments under § 743(b). Therefore, when a net decrease in liabilities under § 752(b) as a result of a deemed contribution of liabilities in Step 1 in an assets-over merger is greater than the transferee partner's outside basis in the terminating partnership, the transferee partner (as a momentary indirect partner in the resulting partnership) must be allocated enough liabilities of the resulting partnership under § 752(a) to avoid recognizing § 731 gain,¹³ and/or recognize § 731 gain to the extent that the transferee partner is not allocated a sufficient amount of the liabilities of the resulting partnership.

Those liabilities of the resulting partnership that are allocated to the transferee partner are included in determining the transferee partner's adjusted basis in the transferred resulting partnership interest under § 1.743-1(c) and the transferee partner's share of the resulting partnership's liabilities for purposes of computing the transferee partner's share of the adjusted basis to the partnership of the resulting partnership's property under § 1.743-1(d)(1). The intended parity of § 743(b) when there is a substantial built-in loss is achieved by taking into account those allocated liabilities in determining the transferee partner's § 743(b) adjustment. Therefore, for purposes of determining A's basis in the transferred Y interest under § 1.743-1(c) and A's share of Y's liabilities for purposes of determining A's share of the adjusted basis to the partnership of Y's property under § 1.743-1(d)(1), A's share of Y's liabilities under § 752(a) after Step 1 of the assets-over merger is \$N14, representing the amount of gain that A would recognize under § 731 after Step 1 of the assets-over merger absent the netting rule in § 1.752-1(f).

The netting rule in § 1.752-1(f) determines the effect of a merger under § 752 with respect to a partner. While the netting rule reflects and implements a "single

¹³ Allocating enough liabilities to avoid gain recognition under § 731 will also prevent negative basis consequences, which are not recognized under federal tax law. See Tufts v. Comm'r, 461 U.S. 300, 310 (fn. 11) (1983).

transaction/unitary basis” approach to prevent gain upon a merger, this does not imply that the steps of a merger should be ignored and a net decrease in liabilities after Step 1 of a merger should not be taken into account in determining adjustments under § 743(b). A’s § 743(b) adjustment can be computed irrespective of whether the netting rule in § 1.752-1(f) applies by respecting the steps of a merger and accounting for the net decrease in liabilities under § 752.¹⁴ Any other rule or result would have the effect

¹⁴ For example, when applying the separate/bifurcated approach of § 743(b) to the facts from Example 2 of § 1.752-1(g) assuming a § 754 election is in effect and accounting for B’s net decrease in liabilities under § 752, B has no adjustment under § 743. This is correct because before the merger, the inside and outside bases of B in partnership T and partnership S are equal. For simplicity, B’s share of partnership liabilities in partnership T and partnership S is determined under § 1.752-3(a)(3). When partnership T merges into partnership S and transfers its assets (\$600 of adjusted basis and value of \$1,000) and liabilities (\$900) to partnership T, B’s share of partnership T’s liabilities decreases by \$630. B’s share of partnership S’s liabilities, as a momentary indirect partner in partnership S, is \$70 (7% of \$1,000). Under the netting rule in § 1.752-1(f), B does not recognize any gain under § 731. Absent the netting rule, B would recognize \$140 of gain under § 731.

For purposes of determining B’s § 743(b) adjustment, B’s outside basis in partnership S (transferred partnership interest) is \$0 (\$420 (B’s outside basis in partnership T before the merger) less \$630 (decrease in B’s share of partnership T’s liabilities) plus \$70 (B’s share of partnership S’s liabilities under § 1.752-3(a)(3) as a momentary indirect partner in partnership S) plus \$140 of additional liabilities of partnership S (representing the amount of gain under § 731 that B does not recognize as a result of the netting rule in § 1.752-1(f))). B’s share of the adjusted basis to the partnership of partnership S’s property is \$0 (negative \$210 (B’s interest as a partner in partnership S’s previously taxed capital (\$70 of cash under § 1.743-1(d)(1)(i) less \$280 of tax gain under § 1.743-1(d)(1)(iii))) plus \$210 (B’s share of partnership S’s liabilities, which is the same amount of liabilities used to compute B’s outside basis in partnership S)). Therefore, because B’s outside basis in partnership S with respect to the transferred partnership interest (\$0) over B’s share of the adjusted basis to the partnership of partnership S’s property (\$0) equals \$0, there is no § 743 adjustment for B.

The separate/bifurcated approach of § 743(b) also reaches the correct result when applied to the same modified facts from Example 2 of § 1.752-1(g) assuming that another partner, A, in partnership T recognizes gain under § 731. Suppose that prior to the merger, A owns a 30% interest in partnership T, but does not own an interest in partnership S, and Z owns an 80% interest in partnership S. A’s adjusted basis in its partnership T interest is \$180 and A’s share of partnership T’s liabilities is \$270. Z’s share of partnership S’s liabilities is \$80. After the merger, A has a 3% interest in partnership S, B has a 25% interest in partnership S, and Z has a 72% interest in partnership S. When partnership T merges into partnership S and transfers its assets (\$600 of adjusted basis and value of \$1,000) and liabilities (\$900) to partnership T, A’s share of partnership T’s liabilities decreases by \$270 and Z’s share of partnership S’s liabilities increases by \$640. A’s share of partnership S’s liabilities, as a momentary indirect partner in partnership S, is \$30 (3% of \$1,000). Under the netting rule in § 1.752-1(f), A will be treated as receiving a distribution under § 752(b) of \$240 (\$270 decrease in A’s share of partnership T’s liabilities less \$30 increase in A’s share of partnership S’s liabilities). A’s adjusted basis in its partnership S interest before the deemed distribution is \$180 (\$180 + \$0). Because the \$240 distribution exceeds A’s adjusted basis in its partnership S interest by \$60 (\$240 - \$180), A will recognize \$60 of gain under § 731. After the merger, A’s adjusted basis in its partnership S interest is \$0 and includes A’s \$30 share of partnership S’s liabilities. Z’s share of partnership S’s liabilities after the merger is \$720 (\$80 + \$640, or 72% of \$1,000).

For purposes of determining A’s § 743(b) adjustment, A’s outside basis in partnership S (transferred partnership interest) is \$0 (\$180 (A’s outside basis in partnership T before the merger) less \$270 (decrease in B’s share of partnership T’s liabilities) plus \$30 (B’s share of partnership S’s liabilities under § 1.752-3(a)(3) as a momentary indirect partner in partnership S) plus \$60 (amount of gain A recognizes under § 731)). A’s share of the adjusted basis to the partnership of partnership S’s property is \$0 (negative \$30 (A’s interest as a partner in partnership S’s previously taxed capital (\$30 of cash under

of frustrating the clear intent of § 743(b), which strives to achieve parity between inside basis of partnership property and outside basis of transferred partnership interests when the transfers are subject to that rule. Further, by not making a § 743(b) adjustment, A could be allocated losses or depreciation deductions from Y in subsequent years with respect to any depreciable built-in loss property that X contributed to Y in the assets-over merger which conflicts with Congressional intent in amending § 743(b) to apply in cases where there is a substantial built-in loss.¹⁵ There is no reason why § 743(b) should be prevented from achieving its intended purpose in this case.

A argues that the Service's interpretation of §§ 743(b) and 752 in the context of an assets-over merger creates a rule that is not in the regulations. We disagree. Although the regulations do not provide a specific example illustrating the analysis for an assets-over merger when § 743(b) applies, the regulations provide the rules necessary to perform the correct analysis consistent with the clear purpose of § 743(b) described above. The Service's position applies the rules in § 1.708-1(c), § 743-1(c) and (d)(1), § 1.752-1(f), and § 1.752-3 in an integrated, logical manner that effectuates Congressional intent consistent with the relevant statutes. In contrast, A seeks to apply the rules in § 1.752-3 in a mechanical manner that fails to give proper consideration to how the effect of the netting rule in § 1.752-1(f) must be taken into account to reach the correct results when § 743(b) applies to an assets-over merger. A's partial, mechanical application of the rules in the regulations reaches an erroneous basis adjustment that would allow the transfer of built-in loss assets to the resulting partnership and fails to achieve parity between A's inside/outside basis amounts contrary to § 743(b).

D. Deferred COD Income Not Treated as "Tax Gain" for Purposes of § 1.743-1(d)(1)(iii)

A transferee partner's share of the adjusted basis of partnership property under § 1.743-1(d)(1) equals the sum of the transferee's interest as a partner in the partnership's previously taxed capital plus the transferee's share of partnership liabilities. In determining a transferee's interest as a partner in the partnership's previously taxed capital, the amount of tax gain and loss (including any remedial allocations under § 1.704-3(d)), that would be allocated to the transferee from a hypothetical transaction described in § 1.743-1(d)(2) (to the extent attributable to the acquired partnership interest) is taken into account. In this case, the amount of tax loss that would be allocated to A from a hypothetical disposition of Y's assets would be \$N17. A argues that, as a result of the § 1.743-1(d)(2) hypothetical transaction, A should also be allocated "tax gain" equal to A's share of X's deferred COD income

§ 1.743-1(d)(1)(i) less \$60 of tax gain under § 1.743-1(d)(1)(iii) adjusted to take into account A's \$60 of § 731 gain)) plus \$30 (A's share of partnership S's liabilities, which is the same amount of liabilities used to compute A's outside basis in partnership S)). Therefore, because A's outside basis in partnership S with respect to the transferred partnership interest (\$0) over A's share of the adjusted basis to the partnership of partnership S's property (\$0) equals \$0, there is no § 743 adjustment for A.

¹⁵ See footnote 5, supra.

under § 108(i) (“deferred COD income”) of \$N9, for purposes of calculating A’s share of Y’s previously taxed capital under § 1.743-1(d)(1). The crux of A’s argument is that this amount of deferred COD income is (or should be treated as) equivalent to “tax gain” within the meaning of § 1.743-1(d)(1)(iii) that would be attributable to the transferred interest in Y that X receives in the merger transaction and that, in certain cases, disparities between inside/outside basis may be created by not including the deferred COD income as tax gain.

We disagree. Deferred COD income is not “tax gain” for purposes of determining the transferee partner’s interest in previously taxed capital. This income is not “tax gain” that would arise upon the disposition of partnership assets within the meaning and for the intent and purposes of § 1.743-1(d)(1)(iii) because it does not arise as a result of a disposition of partnership assets or property at fair market value for cash. The hypothetical transaction described in § 1.743-1(d)(2) is only concerned with determining the amount of partnership tax gain or loss that would result from the disposition of partnership assets at fair market value for cash, for purposes of determining an inside basis adjustment to partnership property. Deferred COD income is not and does not relate to partnership assets or property for purposes of the hypothetical transaction described in § 1.743-1(d)(2), but is simply an item of deferred income that does not have or attract basis, is not transferrable or marketable, and has no fair market value.¹⁶

Although § 1.755-1(b)(1)(ii) allocates the basis adjustment under § 743(b) between classes of property and among items of property within each class based on allocations of tax gain *and income* that would result from a hypothetical sale of all of the partnership property for cash in an amount equal to the fair market value of such property (emphasis added), any ordinary income amounts must still relate to partnership property that can be valued, such as accounts receivable or recapture property. COD income does not relate to any partnership asset that can be assigned a value under the § 755 regulations and, therefore, should not be treated or otherwise taken into consideration as “tax gain” under § 1.743-1(d)(1)(iii).¹⁷ Accordingly, deferred COD income should play no role in determining Y’s previously taxed capital for determining A’s inside basis in Y under § 743(b).

Moreover, treating deferred COD income as “tax gain” frustrates the purpose of § 743(b) and perpetuates the disparity between the transferee partner’s inside and

¹⁶ A argues that the deferred COD income should be treated as gain like recognized COD income is treated as gain for purposes of §§ 338, 382, and 1374, citing Notice 2003-65, 2003-2 C.B. 747, and § 1.1374-4(f). Those Code sections, however, are corporate-level tax provisions that do not apply to partnerships. In addition, the policy rationale for treating recognized COD income as gain for purposes of §§ 338, 382, and 1374 is not relevant for determining whether deferred COD income should be included in calculating a partner’s share of previously taxed capital of a partnership for purposes of § 743(b).

¹⁷ See, generally, Rev. Rul. 91-31, 1991-1 C.B. 19, holding that the reduction of the principal amount of an under-secured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under § 61(a)(12) and does not result in the reduction to the basis of the property securing the debt.

outside basis. Treating deferred COD income as tax gain actually reduces the § 743(b) adjustment that is required to treat the transferee partner as though the transferee partner directly purchased its share of the partnership's assets and, thus, perpetuates the difference between the transferee partner's inside and outside basis. We also disagree with A's argument that it is appropriate to preserve the "status quo ante" when § 743(b) applies to a sale or exchange. The purpose of § 743(b) when it applies to a transaction is to reduce the disparities between the partner's inside basis and outside basis, not to maintain the status quo by perpetuating inside/outside basis disparities.

A points out, not incorrectly, that in a hypothetical situation¹⁸ where the partner has sufficient outside basis in the partnership interest at the time of discharge, the deemed distribution under § 752(b) resulting from the reduction in liabilities will occur immediately under § 108(i)(6) even though the recognition of the § 108(i) amount is deferred. In such a situation, A argues that the failure to treat the deferred COD income as "tax gain" for purposes of calculating the partner's interest in previously taxed capital under § 1.743-1(d)(1) will lead to a permanent disparity between inside and outside basis, which is counter to the intent and purposes of § 743(b). While we acknowledge this point, we disagree with A's argument that this means that deferred COD income must be treated as "tax gain" in computing the partner's interest in previously taxed capital as a matter of policy in every case. We note that doing so would lead to permanent disparities in cases such as this one where the partner has a deferred § 752 amount. Accordingly, to address the concern raised by A's hypothetical situation in which a partner has sufficient outside basis at the time of the discharge to absorb at least a portion of the deemed distribution under § 752(b), it would be appropriate solely for purposes of computing the transferee partner's § 743(b) adjustment to adjust the transferee partner's basis in the transferred partnership interest under § 705 by the amount of the deferred COD income that equals the amount of the deemed distribution under § 752(b) previously taken into account. This adjustment would compensate for the difference in timing created under § 108(i) in taking into account the two related items. Adjusting a transferee partner's basis in its partnership interest in this manner in the hypothetical situation would obviate the need to make any adjustment to the transferee partner's interest in the resulting partnership's previously taxed capital in such a situation. Therefore, we conclude that A's share of Y's previously taxed capital equals the amount of tax loss that would be allocated to A from a hypothetical disposition of Y's assets, or \$N17, and does not include A's deferred COD income of \$N9.

In summary, taking into account the conclusions reached in this technical advice memorandum, the downward inside-basis adjustment under § 743(b) with respect to A is \$N13 (\$N13 (A's share of the adjusted basis to the partnership of Y's property (\$N17 (tax loss) plus \$N14 (A's share of Y's liabilities)) over \$N15 (A's basis in the transferred Y interest)). A asserts that this basis adjustment is inconsistent with the purpose of

¹⁸ Field Counsel and A currently disagree as to whether this hypothetical situation may apply, in part, to the actual facts of this case.

§ 743(b) because it not only eliminates the “true built-in loss” (based on A’s legal position that A’s \$N14 share of Y’s liabilities should be \$N15 and A’s \$N9 deferred COD income should reduce A’s interest in Y’s previously taxed capital when applying the § 743(b) calculation), but it inappropriately creates gain for A. Although A does not specify the amount of gain created, presumably it is the gain that A would recognize upon a sale or exchange of Y’s property after the proposed basis adjustments (reduced by the amount of A’s asserted “true built-in loss”). In any event, we disagree that our position inappropriately creates gain for A.

. This ordinary loss deduction of \$N3 reduced A’s basis in A’s partnership interest in X to \$N15.¹⁹ However, the bases in X’s assets were not reduced by the ordinary loss deduction, and A continued to hold an interest in X and operate X in Year3 and Year4. The downward inside-basis adjustment of \$N13 for A is the logical, necessary, and appropriate consequence of the prior reduction of A’s outside basis to \$N15 as a result of the § 165(a) ordinary loss deduction in Year2²⁰ when § 743(b) applies to a subsequent transaction (in this case, the assets-over merger). The downward inside-basis adjustment of \$N13 does not inappropriately create gain for A but carries out the purpose of § 743(b) by correctly applying the rules in § 1.743-1 to reduce A’s inside basis in Y and thereby eliminate additional losses or deductions for A in subsequent tax years with respect to the partnership property transferred from X to Y in Year4.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

¹⁹ See footnotes 1 and 3, supra.

²⁰ Ibid.