IRC 751 “Hot Asset” Treatment

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Agenda

- Background
- Section 751(a)
  - Ordinary income re-characterization provisions on sale or exchange of partnership interest
- Section 751(b)
  - Certain distributions treated as sales or exchanges
- Current 751(b) Regulations
- Proposed 751(b) Regulations

Background

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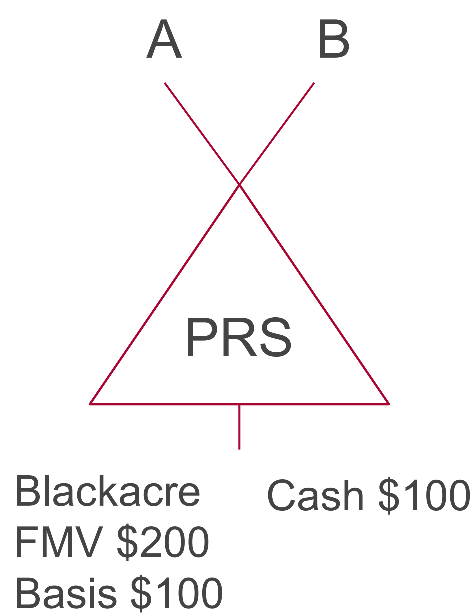
Aggregate vs. Entity

- The Code blends aggregate and entity principles.
- Aggregate: Partners are co-owners, each with an undivided interest in the partnership's assets.
  - Each partner accounts separately for the partner's share in each partnership transaction.
- Entity: The partnership is a separate and distinct taxpayer with its own method of accounting and taxable year; the partnership annual reports its taxable income.
  - Each partner is viewed as owning an undivided interest in the partnership entity, similar to shareholders in a corporation.

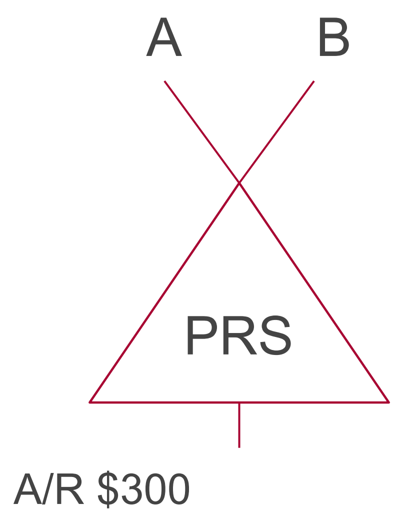
Aggregate vs. Entity: Sale of Partnership Interests

- Entity: Sale of interests without regard to character of the assets.
- Aggregate: Sale of partnership's interest in underlying assets.



Hypo: Each of A and B contribute $100 cash to PRS. PRS buys Blackacre for $100. One year later, B wants to sell his interest in PRS to C for $150. Differences in treatment?

Aggregate vs. Entity: Sale of Partnership Interests



Hypo: Each of A and B contribute $100 cash to PRS. One year later, PRS holds account receivables of $300. B wants to sell his interest in PRS to C for $150. Differences in treatment?

Aggregate vs. Entity: Sale of Partnership Interests

- The Code takes a middle ground on the sale of a partnership interest.

- General Rule: Entity Approach
  - 741: Gain or loss on the sale of a partnership interest is capital.

- Exceptions: Aggregate Approach
  - 751: Part of the gain or loss is ordinary to the extent attributable to certain ordinary income assets.
  - 754 Election or Substantial Built-in Loss: Adjustments to the basis of partnership assets.

History of 751

- Pre-1954, there was little guidance addressing contributions to and distributions from partnerships, and sales of partnership interests.
  - Bureau of Internal Revenue took the position that contributions and liquidations of partnerships were not realization events. Sales of partnership interests should be viewed as a direct sale of partnership property (aggregate approach).
  - Courts rejected that view, and the Service conceded that partnership interests generally should be treated as separate assets.

History of 751

- In 1954, Section 751 was passed to "prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests."
  - 751 targeted distributions that "had the same effect as a sale of … ordinary income or loss items."
  - H.R. 83-1337.
  - House version originally applied to both sales and exchanges of partnership interests <u>and</u> distributions by the partnership.

Section 751(a)

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751(a)

- 751(a): The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to:
  - unrealized receivables of the partnership, or
  - inventory items of the partnership

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

- Commonly referred to as “hot assets.”

- 751 Regulations use a hypothetical sale approach to determine gain attributable to hot assets.
  - Applicable post December 15, 1999.

Hot Assets: Unrealized Receivables

- Unrealized Receivables
  - Includes rights to payments for:
    - goods (excluding capital assets) delivered, or to be delivered; and
    - services rendered, or to be rendered.
  - Amount must not be previously included in income under the partnership's method of accounting.

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Hot Assets: Unrealized Receivables

- Also includes:
  - gain from mining property;
  - stock in a DISC;
  - gain from 1245 property;
  - gain from PFIC stock;
  - gain from 1250 property;
  - gain from farm recapture property;
  - gain from franchises, trademarks, or tradenames; and
  - gain from natural resource recapture; any market discount bond and any short-term obligation to extent treated as ordinary income if sold by the partnership.

Hot Assets: Inventory Items

- Property described in 1221(a)(1);
- any other property which, on sale or exchange, would be considered property other than a capital asset or 1231 property; and
- any other property which, if held by the selling or distributee partner, would be considered property described above.

Hot Assets: Inventory Items

- Property described in 1221(a)(1)
  - Stock-in-trade.
  - Property properly included in the inventory of the taxpayer if on hand at the end of the year.
  - Property primarily for sale to customers in the ordinary course of his trade or business.

751(a) Hypothetical Sale Approach

- Determine overall gain or loss under the entity approach.
  - Amount realized (including discharged liabilities) MINUS outside basis
- Calculate gain or loss from 751(a) property.
  - Gain or loss from selling all 751(a) property for FMV, Hypothetical Sale, 1.751-1(a)(2)
- Calculate remaining capital gain.
  - Total gain MINUS 751(a) gain.
- Apply capital gain look through rules.
  - Look to 1250 capital gain (depreciation on real property), collectibles CG, etc.

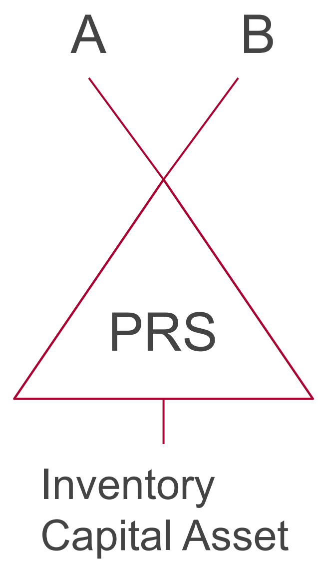
Installment Sale of Partnership Interests

- Section 453: If at least one payment for the sale of property is received after the close of the year in which the sale takes place, the installment method applies.

- Exception: Gain from sale of 751(a) property which, if it had been sold directly, would not have been eligible for 453, must be reported immediately.

751(a) Example 1

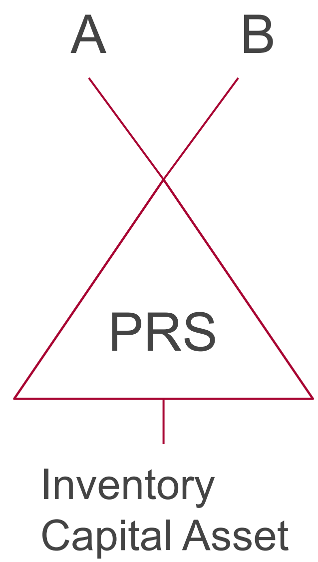
- Amanda and Bob are equal partners in PRS.
  - Note: PRS has no 704(c) property and the capital assets are non-depreciable.
- On Jan 1, Amanda sells her interest (outside basis $75) to Xavier for $125 cash.
- On the date of the sale, partnership has assets as below.



Asset	Basis	FMV	Gain/Loss	A's Share
Inventory	$100	$120	$20	$10
Capital Asset	$50	$130	$80	$40

751(a) Example 1

- Step 1: A’s overall gain.
  - $125-$75 = $50
- Step 2: G/L from 751(a) property.
  - $10
- Step 3: Difference between total gain and 751(a) gain.
  - $50-$10 = $40



Asset	Basis	FMV	Gain/Loss	A’s Share
Inventory	$100	$120	$20	$10
Capital Asset	$50	$130	$80	$40

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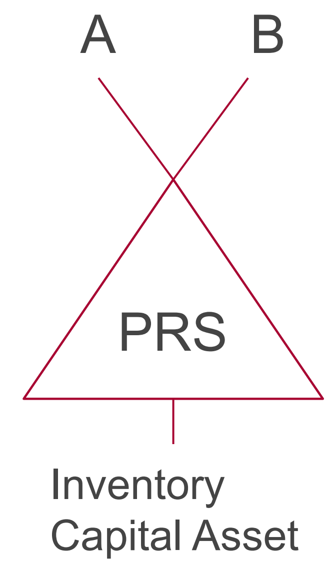
751(a) Example 2

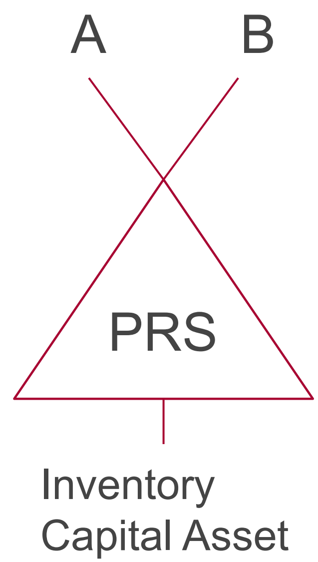
- Amanda and Bob are equal partners in PRS.
  - Note: PRS has no 704(c) property and the capital assets are non-depreciable.
- On Jan 1, Amanda sells her interest (outside basis $75) to Xavier for $125 cash.
- On the date of the sale, partnership has assets as below.



Asset	Basis	FMV	Gain/Loss	A's Share
Inventory	$100	$60	($40)	($20)
Capital Asset	$50	$190	$140	$70

751(a) Example 2

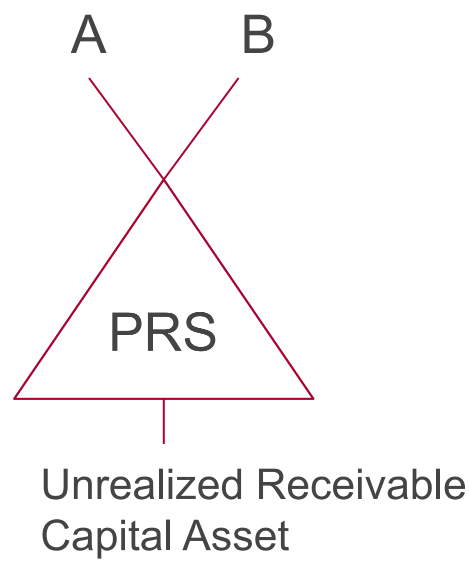
- Step 1: A's overall gain.
  - $125-$75 = $50
- Step 2: G/L from 751(a) property.
  - ($20)
- Step 3: Difference between total gain and 751(a) gain.
  - $50-($20) = $70



Asset	Basis	FMV	Gain/Loss	A's Share
Inventory	$100	$60	($40)	($20)
Capital Asset	$50	$190	$140	$70

751(a) Example 3

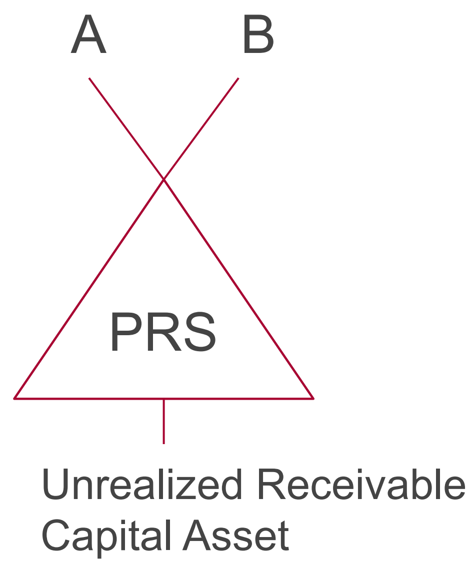
- Amanda and Bob are equal partners in PRS.
  - Note: The capital assets are non-depreciable.
- Amanda contributed the unrealized receivable when it had a FMV of $20 and a basis of $0.
- On Jan 1, Amanda sells her interest (outside basis $50) to Xavier for $100 cash.
- On the date of the sale, partnership has assets as below.



Asset	Basis	FMV	Gain/Loss	A's Share
Unrealized Receivable	$0	$50	$50	$20 704(c) $15 751(a)
Capital Asset	$100	$150	$50	$15

751(a) Example 3

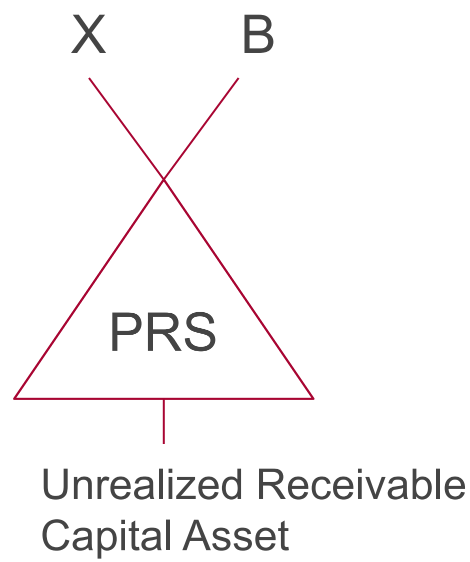
- Step 1: A's overall gain.
  - $100-$50 = $50
- Step 2: G/L from 751(a) property.
  - $35
- Step 3: Difference between total gain and 751(a) gain.
  - $50-$35 = $15



Asset	Basis	FMV	Gain/Loss	A's Share
Unrealized Receivable	$0	$50	$50	$20 704(c) $15 751(a)
Capital Asset	$100	$150	$50	$15

751(a) Example 3 – with 743(b) Adjustment

- If the partnership has an election under 754, or substantial built-in loss, there will be a 743(b) adjustment.
- Adjustment is equal to difference between buyer's outside basis and share of inside basis.
  - $100 - $50 = $50.



Asset	Basis	FMV	Capital	Tax/Book	FMV
Unrealized Receivable	B: $0 X: $0 + $25	$50	B	$50	$100
Capital Asset	B: $50 X: $50 +$25	$150	X	$100	$100

751 Reporting Obligations

- Form 8308: Report of a Sale or Exchange of Certain Partnership Interests
  - A partnership must file a separate Form 8308 for each 751(a) exchange of an interest in the partnership.
  - Form 8308 is due as an attachment to Form 1065 for the tax year of the partnership that includes the last day of the calendar year in which the 751(a) exchange took place.
- 751(a) Statement
  - A transferor must file a statement with the following information:
    - Date of the sale or exchange;
    - Amount of any gain or loss attributable to 751 property; and
    - The amount of gain or loss attributable to capital gain or loss on the sale of the partnership interest.

Section 751(b)

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751(b)

- 751(b) Certain Distributions treated as sales or exchanges
  - (1) General rule. To the extent a partner receives in a distribution –
    - (A) partnership property which is –
      - (i) unrealized receivables, or
      - (ii) inventory items which have appreciated substantially in value,
    - in exchange for all or a part of his interest in other partnership property (including money), or
    - (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),
    - such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

751(b)

- (2) Exceptions. Paragraph (1) shall not apply to –
  - (A) a distribution of property which the distributee contributed to the partnership, or
  - (B) payments, described in section 736(a), to a retiring partner or successor in interest of a deceased partner.
- (3) Substantial appreciation. For purposes of paragraph (1)—
  - (A) In general. Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair marked value exceeds 120 percent of the adjusted basis to the partnership of such property.
  - (B) Certain property excluded. For purposes of subparagraph (A), there shall be excluded any inventory property if a principal purpose for acquiring such property was to avoid the provisions of this subsection relating to inventory items.

751(b)

- Essentially, Section 751(b) recharacterizes a portion of a distribution as a sale or exchange when a partnership that owns “hot assets” makes a non-pro rata distribution of partnership assets.
  - “hot assets” are comprised of certain ordinary income assets:
    - Substantially appreciated inventory
    - unrealized receivables
- Section 751(b) potentially applies to a broad array of distributions (and deemed distributions):
  - Deemed cash distributions pursuant to Section 752(b)
  - Admission of new partner to a law firm (Revenue Ruling 84-102 applied 751(b) where partnership had liabilities and unrealized receivables and each partner entitled to share of unrealized receivables and liable for share of liabilities)

751(b)

- Like Section 751(a), Section 751(b) is designed to prevent the shifting of ordinary income among partners
- Section 751(b), however, applies in a different set of circumstances:
  - where the partnership has “hot assets”, and
  - the partnership makes a disproportionate distribution to a partner
- Thus, Section 751(b) does not apply where the distribution is pro rata or if the partnership doesn’t have hot assets
- A disproportionate or non-pro rata distribution is one that changes the partners’ shares of hot assets and other partnership assets (or “cold assets”).

751(b)

- When Section 751(b) applies to a disproportionate distribution, it will have the effect of characterizing a portion of the distribution as a taxable exchange between the partnership and distributee partner
- Applying Section 751(b) depends on a calculation of a partner's interest in partnership property.
  - However, the statute does not provide a method for making that calculation

751(b)

- Issue Section 751(b) is addressing:
  - preferential treatment given to capital gains for individuals
    - Right now, very significant preference for capital gains
      - 37% (or 40.8%) vs. 23.8%
  - Thus, there is a significant incentive to recharacterize ordinary income as capital gains
  - If certain partners are tax-exempt, shifting ordinary income to them, and shifting capital gains to the taxable partners is appealing given the tax differential
  - Section 751(b) is intended to prevent partners from recharacterizing ordinary income as capital gains in certain circumstances

751(b)– Example

XYZ LLC is taxed as a partnership. Each of members X, Y and Z has an outside basis and capital account equal to $100.

- FMV of inventory exceeds basis by more than 120%
- XYZ LLC has hot assets because inventory is substantially appreciated

Assets	Book/ Basis	FMV	Capital	Tax/Book	FMV
Inventory	$240	$300	X	$100	$150
Capital Asset	$60	$150	Y	$100	$150
			Z	$100	$150
Totals	$300	$450		$300	$450

751(b) Example

- XYZ LLC distributes the Capital Asset (which is a cold asset) to Z in complete liquidation of Z's interest in LLC. Z gets a basis of $100 in the distributed assets.
- Without Section 751(b):
  - When Z sold the Capital Asset, all of the gain would be capital gain. Instead, Z would have a capital gain of $50.
  - When the LLC sold the Inventory, X and Y would recognize ordinary income.
  - Z would not realize any ordinary income.
- However, 751(b) applies to the distribution to Z because the distribution changed Z's interest in hot assets.
  - 751(b) says that the distribution will be treated as a sale or exchange

Two Alternative Sets of Rules

- Under current regulations, a “gross value” approach is used to determine the distributee partner’s reduction or increase in Section 751(b) property.
  - This approach compares the distributee partner’s share of the partnership’ hot assets and cold assets before and after the distribution
  - Next, the current regulations apply a “deemed asset exchange” approach to determine the amount of the income inclusion.
- Under proposed regulations, the “gross value” approach would be replaced with a “hypothetical sale” approach.
  - This approach would determine a partner's interest in Section 751 property by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property at FMV immediately before the distribution.
  - Next, the proposed regulations would replace the deemed asset exchange approach with the “hot asset sale” approach.

Current 751(b) Regulations

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751(b) – Interest in the Partnership

- Neither 751(b) or the underlying regulations provide guidance regarding how to measure a partner's interest in a partnership's hot and cold assets.

- Legislative history indicates a partner's interest in a partnership's hot assets equal the partner's rights to income from the hot assets.

Gross Value Approach (Current Regs)

- The Current Regulations apply a Gross Value approach, pursuant to which each partner's share of the partnership's hot and cold assets is initially determined by reference to the gross value of the assets.
- Compare:
  1. the distributee partner's undivided interest in the gross value of each partnership asset before a distribution to
  2. the partner's undivided interest in the same assets after the distribution (including the distributed assets)

Gross Value Approach (Current Regs)

- If a distribution results in an exchange of all or a portion of the distributee-partner's interest in one class of assets for assets in the other class, the distributee-partner is deemed to
  - receive a distribution of the relinquished assets (immediately prior to the actual distribution); and
  - then exchange the relinquished assets with the partnership for the acquired assets (the "asset exchange approach")
- The deemed asset exchange is fully taxable to the distributee-partner and to the partnership.

Gross Value Approach (7 Steps)

1. Classify the partnership assets
2. Determine the gross value of the distributee-partner's pre- and post-distribution interests in each asset
3. Construct a partnership exchange table.
4. Determine which assets are involved in the Section 751(b) exchange
5. Determine the basis of the assets relinquished
6. Determine the consequences of the exchange
7. Determine treatment of the portion of the distribution not included in the Section 751(b) exchange

Gross Value Approach – Example

- X, Y and Z own equal interests in XYZ which has a balance sheet as follows:

Assets	Basis/Book	FMV	Capital	Tax/Book	FMV
Inventory	$240	$300	X	$100	$150
Capital Asset	$60	$150	Y	$100	$150
			Z	$100	$150
Total	$300	$450		$300	$450

- XYZ distributes the capital asset to Z in complete liquidation of her 1/3 interest.

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Gross Value Approach – Example

- Step 1: Classify the partnership assets.
  - Here, we have one Section 751(b) asset and one capital asset
- Step 2: Determine the gross value of the distributee-partner's pre- and post-distribution interests in each asset

	Z's Pre-Distribution Share of FMV	Z's Post-Distribution Share FMV
Inventory	$100	$0
Capital Asset	$50	$150

Gross Value Approach – Example

- Step 3: Construct partnership exchange table.

	Gross Value of Z's post-distribution interest	(+) Gross Value of property distributed	(-) Gross Value of Z's pre-distribution share	= Change in interest
Hot Assets	$0	$0	($100)	($100)
Cold Assets	$0	$150	($50)	$100

- Step 4: Determine which assets are involved in the Section 751(b) exchange
  - The totals in column 4 demonstrate that Z has exchanged $100 of hot assets for $100 of cold assets

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Gross Value Approach – Example

- The deemed transactions under 751(b) are the following:
  - *Hypothetical Distribution*: Z deemed to receive $100 inventory as a current distribution.
  - *751(b) Exchange:* Z is deemed to transfer the hypothetical distribution of inventory to XYZ in exchange for $100 of the capital asset.
  - *Non-751(b) Distribution:* Z is deemed to receive a liquidating distribution of the remaining $50 worth of the capital asset.

	Z's post-distribution interest	(+) Property distributed	(-) Z's pre-distribution share	= Change in interest
Hot Assets	$0	$0	($100)	($100)
Cold Assets	$0	$150	($50)	$100

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Gross Value Approach – Example

- Step 5: Determine the basis of the assets relinquished:
  - Z takes a transferred basis of $80 in the $100 of inventory received in the deemed distribution
  - Z's outside basis is reduced from $100 to $20
  - XYZ's basis in remaining $200 of inventory is $160

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Gross Value Approach – Example

- Step 6: Determine the consequences of the deemed exchange between Z and XYZ
  - Z: Treated as transferring the hypothetical distribution of inventory to XYZ in exchange for $100 of the capital asset.
    - recognizes ordinary gain of $20.
    - takes a cost basis of $100 in 2/3 of the capital asset, and starts a new holding period.
  - XYZ : Received $100 of inventory in exchange for capital asset with basis of $40.
    - recognizes $60 capital gain, allocated to X and Y.
    - Basis in 1/3 of the inventory acquired in exchange is cost basis of $100.
    - PLR 7823013 held that the partnership also takes a new holding period in the hypothetically purchased property.

Gross Value Approach – Example

- Step 7: Determine treatment of the portion of the distribution not included in the Section 751(b) exchange:
  - Partnership distributes the remaining portion of the capital asset (Z's pro rata share) to Z in complete liquidation of her partnership interest.
  - Z: no G/L.
    - Holds that portion of the capital asset with a basis equal to her outside basis of $20 (total basis of $120).
  - XYZ: no G/L.

Gross Value Approach – Example

Summary:

- Z:
  - recognizes $20 of ordinary income from deemed exchange, and
  - takes a basis of $120 in the capital asset.
- XYZ:
  - recognizes $60 of capital gain from deemed exchange, allocated to X and Y.
  - Holds inventory with a basis of $260.

Challenges with the Current 751(b) Regulations

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Gross Value Approach - Criticism

- Section 751(b) was passed in 1954 and has remained almost unchanged, while many other provisions of Subchapter K have undergone significant change.
- This can create unanticipated results.

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Gross Value Approach - Criticism

- Section 704(b) regulations provide that partnership allocations are respected if they have substantial economic effect.
  - It is common for partnerships to specially allocate items of partnership income and loss other than in accordance with the partner’s relative fair market value of the capital accounts.
  - This arrangement is not consistent with the gross value approach, which assumes a partner’s interest in partnership property is based on the partner’s relative share of the fair market of the capital accounts.

Gross Value Approach - Criticism

- 704(c) provides that income, gain, loss and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take into account the variation between the basis of the property to the partnership and its FMV at the time of contribution.
- The gross value approach is unclear as to whether and to what extent 704(c) is taken into account in determining the partner's share of assets.
- Under 704 regulations, the principles of 704(c) apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to 1.704-1(b)(2)(iv)(f)

751(b) – NYSBA Criticism

The New York State Bar Association summarized the criticisms of the Current Regulations as follows (NYSBA Comments on Proposed Hot Asset Regulations, Sept. 9, 2015):

1. Complicated and expensive to administer;
2. Focused on the distributee-partner's share of the gross value of the hot and cold assets rather than the distributee-partner's share of the income and gain inherent in those assets.
   - a distribution may give rise to a taxable exchange under the Current Regulations even if each partner's share of the hot-asset gain does not change as a result of the distribution.
   - Similarly, a distribution may escape section 751(b) as long as the distribution does not alter any partner's share of the gross value of the hot and cold assets, even if the distribution does alter a partner's share of the built-in gain in hot assets.
3. No meaningful guidance on how to determine a partner's share of the gross value of a partnership asset.
   - Considerable uncertainty in addressing liabilities, section 704(c) (or reverse section 704(c) assets and special allocations
4. Requires knowledge of the fair market value of each partnership asset.
   - Third-party valuations can be expensive, while other partnerships undertake their own valuation (which creates additional uncertainty)
5. Uncertainty as to whether the deemed distribution of the relinquished assets is treated as an actual distribution for other purposes of the Code (such as sections 704(c)(1)(B), 707, 731(a)(1), and 737).

Proposed 751(b) Regulations

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Proposed Regulations

- Proposed Section 751(b) regulations were issued on November 3, 2014.
- Completely revamp the existing regulatory regime.
  - The gross value approach is abandoned in favor of a "hypothetical sale" approach.
  - The proposed regs would also:
    - include rules under Section 704(c) to enable partnerships to calculate partner gain in Section 751 property more precisely, and
    - clarify how basis adjustments under Sections 743(b) and 754(b) affect the computation of partners' interests in Section 751 property
- Generally effective prospectively from the date of finalization.
  - However, taxpayers may rely on the proposed regulations after November 3, 2014 if the partnership and the partners consistently apply the proposed regulations to all 751 transactions

Proposed Regulations

- The Proposed Regulations utilize a hypothetical sale approach to determine a partner's interest in partnership property instead of the gross value approach.
- The hypothetical sale approach determines a partner's interest in Section 751 property by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property at FMV immediately before the distribution.
- Section 751(b) is triggered only if a distribution reduces a partner's net Section 751 unrealized gain or loss.
  - Ordinary income is recognized by the partner whose share is reduced;
  - the basis of the corresponding § 751 property is increased by a like amount.

Proposed Regulations

- Under the Proposed Regulations' hypothetical sale approach, a partnership generally needs to determine if any partner's interest in the partnership's Section 751 property is reduced by comparing for each partner:
  - amount of ordinary income (or ordinary loss) the partner would recognize from hot assets if the partnership sold all of its assets for FMV immediately before the distribution, versus
  - amount of ordinary income (or ordinary loss) the partner recognize from hot assets if the partnership sold all of its assets, and, in the case of the distributee-partner, such partner sold the distributed assets, for FMV immediately after the distribution

Proposed Regulations

- If there is a reduction in the amount of ordinary income (or an increase in the amount of ordinary loss, or both) for any partner, as a result of the distribution (that reduction or increase, a "Section 751(b) amount"), the distribution is considered a "Section 751(b) distribution", and is subject to Section 751(b).
- Once it is determined that a distribution is subject to Section 751(b), any partner with a decrease in net Section 751(b) unrealized gain or loss must recognize ordinary income and make appropriate adjustments to basis.

Proposed Regulations

- After applying the hypothetical sale approach, the Proposed Regulations direct partnerships to use any "reasonable method" to account for the reduction in hot assets
- Reasonable methods include:
  - Hot Asset Approach: Partner with reduction in interest in hot assets deemed to get distribution of hot assets equal to the reduction amount and to sell the hot assets to the partnership immediately before distribution
    - Under this approach, only partner with reduction in hot assets interest would recognize income
  - Deemed Gain Approach: Partnership must recognize gain in hot assets equal to reduction in hot assets and allocate such gain to applicable partners
- Must use approach adopted until the use of that approach becomes unreasonable; have to reevaluate for each distribution

Proposed Regulations

- When making a determination of whether a distribution is a Section 751(b) distribution, the amount of OI or OL that each partner would recognize in the hypothetical sale includes gain or loss allocable to the partner pursuant to Section 704(c)
  - This includes any remedial allocations
- Proposed Regulations require a revaluation of partnership property under Treas. Reg. Sec. 1.704-1(b)(2)(iv)(f) when a distribution is made in consideration for a partnership interest if partnership owns Section 751 property immediately after distribution.
  - This revaluation creates a reverse Section 704(c) layer, preserving partners' shares of BIG and BIL—thereby limiting distributions causing a partner to have a Section 751(b) amount

Proposed Regulations

- Proposed Regulations have rules for basis adjustments
  - For example, for Section 732(c) or 734(b) basis adjustments
    - Any basis increase allocated to distributed capital gain property isn't taken into account in determining the recomputed or adjusted basis of the distributed property for purposes of Section 1245(a)(1)—therefore, won't displace OI potential in distributed asset.
    - Depreciation or amortization is allowable with respect to the basis increase; however, basis increase is not taken into account in determining Section 1231 gain or loss. Prop. Treas. Reg. Sec.1.732-1(c)(2)(iii).
  - Thus, a positive § 734(b) basis adjustment to § 1231 property, for example, will not reduce the recapture on disposition, nor will it reduce the § 1231 gain; rather, it can produce a capital loss on a disposition as to which gain is otherwise recognized

Current Regulations– Example 1

- X, Y and Z each contribute $120 to XYZ for an interest in XYZ. Each has a one-third interest.
- XYZ purchases land for $100 in Year 1.
- XYZ accrues unrealized receivables of $90 in Year 2.

Balance Sheet as of January 1, Year 3

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$100	$100	Z	$120	$150
Totals	$360	$450		$360	$450

- On January 2, Year 3, XYZ distributes $50 cash (cold asset) to Z

Current Regulations– Example 1

- $50 distribution to Z reduces Z's interest from 1/3 to 1/4
  - Exchange Table

Assets	Z's post-distribution share	(+) property distributed	(-) Z's pre-distribution share	Change in Interest
Unrealized Receivable	$22.50	$0	$30.00	($7.50)
Cash	$52.50	$50	$86.66	$15.84
Real Property	$25.00	$0	$33.34	($8.34)

Current Regulations—Example 1

- Under Gross Value Approach, Z's interest in cold assets has increased, and interest in hot assets has decreased
- Distribution is Section 751(b) transaction under the Gross Value Approach

- Now, consider the Hypothetical Sale Approach . . .

Proposed Regulations– Example 1

- Compare each partner's share of OI before the distribution versus each partner's share of OI after the distribution
  - Section 751(b) amount is the decrease in share of OI; if there is a Section 751(b) amount, Section 751(b) applies
  - **Balance Sheet is booked up before the distribution to Z**
  - Each partner has $30 of net unrealized OI

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$100	$100	Z	$120	$150
Totals	$360	$450		$360	$450

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Proposed Regulations—Example 1

- Here, the net unrealized OI before is the same as the net unrealized after
- So, Section 751(b) amount is 0, and distribution is not subject to Section 751(b)
- The result is different than under the gross value approach

Proposed Regulations– Example 2

- Same facts as in Example 1, except that XYZ distributes $150 in cash to Z in liquidation of Z's interest
  - XYZ has Section 754 election in place
  - In hypothetical sale before the distribution, each partner has $30 of Section 751 gain
  - Balance Sheet before distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$100	$100	Z	$120	$150
Totals	$360	$450		$360	$450

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Proposed Regulations—Example 2

- Based on hypothetical sale approach after distribution
  - What are tax consequences without regard to Section 751 & regulations?
    - C recognizes gain of $30
    - Adjustment pursuant to Section 734(b) of $30 to real property basis

Proposed Regulations– Example 2

- Balance Sheet after distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$110	$110	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$130	$100	Z	$0	$0
Totals	$240	$300		$240	$300

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Proposed Regulations—Example 2

- Z has no share of unrealized OI after the distribution
- Section 751(b) amount is $30 minus $0.
- So, Z must recognize $30 of OI using a "reasonable approach" and appropriate basis adjustments must be made
- Under the Deemed Gain Approach, Z would recognize $30 of OI
  - XYZ is deemed to recognize $30 of OI and allocate to Z. Thus, immediately before the distribution,
    - Z increases outside basis by $30
    - XYZ increases basis in unrealized receivables to $30

Proposed Regulations– Example 2

- Balance Sheet, modified as described above, immediately prior to transaction

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$30	$90	Y	$120	$150
Real Property	$100	$100	Z	$150	$150
Totals	$390	$450		$390	$450

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Proposed Regulations– Example 2

- Now, normal distribution rules apply. Z recognizes no gain on distribution. No basis adjustment under Section 734(b)
  - Balance Sheet after distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$110	$110	X	$120	$150
Unrealized Receivable	$30	$90	Y	$120	$150
Real Property	$100	$100	Z	$0	$0
Totals	$240	$300		$240	$300

Proposed Regulations—Example 2

- Hot Asset Sale Approach
- Following are deemed to occur:
  - Z gets a distribution of unrealized receivable. FMV is $30, basis is $0
  - Z sells unrealized receivable to XYZ, recognizes OI of $30
  - XYZ has cost basis in unrealized receivable
  - Z contributes $30 to XYZ
- Normal distribution rules apply. Z does not have gain on distribution. There is no Section 734(b) basis adjustment.

Proposed Regulations

- Are the Proposed Regulations an improvement?
- Are they less complex?
- Given the statutory language of Section 751(b), is it possible to develop simple implementing regulations?

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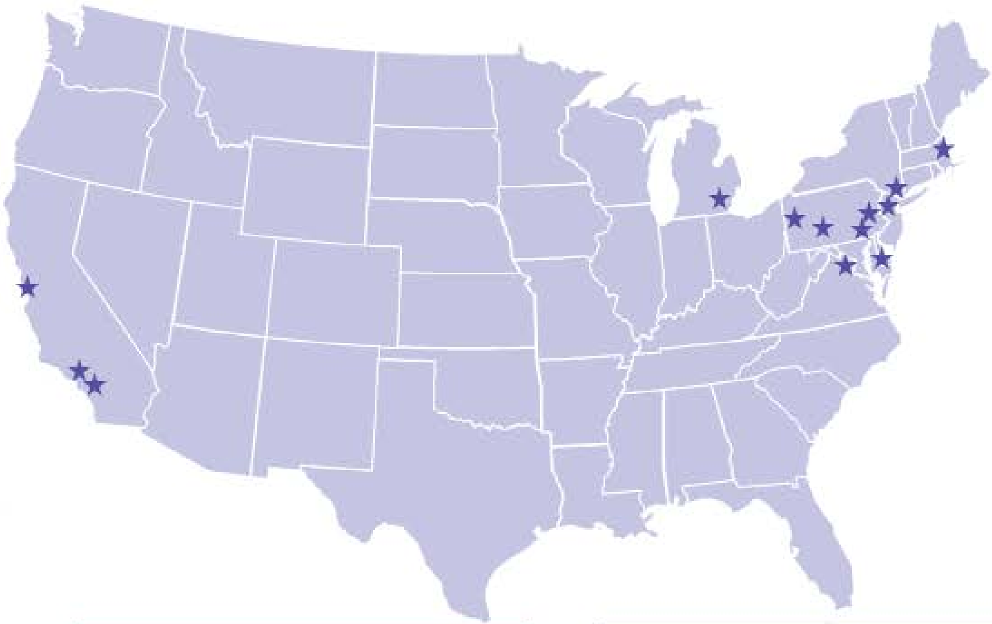

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