

Notice 99-57

The Internal Revenue Service intends to promulgate regulations under § 705 of the Internal Revenue Code to address certain situations where gain or loss may be improperly created by adjusting the basis of a partnership interest for partnership income that is not subject to tax, or for partnership losses or deductions that are permanently denied, with respect to a partner.

BACKGROUND

Section 705(a) provides that the adjusted basis of a partner's interest in a partnership generally shall be increased by the partner's distributive share of (i) taxable income of the partnership as determined under § 703(a), (ii) income of the partnership exempt from tax, and (iii) the excess of the deduction for depletion over the basis of the property subject to depletion. Conversely, the adjusted basis of a partner's interest in a partnership generally shall be decreased by the partner's distributive share of (i) losses of the partnership, (ii) nondeductible expenditures not properly chargeable to capital account, and (iii) in certain cases, deductions for depletion.

The legislative history describing § 705(a) states that adjusting the basis of a partner's interest is necessary to prevent unintended benefit or detriment to the partners. Thus, a partner should add to the basis of the partner's partnership interest the partner's distributive share of nontaxable income so that the partner does not lose the benefit of that type of tax-exempt income. Otherwise, the partner could eventually incur a capital gain with respect to such amounts. H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954).

Rev. Rul. 96-11, 1996-1 C.B. 140, provides an example of how § 705 has been interpreted to carry out the purposes of this legislative history. There, a partnership made a charitable contribution of property with a basis of \$60x and fair market value of \$100x in a transaction that qualified under § 170(c). The ruling

states that “[i]n determining whether a transaction results in exempt income within the meaning of § 705(a)(1)(B), or a nondeductible, noncapital expenditure within the meaning of § 705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income.” The ruling explains that the partners' bases in their partnership interests should be reduced only by their respective shares of the permanent decrease in the partnership's asset basis. This preserves the deduction for the fair market value of appreciated property without the recognition of the appreciation. Reducing the partners' bases in their partnership interests by the fair market value of the property contributed to the charity would subsequently cause the partners to recognize gain (or a reduced loss) upon a disposition of their interests in the partnership attributable to the unrecognized appreciation in the property at the time of the contribution. See also Rev. Rul. 96-10, 1996-1 C.B. 138, which discusses adjustments to basis in partnership interests where loss on sale of partnership property is denied under § 707(b)(1) and subsequent gain is not recognized under §§ 267(d) and 707(b)(1).

Section 743(a) provides that the basis of partnership property shall not be adjusted as the result of the transfer of a partnership interest by sale or exchange or on the death of a partner unless an election under § 754 is in effect with respect to the partnership.

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 respect to which an election under § 754 is in effect shall (i) increase the basis of the partnership property by the excess of the basis to the transferee partner of the transferee partner's interest in the partnership over the transferee partner's proportionate share of the adjusted basis of the partnership property, or (ii) 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 the transferee partner's interest in the partnership.

The partnership rules generally attempt to preserve equality between a partner's basis in the partnership interest and the partner's share of inside basis in the assets of the partnership. In order to promote administrative convenience, however, § 743(a) departs from this general rule, allowing a partner's basis in its partnership interest to diverge from the partner's share of basis in partnership assets in situations where the partnership has not made an election under § 754.

The failure to make a § 754 election generally will result in a timing benefit or detriment to the partner or partners with divergent inside and outside bases. For instance, consider the situation where a person (A) purchases a 50 percent interest in a partnership for \$100x. The partnership owns one asset with a basis of \$100x and a value of \$200x. If the partnership had made a § 754 election, A would have a \$50x special basis adjustment in the property, so that when the partnership disposed of the property for \$200x, A's special basis adjustment would exactly offset A's allocated share of the gain. A's basis in the partnership interest would remain at \$100x after the sale. Accordingly, A would not recognize any gain upon the sale of the partnership interest immediately thereafter.

If the partnership had not made a § 754 election, A would have no special basis adjustment, so that when the partnership disposed of the property for \$200x, A would be allocated \$50x of gain. A's basis in the partnership interest would increase to \$150x under § 705(a)(1)(A), so that A would recognize an offsetting \$50x loss (or reduced gain) upon a subsequent sale of the partnership interest. Thus, without the § 754 election, there may be a timing detriment to A, but the correct amount of cumulative income or loss (albeit possibly of a different character) is ultimately reported by A.

The correct amount of cumulative income may not be reported, however, in certain situations in which A is not subject to tax on the gain that results from the failure to make the § 754 election. For instance, in the example discussed immediately above, if A was a corporation and the property held by the partnership was A stock, under § 1032, the gain allocated to

A (assuming that no § 754 election had been made) would not be subject to tax. See Rev. Rul. 99-57, published in this issue of the Internal Revenue Bulletin. In this situation, it would be inconsistent with the intent of § 705 to increase the basis of A's partnership interest for the non-recognized gain. To do so would create a recognizable loss in a situation where no offsetting gain had previously been recognized.

DESCRIPTION OF REGULATIONS

The regulations will apply specifically to situations where a corporation acquires an interest in a partnership that holds stock in that corporation, and a § 754 election is not in effect with respect to the partnership for the taxable year of the acquisition. In those situations, a corporate partner may increase its basis in its partnership interest under § 705 only by the amount of its share of § 1032 gain that the partner would have realized had a § 754 election been made. Rules regarding tiered-entity structures also will apply.

It is intended that the regulations also will apply to other situations where the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to income tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made an election under § 754. Comments are requested as to the appropriate scope of the regulations in this regard.

EFFECTIVE DATES

In situations where a corporate partner is allocated gain that is subject to § 1032, and the basis of the stock was not adjusted upon the purchase of the partnership interest by the corporate partner under § 743(b), the regulations shall apply to gain or loss allocated with respect to sales of partner stock occurring after December 6, 1999. In other situations, the regulations

will apply to gain or loss realized or income or deductions taken into account after the date of publication of proposed regulations. Moreover, the Service may challenge any transaction within the scope of this Notice under the anti-abuse provisions of § 1.701-2 of the Income Tax Regulations, as appropriate.

The principal author of this notice is Robert Honigman of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this notice contact Robert Honigman at (202) 622-3050 (not a toll-free call).
