

property with a value and adjusted basis equal to \$100x in exchange for a 50 percent partnership interest. Under the partnership agreement, A and B each will be allocated a 50 percent share of all partnership items. One year later, after the value of the stock has increased to \$120x, AB purchases property valued at \$60x from C in exchange for 50 shares of A stock and transfers 50 shares of A stock to D in exchange for services valued at \$60x.

LAW

Section 701 states that the partners in a partnership, and not the partnership, are liable for the income tax imposed by Chapter 1.

Sections 702(a)(1) and 702(a)(2) provide that in determining the partners' income tax, each partner shall take into account separately the partner's distributive share of partnership gains or losses from sales or exchanges of capital assets.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to a partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (the built-in gain or loss).

Section 1.704-3(a)(3) of the Income Tax Regulations defines § 704(c) property as property contributed to a partnership if, at the time of contribution, its book value differs from the contributing partner's adjusted tax basis. Book value is equal to the fair market value of the property at the time of contribution.

Section 705(a)(1) provides that the adjusted basis of a partner's interest in a partnership shall be increased by the sum

of the partner's distributive share for the taxable year and prior taxable years of: (A) taxable income of the partnership as determined under § 703(a), (B) income of the partnership exempt from income tax, and (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 721(a) provides a general non-recognition rule for a partner's contributions of property to a partnership in exchange for a partnership interest. The rule is subject to a limited exception in § 721(b).

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at the time.

Section 723 states that the basis of property contributed to a partnership is the adjusted basis of the property to the partner at the time of contribution increased by the amount (if any) of gain recognized by the contributing partner under § 721(b).

Section 1001 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in § 1011. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of property (other than money) received.

Section 1011 provides that the adjusted basis for determining gain or loss from the sale or other disposition of property by a partnership, whenever acquired, shall be the basis determined under § 1012 and other applicable sections of subchapters O and K.

Section 1032(a) states that a corporation does not recognize gain or loss on the receipt of money or other property in exchange for the corporation's stock. Prior to the enactment of § 1032, a corporation potentially could recognize gain or loss by purchasing and reselling its own shares, even though it would not have recognized gain or loss on the disposition of newly issued shares. This disparity, which gave rise to tax avoidance opportu-

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ISSUE

What are the tax consequences to a partnership and a corporate partner where the corporate partner contributes its own stock to the partnership, and the partnership later exchanges the stock with a third party in a taxable transaction?

FACTS

A, a corporation taxed under subchapter C of the Internal Revenue Code, and B, an individual, form AB partnership for bona fide business purposes. A contributes 100 shares of its own stock, valued at \$100x, with a basis of zero, to AB in exchange for a 50 percent partnership interest. B contributes a parcel of real

nities through selective loss recognition, was eliminated by Congress with the enactment of § 1032. H.R. Rep. No. 1337, 83d Cong., 2d Sess. A268 (1954).

Section 1.1032-1(a) provides that a transfer by a corporation of shares of its own stock as compensation for services is considered, for purposes of § 1032(a), as a disposition by the corporation of the shares for money or other property.

Rev. Rul. 74-503, 1974-2 C.B. 117, considers the tax consequences of a parent corporation's transfer to its subsidiary of its own treasury stock in a transaction to which § 351 applies. The ruling holds that, under certain circumstances, the basis of the parent corporation's treasury stock in the hands of the parent corporation is zero. Accordingly, under the transferred basis rule of § 362(a), the subsidiary corporation's basis of the treasury stock of the parent corporation is also zero.

Partnership taxation is a mixture of provisions that treat the partnership as an aggregate of its members or as a separate entity. Under the aggregate approach, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under the entity approach, the partnership is treated as a separate entity in which partners have no direct interest in partnership assets and operations. In enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if the concepts are more appropriate in applying other provisions of the Code. S.Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954) and H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954); *See also* Treas. Reg. § 1.701-2(e) (1994).

ANALYSIS

When *A* contributes its own stock to *AB*, no gain or loss is recognized to *A* or *AB* under § 721(a). *AB*'s basis in the stock is zero under § 723, and *A*'s basis in its partnership interest in *AB* is zero under § 722. *Cf.* Rev. Rul. 74-503, 1974-2 C.B. 117. When *AB* subsequently purchases property from *C* in exchange for *A* stock and pays *A* stock to *D* in exchange for services, there is a realization of gain by *AB* measured by the difference between the basis of the stock and the value of the property and services received. *AB*

realizes \$120x of gain (\$60x on the exchange of stock for property and \$60x on the payment of stock for services). *AB* allocates \$100x of gain to *A* under § 704(c), and allocates the remaining \$20x pursuant to the partnership agreement, \$10x each to *A* and *B*.

If *A*'s share of the gain from the use of its stock in these transactions was not subject to § 1032, *A* would recognize \$110x of gain. Section 1032 is intended to prevent a corporation from recognizing gain or loss when dealing in its own stock. Under § 704(b) and 704(c), a corporate partner contributing its own stock generally will be allocated an amount of gain attributable to its stock that corresponds to its economic interest in the stock held by the partnership. Accordingly, use of the aggregate theory of partnerships is appropriate in determining the application of § 1032 with respect to gain allocated to a corporate partner. Under § 1032, *A*'s share of the gain resulting from *AB*'s exchange of *A* stock will not be subject to tax. In addition, *A* increases its basis in its partnership interest in *AB* under § 705 by \$110x, the amount equal to *A*'s share of the gain resulting from *AB*'s exchange of *A* stock, thereby preserving the nonrecognition result of the transaction in accordance with the policy underlying § 1032.

Furthermore, in keeping with the nonrecognition policy underlying § 1032, an analysis similar to that described above would apply to a transaction in which a corporate partner is allocated a loss from a transaction involving the disposition of stock of the corporate partner held by the partnership.

HOLDING

If a corporate partner contributes its own stock to a partnership in exchange for a partnership interest, and the partnership later exchanges the stock in a taxable transaction, then the partnership will realize gain that will be allocated to the partners under § 704. Under § 1032, however, the corporate partner will not recognize the gain allocated to it with respect to the sale or exchange of the stock. Furthermore, under § 705, the corporate partner increases its basis in its partnership interest by an amount equal to its share of the gain resulting from the partnership's sale or exchange

of the stock.

DRAFTING INFORMATION

The principal author of this revenue ruling is Robert Honigman of the Office of the 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 revenue ruling contact Robert Honigman at (202) 622-3050 (not a toll-free call).