

Section 704(c) Layers relating to Partnership Mergers, Divisions and Tiered Partnerships

Notice 2009-70

Section 1. PURPOSE

The Internal Revenue Service invites public comments on the proper application of the rules relating to the creation and maintenance of multiple layers of forward and reverse section 704(c) gain and loss to partnerships and tiered partnerships, including in the context of partnership mergers and divisions.

Section 2. BACKGROUND

As discussed in greater detail below, the IRS and Treasury Department issued proposed regulations in 2007 addressing the consequences under sections 704(c)(1)(B) and 737 of certain partnership mergers. The IRS and the Treasury Department received a number of comments in response to these proposed regulations expressing concern about the proposed treatment of section 704(c) layers in connection with a partnership merger. In addition, the IRS and the Treasury Department have become aware that practitioners are taking positions based upon different interpretations of the current tiered partnership rules (Treas. Reg. §1.704-3(a)(9)). A number of practitioners suggest that the tiered partnerships rules may need to be clarified and similar rules be provided with respect to partnership mergers. The IRS and Treasury believe that

further study of certain aspects of the application of section 704(c) is necessary before finalizing the Proposed Merger Regulations.

Section 704(c), in relevant part, provides:

(c) CONTRIBUTED PROPERTY.—

(1) IN GENERAL.—Under regulations prescribed by the Secretary—

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be 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,

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed –

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of distribution.

Section 704(c)(1)(A) was enacted as part of the Tax Reform Act of 1984 (P.L. 98-369). Congress determined that “special rules are needed to prevent an artificial shifting of tax consequences between the partners with respect to pre-contribution gain or loss. This is particularly important since the various partners may have different tax positions.” H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess., 1209 March 5, 1984. See also, Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of H.R. 4170, 212, Dec. 31, 1984.

Section 704(c)(1)(B) was enacted as part of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239). It was Congress’s view that the prior law made it “possible for partners to circumvent the rule requiring pre-contribution gain on contributed property to be allocated to the contributing partner.” S. Finance Comm. 101st Cong.,

Revenue Reconciliation Act of 1989, Explanation of Provisions Approved by the Committee on Oct. 3, 1989, 196 (Comm. Print 1989).

While section 704(c)(1)(B) addresses the recognition of gain by the contributing partner if property contributed by the partner is distributed to another partner, section 737 addresses the tax consequences when a partner who contributed built-in gain or loss property receives a distribution of other property.

Sections 737(a) and (b), in relevant part, provide:

(a) GENERAL RULE. In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of—

(1) the excess (if any) of

(A) the fair market value of property (other than money) received in the distribution over

(B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or

(2) the net precontribution gain of the partner.

Gain recognized under the preceding sentence shall be in addition to any gain recognized under section 731. The character of such gain shall be determined by reference to the proportionate character of the net precontribution gain.

(b) NET PRECONTRIBUTION GAIN. For purposes of this section, the term "net precontribution gain" means the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if all property which—

(1) had been contributed to the partnership by the distributee partner within 7 years of the distribution, and

(2) is held by such partnership immediately before the distribution, had been distributed by such partnership to another partner.

Sections 737(a) and (b) were enacted as part of the Energy Policy Act of 1992 (P.L. 102-486) as a result of Congress's concern that "a partner who contributes

appreciated property to a partnership may be able to avoid or defer the recognition of gain with respect to that property through the mechanism of having the partnership distribute other partnership property to him in partial or complete redemption of his interest while the partnership continues to own the contributed property.” H.R. Rep. 102-631, 102nd Cong., 2d. Sess., 68 (June 30, 1992). See also, S. Finance Comm. Technical Explanation, 138 Cong. Record S11246, S11265, Aug. 3, 1992 (Daily Ed.). Final regulations under sections 704(c)(1)(B) and 737 were issued in T.D. 8642, dated December 22, 1995. Amendments to these provisions were included in T.D. 8717, dated May 8, 1997, T.D. 9193, dated March 21, 2005 and T.D. 9207, dated May 23, 2005.

On August 22, 2007, the IRS and the Treasury Department published in the **Federal Register** (2007-41 I.R.B. 790 [72 FR 46932]) a notice of proposed rulemaking (REG-143397-05) (the Proposed Merger Regulations), consistent with Notice 2005-15 (2005-1 C.B. 527), providing that (1) section 704(c)(1)(B) applies to newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over merger, but does not apply to newly created reverse section 704(c) gain or loss resulting from a revaluation of property in the continuing partnership, and (2) for purposes of section 737(b), net precontribution gain includes newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over merger, but does not include newly created reverse section 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. On November 6, 2007, corrections to the proposed regulations were published in the **Federal Register** (72 FR 62608).

The proposed regulations include several examples. Example (3) of the proposed regulations (see Treas. Proposed Reg. §1.704-4(c)(4)(ii)(F), Example (3)) involves a situation where built-in gain property contributed to the transferor partnership has both a revaluation loss in the transferor partnership and additional gain upon merger with the transferee partnership. The example concludes that the section 704(c) layers are collapsed in the merger and that upon contribution to the transferee partnership the property had only built-in gain and no built-in loss.

Example 3 is as follows.

Example (3). Revaluation loss and merger gain. (i) Facts. On January 1, 2005, A contributes Asset 1, with a basis of \$200x and a fair market value of \$300x, to partnership PRS1 in exchange for a 50 percent interest. On the same date, B contributes \$300x of cash to PRS1 in exchange for a 50 percent interest. Also on January 1, 2005, C contributes Asset 2, with a basis of \$100x and a fair market value of \$200x, to partnership PRS2 in exchange for a 50 percent interest. On the same date, D contributes \$200x of cash to PRS2 in exchange for a 50 percent interest. PRS1 and PRS2 both have provisions in their respective partnership agreements requiring the revaluation of partnership property upon entry of a new partner. PRS2 would not be treated as an investment company (within the meaning of section 351) if it were incorporated. Neither partnership holds any unrealized receivables or inventory for purposes of section 751. In addition, neither partnership has a section 754 election in place. Asset 1 and Asset 2 are nondepreciable capital assets.

Later on in 2005, PRS2 admitted E as a new partner in PRS2 at a time when the fair market value of Asset 2 was \$150x and PRS2's only other asset was cash of \$200x. In exchange for a contribution of cash of \$175x, E was admitted as a one-third partner in PRS2. In accordance with the terms of PRS2's partnership agreement, the partnership revalued its assets upon admission of E so that the unrealized loss of \$50x attributable to Asset 2 was allocated equally between C and D, or \$25x each. On January 1, 2008, PRS 2 merges into PRS1. At the time of the merger, PRS1's only assets are Asset 1, with a fair market value of \$900x, and \$300x in cash. PRS2's only assets are Asset 2, with a fair market value of \$600x, and \$375x in cash. After the merger, the partners have book capital and profits and loss interests in PRS1 as follows: A, 27.5%; B, 27.5%; C, 15%; D, 15%; and E, 15%. On January 1, 2013, Asset 2 is distributed to A when its value is still \$600.

(ii) Analysis. On the date of the merger of PRS2 into PRS1, the fair market value of Asset 2 (\$600x) exceeded its adjusted tax basis (\$100x). Thus, when Asset 2 was contributed to PRS1 in the merger, it was section 704(c) gain property. The total amount of the section 704(c) gain was \$500x (\$600x (fair market value) – 100x (adjusted basis)). The amount of the original section 704(c) gain attributable to Asset 2 equals \$50x, the difference between its fair market value (\$200x) and adjusted tax basis (\$100x) upon contribution to PRS2 by C, less the unrealized loss (\$50x) attributable to the revaluation of PRS2 on the admission of E as a partner in PRS2. The amount of the new section 704(c) gain attributable to Asset 2 equals \$450x, the total section 704(c) gain (\$500x) less the amount of the original section 704(c) gain (\$50x). The distribution of Asset 2 to A occurs more than seven years after the contribution by C to PRS2. Therefore, pursuant to §1.704-4(c)(4)(ii)(A), section 704(c)(1)(B) does not apply to the original section 704(c) gain. The distribution of Asset 2 to A, however, occurs within seven years of the contribution of Asset 2 to PRS1 and PRS2. Pursuant to §1.704-4(c)(4)(ii)(B), section 704(c)(1)(B) applies to the new section 704(c) gain. As the transferees of PRS2's partnership interest in PRS1, C, D and E each succeed to \$150 of new section 704(c) gain. Thus, as a result of the distribution of Asset 2 to A within seven years of the merger, C, D and E are each required to recognize \$150 of gain.

A number of rules in existing regulations may be relevant to mergers, divisions and tiered partnerships. In particular Treas. Reg. §1.704-3(a)(7)-(9) may apply.

Treas. Reg. §1.704-3(a)(7) provides rules when a partner transfers his partnership interest and provides a “step in the shoes” approach:

(7) Transfer of a partnership interest.—If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner. This rule does not apply to any person who acquired a partnership interest from a §1.752-7 liability partner in a transaction in which paragraph (e)(1) of §1.752-7 applies. See §1.752-7(c)(1).

Treas. Reg. §1.704-3(a)(8) provides special rules for certain specific situations, including the disposition of section 704(c) property in a nonrecognition transaction.

Treas. Reg. §1.704-3(a)(8)(i) states, in relevant part:

(8) Special rules.—(i) Disposition in a nonrecognition transaction.—If a partnership disposes of section 704(c) property in a nonrecognition transaction, the substituted basis property (within the meaning of section 7701(a)(42)) is treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property.

Guidance on allocations with regard to the contribution of section 704(c) property in a tiered partnership structure is provided in Treas. Reg. §1.704-3(a)(9):

(9) Tiered partnerships.—If a partnership contributes section 704(c) property to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. Allocations made under this paragraph will be considered to be made in a manner that meets the requirements of §1.704-1(b)(2)(iv)(g) (relating to capital account adjustments where guidance is lacking).

Section 3. DISCUSSION

While no requests for a hearing were received in response to the proposed regulations issued on August 22, 2007, the IRS and the Treasury Department did

receive comments relating to the proposed regulations and took notice of a number of articles published in response to the proposed regulations.

Most of the comments and articles address *Example (3)* which provides that property either has a built-in gain or built-in loss upon merger, not both, and that original section 704(c) gain is reduced by subsequent revaluation losses. Several comments discussed not only the specifics of Example (3), but also the broader implications of the example. In particular, the commentators questioned whether the example implies that a subsequent revaluation loss would reduce prior section 704(c) gains rather than create a new section 704(c) loss layer where there has been no partnership merger. Another comment suggested that the section 704(c) allocations in the example could be different if, for example, the transferor partnership used the remedial method instead of the traditional method. Other commentators expressed concerns that the application of the proposed regulations would result in tax allocations after the merger that are not consistent with the economic arrangement of the partners of the transferor partnership. For example, if layers of reverse section 704(c) built-in gain or built-in loss are collapsed in the merger, then a partner who prior to the merger was allocated a net loss for book purposes with respect to the property would not recognize a corresponding tax loss until liquidation of its interest. They contend that if the transferor partnership had continued in existence instead of liquidating, the section 704(c) layers would have been preserved under the tiered partnership rules of Treas. Reg. §1.704-3(a)(9). Some practitioners believe the results should be the same in a merger.

The IRS and the Treasury Department have also become aware that there are conflicting views among practitioners about how section 704(c) layers should be

maintained with respect to tiered partnerships. One view is that an aggregate approach should apply or be permitted such that a tiered partnership arrangement can be “looked through” and section 704(c) applied as if the partners of the upper-tier partnership directly own a portion of the assets of the lower-tier partnership (the Aggregate Approach). Another view is the entity approach under which the upper-tier partnership is treated as owning an interest in the lower-tier partnership but is not treated as owning any interest in the section 704(c) property of the lower-tier partnership (the Entity Approach). Each approach raises different issues and has unique consequences.

After extensive consideration of the concerns raised, the IRS and the Treasury Department believe that comments would be helpful to the development of guidance concerning section 704(c) layers in tiered partnerships and in mergers and divisions. The IRS and Treasury Department believe that it is appropriate to consider the issues regarding section 704(c) layers in general before finalizing the Proposed Merger Regulations.

Section 4. REQUEST FOR COMMENTS

The IRS and Treasury Department are seeking comments relating to section 704(c) layers, as well as other section 704(c) issues, with respect to tiered partnerships, mergers and divisions. The IRS and the Treasury Department plan to address these issues as part of a future guidance project. However, the IRS and Treasury Department are not requesting comments on the principles described in Notice 2005-15, 2005-1 C.B. 527.

The IRS and Treasury Department include examples below of the types of comments requested, but comments are requested on all aspect of these issues, not only those matters listed.

Single Partnership with Layers – No Tiers

1. Should any changes be made to the events in Treas. Reg. § 1.704-1(b)(2)(iv)(f), the occurrence of which allow for a revaluation of assets? Should additional events be added?
2. After revaluing property, when, if at all, is it appropriate for taxpayers to net additional differences between value and basis against existing section 704(c) layers and when is it appropriate to create new section 704(c) layers if the layers offset one another (e.g., loss and gain layers)?
3. If a partnership has multiple section 704(c) layers, how should tax depreciation, depletion, amortization and gain or loss be allocated between the layers? When is it appropriate for partnerships to allocate these items to the latest layers first, to earlier layers first or to allocate these items pro rata to all layers for this purpose? Are other methods appropriate? How are these amounts allocated between layers if there are offsetting layers (e.g., how should depreciation be allocated between layers if a property has both a \$100 gain layer and a subsequent \$100 loss layer)?
4. What other section 704(c) issues are raised relating to section 704(c) layers, e.g., when partnership property is revalued?

Tiers of Partnerships with Layers

5. Are changes necessary to Treas. Reg. § 1.704-3(a)(7) and (8) to address compliance with section 704(c) and maintenance of section 704(c) layers when property

is either contributed to a partnership or transferred to a partner in a tiered partnership structure?

6. Are there different considerations in making property revaluation decisions in tiered partnership structures than in a single partnership (*e.g.*, should a revaluation of an upper-tier partnership constitute a revaluation event at the lower-tier partnership and should revaluation be dependent upon whether the upper-tier partnership has a significant interest in the lower-tier partnership)? Does the order in which tiered partnerships make property revaluations affect resulting section 704(c) layers and does existing guidance permit taxpayers to make revaluations in the appropriate order as necessary?

7. What issues relating to section 704(c) must taxpayers address in tiered partnership structures? What additional issues should be addressed by the regulations, including Treas. Reg. §1.704-3(a)(9)?

8. When should Treas. Reg. §1.704-3(a)(9) permit taxpayers to use an Aggregate Approach or Entity Approach? What should be the results under these approaches? Should taxpayers be able to use other methods to track section 704(c) layers?

9. Under the Aggregate Approach, how would the section 704(c) layers be maintained by the lower-tier partnership?

10. Is the information necessary to maintain section 704(c) layers under the Aggregate Approach readily available? If the Aggregate Approach is permitted what, if any, additional rules would be necessary so that the partnerships may secure the required information?

11. Under the Entity Approach, if after allocating the upper-tier partnership's distributive share of lower-tier partnership section 704(c) allocations on the sale of an asset at the lower-tier level there are remaining book tax differences in the upper tier partnership, how, if at all, should these differences be resolved at the upper tier level?

Mergers

12. Recognizing that the transferor partnership terminates in a merger, what different issues do mergers raise for the section 704(c) layer rules ?

13. Whether the Aggregate or Entity Approach is used in tiered partnerships, how will the approach be affected by a merger of one of the partnerships in a tiered arrangement, including a partnership that directly holds section 704(c) property and a partnership with an indirect interest in the property?

14. Under the Aggregate Approach, how would the transferee partnership maintain the section 704(c) layers of the transferor partnership?

15. Under the Entity Approach, when should the transferee partnership maintain the layers of the transferor partnership, or should each asset have a single section 704(c) layer as a result of the merger?

16. Are there different considerations if the transferor has partnerships as partners or if the transferee partnership is a partner in another partnership?

Divisions

17. What issues regarding section 704(c) layers are raised in a division of a "traditional" single tier partnership and in the division of a partnership that is part of a tiered partnership structure?

18. Assuming a partnership division should not create new section 704(c) property (or section 737 net precontribution gain) when each partner's overall interest in each partnership property does not change, how should section 704(c) layers be created and maintained when a division is not *pro rata* or other changes in partners or property interests occur at the time of the division?

International Issues

19. What international tax issues are raised on the application of section 704(c) layers to tiered partnerships, mergers and divisions? For example, how should section 704(c) layers be created and maintained in cross-border tiered partnerships and mergers and divisions? Should similar "layers" be created and maintained to track and preserve the character of the gain under international tax provisions, including sections 367, 897, and 1248?

Comments may be submitted on or before **February 22, 2010** to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2009-70), Room 5203. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:PR (Notice 2009-70), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.comments@irscounsel.treas.gov. Include the notice number (Notice 2009-70) in the subject line.

Section 5. DRAFTING INFORMATION

The principal author of this notice is Laura Fields of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this

notice, contact Ms. Fields at (202) 622-3050 (not a toll-free call).