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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-167648-01]

RIN 1545-BA50

Amendments to Rules for Determination of Basis of Partner's Interest; Special Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to special rules on determination of basis of a partner's interest under section 705. The proposed regulations are necessary to coordinate sections 705 and 1032.

DATES: Written or electronic comments and requests for a public hearing must be received by June 27, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-167648-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-167648-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Barbara MacMillan or Rebekah A. Myers, (202) 622-3050; concerning submissions of comments or requests for a hearing, LaNita VanDyke at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-106702-00, 2001-4 I.R.B. 424) under section 705 of the Internal Revenue Code (Code) in the **Federal Register** (66 FR 315). Those proposed regulations provided guidance on the coordination of sections 705 and 1032 in situations where a corporation acquires an interest in a partnership that holds stock in that corporation, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. Final regulations for the issues addressed in those proposed regulations are being published elsewhere in this issue of the **Federal Register**. These proposed regulations propose to revise the final regulations contained in §1.705-2 of 26 CFR part 1 to address remaining issues that Treasury and the IRS considered during the development of the final regulations.

Explanation of Provisions

These proposed regulations provide guidance in situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges

the stock. For reasons similar to those explained in the preamble of the final regulations, in those situations it may be inconsistent with the intent of sections 705 and 1032 to increase the basis of the corporation's partnership interest by the full amount of any gain resulting from the partnership's sale or exchange of the stock which is not recognized by the corporation under section 1032.

Accordingly, the proposed regulations revise the purpose statement of §1.705-2(a) to take into account situations involving such partnership distributions. The proposed regulations provide a specific rule implementing the revised purpose in single partnership cases. The proposed regulations also revise §1.705-2(c) to clarify that the tiered partnerships rule applies to situations involving such partnership distributions.

In addition, the proposed regulations clarify that references in the regulations to stock of a corporate partner include any position in stock of a corporate partner to which section 1032 applies.

Proposed Effective Date

The regulations are proposed to apply to sales or exchanges of stock occurring after March 29, 2002.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not

required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Barbara MacMillan of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from

other offices of the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.705-1 is amended by revising paragraph (a)(7) to read as follows:

§1.705-1 Determination of basis of partner's interest.

(a) * * *

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock or any position in stock to which section 1032 applies of a corporation that holds a direct or indirect interest in the partnership, see §1.705-2.

* * * * *

Par. 3. Section 1.705-2 is amended as follows:

1. Paragraph (a) is amended by adding a new sentence after the third sentence.

2. Paragraph (b) is amended by adding paragraph (b)(2).

3. Paragraph (c)(1) is amended by adding a new sentence after the second sentence.

4. Paragraph (d) is added.

5. Paragraph (e) is amended by removing the period at the end of the paragraph and adding a new phrase at the end of the paragraph.

The additions and revision read as follows:

§1.705-2 Basis adjustments coordinating sections 705 and 1032.

(a) * * * Similarly, in situations where a section 754 election was not in effect for the year in which a partnership distributes money or other property to another partner and that partner recognizes gain on the distribution, the remaining partners' inside basis and outside basis may not be equal. * * *

* * * * *

(b) * * *

(2) Required adjustments relating to distributions. (i) This paragraph (b)(2) applies in situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the

partnership subsequently sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the partnership made the distribution, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(2) are illustrated by the following example:

Example. (i) A, B, and corporation C form partnership PRS. A and B each contribute \$10,000 and C contributes \$20,000 in exchange for a partnership interest. PRS has no liabilities. PRS purchases stock in corporation C for \$10,000, which appreciates in value to \$70,000. PRS distributes \$25,000 to A in complete liquidation of A's interest in PRS in a year for which an election under section 754 is not in effect. PRS later sells the C stock for \$70,000. PRS realizes a gain of \$60,000 on the sale of the C stock. C's share of the gain is \$40,000. Under section 1032, C does not recognize its share of the gain.

(ii) Normally, C would be entitled to a \$40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the C stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which PRS made the distribution to A, PRS would have been entitled to adjust the basis of partnership property under section 734(b)(1)(A) by \$15,000 (the amount of gain recognized by A with respect to the distribution to A under section 731(a)(1)). See §1.734-1(b). Under §1.755-1(c)(1)(ii), the basis adjustment under section 734(b) would have been allocated to the C stock, increasing its basis to \$25,000. (where there is a distribution resulting in an adjustment under section 734(b)(1)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.)

(iii) If a section 754 election had been in effect for the year in which PRS made the distribution to A, the amount of gain that PRS would have recognized upon PRS's disposition of C stock would be \$45,000 (\$70,000 minus \$25,000 basis in the C stock), and the amount of gain C would have recognized upon PRS's disposition of the C stock (absent the application of section

1032) would be \$30,000 (C's share of PRS's gain of \$45,000 from the stock sale). Accordingly, upon PRS's sale of the C stock, the increase in the basis of C's interest in PRS is \$30,000.

* * * * *

(c)(1) * * * Similarly, if a corporation owns an indirect interest in its own stock through a chain of two or more partnerships, and a partnership in the chain distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, then upon any subsequent sale or exchange of the stock, the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

* * * * *

(d) Positions in Stock. For purposes of this section, stock includes any position in stock to which section 1032 applies.

(e) * * * , except that the fourth sentence of paragraph (a), paragraph (b)(2), and the third sentence of paragraph (c)(1) of this section are applicable with respect to sales or exchanges of stock occurring

on or after March 29, 2002.

Deputy Commissioner of Internal Revenue.

Robert E. Wenzel