IRC 751 "Hot Asset" Treatment: New Rules for Calculating Ordinary Income Recharacterization

New IRS Proposal on Determining Partners' Share of Section 751 Ownership

TUESDAY, OCTOBER 17, 2017

1pm Eastern    |    12pm Central   |   11am Mountain    |    10am Pacific

Today’s faculty features:

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Morgan L. Klinzing, Pepper Hamilton, Philadelphia

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IRC 751 “Hot Asset” Treatment

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Section 751
- 751(a) ordinary income re-characterization provisions
- 751(b) listed assets
  - Substantially appreciated inventory
Current rules for 751 calculations
Proposed regulations’ approach
Section 751(a)
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?
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.
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.
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 and distributions by the partnership.
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.
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.
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.
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.
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.
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 $50) to Xavier for $100 cash.

On the date of the sale, partnership has assets as below.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
<th>Gain/Loss</th>
<th>A’s Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$100</td>
<td>$120</td>
<td>$20</td>
<td>$10</td>
</tr>
<tr>
<td>Capital Asset</td>
<td>$50</td>
<td>$130</td>
<td>$100</td>
<td>$40</td>
</tr>
</tbody>
</table>
751(a) Example 1

- Step 1: A’s overall gain.
  - $100-$50 = $50
- Step 2: G/L from 751(a) property.
  - $10
- Step 3: Difference between total gain and 751(a) gain.
  - $50-$10 = $40

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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.

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<tbody>
<tr>
<td>Inventory</td>
<td>$100</td>
<td>$60</td>
<td>($40)</td>
<td>($20)</td>
</tr>
<tr>
<td>Capital Asset</td>
<td>$50</td>
<td>$190</td>
<td>$140</td>
<td>$70</td>
</tr>
</tbody>
</table>
751(a) Example 2

- **Step 1:** A’s overall gain.
  - $100-$50 = $50

- **Step 2:** G/L from 751(a) property.
  - ($20)

- **Step 3:** Difference between total gain and 751(a) gain.
  - $50-($20) = $70

<table>
<thead>
<tr>
<th>Asset</th>
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<td>Capital Asset</td>
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</table>
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.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
<th>Gain/Loss</th>
<th>A’s Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Receivable</td>
<td>$0</td>
<td>$50</td>
<td>$50</td>
<td>$20 704(c)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$15 751(a)</td>
</tr>
<tr>
<td>Capital Asset</td>
<td>$100</td>
<td>$150</td>
<td>$50</td>
<td>$25</td>
</tr>
</tbody>
</table>
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

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<tr>
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<th>A’s Share</th>
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<td>$50</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$15 751(a)</td>
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<tr>
<td>Capital Asset</td>
<td>$100</td>
<td>$150</td>
<td>$50</td>
<td>$25</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
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<th>Capital</th>
<th>Tax/Book</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized Receivable</td>
<td>B: $0</td>
<td>$50</td>
<td>B</td>
<td>$50</td>
<td>$100</td>
</tr>
<tr>
<td></td>
<td>X: $0 + $25</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Asset</td>
<td>B: $50</td>
<td>$150</td>
<td>X</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td></td>
<td>X: $50 +$25</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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).
(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.
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)
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”).
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.
The New York State Bar Association said regarding the Current Regulations (NYSBA Comments on Proposed Hot Asset Regulations, Sept. 9, 2015):

- First, the seven-step process is so complicated that applying it to a distribution from even a small partnership requires a substantial amount of time and effort and the assistance of experts in partnership tax generally and section 751(b) in particular.

- Second, the Existing Regulations generally focus 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. As a result, a distribution may give rise to a taxable exchange under the Existing 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.
Third, nothing in the Existing Regulations (or otherwise) provides meaningful guidance on how to determine a partner’s share of the gross value of a partnership asset. While this might be straightforward in a simple partnership with no liabilities, no assets subject to section 704(c) (or reverse section 704(c)), and no special allocations, there can be considerable uncertainty and further complexity in nearly all other cases, including standard commercial partnership arrangements.

Fourth, although there typically is not a readily ascertainable fair market value for most partnership assets, the application of section 751(b) requires knowledge of the fair market value of each partnership asset. As a result, in applying section 751(b), many partnerships seek a third-party valuation, while other partnerships undertake their own valuation. The factual and uncertain nature of these valuations creates additional uncertainty for taxpayers in applying section 751(b), as the section 751(b) analysis can be quite sensitive to modest changes in asset valuations.
Fifth, it is not clear whether the deemed distribution of the relinquished assets under the Existing Regulations 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.
Issue Section 751(b) is addressing:

- preferential treatment given to capital gains for individuals
  - Right now, very significant preference for capital gains
    - 39.6% (or 43.4%) vs. 23.8%
  - Thus, right now, 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 meant to prevent partners from recharacterizing ordinary income as capital gains in certain circumstances
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

### 751(b)– Example

<table>
<thead>
<tr>
<th>Assets</th>
<th>Book/Basis</th>
<th>FMV</th>
<th>Capital</th>
<th>Tax/Book</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$240</td>
<td>$300</td>
<td>X</td>
<td>$100</td>
<td>$150</td>
</tr>
<tr>
<td>Unrealized Receivable</td>
<td>$60</td>
<td>$150</td>
<td>Y</td>
<td>$100</td>
<td>$150</td>
</tr>
<tr>
<td>Totals</td>
<td>$300</td>
<td>$450</td>
<td>Z</td>
<td>$100</td>
<td>$150</td>
</tr>
</tbody>
</table>
Now, 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.

So, assume that Section 751(b) doesn’t exist in the Code.
- 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.
751(b) Example

- 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
Current 751(b) Regulations
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.
The current regulations apply a “gross value” approach.
Each partner’s share of the partnership’s hot and cold assets is determined by reference to the gross value of the assets.
Gross Value Approach

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

1. Construct a partnership exchange table.
2. Analyze the hypothetical distribution.
3. Analyze the 751(b) exchange.
4. Analyze the non-751(b) distribution.
X, Y and Z own equal interests in XYZ which has a balance sheet as follows:

<table>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Z</td>
<td>$100</td>
<td>$150</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$300</strong></td>
<td><strong>$450</strong></td>
<td><strong>$300</strong></td>
<td><strong>$450</strong></td>
<td></td>
</tr>
</tbody>
</table>

XYZ distributes the capital asset to Z in complete liquidation of her 1/3 interest.
### Gross Value Approach – Example

1. Construct partnership exchange table.

<table>
<thead>
<tr>
<th></th>
<th>Z’s post-distribution interest</th>
<th>(+) Property distributed</th>
<th>(-) Z’s pre-distribution share</th>
<th>= Change in interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hot Assets</td>
<td>$0</td>
<td>$0</td>
<td>$100</td>
<td>($100)</td>
</tr>
<tr>
<td>Cold Assets</td>
<td>$0</td>
<td>$150</td>
<td>($50)</td>
<td>$100</td>
</tr>
</tbody>
</table>
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.

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<td>$150</td>
<td>($50)</td>
<td>$100</td>
</tr>
</tbody>
</table>
2. Analyze the hypothetical distribution of $100 of inventory.
   - Z: no G/L.
     • Takes a transferred basis of $80 in the inventory.
     • Outside basis reduced from $100 to $20.
   - XYZ: no G/L.
     • Basis in remaining $200 of inventory is $160.
3. Analyze the 751(b) exchange.

- **Z**: Treated as transferring the hypothetical distribution of inventory to XYZ in exchange for $100 of the capital asset.
  - Ordinary gain of $20 and cost basis of $100 in this portion of the capital asset.

- **XYZ**: Received $100 of inventory in exchange for capital asset with basis of $40.
  - $60 capital gain, shared by X and Y.
  - Basis in inventory acquired in exchange is cost basis of $100.
4. Analyze the non-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).
  - Ordinary gain of $20 and cost basis of $100 in this portion of the capital asset.
- XYZ: no G/L.
Summary:
- Z: $20 of ordinary income and basis of $120 in the capital asset.
- XYZ: $60 of capital gains allocated to X and Y.
  - Holds inventory with a basis of $260.
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.
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 fair market of the capital accounts.
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)
Proposed 751(b) Regulations
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?
The Proposed Regulations

- provide a method for measuring partners’ interests in Section 751 property
- include rules under Section 704(c) to enable partnerships to calculate partner gain in Section 751 property more precisely, and
- explain how basis adjustments under Sections 743(b) and 754(b) affect the computation of partners’ interests in Section 751 property
The Proposed Regulations utilize a hypothetical sale approach that accounts for Section 704(c). Under the Proposed Regulations, partners have to recognize Section 751(b) amount as ordinary income and make appropriate adjustments to basis; however, no specific method is identified. Have to use a reasonable method which is consistent with the purpose of Section 751(b). The examples utilize a deemed gain approach and hot asset sale approach. Have to use approach adopted until the use of that approach becomes unreasonable; have to reevaluate for each distribution.
The Proposed Regulations utilize the hypothetical sale approach to determine a partner’s interest in partnership property instead of the gross value approach.
Thus, 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
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).

When a partner’s interest in hot assets is reduced, Section 751(b) applies.
After applying the hypothetical sale approach, the Proposed Regulations direct partnerships to use any “reasonable method” to account for the reduction in hot assets.

Based on the Proposed Regulations, reasonable methods include:

- **Hot Asset Approach**: Partner with reduction in interest in hot assets deemed to get distribution of hot assets in reduction amount and sell the hot assets to 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.
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 examples, for Section 732 adjustments
    - Any basis increase allocated to distributed CG 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).
Current Regulations– Example 1

- X, Y and Z contribute $120 to XYZ for an interest in XYZ. Each has a one-third interest.
- XYZ purchases land for $100 in Year 1.
  - Balance Sheet in Year 3
  - XYZ distributes $50 cash (cold asset) to Z in current distribution

<table>
<thead>
<tr>
<th>Assets</th>
<th>Tax</th>
<th>Book</th>
<th>Capital</th>
<th>Tax</th>
<th>Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$260</td>
<td>$260</td>
<td>X</td>
<td>$120</td>
<td>$150</td>
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<tr>
<td>Unrealized Receivable</td>
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<td>Y</td>
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<td>$450</td>
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Distribution to Z reduces Z’s interest to one-quarter

- Exchange Table

<table>
<thead>
<tr>
<th>Assets</th>
<th>Z’s post-distribution share</th>
<th>(+) property distributed</th>
<th>(-) Z’s pre-distribution share</th>
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<tr>
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<td>$25.00</td>
<td>$0</td>
<td>$33.34</td>
<td>($8.34)</td>
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</table>
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.
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

<table>
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<tr>
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<td>$360</td>
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<td></td>
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<td>$450</td>
</tr>
</tbody>
</table>
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.
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

<table>
<thead>
<tr>
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<td>$100</td>
<td>Z</td>
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<td>Totals</td>
<td>$360</td>
<td>$450</td>
<td></td>
<td>$360</td>
<td>$450</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Tax</th>
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<th>Tax</th>
<th>Book</th>
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</thead>
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<tr>
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<td>$300</td>
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</table>
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

<table>
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<tr>
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</table>
Now, normal distribution rules apply. Z recognizes no gain on distribution. No basis adjustment under Section 734(b)

- Balance Sheet after distribution

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<td>$240</td>
<td>$300</td>
<td></td>
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<td>$300</td>
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</tbody>
</table>
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.
Grecian Magnesite Mining and 751
Rev. Rul. 91-32: non-US investor selling an interest in a partnership is treated as realizing income that is ECI to the extent gain on the sale is attributable to a US trade or business of the partnership operated through a fixed place of business.
- Rather than non-US source gain, non-US investor has ECI.

Grecian: US Tax Court held that a non-US investor’s gain on the complete redemption of its partnership interest was not ECI, even though the partnership was engaged in a US trade or business.
Rationale:
- IRS applies a pure “entity” approach to the taxation of gain from the sale of a partnership interest.
- No exception to the entity approach was present on the facts.
  - Court noted that FIRPTA is an exception to the entity approach.
  - In dicta, the Court also noted that 751 is an “aggregate” rule.
Many practitioners do not agree with Court’s determination that 751 is an “aggregate” approach.

- 751 does not treat a taxpayer as if he was selling his share of partnership assets.
- It merely acts to re-characterize a portion of the gain as ordinary income.
- 751 affects character of the income, not the source of the income.
Questions & Answers
Capabilities

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INTELLECTUAL PROPERTY
GOVERNMENT REGULATION
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