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September 9, 2015

The Honorable Mark Mazur
Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, D.C. 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Re: **Report #1329 on the Proposed Regulations under Section 751(b)**

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report provides comments on regulations proposed on November 3, 2014 (the "Proposed Regulations"), concerning the treatment of partnership distributions under section 751(b).

Generally, under section 751(b), to the extent a partnership makes a distribution that alters a partner's interest in "unrealized receivables" and substantially appreciated "inventory items," the distribution is considered a sale or exchange between the distributee and the partnership in the manner prescribed by regulations.

The existing regulations under section 751(b) (the "Existing Regulations"), which are extremely complicated, were first issued in 1956 and remain substantially unchanged. Most significantly, they have not been revised to take into account

section 704(c), which became mandatory in 1984. In addition, the Existing Regulations can be both under-inclusive and over-inclusive in achieving the policy underlying section 751(b).

Notice 2006-14 announced that the Internal Revenue Service (the "Service") and the Department of the Treasury ("Treasury") were studying the Existing Regulations and considering alternative approaches to achieve the purpose of the statute while providing greater simplicity. On November 28, 2006, we submitted comments in Report No. 1122 (the "Prior Report").

We commend the Service and Treasury for their extraordinary efforts to revise the Existing Regulations and note that many of the key changes contained in the Proposed Regulations are consistent with the recommendations made in the Prior Report. The Proposed Regulations represent a significant improvement over the Existing Regulations in achieving the purpose of section 751(b). We note, however, that the Proposed Regulations are quite complex and, as a result, might not provide the "greater simplicity" for section 751(b) to which Notice 2006-14 aspired.

We recognize that the statutory language of section 751(b) may prevent any set of implementing regulations from being simple. We, therefore, believe it would be worthwhile for Congress and Treasury to reevaluate the purpose of section 751(b) and consider the extent to which the stakes involved are worth protecting. As discussed in this current report, we believe the stakes may be worth protecting only to a limited extent. Thus, many of our comments and recommendations emanate from the perspective that simplicity and administrability should take precedence over seeking to provide extensive optionality to taxpayers or attempting to achieve perfection in all possible circumstances.

As discussed in the report, our principal recommendations are as follows:

1. We recommend that the regulations create an exception from the mandatory revaluation rule for liquidating distributions that consist solely of money or other cold assets.

2. The regulations should expand the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10) to contain an explicit admonition against the selection of a section 704(c) method with a view toward avoiding the application of section 751(b) to a distribution while attempting to shift ordinary income among partners in a manner that reduces the present value of the partners' aggregate tax liability.

3. When an upper-tier partnership makes a distribution and is required to revalue its assets under Prop. Treas. Reg. § 1.751-1(b)(2)(iv):

    a. A lower-tier partnership should not be required to revalue its assets unless the same persons own, directly or indirectly, 80 percent or more, rather than more

than 50 percent (as under the Proposed Regulations), of the capital and profits interests in both partnerships. For purposes of determining ownership of the capital and profits interests of a partnership, the regulations should cross reference section 707(b)(3) in order to include ownership held by related parties.

b. When the lower-tier partnership does not revalue its assets, the upper-tier partnership should be permitted to adopt any reasonable method for allocating items from the lower-tier partnership in a manner that takes into account each partner's share of the pre-distribution items of the lower-tier partnership; the adoption of the method should explicitly be made subject to the anti-abuse rule in Treas. Reg. § 1.704-3(a)(10). The synthetic revaluation (described in the Proposed Regulations) would be one such method, but its use would not be required.

c. If there are multiple tiers of lower-tier partnerships, a revaluation should be required in a particular lower-tier partnership only if the ownership threshold is satisfied with respect to that lower-tier partnership and with respect to each intervening partnership between the distributing partnership and the lower-tier partnership.

4. Regarding the special rules for basis adjustments in Prop. Treas. Reg. § 1.732-1(c)(2)(iii)-(vii) and Prop. Treas. Reg. § 1.755-1(c)(2)(iii)-(vi), the regulations should not treat a basis adjustment allocated to a section 1231 asset under the second sentence of Treas. Reg. § 1.732-1(c)(2)(ii) or of Treas. Reg. § 1.755-1(c)(2)(i) as basis in a capital asset; instead, the regulations should treat such adjustment as basis in a section 1231 asset.

   a. If recommendation #4 is accepted, the election provided in Prop. Treas. Reg. § 1.755-1(c)(2)(vi) should be eliminated.

   b. If recommendation #4 is <u>not</u> accepted, the amount of the basis adjustment that is treated as basis in a capital asset should be limited to the lesser of: (i) the amount of the basis adjustment allocated to the asset under the second sentence of Treas. Reg. § 1.732-1(c)(2)(ii) or of Treas. Reg. § 1.755-1(c)(2)(i) and (ii) the amount of ordinary income potential in the asset.

5. A distributee-partner should be required to exchange such partner's reverse section 704(c) amounts in retained hot assets for reverse section 704(c) amounts in distributed hot assets, provided that the distributed hot assets and the retained hot assets produce the same "type" of built-in gain.

6. If the application of the "hypothetical sale" approach results in any partner having a "section 751(b) amount," the final regulations should require the application of the "deemed gain" approach for recognizing the section 751(b) amount.

7. Form 1065 should be amended to require partnerships to indicate whether (i) hot assets are distributed to any partner during the year or (ii) the partnership makes a disproportionate distribution of money or property during the year.

8. The rules for mandatory gain recognition in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(A) should be modified:

    a. to require a distributee-partner to recognize enough gain to avoid any section 734(b) adjustment that would reduce a partner's "net unrealized section 751 gain," and

    b. to provide that the character of the gain should be based on the character of the distributee-partner's relative share of the built-in gain in the partnership's assets.

9. The rules for elective gain recognition in Prop. Treas. Reg. § 1.751-1(b)(3)(ii)(B) should be eliminated.

10. The regulations should clarify that the previously contributed property exception under section 751(b)(2)(A) continues to apply with respect to contributed property notwithstanding subsequent adjustments that affect the amount of ordinary income potential in the asset, such as additional depreciation (in the case of depreciable property) and additional earnings and profits (in the case of stock in a controlled foreign corporation).

11. The final regulations should retain the general anti-abuse rule that allows a transaction to be recast to achieve results consistent with the purpose of section 751. The anti-abuse rule should not, however, create presumptions or disclosure obligations for certain transactions. Instead, transactions that are inconsistent with the purpose of section 751(b) should be illustrated in examples.

12. The Service and Treasury should allow for reasonable applications of the hypothetical sale approach for all prior distributions, not simply those that occur after the issuance of the Proposed Regulations.

13. We encourage Congress and Treasury to reevaluate the purposes of, and stakes involved with, section 751(b) and consider whether the statute should be amended to make section 751(b) operate far more narrowly as an anti-abuse rule

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

David R. Sicular
Chair

Enclosure

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