SMU Law Review

Volume 51 | Issue 1 Article 2

1998

Simplifying Subchapter K: The Deferred Sale Method

Laura E. Cunningham

Noel B. Cunningham

Articles

SIMPLIFYING SUBCHAPTER K: THE DEFERRED SALE METHOD

*Laura E. Cunningham**
*and Noël B. Cunningham***

I. INTRODUCTION

ON December 17, 1996, the Treasury Department issued final regulations expanding access to partnership status to business entities that would have been treated as corporations for tax purposes under prior law.[1] The appeal of a flow-through regime, without the restrictions of Subchapter S, will cause many—if not most—new unincorporated businesses to "check the box" in favor of partnership tax treatment. This new, expanded coverage provides an opportunity to critically examine Subchapter K to determine if there are ways in which it can be improved.[2] In this Article, we focus on one major problem area that we feel is ripe for reform: the treatment of contributions of property to partnerships.

The basic problem underlying the current treatment of contributions relates to the taxation of built-in gain (or loss) inherent in contributed property at the time of contribution. General tax principles indicate that such gain or loss should eventually be taxed to the contributor. However, under Subchapter K, this treatment does not always occur for two rea-

* Associate Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University.

** Professor of Law, New York University School of Law.

The author acknowledges the generous support of the Filomen D'Agostino Research Fund.

1. *See* Treas. Reg. §§ 301.7701-1 to -3 (1996).

2. The Joint Committee on Taxation undertook just such a review in the latter part of 1996 and issued a report of its study on April 8, 1997. *See* STAFF OF JOINT COMM. ON TAXATION, REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES (1997). While the Joint Committee considered minor proposals dealing with the taxation of pre-contribution gain, its proposals fell far short of the comprehensive reform advocated here. *See id.* at 42-43. In addition, the American Law Institute is also engaged in a study of private business enterprises, including Subchapter K. For a thoughtful set of proposed revisions to Subchapter K dealing with both contributions and distributions of property, see American Law Institute, *Federal Income Tax Project: Taxation of Private Business Enterprises* 29-79 (Memorandum No. 3, Sept. 10, 1997).

sons. First, although section 704(c)(1)(A)[3] generally requires the contributor to take into account any built-in gain or loss inherent in contributed property, in many cases the so-called "ceiling rule" prevents this result.[4] The ceiling rule limits the amount of an item (e.g., gain or loss) that can be allocated among the partners to the amount realized by the partnership entity. When it applies, the ceiling rule has the effect of shifting precontribution gain or loss to noncontributing partners.[5] Second, Subchapter K is deficient in that the existing statutory structure permits partners to essentially sell or exchange contributed property without recognition of gain or loss. Sections 721 and 731 generally permit property to be contributed to, and distributed from, partnerships without recognition of gain or loss.[6] By combining these two provisions, partners are able to sell or exchange property without the recognition of gain.

Congress and the Treasury are well aware that partnerships have been formed to take advantage of the opportunities for shifting and nonrecognition of gain provided by Subchapter K and have attempted to stem the most abusive transactions. Complex regulations under section 704(c)(1)(A), issued by the Treasury in 1993,[7] contain an anti-abuse rule designed to restrict the circumstances under which partners can take advantage of the ceiling rule to shift built-in gain. In an effort to narrow the circumstances in which Subchapter K could be used to achieve a sale or exchange without recognition, Congress enacted three separate statutory provisions (sections 704(c)(1)(B), 707(a)(2)(B), and 737), and the Treasury has promulgated three additional sets of regulations, containing two more anti-abuse rules,[8] aimed specifically at nonrecognition attempts. The resulting statutory and regulatory structure is extraordinarily complex, controversial, and in many cases ineffective in taxing built-in gain to the contributor. Sophisticated planners continue to structure transactions designed to avoid or shift built-in gain.

We believe that the piecemeal legislative and regulatory efforts to prevent abusive transactions have led to unnecessary complexity and uncertainty in the law of partnership tax. Particularly troubling is the proliferation of anti-abuse rules of indeterminate scope. We feel that the time has come for Congress to enact a rule that requires the property contributor to be responsible for the built-in gain or loss in all events. Not only would such a rule achieve more satisfactory tax results than present law, it would also significantly reduce the complexity and uncertainty of current law and make many of the statutes, regulations, and anti-abuse rules unnecessary. We accept the basic premise of section 721—that formation of a partnership should not result in immediate rec-

3. All statutory citations refer to the Internal Revenue Code of 1986, as amended.
4. The current embodiment of the ceiling rule appears in Treas. Reg. § 1.704-3(b)(1) (as amended in 1995).
5. *See infra* part II.
6. *See* I.R.C. §§ 721, 731 (1994).
7. *See* Treas. Reg. § 1.704-3 (as amended by T.D. 8585, 1995-1 C.B. 120).
8. *See* Treas. Reg. § 1.704-4(f) (1995); Treas. Reg. § 1.737-4 (1995).

ognition of gain or loss.[9] What we advocate here is the so-called "deferred sale method" of accounting for built-in gain or loss. That method defers recognition of built-in gain or loss until certain triggering events occur. Triggering events include a sale or distribution by the partnership of the contributed property, the sale or liquidation (partial or full) of the contributing partner's partnership interest, and depreciation of the property.

The deferred sale method is not new, nor is it radical.[10] One version of the method was originally proposed in 1932, and variations on the theme have been periodically reconsidered since then. Yet each time it was considered, it was rejected as too complex and beyond the understanding of most taxpayers. Although those criticisms may once have been valid, they no longer are. Compared to the mess of current law, the deferred sale method is straightforward. We believe that if the deferred sale method were adopted, the law would be vastly simplified, far more certain, and would generate far more satisfactory tax results than current law.[11]

Some might argue that recognition of gain on the contribution of property to a partnership, even on a deferred basis, is a radical change. Actually, it is not. The law already generally holds the contributor of property responsible for any gain or loss in that property, and the timing of that recognition is approximately the same as it would be under the change proposed here. Most of the complications in current law relate to those instances in which the contributor avoids this responsibility. Since the deferred sale method always taxes the contributor on built-in gain or loss, it would eliminate these complications and would operate far more simply and effectively.

This Article analyzes the current law treatment of contributions of property to partnerships and suggests reforms. In Part II, we analyze

9. Immediate recognition of gain was advocated in Philip F. Postlewaite et al., *A Critique of the A.L.I.'s Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423, 464-479 (1986). *See also* David R. Keyser, *A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation*, 5 AM. J. TAX POL'Y 269 (1986). In this Article, we accept as a basic operating principle that immediate recognition would discourage the formation of partnerships and deter new business enterprises. *See generally* Karen C. Burke, *Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations*, 63 IND. L.J. 489 (1988). In the context of discussing the disguised sale rules, Professor Burke finds the deferred sale method more consistent with the aggregate conception of partnerships than the "immediate sale" approach advocated by Professor Postlewaite. *See id.* at 491.

10. For a far more comprehensive solution to the contribution problem, see Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173 (1991), in which Professor Gergen proposes an "accounts based system" for dealing with contributions and distributions. His proposal is similar in many ways to the deferred sale method, but is significantly more complicated and is intended to work in conjunction with the other far reaching proposals he has suggested, such as eliminating special allocations and guaranteed payments. *See* Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990). *See also* Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992).

11. See Burke, *supra* note 9, at 529-36, in which Professor Burke argues in favor of adopting the deferred sale method as a solution to the problem of disguised sales.

how the law developed, paying particular attention to the legislative choices made in 1954 and the statutory and regulatory rules that developed over the next four decades. In Part III, we advocate legislative adoption of the deferred sale method and describe how the deferred sale method would actually work in practice, emphasizing two major points: first, the deferred sale method would not be a radical change; and second, Subchapter K would be significantly simplified and improved if it were enacted.

II. DEVELOPMENT OF THE LAW

A. The Initial Decision—1954

One of the fundamental questions faced by Congress when it enacted Subchapter K in 1954 was how and when to tax built-in gain (or loss) inherent in property contributed to a partnership. The law prior to 1954 was confused: while courts had held that no gain or loss should be recognized by the contributing partner, there was no law on the question of who should eventually report the "built-in" gain or loss.[12] Primarily because of a desire not to discourage the formation of partnerships and deter new business enterprises,[13] Congress enacted section 721, which continued the rule of nonrecognition of gain or loss on formation. The corollary, however, of how (and to whom) to tax the unrecognized gain was more difficult conceptually and received more attention.[14]

In deciding how to tax built-in gain and loss on contributed property, Congress was faced with the struggle between the two competing conceptual views of the essence of a partnership.[15] One view was that a partnership should be treated as a distinct entity, like a corporation; the other was that it should be treated as an aggregate of its partners, each of whom owns an undivided interest in each of the partnership's assets. Entity characterization would dictate that a contribution to a partnership would be treated as a realization event in which the contributor transfers property in exchange for a distinct and different asset: a partnership interest. Since the exchange would be tax-free under section 721, the contributing partner would take a substituted basis in the partnership interest received, thereby preserving any inherent gain or loss. The partnership

12. Prior to 1954, there was very little law on the taxation of partnerships aside from two cases that had held that the formation of a partnership was not taxable: Archbald v. Commissioner, 27 B.T.A. 837 (1933) and Helvering v. Walbridge, 70 F.2d 683 (2d Cir. 1934), and § 113(a)(13) of the 1939 Code, which gave the partnership a transferred basis in contributed property.

13. *See generally* J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 Colum. L. Rev. 1183, 1204-05 (1954) [hereinafter Jackson et al., *1954 Code*]; J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners, American Law Institute Draft*, 9 Tax L. Rev. 109, 120 (1954) [hereinafter Jackson et al., *A.L.I. Report*].

14. *See* Jackson et al., *1954 Code*, *supra* note 13, at 1204 ("Perhaps the most baffling question in the entire muddled field of partnership taxation was the proper tax treatment to be accorded property contributed at a value other than its tax basis.").

15. *See id.*

would take a transferred basis in the contributed asset, and any gain or loss on the ultimate sale of the property would be divided among the members of the partnership without regard to its source. Although this approach shifted built-in gain from the contributor to the other partners, it was thought that the shift was merely temporary and would be corrected upon eventual disposition of the contributor's partnership interest upon sale or liquidation. The major disadvantage of this approach was the perceived complexity of requiring partners and partnerships to keep track of two bases: the partnership's basis in the contributed property and the contributor's basis in her partnership interest.

If one views the partnership not as a distinct entity, but as an aggregate of its members, then contributions of property should be treated differently. A pure aggregate view of the partnership would treat each partner as owning an undivided interest in each of the partnership's assets. Therefore, when a partner contributes property to a partnership, a pure aggregate approach would treat the contributing partner as selling or exchanging a portion of the contributed property in exchange for an interest in each of the other partnership assets, in what amounts to a partial sale or exchange of the contributed property. If that sale or exchange were nontaxable, as Congress intended, the difficult question would be how and when to tax the built-in gain. In that context, the "deferred sale" approach was devised.

The deferred sale approach (also referred to as the credited value approach) was developed by the American Law Institute (A.L.I.) as part of its comprehensive study advising Congress in connection with the drafting of Subchapter K.[16] Under this approach, the contribution was treated as a partial sale, with recognition of gain deferred until a specific event. In the case of non-depreciable property, the gain was deferred until the earlier of when the partnership disposed of the contributed property or when the contributing partner disposed of her partnership interest. In the case of depreciable property, the deferred gain would be reported over the remaining life of the property. To illustrate, consider the facts of the following basic example, to which we will refer throughout this Article:

Example: On January 1, 1998, *A*, *B*, and *C* form an equal partnership, PRS, to which *A* contributes Blackacre (FMV = \$1,200, basis =

16. *See* Jackson et al., *A.L.I. Report*, *supra* note 13, at 120-23. The deferred sale approach considered in 1954 was not entirely new; it was similar to the approach taken in a 1932 General Counsel Memorandum. See Gen. Couns. Mem. 10,092 (1932), which was subsequently revoked in 1950. *See also* Gen. Couns. Mem. 26,379 (1950). General Counsel Memorandum 10,092 utilized the credited value, deferred sale approach, with one modification: the amount of gain, loss, or deduction allocated among the partners could not exceed that recognized by the partnership at the entity level. This General Counsel Memorandum was the origin of the "ceiling rule," and, prior to its revocation, was apparently ignored by taxpayers and service personnel alike. *See* Jackson et al., *A.L.I. Report*, *supra* note 13, at 123. The A.L.I.'s version of the deferred sale approach did not incorporate the ceiling rule.

$300), *B* contributes nonmarketable[17] securities (FMV = $1,200, basis = $1,200), and *C* contributes $1,200 cash. Under the aggregate view, each partner has a 1/3 undivided interest in each of the partnership's assets. Under the deferred sale approach considered in 1954, *A* would be treated as exchanging 2/3 (or $800 worth) of Blackacre for $800 worth of securities and cash and would eventually have to report $600 of gain.[18] Assuming that Blackacre is non-depreciable, this gain would be reported on the earlier of when PRS disposes of Blackacre or when *A* disposes of her interest in PRS. If Blackacre were depreciable, the gain would be reported over the property's remaining useful life.[19] PRS would take an aggregate basis of $900 in Blackacre, $800 of which is attributable to the portions that *B* and *C* purchased and $100 attributable to the portion that *A* still owns. PRS would have to keep track of each partner's basis in Blackacre.

As you can imagine, this partial sale approach could become complicated when multiple assets are contributed to a partnership. Not only would each contributed property have to be valued, but each partner also would have to keep track of her share of the partnership's basis in each asset.[20]

Of the methods considered by Congress and the A.L.I.[21] in 1954, clearly the deferred sale method was the most conceptually correct. Entity treatment was inconsistent with the general aggregate approach taken towards partnerships throughout the rest of Subchapter K and allowed

---

17. *See* I.R.C. § 731(c) (1994). Under this provision, which was enacted in 1991, marketable securities are generally taken into account at their fair market value and treated as cash. Prior to its enactment, transactions such as the one described in the text were designed with marketable securities.

18. Since *A* has sold 2/3 of Blackacre, she should be entitled to offset her $800 amount realized with 2/3 of her basis, or $200.

19. For example, if there were five years remaining in Blackacre's useful life, in addition to all other partnership items, *A* would report $120 each year for five years.

20. For example, if *B*'s basis in the securities were $600, then *B* would also have deferred gain, and PRS would have to keep track of each partner's basis in their respective interests in the securities as well.

21. The A.L.I. ultimately recommended a completely different approach based on the aggregate conception of partnerships that it called the "transference of basis" approach. *See* Jackson et al., *A.L.I. Report*, *supra* note 13, at 129-30. Under that rule, the contributor's basis in the contributed property is transferred to the partnership (and a pro-rata share of that basis to each other partner), with no attempt to keep track of a separate basis in the contributor's partnership interest, or to trace eventual gain recognized to the contributing partner. *See id.* at 127-29. This approach is significantly different from the deferred sale method in two significant ways. First, it makes no attempt to tax built-in gain to the contributor and is, therefore, inconsistent with the pure aggregate view of partnerships. Similar to the entity approach, it freely permits the shifting of gain and loss among partners, but, in contrast with the entity approach, it makes no attempt to offset the shift on eventual disposition of the partner's interest in the partnership. Second, it is extremely simple: built-in gain and loss is treated like all other gains and losses, and there is no difference between a partner's share of inside and outside basis. To illustrate, in the above example, PRS would take a basis of $300 in Blackacre, $1,200 in the securities, and $1,200 in the cash, and each of the partners would have a basis of $900 in her partnership interest. The transference of basis approach allowed unfettered, permanent shifting of income among taxpayers. The A.L.I. did not view this as a problem because it presumed the partners would take into account the gain potential of contributed assets when striking their deal. *See id.* at 128-29.

shifting of income, albeit temporarily. Only the deferred sale method, without the ceiling limitation,[22] approximated pure aggregate treatment and avoided shifts of gain and loss among partners.

When Congress ultimately enacted Subchapter K, it generally adopted the aggregate conception of partnerships.[23] While the partnership entity files an information return, the partnership entity pays no tax, and each partner must individually account for her share of the income and deduction from the partnership's operations. Nevertheless, in the context of contributed property, Congress opted for entity treatment as the basic rule: under sections 704(c)(1) and 721, the built-in gain or loss was not recognized at the time of contribution and, thus, could be allocated among all of the partners when ultimately recognized. The contributor takes a substituted basis in her partnership interest, i.e., she takes a basis in her partnership interest equal to the basis she had in the property transferred. This regime permitted the shifting of built-in gain or loss to the non-contributing partners. This shifting was viewed as tolerable because it would be corrected later upon liquidation, sale, or exchange of the partnership interests.[24] Congress did provide, however, that partners could elect to apply a variation of aggregate treatment by allocating tax items with respect to contributed property among the partners, so as to take into account the disparity between the property's basis and value at the time of contribution. This elective treatment was provided in the interest of giving partners flexibility and fell short of the pure aggregate approach of the deferred sale method because it incorporated the ceiling rule.[25] The ceiling rule limits the amount of gain or loss allocated to any partner to that realized by the partnership entity. Not only is this inconsistent with a pure aggregate approach, but the ceiling rule also had the effect of permitting partners to shift precontribution gain, even if the partnership elected the so-called aggregate rule of section 704(c)(2).[26]

As one reads the A.L.I. draft proposal and the Committee reports accompanying the enactment of Subchapter K with the benefit of more than forty years of hindsight, it is impossible to ignore the naiveté with which policy makers approached the problems posed by contributed property. Congress (and the A.L.I.) seemed primarily concerned with

---

22. *See supra* note 16 and accompanying text.

23. *See* S. REP. No. 83-1622, at 89 (1954); H.R. REP. No. 83-1337, at 65 (1954).

24. *See* S. REP. No. 83-1622, *supra* note 23, at 90.

25. *See id.* at 93. The ceiling rule is implicit in the example provided in the committee reports, which posits a contribution of depreciable property by one partner and cash by another. The property is worth $100, and has a basis of $40, and the report states that the cash contributor would be entitled to all of the $40 basis for depreciation, not the full $50 required by pure aggregate treatment.

26. *See generally* Laura E. Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93 (1996) [hereinafter Cunningham, *Section 704(c)*]; John P. Steines, Jr., *Partnership Allocations of Built-in Gain or Loss*, 45 TAX L. REV. 615 (1990); R. Donald Turlington, *Section 704(c) and Partnership Book-Tax Disparities, The Ceiling Rule and the Art of Tax Avoidance*, 46 INST. ON FED. TAX'N 26 (1988).

making the law simple and consistent with the expectations of partners.[27] They did not view any of the questions surrounding contributed property as issues of revenue or more general tax policy, and the time value of money was not an issue at all. In discussing the choices between the various ways to treat contributed property, the A.L.I. report states: "Since this aspect of the tax treatment of contributed property relates essentially to the relationship between the partners, rather than to an issue between the Treasury and the partners, the paramount consideration should be a set of rules permitting sufficient flexibility in consummating partnership arrangements."[28]

Yet even with the benefit of hindsight, it is hard to fault the 1954 Congressional decision. It was a much simpler tax world then, and the disadvantages of the entity approach, which allowed complete nonrecognition at the time of formation, temporary shifting of gain and loss among partners coupled with eventual correction on disposition of partnership interests, were probably viewed as minor compared to the burdensome complexity of the deferred sale method. Yet, there were, in fact, significant revenue and policy considerations that should have been taken into account. Two of the most serious problems that were to develop in Subchapter K can be traced to Congress's decision in 1954 to allow nonrecognition of gain on contributions (and distributions) and its willingness to allow shifting of precontribution gain and loss. Congress opened the door to the use of Subchapter K to avoid the recognition of gain on the disposition of property ("disguised sales") and the ability of partnerships to shift built-in gain from one partner to another because of inadequate inside basis ("ceiling rule"), both of which are discussed more fully below. These problems stem from the fact that the contributor of property can, under certain circumstances, shift the precontribution gain inherent in property to another partner. If the contributor of property were required in all events to eventually recognize that gain, these problems would never have arisen.

In sum, in 1954, Congress adopted an entity approach for taxing contributions of property. Although Congress understood that this approach was not theoretically consistent with the aggregate theory of partnerships, it determined that the relative simplicity outweighed the perceived complexities associated with aggregate approaches. The shift of income and loss permitted by the entity rule was not thought to be a revenue concern because it was thought to be only temporary.

27. In explaining its choice of the entity rule for allocating pre-contribution gain or loss, the Committee reports state "[t]his general treatment was adopted because of its extreme simplicity as contrasted with any other alternative and because it conforms to the usual expectations of partners." S. Rep. No. 83-1622, *supra* note 23, at 90.

28. Jackson et al., *A.L.I. Report*, *supra* note 13, at 132-33.

B. Suffering the Consequences of Nonrecognition: The Ceiling Rule, Disguised Sales, and Mixing Bowls

In the years following the enactment of Subchapter K, it became apparent that the powerful nonrecognition regime it created was susceptible to uses well beyond those contemplated by Congress in 1954. The transactions took advantage of the opportunities provided by the combination of section 721's rule of nonrecognition of gain on contributions, section 704(c)(1)'s allocation of built-in gain or loss among the partners as a group, and § 731's rule of nonrecognition of gain on distribution.

First, section 704(c)(1) plainly allowed partners to shift gain or loss among themselves, and any corrective gains or losses on disposition of partnership interests were delayed indefinitely if the partnership remained in existence. While Congress may not have believed in 1954 that revenue concerns were at issue, taxpayers had a much better sense of the time value of money and how to utilize tax-exempt partners, and freely took advantage of this opportunity to defer or eliminate liability for built-in gain. It took thirty years, but Congress finally responded in 1984 by amending section 704(c) to make it mandatory that allocations of built-in gain or loss be made to the contributing partner. The details were left to the Treasury, which took another decade to issue final regulations.[29] Those regulations authorized taxpayers to choose any reasonable method for making section 704(c) allocations and listed three methods that the Treasury considered reasonable.[30] The first, called the "traditional method," essentially adopted the rules used between 1954 and 1984 for making section 704(c)(2) elective allocations, ceiling rule and all. The second, the "traditional method with curative allocations," incorporated the traditional method, but permitted partnerships to use other items of partnership income and loss to correct distortions caused by the ceiling rule. Finally, the "remedial allocation method" represented wholesale abandonment of the ceiling rule and is similar, though not identical, to the partial deferred sale approach considered by the A.L.I. in 1954. Yet, the remedial allocation method is optional only; the Treasury will not impose it upon taxpayers. This is apparently because of the Treasury's underlying belief that it lacked the authority to overrule the ceiling rule.[31] As a result, the final section 704(c) regulations preserve the ceiling rule, which continues to allow shifting of precontribution gain or loss.[32] Also troubling is an anti-abuse rule issued as part of the regulations, which purports to disallow use of an allocation method (including those blessed

29. During that time, several commentators issued their opinions on the approach the regulations should take. *See generally* Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 Tax L. Rev. 627 (1986); Steines, *supra* note 26; *N.Y. State Bar Ass'n Tax Section Comments Relating To Proposed Regulations to Be Issued Pursuant to Section 704(c), 707(a)(2), and 752* (1985).

30. *See* Treas. Reg. § 1.704-3 (as amended in 1995).

31. *See* Cunningham, *Section 704(c)*, *supra* note 26, at 116-17.

32. *See supra* note 25 and text accompanying.

by the regulations) if a contribution and corresponding allocation of tax items is made "with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."[33] Commentators disagree on the scope of this anti-abuse rule.[34] It could take years of litigation and uncertainty to determine who is correct.

C. Disguised Sales

Another type of transaction that evolved in response to Subchapter K's nonrecognition regime was the "disguised sale." Because contributions of property to and distributions of property from partnerships are nonrecognition events under sections 721 and 731, taxpayers were able to effectively sell or exchange property without recognition of gain. To illustrate, reconsider the facts of our basic example in which *A* contributes Blackacre (fair market value = $1,200, basis = $300) to PRS. Suppose, after some period of time, PRS distributes the securities to *A* in liquidation of her partnership interest. If both the contribution and distribution are respected as independent transactions, *A* does not recognize any gain and takes a $300 basis in the securities.

Notice what has happened from *A*'s perspective: she has exchanged appreciated real property for marketable securities without the recognition of gain! For this reason, early regulations took the position that, under appropriate circumstances, the Service would recharacterize a contribution and distribution as a disguised sale.[35] It was never clear, however, what constituted a disguised sale. The courts were hesitant to define the line and rarely found a disguised sale.[36] Some of these cases were brought to the attention of Congress, which viewed the underlying transactions as an inappropriate use of Subchapter K. In 1984, it enacted section 707(a)(2)(B) in an attempt to stem the tide.[37] Again Congress

33. Treas. Reg. § 1.704-3(a)(10).

34. *See, e.g.*, William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 10.04[3][a] (3d ed. 1997). *See also* Cunningham, *Section 704(c)*, *supra* note 26, at 115-23.

35. *See* Treas. Reg. § 1.731-1(c)(3) (as amended in 1997). *See generally* McKee et al., *supra* note 34, ¶ 13.02[3][b] (describing legislative motivations for enacting regulations regarding disguised sales).

36. *See, e.g.*, Otey v. Commissioner, 70 T.C. 312 (1978), *aff'd per curium*, 634 F.2d 1046 (6th Cir. 1980); Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980). These cases (and others) are discussed in *Federal Income Tax Project: Subchapter K, Proposals on the Taxation of Partners* 171-174 (Am. Law Inst. 1984) [hereinafter *1984 A.L.I. Project*].

37. Section 707(a)(2)(B) states:

> If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

I.R.C. § 707(a)(2)(B) (1994).

left the details to the Treasury, which eventually issued regulations[38] that recharacterize a contribution and related distribution as a sale only if, based upon all the facts and circumstances, two conditions are met: the partnership would not have distributed money or other property to the contributing partner *but for* that partner's contribution of property to the partnership, and, in the case of a contribution and distribution that are not simultaneous, the second transfer (usually the distribution) is not dependent on the entrepreneurial risks of the enterprise.[39]

Analytically, whether a given contribution and related distribution constitute a disguised sale ultimately depends on all of the attendant circumstances. To aid in this determination, the Treasury created two important alternate presumptions. If the two transfers occur within two years of one another, they are presumed to constitute a sale; if they are separated by more than two years, then there is a presumption against sale treatment.

The regulations under section 707(a)(2)(B) are inordinately complex. These regulations established rules to determine the appropriate treatment of distributions of operating cash flow, as well as to identify when the deemed cash distribution resulting from an increase in a partner's share of liabilities should be treated as a transfer as part of a disguised sale. Nevertheless, the two-year presumptions created a regime in which a disguised sale could be structured, so long as it was not completed within two years.

D. Mixing Bowl Transactions

Section 707(a)(2)(B)'s enactment in 1984 did not prevent yet another transaction permitted by the powerful combination of sections 721 and 731, the so-called "mixing bowl" transaction. There were two basic types of mixing bowl transactions. The first was a contribution of appreciated property to a partnership, followed by a distribution of that property to a different partner. As a result, the contributor was essentially permitted to exchange the contributed property for an undivided interest in the partnership's other assets, without recognition of gain. The second variation involved a contribution of appreciated property, followed (more than two years later, to avoid section 707(a)(2)(B) by a distribution to the contributor of different property. Again, the contributor was permitted to exchange her appreciated property for different property without recognition of gain.

Congress reacted to the mixing bowl transaction by enacting section 704(c)(1)(B) in 1989 and section 737 in 1992, which apply only to property distributions not recharacterized as sales by section 707(a)(2)(B).[40] Section 704(c)(1)(B) applies when contributed property is distributed by the partnership within five years of its contribution. In that event, the

38. *See* T.D. 8439, 1992-2 C.B. 126.
39. *See id.* at 132.
40. *See generally* McKee et al., *supra* note 34, ¶ 19.08.

contributor is required to recognize the built-in gain or loss as though the partnership had sold the contributed property on the date of distribution for its fair market value at that time. If the contribution and distribution are separated by more than five years, then section 704(c)(1)(B) does not apply.

Section 737 applies a similar five-year rule when a contributing partner receives a distribution of other property. The effect of the rule is to require the partner to recognize any built-in gain on the contributed property that remains unrecognized as of the date of the distribution.

The Treasury issued regulations under sections 704(c)(1)(B) and 737 in 1995. Both sets of regulations provide detailed rules for applying the provisions, and both contain anti-abuse rules.[41] These rules apply when a transaction is structured to achieve a tax result inconsistent with the purpose of the underlying statute. Like the section 704(c) anti-abuse rule, the scope of these anti-abuse rules is unclear and will only be resolved after years of litigation and uncertainty.[42] Congress amended sections 704(e)(1)(B) and 737, applicable to property contributed after June 8, 1997, to change the five-year period in each of those sections to seven years.[43]

In sum, the Congressional choice in 1954 to permit partners to contribute property to a partnership without recognizing gain or loss, and not to strictly require that the built-in gain or loss be taxed to the contributor, led to abuses of the nonrecognition regime. Congress responded piecemeal to each type of abuse as it became obvious. First, in 1984, Congress made the so-called aggregate treatment of prior section 704(c)(2) mandatory, but because it did not wholesale reject the ceiling rule, shifting of built-in gain and loss was still possible. The Treasury responded by enacting complex regulations giving various alternatives for making the required allocations, coupled with an anti-abuse rule of uncertain breadth. Also in 1984, Congress enacted section 707(a)(2)(B), attempting to stem the tide of non-taxable exchanges permitted by Subchapter K's nonrecognition regime. Again the Treasury responded with inordinately complex regulations, containing a two-year presumption that effectively eviscerated the statute. Because the mixing bowl transaction developed, Congress enacted section 704(c)(1)(B) in 1989 and section 737 in 1992, and the Treasury produced two more sets of complex regulations and two more anti-abuse rules of uncertain breadth. As a result, the body of statutory and regulatory rules governing contributed property has grown far more complex and cumbersome than Congress ever anticipated in 1954, when it opted for simplicity over theoretical accuracy. While the 1997 change will increase the probability that contributors will be re-

41. *See* Treas. Reg. §§ 1.704-4(f)(1) and 1.737-4(a).

42. *See generally* McKEE ET AL., *supra* note 34, ¶¶ 10.04[4][g] and 19.08[5].

43. Tax Payer Relief Act of 1997, H.R. 2014, 105th Cong. § 1063(a). For an excellent analysis of mixing bowl transactions see Abraham N.M. Shashy, Jr., *Mixing Bowl Transactions: The Basic Statutory Framework*, 55 INST. ON FED. TAX'N 2-1 (1997).

quired to report built-in gain, changing the statutory period for distributions from five to seven years in no way mitigates the complexity of current law.

E. Reconsidering Deferred Sales in 1984

In the early 1980s, the A.L.I. undertook a major review of partnership taxation and in 1984 published its report,[44] which included recommendations concerning contributed property. In this 1984 A.L.I. Project, the A.L.I. explored the possibility of switching to a deferred sale approach (also described as a "credited value" approach) for taxing built-in gain and loss on contributed property. This proposal differed from the A.L.I.'s 1954 deferred sale proposal in that the entire property, not just a portion of it, is deemed sold. Although the full deferred sale approach produces results very similar to the partial sale rule, it is far simpler to apply. To illustrate, in the above example, *A* would have a deferred gain of $900, and the partnership would have a single basis of $1,200, which it would use for all purposes. Once again, *A* would recognize the $900 precontribution gain on the earlier of the date PRS sold Blackacre or the date *A* disposed of her partnership interest. If Blackacre were depreciable, she would recognize the $900 gain over Blackacre's remaining useful life.

At first blush, these results appear to be inconsistent with a pure aggregate approach and to tax *A* far too heavily. Under the A.L.I.'s 1954 proposal, *A* only had to recognize $600 of gain, while under the full deferred sale approach she must recognize $900. However, upon closer examination, it can be demonstrated that the two approaches tax the same amount of gain, and that the full deferred sale method is a far simpler method to get the appropriate answer.[45]

Remember that both the $600 and the $900 gains are deferred. If PRS sold Blackacre for $1,200, in addition to the $600 deferred gain that would be triggered under the partial sale method, *A* would have $300 of current gain on the sale (remember, *A*'s basis in her undivided 1/3 interest in Blackacre is $100) for a total of $900 gain. This is exactly the same amount of gain that would be triggered under the full sale method. If *A* sold her interest for $1,200, under the partial sale method, in addition to the $600 of gain that would be triggered, she would have $300 of gain on the sale of the interest itself. Again, the same amount as under the full sale method. Finally, although it is more complicated, it can be shown that in the case of depreciable property, the tax results of the two methods are also the same.[46] The difference is that the full sale method simply

44. *1984 A.L.I. Project*, *supra* note 36, at 127.

45. *See* Marich & McKee, *supra* note 29, at 684; Burke, *supra* note 9, at 530-31.

46. If Blackacre were depreciable and had five years remaining in its useful life and PRS used the straight-line method of depreciation, under the partial deferred sale, *A* (whose basis is $100 in the unsold portion of Blackacre) would be entitled to depreciation of $20 per year. *A* would also have to report 1/5 of the $600 deferred gain each, or $120. Taking into account only the depreciation and the deferred gain, *A* would have net income

avoids much of the complexity of the earlier method by giving the partnership a single basis in each asset.

In spite of the obvious advantages of the deferred sale treatment, the A.L.I. ultimately decided not to recommend its adoption. The primary reasons given were similar to those that prevented recommendation of the method in 1954, including difficulty of valuing contributed property and perceived complexity.[47] While stating that the decision whether or not to recommend a deferred sale approach was a difficult one for the Project, the authors ultimately seemed to believe that until it could be demonstrated that partnerships were intentionally being used to shift gain or loss, adoption of the deferred sale approach was unwise.

III. MECHANICS OF THE DEFERRED SALE

A. Method & Comparison to Current Law

We believe that the current statutory and regulatory structure dealing with contributed property is needlessly complex and reaches unsatisfactory results in many cases. For these reasons, we advocate reform through taxation of built-in gain and loss under the deferred sale method. This section describes that method in more detail, illustrates how it would apply to a number of different transactions, and compares it to current law.[48]

Under the deferred sale method, when a partner contributes property to the partnership with a basis different from its fair market value, the partnership would allocate to the contributing partner any built-in gain or loss in the property. The partnership's basis in the contributed property would be equal to its fair market value. The contributing partner would recognize the built-in gain or loss on a deferred basis whenever a gain or loss-triggering event arose. Events triggering recognition of the deferred gain or loss would include depreciation of the property by the partnership, disposition of the property by the partnership (including distribution of the property to a partner), and disposition by the partner of all or part of her partnership interest (whether by sale or liquidation). As the contributor recognizes the built-in gain or loss, her outside basis would be adjusted accordingly.

Although the ultimate tax results achieved by the deferred sale method are strikingly similar to those obtained in many cases under current law, mechanically the method is significantly easier to apply than current law. In those cases where the deferred sale method achieves different tax re-

---

of \$100 each year. Under the full deferred sale method, PRS would be entitled to 1/5 of \$1,200, or \$240 each year. *A*'s share would be \$80. In addition, *A* would report 1/5 of her \$900 deferred gain each year, or \$180. Taking into account only *A*'s depreciation and her deferred gain, she would have net income of \$100 each year for five years.

47. *See 1984 A.L.I. Project*, *supra* note 36, at 131-40.

48. The deferred sale method has been compared to the treatment of "deferred intercompany transactions" under the consolidated return regulations (Treas. Reg. § 1.1502-13). *See, e.g.*, *1984 A.L.I. Project*, *supra* note 36, at 129 n.5.

sults than current law, we believe that the deferred sale results are superior. In this section, we illustrate the mechanics of the deferred sale method in a variety of common transactions and compare and contrast the results of that method to current law. All of these transactions are based upon our basic example. Recall, on January 1, 1998, *A*, *B*, and *C* form an equal partnership, PRS, to which *A* contributes Blackacre (FMV = $1,200, basis = $300), *B* contributes nonmarketable securities (FMV = $1,200, basis = $1,200), and *C* contributes $1,200 cash. Assume initially that Blackacre is nondepreciable property. Assume throughout that PRS has made an election under section 754.[49]

B. FORMATION

The tax consequences of forming a partnership do not differ significantly between the deferred sale method and current law. To illustrate, compare the tax consequences of the two methods when applied to our basic example:

> *Deferred Sale Method*: At the time of formation, PRS takes a basis of $1,200 in Blackacre and allocates $900 of deferred gain to *A*, none of which is currently recognized. *A*'s initial outside basis is $300.
>
> *Current Law:* PRS takes a transferred basis in Blackacre of $300 for tax purposes[50] and a basis of $1,200 for book purposes.[51] PRS must keep two sets of books, one for tax, and one for book purposes. *A* takes an outside basis of $300.[52] The $900 discrepancy between *A*'s tax and book capital accounts reflects the $900 inherent built-in gain.[53]
>
> *Comparison:* Formation of the partnership does not trigger any immediate tax consequences under either method. There are, however, two differences. First, under current law, PRS must maintain two sets of books, one for tax and one for financial accounting purposes. Second, the partnership's tax basis is different under the two methods. Under the deferred sale method, it is equal to the fair market value of the property, while under current law it is a transferred basis.[54] In the case of nondepreciable property, this difference is not significant. However, as discussed below, the difference is significant when the contributed property is depreciable, because it affects the

49. When a § 754 election has been made, a partnership must adjust the bases of its assets in an amount determined under § 743(b) (in the case of a transfer of partnership interest) or § 734(b) (in the case of a distribution). These adjustments are allocated among the partnership's assets in the manner prescribed in § 755. *See generally* McKEE ET AL., *supra* note 34, at chs. 24-25 (discussing optional adjustments to the basis of partnership assets related to transfers and distributions of partnership interests); LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 144-49, 169-78 (1996).

50. *See* I.R.C. § 723 (1994).

51. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d) (as amended in 1994).

52. *See* I.R.C. § 722 (1994).

53. *See* I.R.C. § 704(c)(1)(A) (1994); Treas. Reg. § 1.704-3(a)(3)(ii) (as amended in 1995).

54. *See* I.R.C. § 723 (1994).

amount of depreciation to which the partnership is entitled.[55]

C. Sale of the Contributed Property

The tax consequences resulting from the sale of the contributed property do not differ significantly between the two methods unless the ceiling rule applies. When it does, the deferred sale method is clearly superior to current law. Even when the ceiling rule is not implicated, the deferred sale method is less complex than current law.

To illustrate, consider the tax consequences when PRS sells Blackacre for, in the alternative, $1,500 and $900. Assume in both cases that *A*'s outside basis is $300 at the time of the sale.

(i) Sale at a gain: PRS sells Blackacre for $1,500.

Deferred Sale Method: PRS has a $300 gain, which is allocated equally among the partners, $100 each.[56] In addition, the sale triggers recognition of *A*'s full $900 deferred gain.[57] *A* recognizes total gain on the transaction of $1,000, which increases her outside basis to $1,300.[58]

Current Law: PRS must separately compute its tax and book gain from the sale. PRS has a book gain of $300, which is allocated equally among the partners, and a tax gain of $1,200, the first $900 of which must be allocated to *A* under section 704(c) and the balance of $300 in the same manner as the book gain. Therefore, *A* has a total tax gain of $1,000, increasing her outside basis to $1,300.[59]

Comparison: Although there is no difference in the amount and timing of the gain reported by the partners, the accounting is significantly more complex under current law. The deferred sale method eliminates the need for the partnership to maintain separate book and tax accounts.

(ii) Sale at a book loss and tax gain: PRS sells Blackacre for $900

Deferred Sale Method: PRS has a loss of $300, which it allocates equally among the partners, i.e., $100 each. In addition, *A*'s full $900 deferred gain is triggered. Therefore, *A* reports a net gain of $800 and increases her outside basis to $1,100.[60]

Current Law: PRS has a book loss of $300 and a tax gain of $600—a classic ceiling rule situation.[61] The book loss is allocated equally among the partners in accordance with the partnership

55. *See infra* part III.C.
56. This gain should be characterized at the partnership level as if PRS purchased Blackacre on the date of formation. If desired, one could allow the partnership to tack the contributor's holding period to its own. *Cf.* I.R.C. § 1223(2) (1994).
57. The character of this gain would be determined at the time of contribution.
58. If the deferred sale method were adopted, § 705(a)(1) would need to be amended to provide for an increase in outside basis as deferred gain is recognized.
59. *See* I.R.C. § 705(a)(1)(A) (1994).
60. *See* I.R.C. § 705(a) (1994).
61. *See* Treas. Reg. § 1.704-3(b) (as amended in 1995).

agreement.[62] Allocation of the tax gain depends on how PRS accounts for built-in gains and losses under section 704(c).[63] Under the traditional method[64] (assuming the transaction is not subject to the section 704(c) anti-abuse rule),[65] the partnership must allocate the entire $600 gain to *A*, and *B* and *C* are deprived of a tax loss to match their book loss. This has the effect of shifting a portion of *A*'s precontribution gain (i.e., $200) to *B* and *C*. If PRS uses the traditional method with curative allocations[66] (and there are in fact appropriate other items to allocate to *A*),[67] then it will allocate an additional $200 of tax gain to *A*. If the partnership has elected the remedial allocation method,[68] then PRS will allocate $200 of additional gain to *A*, and a loss of $100 each to *B* and *C* to match their book losses. In both cases, *A* reports a total gain of $800 and increases her outside basis to $1,100.[69]

Comparison: Under *some* circumstances, there is no difference between the deferred sale method and current law. If the partnership adopts the remedial allocation method, the end result will be the same. Also, the traditional method with curative allocations will reach the same result as the deferred sale method *so long as* the partnership has sufficient appropriate items with which to make the curative allocations. If it does not, then a shifting of a portion of the precontribution gain will occur. However, when the partnership uses the traditional method, there is a significant difference in result, which permits the shifting of $200 of precontribution gain from *A* to *B* and *C*. This latter result is patently inconsistent with the stated purpose of section 704(c), "to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss."[70] Unless the partnership elects the remedial method, the deferred sale method is far superior to current law in that its results are certain and shifting is not possible.

D. Sale of Partnership Interest

Some differences in the character of gain or loss recognized by the contributor of property when she sells all or part of her interest in the part-

---

62. *See* I.R.C. § 704(a) (1994).

63. Under § 704(c)(1)(A) and Treas. Reg. § 1.704-3(a)(1), a partnership must account for any built-in gain or loss using a reasonable method that is consistent with the purpose of § 704(c), i.e., to prevent the shifting of tax consequences among partners with respect to built-in gain. *See generally* Cunningham, *Section 704(c)*, *supra* note 26, at 105-15 (explaining the methods prescribed by the regulations).

64. *See* Treas. Reg. § 1.704-3(b) (as amended in 1995).

65. *See* Treas. Reg. § 1.704-3(a)(10) (as amended in 1995).

66. *See* Treas. Reg. § 1.704-3(c) (as amended in 1995).

67. *See* Treas. Reg. § 1.704-3(c)(3)(iii) (as amended in 1995). To be reasonable, a curative allocation must be expected to have substantially the same effect on each partner's tax liability as the item subject to the ceiling rule. Thus, PRS will only be able to make the curative allocation if, in fact, it has recognized $200 of capital gain from another transaction that was allocated to *B* and *C*'s book accounts.

68. *See* Treas. Reg. § 1.704-3(d) (as amended in 1995). The remedial allocation method is really nothing more than a type of deferred sale method, which is elective.

69. *See* I.R.C. § 705(a) (1994).

70. Treas. Reg. § 1.704-3(c)(a)(1) (as amended in 1995).

nership may arise, but generally the two methods produce similar results. To illustrate, suppose *A* sells her interest in PRS to *D* for $1,400. At the time of the sale *A*'s outside basis is $300 and PRS is still holding Blackacre.

> *Deferred Sale Method:* The sale of *A*'s interest in PRS triggers the recognition of *A*'s $900 of deferred gain, increasing her outside basis to $1,200. The sale also results in an additional gain of $200 for a total gain of $1,100 on the transaction.[71] *D*'s outside basis is $1,400[72] and would be entitled to a section 743(b) adjustment of $200.[73]
>
> *Current Law: A* recognizes a $1,100 gain on the sale.[74] *D* is entitled to a section 743(b) adjustment of $1,100.[75]
>
> *Comparison:* There is no difference in either the amount or timing of *A*'s gain on the sale, although there may be a difference in the character of *A*'s gain.[76] If there is a section 754 election in place, then there *should* be no difference from the buyer's point of view. If there is no election, then the buyer will have more inside gain under current law than under the deferred sale method. Again, the deferred sale method is somewhat more complex than current law.

The analysis would be similar if *A* were to sell only a portion of her interest.[77]

---

71. The character of the $200 gain from the sale of the partnership interest would depend on the nature of the partnership's assets. *See* I.R.C. §§ 751(a) and 741 (1994).

72. *See* I.R.C. § 742 (1994).

73. The purpose of the § 743(b) adjustment is to equate a transferee's outside basis with her share of inside basis and is determined by comparing the two. Here, the transferee's outside basis is $1,400, and her share of inside basis is $1,200; therefore, the adjustment is $200. Once determined, the adjustment is allocated among the partnership's assets in the manner prescribed in § 755. These "special basis adjustments" are for the benefit or detriment of the transferee partner only.

74. Again, the character of the gain would depend on the nature of the partnership's assets. *See* I.R.C. §§ 751(a) and 741 (1994).

75. The adjustment is $900 more under the deferred sale method in order to offset the $900 of § 704(c) gain inherent in the property for which *D* is now responsible.

76. There may be a difference in characterization depending on the nature of the partnership's assets. Under the deferred sale method, the deferred gain is characterized at the time of the contribution, while under current law the gain from the entire sale of the partnership interest is determined based upon the composition of the partnership's assets at the time of the sale. *See* I.R.C. § 751(a) (1994).

77. For example, if *A* sells one half of her interest in PRS to *D* for $500, then:

> *Deferred Sale Method:* When *A* sells 1/2 of her partnership interest in which she has a basis of $150, 1/2 of her deferred gain, or $450, is triggered. This instantaneously increases her outside basis in the 1/2 interest sold to $600. Thus, she has a loss of $100 on the sale (probably a capital loss) and a net gain of $350 on the transaction. Her outside basis in the remaining partnership interest is $150.
>
> *Current Law:* If *A* were to sell 1/2 of her interest in PRS for $500, she would have a gain of $350.
>
> *Comparison:* With respect to *A*, there is no difference in either the timing or the amount of the gain on the transaction. As noted above, there may be difference in character.

E. Death of a Partner[78]

Under current law, the successor in interest to a deceased partner generally takes a "stepped-up" basis in that interest equal to its fair market value under section 1014(a). Items of income with respect to a decedent (IRD), however, are not eligible under section 1014,[79] and, therefore, the decedent's successor in interest must reduce her outside basis by any items of IRD attributable to the partnership interest.[80] If the partnership has a section 754 election in effect, then the successor gets a special basis adjustment with respect to the partnership assets under sections 743(b) and 755. Thus, under current law, any built-in gain still unrecognized at the death of the contributing partner may disappear, assuming the existence of a section 754 election.

In crafting the deferred sale method, a threshold policy question must be addressed: should death eliminate the still unrecognized deferred gain of a deceased partner or should that gain be treated like income in respect of a decedent and continued following the partner's death? The rule that most nearly approximates present law would eliminate the deferred gain account at death. Yet an argument can be made that the deferred gain account is more like an installment obligation, which is treated as income in respect of a decedent.[81]

If the policy choice is made *not* to treat deferred gain as IRD, there would not be any significant differences between current law and the deferred sale method. If the deferred gain were treated as IRD, then it would not be entitled to a step-up and would be taxed eventually to the decedent's successor. To illustrate, suppose *A* dies leaving her partnership interest to *B*. At the time of *A*'s death, her outside basis is $300, the value of her interest is $1,200, and PRS is still holding Blackacre.

> *Deferred Sale Method:* There are two alternative treatments possible. First, the deferred gain could be considered IRD, in which case *A*'s successor would be responsible for the gain when a triggering event later occurs.[82] Second, the deferred gain could be treated as unrealized appreciation, in which case *A*'s successor would be entitled to a section 1014 basis of $1,200, and the deferred gain would disappear.
>
> *Current Law:* Under section 1014, *A*'s estate takes a stepped-up basis of $1,200 in the partnership interest. *A*'s successor would be entitled to a section 743(b) adjustment of $900.[83]

---

78. For a more complete discussion of the tax consequences resulting from the death of a partner, see McKee et al., *supra* note 34; Cunningham & Cunningham, *supra* note 49, at 202-07.

79. *See* I.R.C. § 1014(c) (1994).

80. Under Treas. Reg. § 1.742-1, a successor's outside basis is equal to the net value of the partnership interest, plus her share of liabilities, less any items of income with respect to a decedent.

81. *See* I.R.C. § 691(a)(4) (1994).

82. *See* I.R.C. § 691(a) (1994).

83. Prior to her death, *A*'s share of inside basis was $300. Since *A*'s estate takes a basis of $1,200, the § 743(b) adjustment is $900.

Comparison: Unless the deferred gain is treated as IRD, there are no significant differences.

F. Admission of a New Partner

If one adopted the deferred sale method for contributions, then a similar rule should apply when a new partner is admitted. In such a case, the partnership would book up its assets to fair market value and allocate the inherent gain or loss among its partners. Each of the old partners would eventually be responsible for her distributive share of that gain or loss—albeit on a deferred basis. To illustrate, consider the tax consequences if, on January 1, 2000, *D* contributes $2,000 for a one-quarter interest in PRS. On this date, PRS's assets have the following book and fair market values:

	Book	FMV
Blackacre	$1,200	$2,700
Whiteacre	1,200	300
Securities	1,200	3,000
	$3,600	$6,000

	Capital Accounts	
	Book	FMV
A	$1,200	$2,000
B	1,200	2,000
C	1,200	2,000
	$3,600	$6,000

Deferred Sale Method: When *D* joins the partnership, the partnership must book up its assets to fair market value, and all unrealized gain and loss existing at that time must be allocated equally among *A*, *B*, and *C*. As in the case of contributed property, this gain or loss will be deferred until a triggering event. The partnership will step up (or down) its basis in each of its assets to fair market value. PRS's balance sheet after the admission of *D* will be:

	Book
Cash	$2,000
Blackacre	2,700
Whiteacre	300
Securities	3,000
	$8,000

	Capital Accounts
	Book
A	$2,000
B	2,000
C	2,000
D	2,000
	$8,000

If PRS were to subsequently sell Blackacre, Whiteacre, or the securities, in addition to their normal distributive shares, *A*, *B*, and *C* would each have a gain (or loss) of $500, $300, and $600, respectively. These gains and losses would also be triggered for any partner who disposes of her interest. In addition, *A* (who originally contributed Blackacre to PRS) must recognize $900 of deferred gain if PRS disposes of Blackacre or if she disposes of her partnership interest.

Current Law: This is known as a "reverse section 704(c)" transaction, and the current regulations under section 704(b) require treatment similar to that described above for contributed property.[84] When a new partner is admitted, the partnership is permitted to book up its assets and capital accounts to reflect the disparities between fair market value and tax basis.[85] The discrepancy between each partner's book and tax capital account reflects his or her share of section 704(c)-type gain, which the partnership must allocate under section 704(c) principles, e.g., under the traditional method, the traditional method with curative allocations, or the remedial allocation method.[86]

Comparison: Because the current sections 704(b) and 704(c) regulations require that "reverse section 704(c)" transaction be accounted for in the same fashion as contributions, applying the deferred sale method to the admission of new partners creates no new complications. Of course, to the extent that there are differences between the two methods in handling precontribution gain, the same differences will exist with respect to "section 704(c)-type" gain. For example, if ceiling rule limitations come into play, the deferred sale method would avoid the shifting of gain or loss that can occur under present law. Of the two, the deferred sale method is certainly simpler in that the partnership will account for all section 704(c)-type gain, in the same way and will never result in the shifting of gain.

G. Distributions (Disguised Sales and Mixing Bowl Transactions)

As discussed above, under current law, distributions *sometimes* trigger the recognition of all or a portion of built-in gain or loss by a contributing partner. The result varies depending upon the composition of the distribution (cash or property, and which property), the timing of the distribution, and the facts and circumstances surrounding the distribution. The analysis is quite complex and implicates three Code sections: sections 707(a)(2)(B), 704(c)(1)(B), and 737. The analysis begins with section 707(a)(2)(B), which treats a contribution and a related distribution as a disguised sale if, based upon all the circumstances, two conditions are met: first, the partnership would not have made the distribution to the partner in the absence of the contribution, and second, the second transfer (usually the distribution) is not dependent on the entrepreneurial

84. *See* Treas. Reg. § 1.704-1(b)(4)(i) (as amended in 1994).
85. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 1994).
86. *See* Treas. Reg. § 1.704-3(a)(6)(i) (as amended in 1995).

risks of the partnership.[87] In determining whether these two conditions are met, the regulations create two alternative presumptions. If the transfers occur within two years of one another, a rebuttable presumption is created that they constitute a sale;[88] if they occur more than two years apart, a rebuttable presumption is created that they do not.[89] If the transfers do constitute a sale, then they are treated as a sale for all purposes of the Code.[90]

If section 707(a)(2)(B) does not apply, the contributor will still be taxed on all or a portion of the built-in gain if, within seven years of contribution, the contributed property is distributed by the partnership to another partner,[91] or if the contributor receives a distribution of other partnership property.[92] The amount of built-in gain that is recognized depends, inter alia, on the value of the property distributed. Under this regime, distributions made more than seven years after the contribution generally will not trigger any built-in gain.[93]

In contrast to the uncertainty and complexity of the disguised sale and mixing bowl rules, the deferred sale method is straightforward: deferred gain is recognized if (i) the partnership distributes the contributed property to another partner, or (ii) the contributor receives a distribution in whole or partial liquidation of her partnership interest. This result is independent of the timing of the distribution and the facts and circumstances surrounding the distribution. Hence, it eliminates the need for sections 704(c)(1)(B), 707(a)(2)(B), and 737, as well as all of the regulations issued under those sections. Therefore, by insisting that the contributor of property must *always* eventually recognize built-in gain, the adoption of the deferred sale method would enormously simplify the law.

To illustrate the difference between the two methods, consider the following five alternative distributions made by PRS, each of which is proportional. At the time of each distribution, *A*'s outside basis is $300 and *C*'s outside basis is $1,200. The alternatives are: (i) three years after formation, PRS distributes $1,500 of nonmarketable securities to *A* in complete liquidation of her interest; (ii) three years after formation, PRS distributes $900 of nonmarketable securities to *A* in complete liquidation of her interest; (iii) eight years after formation, PRS distributes $1,500 of nonmarketable securities to *A* in complete liquidation of her interest; (iv) three years after formation, PRS distributes Blackacre, then worth $1,500, to *C* in complete liquidation of her interest in PRS; and (v) three years after formation, PRS distributes Blackacre, then worth $900, to *C* in

87. *See* Treas. Reg. § 1.707-3(b)(1) (as amended in 1995).
88. *See* Treas. Reg. § 1.707-3(c).
89. *See* Treas. Reg. § 1.707-3(d).
90. *See* Treas. Reg. § 1.707-3(a)(2).
91. I.R.C. § 704(c)(1)(B) (1994).
92. I.R.C. § 737 (1994).
93. Technically, it is possible that § 707(a)(2)(B) could still apply. Also, the distribution could violate the anti-abuse rule under Treas. Reg. § 1.704-4(f). Example 2 under this regulation suspends the statutory period. This example is controversial and may be held invalid by the courts. *See* McKee et al., *supra* note 34, ¶ 10.04[4][g].

complete liquidation of her interest in PRS. As a result of each alternative distribution, under the deferred sale method, *A* must recognize the $900 of deferred gain. Under current law, however, the analysis is much more complicated and uncertain, and the amount that *A* must recognize varies from alternative to alternative.

(i) Three years after formation, PRS distributes $1,500 of nonmarketable securities to *A* in complete liquidation of her interest.

Deferred Sale Method: The distribution triggers *A*'s $900 deferred gain, increasing her outside basis to $1,200.[94] When she receives the nonmarketable securities, she recognizes no further gain or loss and takes a $1,200 basis in the securities.[95]

Current Law: The first issue is whether the contribution of Blackacre and the distribution of the securities constitute a disguised sale under section 707(a)(2)(B).[96] If they do, then *A* is treated as if she sold Blackacre on the date of formation.[97] To determine *A*'s amount realized from the sale, the value of the securities would have to be discounted back to the date of formation.[98] Since the distribution occurs more than two years after Blackacre was contributed, a presumption is created that there is not a sale.[99] If this is the case, because the distribution occurred within seven years of the contribution, section 737 will apply. Under this provision, *A* must recognize the lesser of the excess distribution ($1,200)[100] or her net precontribution gain ($900),[101] or $900. She also must increase her outside basis by $900 to $1,200.[102] She therefore takes a $1,200 basis in the securities.[103]

Comparison: If the transaction falls under section 737, the results under the two methods on these facts are the same. If the transaction falls under section 707(a)(2)(B), the results are similar, but much more complicated because the sale is deemed to occur on the date of the contribution.

(ii) Three years after formation, PRS distributes $900 of nonmarketable securities to *A* in complete liquidation of her interest.

Deferred Sale Method: *A*'s $900 deferred gain is triggered, increasing her outside basis to $1,200. She takes a $1,200 basis in the securities.[104]

94. *See* I.R.C. § 705(a)(1) (1994).
95. *See* I.R.C. § 732(b) (1994).
96. *See* Treas. Reg. § 1.707-3(d) (1992).
97. *See* Treas. Reg. § 1.707-3(a)(2) (1992).
98. *See* I.R.C. § 1274 (1994). For an illustration of how this is done, see Treas. Reg. § 1.707-3(f)(ex. 2) (1992).
99. *See* Treas. Reg. § 1.707-3(d) (1992).
100. "Excess distribution" is the term used to describe the excess of the fair market value of the property (other than money) received in the distribution over the partner's outside basis immediately before the distribution (reduced by any money received). *See* I.R.C. § 737(a)(1) (1994).
101. *See* I.R.C. § 737(b) (1994).
102. *See* I.R.C. § 737(c)(1) (1994).
103. *See* I.R.C. § 732(b) (1994).
104. *See id.*

Current Law: Again, one must first decide if the contribution of Blackacre followed by the distribution is properly characterized as a disguised sale of Blackacre. Assuming that it is not (because of the two-year presumption),[105] because the distribution occurs within seven years of the contribution, *A* must recognize $600 under section 737.[106] This increases her outside basis to $900. She therefore takes a $900 basis in the securities.[107]

Comparison: The principal difference between the two methods is that the amount of gain that must be recognized under the deferred sale method is not dependent on the value of the liquidating distribution. Although *A* must recognize $300 more under the deferred sale method, *A* has an equal and offsetting loss in the securities.

(iii) Eight years after formation, PRS distributes $1,500 of nonmarketable securities to *A* in complete liquidation of her interest.

Deferred Sale Method: The timing of the distribution does not matter. As in the case where the distribution occurred within seven years, *A* must recognize the $900 in deferred gain and takes a $1,200 basis in the securities.

Current Law: Once again, one first must determine whether the contribution and distribution constitute a disguised sale.[108] In the absence of special facts, this seems unlikely. Since the distribution occurs more than seven years after the contribution, by its terms, section 737 does not apply.[109] Therefore, it is very likely that *A* will not recognize any gain and will take a $300 basis in the securities.[110] If there is a section 754 election in place, PRS should be entitled to a section 734(b) adjustment of $900.

Comparison: Current law and the deferred sale method produce very different tax results on these facts. Under the deferred sale method, the contributor of section 704(c) property always remains responsible for any precontribution gain, while under current law this is true only for seven years.

(iv) Three years after formation, PRS distributes Blackacre, then worth $1,500, to *C* in complete liquidation of her interest in PRS.

Deferred Sale Method: The distribution triggers *A*'s $900 of deferred gain, increasing *A*'s outside basis to $1,200. *C* reports no gain or loss on the distribution and takes a basis of $1,200 in Blackacre.

Current Law: Since the distribution of Blackacre occurs within seven years of *A*'s contribution, under section 704(c)(1)(B), *A* must recognize $900 of gain. This has the effect of increasing *A*'s outside basis to $1,200 and PRS's basis in Blackacre (immediately prior to the distribution) to $1,200. *C* takes a $1,200 basis in Blackacre.

---

105. *See* Treas. Reg. § 1.707-3(d) (1992).

106. Under § 737(a), *A* must recognize the lesser of the excess distribution ($600) or the net precontribution gain ($900). Since the excess distribution is the lesser, *A* does not recognize $300 of the built-in gain.

107. *See* I.R.C. § 732(b) (1994).

108. *See* Treas. Reg. § 1.707-3(d) (1992).

109. *See id.*

110. *See id.*

Comparison: The deferred sale method works precisely the same as current law on these facts.

(v) Three years after formation, PRS distributes Blackacre, then worth $900, to *C* in complete liquidation of her interest in PRS.

Deferred Sale Method: Under the deferred sale method, the value of Blackacre at the time of its distribution to *C* is irrelevant. *A* will still recognize her $900 deferred gain, and *C* will take a $1,200 basis in Blackacre.[111]

Current Law: The amount taxed to *A* under section 704(c)(1)(B) will be only $600, because that section posits a hypothetical sale of the property at its fair market value at the time of distribution. *A*'s outside basis will increase to $900, and *C* will take a basis in Blackacre of $900.

Comparison: Because the deferred sale method is unconcerned with changes in the fair market value of the contributed property, it achieves a different result in this case and is preferable because it taxes *A* on the full amount of built-in gain.

G. Depreciable Property

Until now we have assumed that the contributed property, Blackacre, is non-depreciable. In this section we will consider what difference it makes if the contributed property is depreciable. We demonstrate that in the case of depreciable property the deferred sale method generates significantly better results than current law. The analysis varies depending on whether a partnership applying current law elects to use the traditional method, the traditional method with curative allocations, or the remedial allocation method. Yet in each case, the results achieved by applying the deferred sale method are preferable.

Under the traditional method and the traditional method with curative allocations, upon receipt of contributed property a partnership steps into the shoes of the contributing partner for depreciation purposes; the partnership takes a transferred basis[112] and continues to depreciate the property using the same method of depreciation as the transferor.[113] In stark contrast, the deferred sale method gives the partnership a fair market value basis in the property. The partnership is treated as though it just purchased the property and, therefore, should not be restricted in its choice of method of depreciation.[114] The remedial allocation method of

111. Similar results would occur if the distribution was in partial liquidation of *A*'s interest. Suppose *A* were to receive $1,000 in securities, reducing her interest from 1/3 to 1/5 in the partnership. In addition to the tax consequences of the distribution, she would also have to recognize a portion of her deferred gain. Since her interest in Blackacre (through the partnership) has been reduced from 1/3 to 1/5, she must recognize 40% of the deferred gain (13.3/33.3 = .40).

112. *See* I.R.C. § 723 (1994).

113. *See* I.R.C. § 168(i)(7) (1994).

114. If desired, it would be possible to treat the transaction as a contribution in part and a purchase in part. This is the approach of the remedial method. *See* Treas. Reg. § 1.704-3(d)(2) (as amended in 1995).

current law combines these two approaches: for book purposes, the partnership's acquisition of the property is treated in part as a contribution and in part as a purchase.[115] In many ways, the remedial allocation method is similar to the "partial deferred sale" approach considered and rejected by the A.L.I. in 1954.[116] The results under the remedial allocation method are similar to those of the deferred sale method, but remain optional. For that reason, partnerships that are in a position to take advantage of one of the other two methods are not apt to elect the remedial method.

Under the deferred sale method, the partnership is treated as if it purchased the contributed property. It therefore takes a cost basis and is entitled to choose any method of depreciation permitted by the Code. As the partnership recovers its cost, the contributor must recognize her deferred gain or loss. Although this can be accomplished in a variety of ways, we suggest a proportional approach.[117] Under this proposal, the contributor must recognize her deferred gain at the same rate as the partnership recovers its unadjusted cost basis. Using this approach, if the partnership recovers twenty percent of its unadjusted cost in a particular year, the contributor must recognize twenty percent of her deferred gain in that same year.

To illustrate, reconsider our basic example except assume that Blackacre is a ten-year property[118] that *A* purchased seven years ago for $1,000 and that *A* has been depreciating it using the straight-line method (i.e., $100 per year). For simplicity, ignore all conventions.[119] On the date of formation, *A*'s adjusted basis in Blackacre is $300, and there are three years remaining in its recovery period.

> *Deferred Sale Method*: Under the deferred sale method, PRS would be treated as if it purchased Blackacre for $1,200 and would be entitled to use any method of depreciation permitted by the Code. If PRS elects to use the straight-line method over ten years, it would be entitled to a depreciation deduction of ten percent of its unadjusted cost, or $120 each year. Of this amount, PRS would allocate $40 to each partner. Concurrently, under the proportional approach, *A* must also report ten percent of her deferred gain, or $90 each year. Therefore, for each of the first ten years, *A* must report $90 of deferred gain and will be entitled to $40 of depreciation.
>
> *Current Law:* First, assuming that PRS has not adopted the remedial allocation method, PRS will step into *A*'s shoes for depreciation purposes and must use the straight-line method over the remaining three years in Blackacre's recovery period, meaning its depreciation

115. *See* Treas. Reg. § 1.704-3(d)(2) (as amended in 1995).

116. *See supra* notes 16-28 and accompanying text.

117. Other approaches include reporting built-in gains pro rata over the property's recovery period without respect to the method of depreciation chosen, and the approach adopted by the remedial method, discussed immediately below.

118. *See* I.R.C. § 168(e)(3)(D) (1994).

119. *See generally* I.R.C. § 168(d) (1994).

deduction will equal $100 per year for three years.[120] Under the capital accounting rules, PRS must recover the same proportion of its book basis as it does for tax purposes, i.e., $400 per year for three years.[121]

This presents another classic ceiling rule problem: if PRS uses the traditional method (and is not subject to the § 704(c) anti-abuse rule),[122] the first year it will have $400 of book depreciation, which it will allocate equally among the partners; however, it will only have $100 of tax depreciation. Although *B* and *C* should each be entitled to $133 of tax depreciation, under the traditional method they will be limited to $50 each.[123] This method means that each year, for three years, *B* and *C* are overstating their income by $83.33. The net effect of this method is to shift $500 of *A*'s precontribution gain to *B* and *C* over three years, once again a clear violation of the stated purpose underlying section 704(c). Yet this is the result mandated by the ceiling rule, and, unless within the scope of the anti-abuse rule,[124] it is permissible.

Under the traditional method with curative allocations (again, if not subject to the anti-abuse rule), if the partnership has sufficient ordinary income, PRS would be able to offset the effects of the ceiling rule by allocating $167 of its ordinary income to *A* for tax purposes while allocating this same amount of income to *B* and *C* ($83.33 each) for book purposes. This allocation offsets the shortfall in depreciation to *B* and *C* and taxes *A* on her precontribution gain. In the usual case, Blackacre would be fully depreciated at the end of three years.[125]

Under the remedial allocation method, the computations are significantly more complex. The partnership must use a special rule to determine the amount of book depreciation. This special rule is loosely based on the notion that the partner sold a portion of the property to the partnership under the deferred sale method and contributed the balance. The partnership takes a fair market value basis (for book purposes) in the purchased portion (here $900) and a transferred basis in the contributed portion (here $300). As to the portion with the transferred basis (here $300), the partnership steps into the shoes of the partner for both book and tax purposes and must continue to use the contributing partner's cost recovery method. The value of the property in excess of its basis (here $900) is treated for book purposes as the purchase price of the balance of the property. With respect to this latter amount, the partnership may use any depreciation method permitted by the Code. On our facts,

---

120. *See* I.R.C. § 168(i)(7) (1994).

121. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) (1994).

122. *See* Treas. Reg. § 1.704-3(a)(10) (as amended in 1995).

123. *See* Treas. Reg. § 1.704-3(b)(2) (ex. 1) (as amended in 1995).

124. Whether this type of garden-variety ceiling rule situation is within the anti-abuse rule is open to dispute. We do not believe it is. *See* Cunningham, *Section 704(c)*, *supra* note 26, at 116-20.

125. Under certain circumstances, curative allocations may have to be spread over a longer period of time, such as the economic life of the property. *See* Treas. Reg. § 1.704-3(c)(3)(ii) (as amended in 1995).

PRS would be treated as if it acquired two pieces of property, one that was contributed by *A* (value and basis equal to $300) and one that was purchased by PRS for $900. With respect to the contributed portion, PRS is entitled to depreciation of $100 per year for three years for both book and tax purposes. With respect to the $900 portion that is notionally purchased, let us assume that PRS chooses to depreciate it for book purposes using the straight-line method over ten years, or $90 per year. Therefore, PRS would have book depreciation of $190 for the first three years (i.e., $100 + $90) and then $90 per year for the remaining seven years. For the first three years PRS allocates its $190 of book depreciation equally among the partners, or $63.33 each. The $100 of tax depreciation in each of those three years is shared equally by *B* and *C*, or $50 each. Since this amount is less than their respective book allocations, they each are given a remedial allocation of ($13.33), and *A* is given an offsetting positive allocation of $26.67. For the remaining seven years, each partner is entitled to book depreciation of $30 per year. Since there is no longer any tax depreciation, *B* and *C* are each given remedial allocations of $30, and *A* is given an offsetting positive allocation of $60.

Comparison: The results under the deferred sale method are dramatically different from, and far superior to, those under the traditional method of current law. It eliminates the ceiling rule problems and requires the partnership to recover its cost as if the partnership just purchased the property. Also, in many cases, the deferred sale method is superior to the traditional method with curative allocations. First, it is not dependent on the presence of other appropriate items of income; second, the recovery period used for the property is always reasonable under the deferred sale method, while it may be unreasonably short in the case of the traditional method with curative allocations. This latter aspect could be used in transactions that might be viewed as abusive.[126] While the results under the remedial method and the deferred sale method are generally consistent, the remedial method is elective and somewhat more complicated.

H. Complications

While adoption of the deferred sale method would vastly simplify the taxation of partnerships in many ways, there are some instances in which it might be more complicated than under current law. These complications arise when the partnership disposes of the contributed property in a nonrecognition transaction or an installment sale and stem from the fact that the deferred sale method gives the partnership a stepped up basis before the contributing partner recognizes the deferred gain. While one obvious and simple solution would be to require the contributing partner to recognize any remaining deferred gain at the time the partnership enters into one of these problematic transactions, to do so would represent a significant change in current law. It therefore becomes necessary to

126. *See, e.g.*, Treas. Reg. § 1.704-3(c)(4)(ex. 3) (as amended in 1995) (illustrating the unreasonable use of the traditional method with curative allocations).

devise a system under which the disparity between the partnership's basis and that of the contributor can be taken into account. Below we describe four of the troublesome transactions, including (i) a like-kind exchange, (ii) a contribution to a corporation, (iii) an installment sale, and (iv) a contribution to a lower-tiered partnership, and suggest how they could be dealt with under the deferred sale method.[127] We conclude that all of these transactions can be handled in a satisfactory manner.

I. Like-Kind Exchanges—Section 1031

The first of the problematic transactions is the exchange by the partnership of contributed property for other like-kind property in a transaction qualifying for full or partial nonrecognition of gain under section 1031. Under current law, the property acquired in the exchange is essentially substituted for the contributed property, and the built-in gain or loss is carried forward into that property.[128]

Like-kind exchanges are the easiest of the three transactions to adapt to the deferred sale method. We suggest that, like current law, recognition of the deferred gain should be postponed until the partnership disposes of the property acquired in the exchange. The contributor should only recognize gain to the extent that the boot received by the partnership in the exchange exceeds the gain realized by the partnership. Deferred loss would not be recognized on an exchange.[129] To illustrate, consider the following examples, using the facts of the basic example described above:

Assume that on January 1, 2000, PRS exchanges Blackacre solely for Whiteacre in an exchange qualifying for nonrecognition treatment under section 1031(a). At the time of the exchange, both Blackacre and Whiteacre are valued at $1,500.

> *Deferred Sale Method:* PRS realizes a $300 book and tax gain, none of which is recognized. PRS takes a substituted basis of $1,200 in Whiteacre. None of *A*'s deferred gain is recognized, but is essentially carried forward into Whiteacre.

127. These transactions are similar to examples involving intercompany sales under the consolidated return regulations. An intercompany sale is a sale between members of the same consolidated group. *See generally* Treas. Reg. § 1.1502-13 (as amended in 1997). These regulations treat intercompany sales as if they occurred between divisions of the same corporation, and the seller's gain or loss is not immediately taken into account. *See* Treas. Reg. § 1.1502-13(b)(2). Instead, under a matching rule, the gain or loss is held in abeyance until the buyer recognizes its corresponding gain or loss. *See* Treas. Reg. § 1.1502-13(c)(2). To illustrate how these complicated rules work in a simple case, suppose *S* and *B* are members of the same consolidated group, and *S* sells Blackacre with a basis of $70 to *B* for $100. *S*'s $30 gain is not currently recognized as an intercompany gain. If *B* subsequently sells Blackacre to a nonmember for $110, *B* will have a gain of $10 and *S* must recognize its $30 gain.

128. *See* Treas. Reg. § 1.704-3(a)(8) (as amended in 1995). The regulations do not provide detailed rules for the case where some gain is recognized in a nonrecognition transaction; they merely state that, in that instance, "appropriate adjustments must be made." *Id.*

129. *Cf.* Treas. Reg. § 1.1502-13(c)(7)(ii)(ex. 1)(h) (as amended in 1997) (intercompany sale followed by a § 1031 exchange with a nonmember—intercompany gain not recognized).

Current Law: Under current law, PRS realizes a book gain of $300 and a tax gain of $1,200, neither of which is recognized. PRS takes a substituted basis in Whiteacre of $1,200 for book purposes and $300 for tax purposes. *A*'s § 704(c) gain of $900 is carried forward into Whiteacre.

Comparison: On these facts, there is no significant difference between the two methods.

Assume instead that PRS exchanges Blackacre (worth $1,500) for Whiteacre (worth $1,400) plus $100 cash.

Deferred Sale Method: PRS realizes a tax and book gain of $300 and must recognize $100 of that gain. Because the boot received did not exceed the gain realized by PRS, none of *A*'s deferred gain is triggered.

Current Law: PRS recognizes $100 of gain for book and tax purposes. None of *A*'s section 704(c) gain is recognized.

Comparison: On these facts, there is no significant difference between the two methods.

Assume instead that Blackacre's value is $900 at the time it is exchanged for Whiteacre (worth $800) plus $100 cash.

Deferred Sale Method: PRS realizes a $300 loss, none of which is recognized.[130] Because PRS received $100 of boot in excess of its recognized gain, *A* must recognize $100 of deferred gain.

Current Law: PRS realizes a book loss of $300 and a tax gain of $600. The $100 of tax gain must be allocated to *A* under section 704(c).

Comparison: On these facts, there is no significant difference between the two methods.

J. Incorporation—Section 351

Under current law, no gain or loss is recognized when a partnership incorporates its business.[131] The corporation essentially steps into the shoes of the partnership for purposes of determining its basis in the assets received and for computing depreciation. Each partner takes a basis in the stock received equal to her basis in her partnership interest. Thus, under current law, when a partner contributes property to a partnership that is subsequently transferred to a corporation, both the partner and the corporation are in the same position as though the property had been contributed directly to the corporation by the partner. Any unrecognized built-in gain will be taxed twice: once to the corporation when it sells or disposes of the property and, again, to the contributor when she sells her stock.

Replicating these results under the deferred sale method is tricky, because the partnership's basis in the contributed property, which is transferred to the corporation has been stepped up prior to recognition of all

130. *See* I.R.C. § 1031(c) (1994).
131. *See* I.R.C. § 351 (1994).

of the contributor's deferred gain. Two possibilities exist for dealing with this problem. First, the transfer of the contributed property to a corporation in a nonrecognition transaction could be treated as an event which triggers recognition of deferred gain.[132] This possibility obviously represents a major change in current law. The only way to replicate the current law result is to reduce the corporation's basis in the contributed property by the amount of any as yet unrecognized deferred gain.[133]

To illustrate, suppose that sometime after the formation of PRS, the partnership contributes all of its assets to a newly formed corporation, *X*, in exchange for stock in a section 351 transaction. The stock is distributed equally to *A*, *B*, and *C* in liquidation of the partnership.

Deferred Sale Method: Under the rule suggested above, immediately before the formation of *X*, PRS's basis in Blackacre would be reduced to $300. *X* will take a basis in Blackacre of $300, and *A*'s basis in her stock will be $300.

Current law: Neither PRS nor any of the partners recognize gain or loss. *X* takes a transferred basis of $300 in Blackacre, and *A* takes a substituted basis of $300 in her stock.

Comparison: On these facts, there is no significant difference between the two methods.

K. Installment Sales—Section 453

As a policy matter, one must decide whether, and how, to take into account deferred gain or loss when a partnership sells contributed property on the installment method. Section 453 provides that, absent an election to the contrary, "income from an installment sale shall be taken into account . . . under the installment method."[134] An installment sale is one in which at least one payment is to be received following the year of sale,[135] and the installment method allows ratable reporting of the gain as payments are received.[136]

Because current law gives the partnership a transferred basis in the contributed property, any gain that the partnership realizes on a later sale will include some or all of the built-in gain that must be allocated to the contributor under section 704(c). When that sale is made as an installment sale, the partnership will not report the section 704(c) gain (and neither will the contributor) until payments are received. Thus, current law allows reporting of the section 704(c) gain under the installment method.

132. This is how consolidated return regulations treat an intercompany sale followed by a § 351 transfer to a corporation that is not a member of the consolidated group. *See* Treas. Reg. § 1.1502-13(c)(7)(ii)(ex.1) (as amended in 1997).

133. These adjustments are similar to those required under sections 704(c)(1)(B) and 737 of current law.

134. I.R.C. § 453(a) (1994).

135. *See* I.R.C. § 453(b)(1) (1994).

136. *See* I.R.C. § 453(c) (1994). As each payment is received, the taxpayer reports a percentage determined by dividing the gross profit by the total contract price. *See* Treas. Reg. § 15A.453-1(b)(2) (as amended in 1994).

It is conceptually difficult to adapt the installment method to deferred gain under the deferred sale approach, because that approach posits a theoretical sale at the time the property is contributed to the partnership. The subsequent sale by the partnership will realize not only gain in excess of the deferred gain, but it will also trigger recognition of the deferred gain. The simplest approach would be to require immediate recognition of the deferred gain, while permitting the partnership to report its gain on the installment method. This approach, however, would be a significant change from current law and may be viewed by some as too harsh. To preserve the current rules, we suggest that the installment sale rules be applied by essentially ignoring the theoretical sale that took place at the time of the contribution and by computing the partnership's gross profit using not the partnership's basis, but the contributor's basis in the property at the time of formation (adjusted for any deferred gain since recognized).[137] As the partnership receives payments with respect to the sale and applies its gross profit percentage to the payments, the resulting gain should be shared appropriately between the contributor and the partnership. We believe this is the correct approach if the goal is to parallel current law governing the timing of recognition of built-in gain. Yet, in contrast with current law, the ceiling rule problems are eliminated.

To illustrate, suppose PRS sells Blackacre, nondepreciable real property, to *X*, an unrelated party, for a total purchase price of $1,500, payable in three annual installments of $500 plus adequate stated interest.

> *Deferred Sale Method:* For purposes of section 453, PRS would determine its gross profit from the sale with reference to *A*'s basis in Blackacre at the time of contribution, $300. Therefore, the total gross profit from the sale is $1,200, $400 of which must be reported each year for three years.[138] Of this $1,200 gain, $300 (or 1/4) is allocable to PRS and $900 (or 3/4) is *A*'s deferred gain. Sharing the gain proportionately, of each $400 payment, $100 is allocable to PRS, and $300 is allocable to *A*.
>
> *Current Law:* On the sale, PRS has a realized book gain of $300 and a tax gain of $1,200. Under the installment method, PRS would report this gain over three years at the rate of $100 for book purposes and $400 for tax purposes. For tax purposes, PRS would allocate a $100 gain in the same manner as book gain and the $300 balance to *A* as a section 704(c) gain.
>
> *Comparison:* On these facts, there is no significant difference between the two methods.

Under our suggested rule, it is possible that an installment sale that triggers deferred gain can occur even though the partnership is selling at a loss. Under current law, this would be a ceiling rule situation: the contributor would report less than all of the built-in gain, and the non-con-

137. This treatment is quite similar to that prescribed for an intercompany sale followed by an installment sale to a nonmember. *See* Treas. Reg. § 1.1502-13(c)(7)(ii)(ex.5) (as amended in 1997).

138. The gross profit percentage is $1,200/$1,500, or 80%.

tributors would receive no tax loss to match their book loss. But, because the sale is an installment sale, the contributor would recognize the built-in gain realized on the sale under the installment method. If the partnership elected the remedial allocation method or the traditional method with curative allocations, the allocations necessary to give the non-contributors their tax loss (and the offsetting gain allocation to the contributor, in the case of the remedial allocation method) would occur in the year the sale takes place. As a result, current law would tax the contributor on a portion of the built-in gain in the current year while the portion actually realized by the partnership would be reported under the installment method.

In the context of the deferred sale approach, if all of the deferred gain was reported under the installment method, the result would be more favorable than under current law. In such a case, the total gain from the installment sale will be less than the contributor's deferred gain in an amount precisely equal to the partnership's loss. To preserve current law treatment, those two amounts should offset each other currently. We recommend that both the excess gain (that amount of deferred gain which is calculated by subtracting the contributor's basis from the partnership's sale price) and the partnership's loss be recognized currently. The balance of the deferred gain should be recognized as the partnership receives payments. To illustrate, suppose PRS sold Blackacre for a total purchase price of $900, payable in three annual installments of $300 (plus interest).

> *Deferred Sale Method:* PRS has a loss on the sale of $300 which is allocated equally among the partners. The sale triggers *A*'s $900 deferred gain, $300 of which she must report currently. The $600 balance is eligible for the installment sale method, or $200 a year for three years.
>
> *Current Law:* Under the traditional method, PRS has a book loss of $300 (but no corresponding tax loss) and a tax gain of $600. The book loss is allocated equally among the partners, and the tax gain is allocated entirely to *A*. The tax gain may be reported under the installment method at the rate of $200 a year for three years. The net effect of these allocations is to shift $200 of *A*'s precontribution gain to *B* and *C*. If PRS used the traditional method with curative allocations, this distortion might be avoided; if it used the remedial allocation method, it would be avoided.

L. Contributions to Lower-Tier Partnerships

A similar problem exists when a partnership contributes section 704(c) property to another partnership. If this transaction triggered deferred gain or loss, it might be viewed as unduly harsh in some cases (e.g., the further contribution of gain property to a lower-tier partnership) or unduly favorable in others (a loss may be recognized on the contribution to the lower-tier partnership).[139] As a policy matter, if one wanted to preserve the nonrecognition treatment traditionally granted to transactions in which section 704(c) property is contributed to lower-tier partnerships, this nonrecognition could be accomplished simply by modifying the events that trigger the deferred gain or loss. The major modification would be that the gain or loss would be triggered when the lower-tier (not the upper-tier) partnership disposes of the property or, in the case of depreciable property, as the lower-tier partnership depreciates the property. In addition, the gain or loss would be triggered if the upper-tier partnership disposes of its interest in the lower-tier partnership.

To illustrate, suppose PRS contributed Blackacre (value and basis of $1,200)[140] to a new partnership, LPRS, in exchange for a fifty percent interest. Under the deferred sale method, *A*'s $900 deferred gain would be triggered if any of the following events occur: (i) *A* disposes of her interest in PRS; (ii) PRS disposes of its interest in LPRS; or (iii) LPRS disposes of Blackacre. If Blackacre is depreciable, then *A* will report the $900 gain as LPRS depreciates Blackacre.

IV. CONCLUSION

There is no doubt that the current law governing contributions of property to partnerships is incredibly complex. Yet, current law fails to accomplish the basic goal of taxing the contributor on built-in gain or loss. It is therefore our opinion that Subchapter K should be reformed to accomplish that goal.

In this Article, we have advocated the deferred sale approach to taxing contributions to partnerships. We have demonstrated that this proposal is not radical. In many cases it replicates the result of current law, and, in those cases where it does not, it reaches a better result. Deferred sale treatment effectively taxes the contributor of property on the gain or loss inherent in that property at the time of contribution, and it does so in a far less complex manner than current law. The gain is not taxed immediately, but only as and when appropriate: when the partnership depreciates, sells, or distributes the contributed property, or when the contributor sells or otherwise reduces or terminates his interest in the partnership.

In addition to the fact that the deferred sale approach results in better tax consequences than current law, it does so in a far less complex manner than present law. Prior objections to deferred sale treatment based on valuation difficulties are no longer valid; current law already requires that contributed property be valued. But the current law requirement

139. *See* McKee et al., *supra* note 34, ¶ 10.04[3][d] (praising the adoption of the remedial allocation method by the final regulations rather than the full-blown deferred sale method, which had been used in the proposed regulations).

140. If there were a difference between basis and fair market value at the time of contribution to LPRS, then PRS would have its own deferred gain or loss that would be taken into account under the rules already developed.

that partnerships maintain two sets of accounts, one for book purposes and another for tax purposes, could be eliminated. Instead, only one set of accounts is necessary, in addition to maintenance of a deferred gain account for contributing partners. Deferred sale treatment would eliminate the ceiling rule distortions of current law and, hence, the need for the complex sections 704(c) regulations and the anti-abuse rule. It would also eliminate the need for all of the Congressional bandaids applied since 1984. Sections 704(c)(1)(B), 707(a)(2)(B), and 737 would no longer be necessary, as all issues concerning contributed property could be dealt with in one set of rules: the deferred sale rules.

Congressional action is clearly required in order to implement the deferred sale approach. The Treasury demonstrated its unwillingness to impose this approach when it created the optional remedial allocation method under section 704(c). Given the existing statutory structure dealing with disguised sales and mixing bowl transactions, statutory reform is necessary. We therefore encourage Congress to act in this matter in the interest of a better and less complex Subchapter K.