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REPAIRING INSIDE BASIS ADJUSTMENTS

*Karen C. Burke**

I. INTRODUCTION

Optional basis adjustments under Subchapter K have come under increased scrutiny as a result of tax shelter abuses involving partnerships.[1] Recent legislation requires mandatory adjustments under sections 734(b) and 743(b) upon certain distributions of partnership property and transfers of partnership interests.[2] These amendments were targeted at situations in which the failure to make such adjustments potentially gave rise to duplication of losses. Thus, a section 743(b) adjustment is mandatory upon a sale of an interest in a partnership with a "substantial built-in loss" to ensure that the purchasing partner cannot duplicate the selling partner's built-in loss inherent in the partnership assets.[3] Similarly, a section 734(b) adjustment is mandatory where a distribution in liquidation of a partner's interest would give rise to a "substantial basis reduction" if a section 754 election were in effect.[4] The provision is intended to prevent a liquidating distribution of low-basis property to a departing partner with a high outside basis from leaving the continuing partners with lower net built-in gain (or higher net built-in loss) than before the distribution. With respect to all current distributions and many liquidating distributions, inside basis adjustments remain optional.

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[1]For recommendations related to such tax-shelter transactions, see STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 29-30, 181-241 (Comm. Print 2003).

[2]American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833, 118 Stat. 1418, 1589, 1591-92 (amended sections 734 and 743) [hereinafter 2004 Act]. The 2004 Act also amended section 704(c) to disallow use of a built-in loss inherent in contributed property by any partner other than the contributing partner. *See* I.R.C. § 704(c)(1)(C). In addition, no basis decrease is permitted for corporate stock of a partner or related person as a result of the basis allocation rules of section 755; the partnership must recognize gain to the extent that the required downward adjustment exceeds the basis of the remaining partnership assets. *See* I.R.C. § 755(c). For a description of these changes, see H.R. CONF. REP. No. 108-755, at 621-627 (2004).

[3]To satisfy the threshold, the partnership's basis in its property, immediately following transfer of an interest, must exceed the fair market value of such property by more than $250,000. *See* I.R.C. § 743(d). Under sections 743(b) and (d), the purchaser's basis in partnership assets must be decreased to reflect the built-in loss attributable to the selling partner.

[4]*See* I.R.C. § 734(a). A downward adjustment of more than $250,000 to the basis of retained property is considered substantial. *See* I.R.C. § 734(d). When the partnership has a section 754 election in effect (or the mandatory adjustment provision applies), the basis of retained partnership property is reduced, under sections 734(b)(2)(A) and (B), to the extent that the distributee partner recognizes a loss or takes a basis in the distributed property higher than its former basis in the partnership's hands. *See* I.R.C. §§ 734(a), 734(b)(2), 755. Because only liquidating distributions give rise to recognized loss or an inflated basis in distributed assets, a current distribution cannot trigger a mandatory section 734(b) adjustment. *See* I.R.C. §§ 731(a)(2), 732.

While preventing loss duplication may be particularly urgent, these anti-tax-shelter measures represent a retreat from broader proposals calling for mandatory section 734(b) adjustments for both current and liquidating distributions.[5] Although recent regulations integrate section 743(b) adjustments and section 704(c) allocations, the basic mechanics of section 734(b) adjustments have remained largely unchanged since 1954.[6] In a recent article, Professor Abrams criticizes the common basis approach of section 734(b) for failing to allocate adjustments properly when partnership property is revalued following a non-pro rata current distribution of appreciated property.[7] His central claim is that, by analogy to section 743(b), the section 734(b) adjustment should benefit only the distributee partner rather than all of the continuing partners. Abrams also proposes treating a distribution of appreciated property as triggering remedial allocations of income and offsetting loss to prevent shifting of built-in gain as a result of the distribution. If these changes were made, Abrams argues that the section 734(b) adjustment would reach sensible results consistent with the purpose of the optional basis adjustments.

Part II of this article provides an overview of Abrams' proposed repairs to section 734(b). Part III suggests an alternative approach that would treat a non-pro rata current distribution of appreciated property as a deemed sale and extend section 704(c) principles to allocate the section 734(b) adjustment in a manner that aligns the continuing partners' post-distribution shares of inside basis, gain, and value. Part IV argues that the common basis approach of section 734(b), modified by section 704(c) principles, produces the correct results when revalued partnership property is depreciable or the distributee sells her reduced partnership interest. Finally, Part V suggests that a partial liquidation approach would remedy the underlying flaws in the common basis approach of section 734(b), without the need for complex section 704(c) special allocations, and would also cure defects in the 2004 legislation.[8] While Congress recognized the need for at least partially mandatory section 734(b) adjustments, it remains to be seen whether mandatory adjustments will be extended to distributions (both liquidating and nonliquidating) that shift gains as well as losses.

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[5]*See, e.g.*, William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3, 23 (1991). For an analysis of prior legislative proposals mandating section 734(b) adjustments, compare Karen C. Burke, *Reassessing the Administration's Proposals for Reform of Subchapter K*, 86 TAX NOTES (TA) 1423 (Mar. 6, 2000) with Ernst & Young LLP, *Analysis of the Administration's Partnership Proposals*, 84 TAX NOTES (TA) 103 (July 5, 1999).

[6]*See generally* Martin J. McMahon, Jr., *Optional Partnership Inside Basis Adjustments*, 52 TAX LAW. 35, 78 (1998). Any basis adjustments are allocated under the rules of section 755. *See* Reg. § 1.755-1(c).

[7]*See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 TAX LAW. 343 (2004).

[8]*See* Andrews, *supra* note 5, at 65-66 (recommending partial liquidation approach); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677, 710-713 (1998); *see also* GEORGE K. YIN & DAVID J. SHAKOW, ALI FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES (REPORTERS' STUDY) 306-313 (1999) [hereinafter ALI REPORTERS' STUDY].

II. NEEDED REPAIR: ABRAMS' PROPOSAL

Under Subchapter K, a non-pro rata current distribution is generally treated as a nonrecognition event.[9] Unless the partnership has a section 754 election in effect, the partnership's basis in undistributed assets remains unchanged.[10] The optional basis adjustment under section 734(b) allows an adjustment to the basis of retained partnership property to the extent that the distributee recognizes gain (or loss) or takes a basis in distributed assets that is different from their former basis in the partnership's hands.[11] The section 734(b) adjustment is necessary to maintain parity between the partnership's aggregate inside basis and the partners' aggregate outside basis, thereby preserving the partners' aggregate shares of unrealized appreciation in retained and distributed partnership property. While the section 734(b) adjustment provides the correct overall adjustment to inside basis, Abrams proposes to fix the allocation of the adjustment and to tax nondistributee partners on their share of built-in gain in distributed property.

Example (1). Assume that *P* receives a distribution of Whiteacre, reducing her interest in the equal *PQ* partnership from 1/2 to 1/6, when the partnership has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Blackacre	$60	$300	*P*	$100	$250
Whiteacre	140	200	*Q*	100	250
Total	$200	$500	Total	$200	$500

The partnership, which has a section 754 election in effect, revalues its assets in connection with the distribution.[12] The distribution triggers a positive section 734(b) adjustment of $40, equal to the excess of Whiteacre's predistribution basis ($140) over *P*'s basis in her partnership interest ($100). Under section 755, the $40 adjustment increases the partnership's common basis in Blackacre, reducing the partnership's post-distribution taxable gain to $200.[13] Under section 732(a)(2), *P* takes a basis of $100 in Whiteacre, leaving *P* with $100 of gain outside the partnership. Because *P*'s share of the partnership's predistribution gain was $150, it would appear that *P* should be taxed on only $50 of gain inside the partnership. The remaining $150 of gain should be taxed to *Q*. Each partner would thus be taxed on gain equal to the book-tax disparity in

[9] *See* I.R.C. §§ 731-733.

[10] *See* I.R.C. § 734(a).

[11] *See* I.R.C. §§ 731(a), 732(a)(2), 734(b).

[12] *See* Reg. § 1.704-1(b)(2)(iv)(f) (revaluation permitted but not required). This example is taken from Abrams, *supra* note 7, at 351-53.

[13] *See* Reg. § 1.755-1(c)(1). Accordingly, the partnership has the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Tax	Book
Blackacre	$100	$300	*P*	$0	$50
			Q	100	250
			Total	$100	$300

her post-distribution capital account. Following a sale of Blackacre, each partner would be entitled to a liquidating distribution equal to the value of her post-distribution interest. Although the distribution alters the partners' respective shares of gain inside and outside the partnership, neither partner would be undertaxed or overtaxed.

As Abrams argues, however, the existing rules may not reach such sensible results when a non-pro rata current distribution triggers a revaluation and section 734(b) adjustment. Because *P* and *Q* shared the partnership's predistribution gain equally, each partner's book capital account was credited with 1/2 of the appreciation in the partnership's assets. The $40 upward section 734(b) adjustment to the common basis of the partnership property apparently reduces each partner's share of Blackacre's built-in gain by $20, leaving each partner with a $100 share of taxable gain.[14] If Blackacre is sold when its value is unchanged, each partner would thus recognize $100 of taxable gain allocated in the same manner as the unrealized appreciation was booked up.[15] In this event, however, *P* is taxed on $50 too much gain inside the partnership and *Q* is taxed on $50 too little gain inside the partnership.[16] To remedy these shortcomings, Abrams proposes two fixes in connection with a non-pro rata current distribution of appreciated property: (1) the distribution would trigger remedial allocations of income to the nondistributee partner(s) and offsetting remedial allocations of loss to the distributee partner, and (2) any section 734(b) adjustment would be made only on behalf of the distributee partner by analogy to the section 743(b) adjustment.[17]

Consider first the proposed remedial allocations intended to address the problem of shifted gain.[18] Under current law, the distribution of Whiteacre shifts the entire built-in gain of $60 to *P*, even though *Q* enjoys the economic benefit of 1/2 of the appreciation as a result of the revaluation. Under a deemed sale approach, *Q* would be taxed immediately on $30 of shifted gain, with an appropriate adjustment to the basis of Whiteacre immediately before the distribution.[19] *P*'s share of the built-in gain would be preserved in the distributed property. In lieu of a deemed sale approach, Abrams suggests remedial allocations which serve essentially the same purpose.[20] Under the proposal, the distribution would

[14] *See* Abrams, *supra* note 7, at 349 (noting that "[u]nder current law . . . the basis adjustment reduces not P's gain alone but rather the overall gain to the partnership").

[15] *See* Reg. § 1.704-1(b)(4)(i).

[16] *P* is overtaxed by $50 ($200 total gain less *P*'s $150 share of predistribution gain) and *Q* is undertaxed by $50 (*Q*'s $150 share of predistribution gain less $100 gain inside partnership). Upon liquidation of the partnership, *P* will recognize a loss of $50 ($50 distribution less $100 outside basis) and *Q* will recognize an offsetting gain of $50 ($250 distribution less $200 outside basis).

[17] *See* Abrams, *supra* note 7, at 364-66, 370.

[18] *See* I.R.C. § 704(c)(1)(A); Reg. § 1.704-3(d). The remedial allocation method is intended to eliminate distortions caused by the ceiling rule.

[19] *See* I.R.C. § 704(c)(1)(B) (taxing built-in gain to contributing partner if section 704(c) property is distributed within seven years of contribution); *see also* I.R.C. § 737 (taxing precontribution gain in connection with certain distributions).

[20] *See* Abrams, *supra* note 7, at 363 ("Indeed, the right answer is mandated remedial allocations.").

trigger a remedial allocation of $30 income to *Q* and an offsetting remedial allocation of $30 loss to *P*.[21] Leaving aside technical details, the net result is a $30 increase in *Q*'s taxable income and a $30 reduction in *P*'s taxable income.

The remedial allocations are not sufficient, however, completely to cure overtaxation of *P* and undertaxation of *Q*. Abrams suggests that an additional fix—namely, eliminating the existing defect in allocating section 734(b) basis adjustments—is needed. Under current law, the section 734(b) basis adjustment affects the common basis of partnership property and thus potentially benefits all of the continuing partners.[22] By contrast, a section 743(b) adjustment upon sale of a partnership interest benefits only the purchasing partner and does not affect the common basis of partnership property.[23] Borrowing from the section 743(b) concept, Abrams would apply the section 734(b) adjustment "*in favor of P alone*."[24] Thus, the positive section 734(b) adjustment would reduce *P*'s post-distribution share of the built-in gain in Blackacre from $120 to $80. The remaining built-in tax gain of $120 would be allocated to *Q*. The proposed change would affect only non-pro rata current distributions, because the section 734(b) adjustment already works properly in the case of liquidating distributions.[25]

Together, these two fixes produce "a very nice result: there are no book-tax disparities anywhere in sight, and each partner has been taxed on precisely [her] share of the partnership's gains."[26] Thus, *P* would have a $50 net gain inside the partnership ($80 gain from Blackacre less $30 remedial loss) and $100 gain outside the partnership. *Q* would be taxed on $150 gain inside the partnership ($120 gain from Blackacre plus $30 remedial income). Abrams argues that "the legislative fix is not difficult" and would merely require "application of a well-

[21]*See id.* at 364-65. In fact, Abrams recognizes that allowing *P* an immediate loss of $30 might be abusive, and therefore suggests that the remedial loss be converted into a deferred $30 adjustment to the basis of the distributed property. *See id.* at 364, 366.

[22]*See* Reg. § 1.734-1(b).

[23]*See* Reg. § 1.743-1(a).

[24]Abrams, *supra* note 7, at 365 (emphasis in original).

[25]*See id.* at 366.

[26]*Id.* If the section 734(b) adjustment is allocated entirely to *P*, the partners would have the following book capital accounts (CA) and outside bases (OB):

	P		*Q*	
	CA	OB	CA	OB
Initial	$100	$100	$100	$100
Book-Up of Blackacre	120		120	
Book-Up of Whiteacre	30		30	
Distribution of Whiteacre	(200)	(100)		
Remedial Allocations		(30)		30
Sale of Blackacre		80		120
Total	$50	$50	$250	$250

The $30 remedial loss allocation is converted into a deferred basis adjustment to Whiteacre in *P*'s hands. *See id.*

understood solution to a well-understood problem" in a different context.[27] Indeed, Abrams maintains that "[i]t all goes back to contributed property and section 704(c)(1)(A)."[28] While the drafters of the section 704(c) regulations "knew that the principles they were crafting could be useful in other contexts, they apparently did not see the connection to distributed property."[29]

In the above example, the revaluation has the effect of exaggerating *P*'s overtaxation. To see this point, assume that the partnership does not elect to revalue its assets and no gain is recognized on the distribution of Whiteacre. The section 734(b) adjustment of $40 increases the partnership's common basis in Blackacre, reducing the partnership's inside gain to $200. If the inside gain is allocated 1/6 to *P* ($33.33) and 5/6 to *Q* ($166.67), *P* is undertaxed by $16.67 (and *Q* is correspondingly overtaxed by $16.67). Of course, the failure to revalue the partnership property may also distort the partners' economic arrangement.[30] Although allocating built-in tax gain in accordance with the partners' post-distribution (rather than predistribution) sharing ratios improves *P*'s tax situation, the common basis approach again appears flawed.

Consider, however, a slight variation in which distributed Whiteacre (worth $200) has a basis of $80 in the partnership's hands and retained Blackacre (worth $300) has a basis of $120.[31] Under these facts, *P* simply takes a carryover basis of $80 in Whiteacre, leaving *P* with a basis of $20 in her partnership interest. Because the partnership is not entitled to a section 734(b) adjustment, Blackacre continues to have built-in gain of $180 ($300 value less $120 basis). *P*'s built-in gain in Whiteacre is $120 ($200 value less $80 basis) and her 1/6 share of built-in gain in Blackacre is $30 (1/6 of $180), while *Q*'s 5/6 share of built-in gain in Blackacre is $150 (5/6 of $180). Because the distributed property (Whiteacre) represents 4/5 of *P*'s former interest in terms of both basis ($80) and value ($200), the distribution does not distort the partners' shares of built-in gain inside and outside the partnership. As a result, *P*'s post-distribution 1/6 share of the partnership's common basis ($20) plus her 1/6 share of the partnership's built-in gain ($30) is equal to the value of her retained interest ($50).

As the partnership's built-in gain in Whiteacre ($120) corresponds exactly to *P*'s built-in gain in the redeemed 4/5 of her partnership interest, no revaluation or special section 704(c) allocations are necessary to prevent overtaxation or undertaxation. Thus, one solution would be simply to treat a non-pro rata current distribution as a partial liquidation of the distributee's interest by value, with

[27] *Id.* at 363.

[28] *Id.* at 356.

[29] *Id.*

[30] *See id.* at 347 (noting that "[a]lthough current law does not require the restatement, most advisors recommend it . . . .").

[31] The partnership's total inside basis is still $200, but Whiteacre's basis is $60 lower and Blackacre's basis is $60 higher than in *Example (1)*; Whiteacre's basis has been tailored to produce the same tax consequences that would result from treating the distribution in *Example (1)* as a partial liquidation of *P*'s redeemed interest (with a basis and value equal to 4/5 of *P*'s entire interest). *See infra* notes 88-89 and accompanying text.

appropriate adjustments to the basis of distributed and retained assets to preserve proportionality between the partners' post-distribution profit shares and shares of built-in gain within the partnership.[32] Under existing law, however, a non-pro rata current distribution may absorb the distributee's entire outside basis, thereby leaving her with a disproportionate share of built-in tax gain inside the partnership relative to the value of her retained partnership interest. While the section 734(b) adjustment preserves parity between the partnership's aggregate inside basis and the partners' aggregate outside basis, it does not eliminate such partner-specific disparities. Nevertheless, a revaluation of partnership property coupled with special section 704(c) allocations may permit the section 734(b) adjustment to perform this unintended function.

III. MORE ROAD WORK: ALIGNING INSIDE BASIS, GAIN, AND VALUE

When partnership property is revalued following a non-pro rata distribution of appreciated property, Abrams suggests that the flaw in the section 734(b) adjustment can be remedied by converting the common basis adjustment into a personal adjustment for the exclusive benefit of the distributee partner.[33] However, Abrams' proposal provides only a partial solution. If the increased basis of retained property is relevant for purposes other than reducing excess built-in tax gain, allocating the adjustment to the distributee partner may produce the wrong result. For example, a non-pro rata current distribution of built-in loss property may leave the nondistributee partners with a higher net built-in gain (or lower net built-in loss) than prior to the distribution. In this situation, the section 734(b) adjustment should benefit the nondistributee partners by preserving their shares of built-in loss.[34] In understanding the operation of section 734(b) as providing a common basis adjustment following a non-pro rata current distribution, the key is to focus on the partners' post-distribution shares of inside basis, gain, and value.

A. *Deemed Sale Approach*

Under section 704(c), remedial allocations are intended to approximate the results of a deferred sale of contributed property.[35] Because Subchapter K already requires deemed sale treatment in order to prevent shifts of built-in gain inherent in distributed property in certain circumstances, extending deemed sale treatment would seem simpler than implementing remedial allocations of in-

[32] *See* Andrews, *supra* note 5, at 75.

[33] *See* Abrams, *supra* note 7, at 345-46 ("But who should get the benefit of that adjustment?").

[34] While this flaw could be remedied by allowing the nondistributee partners to recognize immediately their share of the built-in loss inherent in the distributed property, such loss recognition has the potential for abuse. *See* I.R.C. § 311(a)-(b); *see also* ALI Reporters' Study, *supra* note 8, at 247-48 (proposing recognition of gain, but not loss, on a current distribution of property).

[35] *See generally* Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of the Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 Tax L. Rev. 627 (1986).

come (and offsetting loss).[36] In the above example, the distribution of Whiteacre to *P* would be treated as a deemed sale of *Q*'s 1/2 of the property for its fair market value at the time of the distribution.[37] *Q* would be taxed immediately on $30 of built-in gain, with appropriate adjustments to the basis of the distributed property and *Q*'s outside basis.[38] While the basis of Whiteacre in *P*'s hands would continue to be limited to $100 (*P*'s outside basis), the amount of the section 734(b) adjustment would be increased from $40 to $70 to reflect the $30 increase in the partnership's basis in Whiteacre as a result of the deemed sale. If the augmented section 734(b) adjustment is viewed as benefitting *P* alone, *P*'s gain inside the partnership would be reduced to $50 ($120 gain from Blackacre less $70 section 734(b) adjustment), leaving $120 of taxable gain allocable to *Q*. Thus, the deemed sale approach coupled with the proposed fix to the allocation of section 734(b) adjustments would ensure that both partners are taxed on total gain of $150.

The deemed sale approach accomplishes essentially the same result as Abrams' proposed remedial allocations of income and loss. As Abrams points out, allocating a remedial loss of $30 to *P* immediately would present opportunities for abuse.[39] To avoid reducing *P*'s outside basis to negative $30 ($0 less $30 remedial loss), Abrams would convert the remedial loss allocation into a deferred adjustment to *P*'s basis in Whiteacre.[40] *P*'s basis increase in Whiteacre would be permitted when *P*'s outside basis is sufficient to absorb the negative adjustment. By contrast, the deemed sale approach eliminates the problem of negative outside basis for the distributee.[41] In effect, it gives *P* the benefit of an additional $30 increase to the basis of Blackacre, reducing *P*'s built-in tax gain.[42]

[36]Other commentators have proposed deferred remedial allocations to cure the flaws in the section 734(b) adjustment. *See, e.g.*, Ernst & Young LLP, *supra* note 5, at 137-38. By contrast, Abrams would apparently trigger remedial allocations only with respect to the distributed property upon distribution. *See* Abrams, *supra* note 7, at 363-64.

[37]*See* Reg. § 1.704-4(a)(1) (deemed sale for fair market value).

[38]Thus, *Q*'s outside basis would be increased to reflect $30 of gain recognized and the basis of Whiteacre would be increased from $140 to $170 immediately before the distribution. *See* Reg. § 1.704-4(e) (requiring basis adjustments). Any section 734(b) adjustment must be made after (and must take into account) the basis adjustments arising from the deemed sale. *See* Reg. § 1.704-4(e)(3).

[39]*See* Abrams, *supra* note 7, at 364.

[40]*See id.* If the distributee no longer owns the distributed property, the distributee would be allowed an immediate loss in lieu of the basis adjustment. *Id.* at 366. Alternatively, the basis adjustment could be transferred to any substituted-basis property acquired by the distributee in exchange for the distributed property. *See id.* at 366 n.65.

[41]*See id.* at 365 ("While there is nothing inherently wrong with [driving the distributee's outside basis negative], it unquestionably is not an outcome consistent with the current workings of Subchapter K."); *id.* at 366 (referring to "pesky negative outside basis"). Under Abrams' proposal, *Q*'s outside basis is positive $130 ($100 plus $30 remedial income) and *P*'s outside basis is negative $30 ($0 less $30 remedial loss) immediately prior to sale of Blackacre. *See supra* note 26. The partners' *net* outside basis ($100) is thus equal to the partnership's basis in Blackacre ($60 plus $40 section 734(b) adjustment).

[42]If *Q*'s outside basis is $130, *Q*'s tax capital account and share of inside basis should also be $130. Under Abrams' proposal, however, the partnership's basis in Blackacre is only $100, or $30 less than *Q*'s share of inside basis. *See* Abrams, *supra* note 7, at 365. Moreover, if the negative amount of *P*'s outside basis is ignored, aggregate outside basis ($130) no longer equals aggregate inside basis ($100).

But the underlying question remains whether *Q* should be required to recognize $30 of gain in connection with the distribution of Whiteacre. Because the partners have booked up the predistribution gain equally, Abrams argues that taxing *Q* immediately is necessary to prevent an improper shift of *Q*'s built-in gain to *P*.[43] But this argument seems excessively mechanical, at least if one recognizes that Subchapter K permits extremely (perhaps inordinately) flexible allocations of particular items. Indeed, if *P* wants Whiteacre but *Q* is unwilling to be taxed immediately on her $30 share of the gain, the partners might simply keep Whiteacre inside the partnership. To satisfy *P*'s wishes, the partners could allocate the entire unrealized appreciation in Whiteacre to *P*, with a corresponding reduction in *P*'s share of the unrealized appreciation in Blackacre. Subject to the substantial economic effect test, such special allocations presumably would be respected.[44]

Moreover, there may be a strong argument for requiring both *P* and *Q* (or neither) to recognize gain upon distribution of Whiteacre. A distribution of appreciated property in partial liquidation of a partner's interest involves an exchange between the redeemed and nonredeemed partners.[45] While the fiction of a one-sided sale may be useful for eliminating shifts in hot-asset appreciation under section 751(b),[46] the general rule is that both parties to an exchange should be taxed. Thus, taxing *Q* alone may seem unfair. Perhaps the argument is simply that taxing *Q* immediately is necessary to permit the section 734(b) adjustment to function properly. But that argument goes too far: it is possible to perfect the section 734(b) adjustment without requiring immediate gain recognition when appreciated property is distributed and the partners' sharing ratios are altered.[47]

B. *Convergence Between Sections 734(b) and 743(b)*

The major thrust of Abrams' proposal concerns the need to fix section 734(b) to operate more like section 743(b). While recent regulations refine and improve optional basis adjustments under section 743(b) upon a disposition of a partnership interest, the accompanying changes to section 734(b) are much less exten-

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[43]*See* Abrams, *supra* note 7, at 363 (noting that legislative action would be required, because there is no statutory authority for taxing nondistributee partners unless a distribution triggers a shift in ordinary income under section 751(b)).

[44]*See id.* at 348 n.24 (noting that the "revaluation book gain could have been allocated however the partners wanted"). Generally, an agreement between existing partners that adjusts their shares of unrealized appreciation is not treated as a taxable capital shift. *See, e.g.*, Prop. Reg. § 1.704-1(b)(2)(iv)(s), 68 Fed. Reg. 2930, 2934 (2003) (requiring remedial allocations only if exercise of an option results in a shift in unrealized appreciation that has previously been reflected in the partners' capital accounts). *But see* I.R.C. § 707(a)(2)(B) (treating certain property transfers and related allocations as a disguised sale).

[45]Thus, *P* would receive a $30 increase in the basis of Whiteacre because her outside basis would increase by her share of the gain inherent in the distributed property.

[46]*See* Andrews, *supra* note 5, at 52 (transforming the statutory mechanism of section 751(b) from an "exchange" to a deemed sale model); Burke, *supra* note 8, at 705.

[47]*See infra* notes 83-97 and accompanying text.

sive.[48] The section 743(b) regulations integrate basis adjustments upon a sale of a partnership interest with section 704(c) allocations when property is contributed to a partnership or subsequently revalued. By contrast, the existing section 734(b) regulations largely predate the capital account requirements that have come to play such a pervasive role in Subchapter K. In the context of a revaluation of partnership property, Abrams argues that the amount of the section 734(b) adjustment is right but the allocation of the adjustment is wrong.[49] Because most partnerships are likely to revalue property in connection with a distribution, this flaw should no longer be viewed as tolerable.

Fortunately, Abrams argues, the flaw is easy to cure: what is needed is to allocate the section 734(b) adjustment solely to the distributee.[50] In effect, the section 734(b) adjustment would operate more like a personal basis adjustment for the sole benefit of the distributee than a common basis adjustment for the benefit of all of the continuing partners. According to Abrams, the proposed fix works both for simple non-pro rata cash distributions and in more complicated situations involving disproportionate distributions of appreciated property. In the case of a cash distribution in excess of outside basis, the distributee in effect recognizes a portion of the gain inherent in her share of partnership assets. Unless she receives the entire benefit of the section 734(b) adjustment, she will be taxed on the same gain again when the partnership's retained property is sold.[51] If the distributee instead receives appreciated property and takes a basis in such property less than its former basis in the partnership's hands, the section 734(b) adjustment eliminates a share of her gain inside the partnership to compensate for increased gain taxable to her upon a sale of the distributed property.[52]

Consider again the facts of *Example (1)*, above, in which *P* receives a non-pro rata distribution of Whiteacre, with a basis in the partnership's hands of $140 and a fair market value of $200. *P*'s basis in the distributed property is only $100, triggering a $40 upward section 734(b) adjustment to the common basis of partnership property. Under Abrams' proposal, the $40 basis adjustment serves to eliminate $40 of *P*'s taxable gain from Blackacre, thereby preventing

[48] *See* Abrams, *supra* note 7, at 344 ("Unfortunately, the regulations applicable to section 734(b) adjustments were not much changed, and that is indeed unfortunate."); McMahon, *supra* note 6, at 78.

[49] *See* Abrams, *supra* note 7, at 344-45; *see also id.* at 365 ("Once again section 734(b) provides the proper adjustment but fails to allocate it in the proper way."). *But see id.* at 345 n.9 (noting that the amount of the section 734(b) adjustment will be wrong if there is a discrepancy between aggregate inside basis and aggregate outside basis at the time of the distribution because of a failure to make a prior optional basis adjustment under section 734(b) or section 743(b)). *See also* Andrews, *supra* note 5, at 13, 22 (proposing a remedy for the technical flaw in existing section 734(b) adjustments); Noël B. Cunningham, *Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77, 80-81 (1991); McMahon, *supra* note 6, at 67-68.

[50] *See* Abrams, *supra* note 7, at 349 (noting that "the central point of [the] article is that [the section 734(b) adjustment] should be so allocable").

[51] *Id.* at 350.

[52] *Id.* at 352.

overtaxation of *P* inside the partnership.[53] The revaluation freezes each partner's predistribution share of the gain inside the partnership attributable to Blackacre ($120 each) prior to any basis adjustments. Taxing the nondistributee partner (*Q*) on her share of the booked-up gain ensures that the book-tax disparity in her capital account created by the revaluation is only temporary.[54] Because *Q*'s book capital account was increased by $120 of book gain attributable to Blackacre at the time of the distribution, *Q* must be allocated matching tax gain of $120 when Blackacre is sold. *Q*'s built-in tax gain should not be reduced by any portion of the basis adjustment because *Q* had a $120 share of the predistribution gain inherent in Blackacre. This counterintuitive result occurs because the revaluation has frozen *Q*'s (and *P*'s) share of predistribution gain.

The situation is quite different with respect to *P*, however, because a portion of her share of the taxable gain inherent in Blackacre was effectively shifted to the distributed property, leaving her with too much tax gain inside the partnership. One way to understand what has happened to *P* is to consider her post-distribution share of the partnership's inside basis, gain, and value:

	Inside Basis	+	Gain	=	Value
P's share	(70)		120		50

P's share of the partnership's inside basis is negative $70, that is, the amount *P* would receive upon a hypothetical liquidation of the partnership ($50) less *P*'s share of the taxable gain inherent in Blackacre ($120). The recent section 743(b) regulations recognize that a partner's share of tax capital can be negative, even though the partnership's aggregate inside basis can never be less than zero.[55] What might seem puzzling, however, is that *P*'s share of inside basis is negative $70, or $30 more than the section 734(b) basis adjustment of $40. This discrepancy disappears if the distribution of Whiteacre to *P* is treated as a deemed sale of *Q*'s portion of the distributed property, triggering gain of $30 to *Q*. Immediately prior to the distribution, the partnership's basis in Whiteacre is increased from $140 to $170 ($140 plus $30 gain recognized by *Q*). Because *P*'s outside basis is only $100, the distribution of Whiteacre now triggers a $70 upward section 734(b) adjustment, increasing retained Blackacre's basis from $60 to

[53]Thus, *P* recognizes total gain of $80 inside the partnership ($120 booked-up gain less $40 section 734(b) adjustment) and $70 gain outside the partnership ($200 value of Whiteacre less $130 basis); *P*'s basis in Whiteacre reflects *P*'s $30 of remedial loss "converted into asset basis." *Id.* at 365-66.

[54]*See id.* at 354-55 (distinguishing between "temporary" and "permanent" book-tax disparities).

[55]Under the section 743 regulations, a partner's share of "previously taxed capital" is equal to: (i) the amount of cash she would receive on liquidation of the partnership following a hypothetical sale, increased by (ii) her share of tax loss on the hypothetical sale, and decreased by (iii) her share of tax gain on the hypothetical sale. *See* Reg. § 1.743-1(d). A partner's share of the partnership's common basis is equal to her share of partnership liabilities plus her share of previously taxed capital. *See* Reg. § 1.743-1(d)(1). Because partnership liabilities are included in both outside basis and the partnership's common basis, they generally cancel each other.

$130.[56] The augmented section 734(b) adjustment is precisely the amount necessary to restore *P*'s share of inside basis to zero and to eliminate her share of gain in excess of value:

	Inside Basis	+	Gain	=	Value
P's share	(70)		120		50
§ 734(b) adjustment	70		(70)		___
	0		50		50

In effect, *P* has withdrawn from the partnership a share of tax capital ($170) in excess of her total tax capital ($100) upon the distribution of Whiteacre. The section 734(b) adjustment restores the excess tax capital withdrawn by *P*, eliminating her negative share of inside basis. Following the distribution and section 734(b) adjustment, *Q*'s share of inside basis ($130) plus gain ($120) equals the value of *Q*'s partnership interest ($250).

C. *Effect of Revaluation on Section 734(b) Adjustment*

A revaluation produces some surprising results. While the statute requires an adjustment to the common basis of partnership property, Abrams concludes that the common basis method of allocating section 734(b) adjustments is simply wrong. What is needed instead is an adjustment exclusively for the benefit of the distributee partner by analogy to section 743(b). While Abrams' argument that the section 734(b) adjustment should reduce solely *P*'s share of built-in tax gain seems correct, the underlying problem arises from the interaction of section 734(b) and section 704(c) following a revaluation. Thus, a solution may require special section 704(c) allocations that affect all partners, not just the distributee.

A revaluation has the unanticipated effect of fundamentally altering the operation of the section 734(b) adjustment. The 1954 Code drafters presumably expected that a non-pro rata current distribution would generally be accompanied by a shift in the partners' sharing ratios with respect to all unrealized gains and losses, including those arising prior to the distribution. Accordingly, all of the continuing partners (including the distributee whose interest was reduced) would share any section 734(b) adjustment in proportion to their post-distribution sharing ratios. By contrast, a revaluation distorts the allocation of the section 734(b) adjustments, as an adjustment to the common basis of partnership property reduces built-in gain that has been frozen in proportion to the partners' predistribution interests. The revaluation concept arbitrarily bifurcates predistribution and post-distribution sharing of gains and losses, while ignoring shifts in the partners' relative shares of inside basis and value.

[56] Accordingly, the partnership has the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Tax	Book
Blackacre	$130	$300	*P*	$0	$50
			Q	130	250
			Total	$130	$300

For purposes of reducing built-in tax gain, the adjustment properly belongs to *P* because otherwise she will be overtaxed inside the partnership. *Q* appears not to be harmed even if the partnership fails to make a section 754 election. Indeed, if the partnership makes the election, *Q* may be taxed on less than her predistribution share of built-in tax gain unless the adjustment is allocated entirely to *P*. But treating the adjustment as a partner-specific adjustment solely for *P*'s benefit, by analogy to section 743(b), produces strange results if the partnership property is, for example, depreciable section 1250 property.[57] Without the adjustment, *Q*'s previously taxed capital ($130) exceeds the total common basis of the partnership property ($60); the section 734(b) adjustment eliminates this disparity, thereby ensuring that aggregate inside basis equals aggregate outside basis. Under section 704(c) principles, the adjustment thus belongs to both *P* and *Q* but is shared differently for purposes of reducing built-in tax gain and generating tax depreciation.[58]

Because a distribution affects the common basis of the partnership property, it necessarily affects both the distributee and nondistributee partners. But the common basis adjustment does not function properly, absent section 704(c) special allocations, because the partners' shares of inside basis, gain, and value are no longer aligned proportionately. If no section 734(b) adjustment is made, the revaluation has the bizarre result of leaving *P* with a share of unrealized appreciation ($120) in excess of the value of her remaining partnership interest ($50).[59] Even though the revaluation freezes the partners' predistribution shares of unrealized appreciation, it cannot prevent a shift in the partners' relative shares of inside basis and value. While *P* has essentially sold a portion of her partnership interest, the absence of a partial liquidation rule allows *P* to apply her entire basis against the distribution (rather than only a ratable portion). Despite the adjustment to common basis, the post-distribution disparities between the continuing partners' shares of inside basis, gain, and value can apparently be cured only by mandatory revaluations and special section 704(c) allocations.

IV. INTEGRATING REVALUATIONS, SECTION 704(c), AND SECTION 734(b)

When the common basis approach was adopted in 1954, the drafters obviously could not have anticipated the concepts of revaluations or reverse section 704(c) allocations. Thus far, the section 734(b) regulations have not been revised to integrate adjustments to the partnership's common basis with revaluations and section 704(c) allocations. While the section 734(b) adjustment affects

[57]In the case of depreciable section 1245 property, a non-pro rata distribution generally triggers section 751(b). *See* Reg. § 1.755-1(a) (treating potential section 1245 recapture as a separate ordinary income asset).

[58]*See infra* notes 67-70 and accompanying text.

[59]If *P* sold her retained interest for $50, she would recognize only $50 of gain ($50 amount realized less $0 outside basis). If a third party purchases *P*'s partnership interest for $50, the purchaser's section 743(b) adjustment should eliminate the built-in tax gain inherited from *P*. *See infra* notes 73-75 and accompanying text.

the common basis of partnership property, section 704(c) governs allocation of built-in tax gain and future tax depreciation. If the underlying partnership property has been revalued, the tax allocations attributable to the section 734(b) adjustment cannot have economic effect. The section 704(b) regulations may provide a technical argument, however, for allocating the section 734(b) adjustment in a manner that coordinates inside basis, gain, and value.[60]

A. *Capital Account Adjustments*

The section 704(b) capital account rules provide scant guidance concerning the manner in which the section 734(b) adjustment should be reflected in the partners' capital accounts. If retained partnership property has not been booked up in connection with a nonliquidating distribution, the section 704(b) regulations provide that the section 734(b) adjustment will be shared among the partners in the same manner as the gain displaced by the adjustment.[61] If partnership property has been revalued, the section 734(b) adjustment cannot be separately reflected in the partners' book capital accounts.[62] Nevertheless, a corresponding adjustment seems necessary to the partners' tax capital accounts in order to reflect properly any remaining book-tax disparities.[63]

In *Example (1)*, above, *P*'s share of inside basis has been exhausted by the distribution; indeed, the distribution drives *P*'s share of inside basis negative by precisely the amount of the section 734(b) adjustment.[64] Because *P*'s share of inside basis is negative $70, her tax capital account must also be negative $70. If the section 734(b) adjustment is credited entirely to *P*, her tax capital account (and share of inside basis) is increased to $0 ($70 negative balance increased by $70 section 734(b) adjustment) and her share of built-in tax gain is reduced to $50 ($120 less $70 gain displaced by the basis adjustment).[65] *P*'s remaining book-tax disparity of $50 is equal to the difference between her tax capital account ($0) and her remaining taxable gain inside the partnership. While section 704(c) is generally intended to remedy disparities between tax basis and book value, allocating the section 734(b) adjustment in this manner is necessary

[60]*See* Reg. § 1.704-1(b)(4)(i); Monte A. Jackel & Shari R. Fessler, *The Mysterious Case of Partnership Basis Adjustment*, 89 TAX NOTES (TA) 529, 534-35, 540 n.39 (Oct. 23, 2000).

[61]*See* Reg. § 1.704-1(b)(2)(iv)(m)(4). The displaced gain is determined as if, immediately prior to the adjustment, the affected property were sold for its recomputed tax basis. In the case of a liquidating distribution, the adjustment must be allocated to the partner whose interest is liquidated. *See id.*; Reg. § 1.704-1(b)(5), Ex. (14)(vi).

[62]If partnership property has been revalued, the section 734(b) adjustment may be reflected in the partners' capital accounts only to the extent that the adjustment exceeds the difference between the book basis of such property and its tax basis immediately prior to the adjustment. *See* Reg. § 1.704-1(b)(2)(iv)(m)(5).

[63]WILLIAM S. MCKEE ET AL., FEDERAL INCOME TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.02[2][c], at 10-49 (3d ed. 1997).

[64]For this purpose, assume that *Q* recognizes $30 gain on distribution of Whiteacre, and the partnership receives a $70 adjustment to Blackacre following the distribution.

[65]Such an adjustment may be justified by the rules applicable to capital account adjustments where guidance is lacking. *See* Reg. § 1.704-1(b)(2)(iv)(q).

to eliminate the disparity between *P*'s share of built-in tax gain and the value of her retained interest.

Once *P*'s tax capital account is credited with the section 734(b) adjustment, section 704(c) principles should control allocation of the remaining built-in tax gain ($170), although it is not entirely clear how these principles should operate.[66] If shares of basis and appreciation are determined under section 704(c), the result should be essentially the same as if *P* contributed section 704(c) property with a tax basis of $0 and a fair market value of $50, while *Q* contributed property with a tax basis of $130 and a fair market value of $250. If Blackacre is eventually sold when its value remains $300, the built-in tax gain should be allocated $50 to *P* and $120 to *Q*. Thus, the section 704(c) allocation mimics the effect of a section 743(b) adjustment by reducing *P*'s share of built-in tax gain resulting from the revaluation. Because the section 734(b) adjustment affects common basis, however, it potentially benefits all of the continuing partners for depreciation purposes. By contrast, a section 743(b) adjustment generates depreciation deductions only for the purchasing partner.

B. *Depreciation Deductions and Section 734(b)*

A positive section 734(b) adjustment serves essentially two functions: (1) it displaces gain inherent in the partnership's retained assets, and (2) it gives rise to actual tax items of depreciation if the partnership's retained property is depreciable.[67] A revaluation freezes only the partners' predistribution shares of unrealized appreciation; any future book income or loss will be allocated according to their altered sharing ratios as a result of the distribution. Thus, any section 734(b) adjustment should generally be shared for purposes of book depreciation in the same ratio as the partners' post-distribution percentage interests in the partnership. In accordance with section 704(c) principles, tax depreciation must then be allocated in a manner that eliminates book-tax disparities.

Example (2). The facts are the same as in *Example (1)*, except that Blackacre and Whiteacre are both depreciable section 1250 property.[68] *P* and *Q* each contribute $250 to the equal *PQ* partnership which purchases Blackacre for $300

[66]If section 704(c) does not apply, the partners' distributive shares must be determined in accordance with the partners' interests in the partnership. *See* Reg. § 1.704-1(b)(4)(i). By analogy, the special partners' interest test would support allocating the section 734(b) adjustment entirely to *P* (to eliminate *P*'s negative tax capital account) if Blackacre were sold for its recomputed tax basis of $130. *See* Reg. § 1.704-1(b)(3).

[67]In the context of the antichurning rules for intangibles, the section 197 Regulations conclude that it may be inappropriate to allocate the section 734(b) adjustment among partners based on which partner's built-in gain is reduced; instead, the adjustment must generally be allocated in proportion to the partners' respective post-distribution book capital accounts. *See* T.D. 8907, 2000-2 C.B. 558, 559-60; T.D. 8865, 2000-1 C.B. 589, 592-93. *See generally* Karen C. Burke, *Partnership Inside Basis Adjustments and Remedial Allocations*, 90 TAX NOTES (TA) 1689 (Mar. 19, 2001).

[68]Assuming the property is depreciated under the straight-line method, no portion of the gain would be treated as derived from an ordinary income asset for purposes of section 751(c) or the section 755 regulations. *See* I.R.C. §§ 751(c), 1250(a); Reg. § 1.755-1(a). For purposes of section 168, the increase in basis attributable to the section 734(b) adjustment is treated as newly-purchased depreciable property. *See* Reg. § 1.734-1(e).

and Whiteacre for $200. The partnership depreciates the basis of Blackacre to $60 and the basis of Whiteacre to $140, allocating the $300 of depreciation deductions equally to *P* and *Q* ($150 each). *P* receives a distribution of Whiteacre when the partnership has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Blackacre	$60	$300	*P*	$100	$250
Whiteacre	140	200	*Q*	100	250
Total	$200	$500	Total	$200	$500

The partnership, which has a section 754 election in effect, revalues its assets in connection with the distribution. Following the distribution, *P* has a 1/6 interest ($50/$300) and *Q* has a 5/6 interest ($250/$300) in the reconstituted *PQ* partnership.[69]

When Blackacre is fully depreciated, both the tax and book basis of the property will be zero, that is, any built-in tax gain from the revaluation will have been eliminated. If the value of Blackacre remains unchanged, the partnership will have $300 of gain for both book and tax purposes ($300 fair market value less $0 book and tax basis), allocated 1/6 to *P* ($50) and 5/6 to *Q* ($250) in proportion to their respective post-distribution percentage interests. The partnership's book depreciation ($300) should be allocated among the partners in the same ratio. Because section 704(c) principles require tax depreciation to follow book depreciation, the tax depreciation attributable to the section 734(b) adjustment should presumably inure first to the benefit of *Q* (not *P*), as only *Q* has a positive share of inside basis.[70] Thus, a single adjustment to the common basis of partnership property impacts the distributee and nondistributee partners differently depending upon whether the adjustment is viewed as reducing built-in tax gain or generating additional tax depreciation.

C. *Interaction Between Section 734(b) and Section 743(b) Adjustments*

If a nonliquidating distribution that triggers a section 734(b) adjustment is followed by a sale of the distributee's reduced partnership interest, the distributee's share of inside basis and unrealized appreciation is the proper starting point for computing the purchasing partner's section 743(b) adjustment. Because the

[69]*Example (2)* has been constructed so that the partnership's post-distribution balance sheet is the same as in *Example (1)*:

Assets	Basis	Value	Capital	Tax	Book
Blackacre	$100	$300	*P*	$0	$50
			Q	100	250
			Total	$100	$300

[70]For tax purposes, the basis attributable to the section 734(b) adjustment benefits those partners who would otherwise be deprived of depreciation deductions because of the ceiling rule. *See supra* note 67 and accompanying text; *cf.* Reg. § 1.743-1(j)(3)(ii), Ex. (2) (limiting use of section 743(b) adjustment to transferee partner in ceiling-rule situation).

section 743(b) adjustment is personal to the purchasing partner, it does not affect the common basis of partnership property. The amount of the section 743(b) adjustment should be sufficient to eliminate the purchaser's share of built-in tax gain inherited from the selling partner.

Example (3). Assume that *A* receives a distribution of $135 cash when the partnership has the following balance sheet:[71]

Assets	Basis	Value	Capital	Basis	Value
Redacre	$120	$270	*A*	$100	$150
Cash	180	180	*B*	100	150
Total	$300	$450	*C*	100	150
			Total	$300	$450

The partnership, which has a section 754 election in effect, revalues its assets in connection with the distribution. *A* recognizes $35 of gain ($135 cash less $100 outside basis), triggering a positive section 734(b) adjustment that increases the basis of Redacre from $120 to $155.[72] The revaluation freezes each partner's predistribution 1/3 share ($50) of the total unrealized appreciation. Taking into account the section 734(b) adjustment, *A* is left with the following share of inside basis, gain, and value:

	Inside Basis	+	Gain	=	Value
A's share	(35)		50		15
§ 734(b) adjustment	35		(35)		___
	0		15		15

If *A* subsequently sells her remaining partnership interest to *D* for $15 cash, *D* is entitled to a section 743(b) adjustment of $15. The amount of the section 743(b) adjustment equals the difference between *D*'s outside basis ($15) and her share of the partnership's common basis ($0) inherited from *A*.[73] Thus, *D*'s section 743(b) adjustment is $15 ($15 outside basis less $0 share of common basis), the amount necessary to eliminate *D*'s inherited share of built-in tax gain.

The total amount of the section 734(b) adjustment ($35) plus *D*'s section 743(b) adjustment ($15) is $50. If *A* instead received $150 cash in a liquidating distri-

[71]This example is taken from Abrams, *supra* note 7, at 366-68.

[72]The partnership has the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Tax	Book
Redacre	$155	$270	*A*	$0	$15
Cash	45	45	*B*	100	150
Total	$200	$315	*C*	100	150
			Total	$200	$315

[73]Under the section 743(b) regulations, *D*'s share of the partnership's common basis is equal to the cash *D* would receive upon a liquidation of the partnership following a hypothetical sale of the partnership's assets for fair market value, decreased by *D*'s share of tax gain on the hypothetical sale. Reg. § 1.743-1(d). Accordingly, *D*'s share of the partnership's common basis is $0 (*i.e.*, $15 cash liquidating distribution less $15 share of built-in tax gain inherited from *A*).

bution, she would recognize gain of $50, triggering a positive section 734(b) adjustment of $50.[74] The adjustment would benefit the nondistributee partners (*B* and *C*) by eliminating their $50 share of the built-in tax gain attributable to *A*'s former interest. Even though the transaction is structured as a current distribution of $135 followed by a sale of *A*'s remaining interest for $15, the combined inside basis adjustments remain $50.[75] Note that the revaluation freezes *A*'s entire share of appreciation in Redacre ($50) despite the fact that 90% of *A*'s interest has been redeemed as a result of the cash distribution ($135/$150).[76] While the revaluation preserves *A*'s share of unrealized appreciation in undistributed assets, it does not prevent shifts in her share of inside basis and value.

V. FUTURE REFORM

Abrams asks: "How did all this come to be? . . . [W]hy has nothing been done to fix it in the last 50 years?"[77] He suggests several plausible answers to this puzzle. First, the section 734(b) adjustment generally works well in the case of a complete liquidation of a partner's interest, given that the "continuing partners are, in effect, taking over the capital account of the exiting partner."[78] Moreover, it is difficult to disentangle the underlying flaw in the operation of the section 734(b) adjustment in a nonliquidating context, which presents other complications.[79] Second, the section 734(b) adjustment predates the revaluation concept by nearly 40 years, and "without that concept application of the section 734(b) adjustment makes no great sense however it is done."[80] Without a book-up and capital accounts, moreover, "it is very hard to separate what should be an unchanging sharing of accrued but unrealized gains and losses as of the date of distribution from a new, reduced sharing by the distributee going forward . . . . But that day is long gone."[81] At bottom, Abrams finds it "really unfathomable" that the 1954 Code drafters chose a common basis approach under section 734(b).[82]

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[74]The section 734(b) adjustment would be credited entirely to the liquidated partner's tax capital account. *See* Reg. § 1.704-1(b)(5), Ex. (14)(vi).

[75]*Cf.* Abrams, *supra* note 7, at 368 (suggesting that "dividing the transaction into a part-distribution, part-sale" can leverage aggregate inside basis adjustments).

[76]*A*'s post-distribution interest represents less than 5% of the partnership's total value ($15/$315) but roughly 13% of the total appreciation ($15/$115).

[77]Abrams, *supra* note 7, at 368.

[78]*Id.* at 366; *cf. id.* ("Moreover, they are entitled to the basis adjustment not in their own right but rather as transferees of the exiting partner."); *see* Andrews, *supra* note 5, at 57 (explaining that "liquidating distributions have one important simplifying characteristic . . . every former partner is either a continuing partner or a distributee, but not both"); McMahon, *supra* note 6, at 38 ("The basis adjustment reflects the cost to the other partners of purchasing the distributee partner's interest in the remaining partnership assets.").

[79]*See* Abrams, *supra* note 7, at 369 n.71 (pointing out that "a non-pro rata nonliquidating distribution is akin to a partial sale of a partnership interest by one partner to the others" but the current rules permit the distributee's entire outside basis "to shelter the gain on the distribution while only a portion is available on the sale").

[80]*Id.* at 369.

[81]*Id.* at 370.

[82]*Id.* at 349. Abrams notes that the drafters of section 734(b) were aware that "optional basis adjustments can be made to affect a single partner . . . without any impact on those partners who had no connection with the triggering event." *Id.* at 351.

The common basis approach may be less flawed, however, than appears.

A. *Partial Liquidation Approach*

Reform proposals have sought to perfect the common basis approach of section 734(b) by treating a non-pro rata current distribution that alters the partners' continuing interests as a partial liquidation. Under these proposals, the distributee would be treated as owning two interests, one redeemed and the other continuing, and the continuing partners' shares of unrealized gains or losses in the partnership's retained property would be preserved in accordance with their post-distribution interests.[83] A partial liquidation approach combined with mandatory section 734(b) adjustments to the partnership's common basis would solve all of the problems addressed by Abrams without the need for special section 704(c) allocations.[84]

Example (4). *P* and *Q* each contribute $100 to the *PQ* partnership. The partnership purchases Blackacre for $60 and retains $140 cash. When Blackacre has appreciated to $340, the partnership distributes $120 cash to *P* in a nonliquidating distribution, reducing *P*'s interest in the partnership from 1/2 ($240/$480) to 1/3 ($120/$360).[85] The partnership does not revalue its assets in connection with the distribution. Under a partial liquidation approach, *P* would be treated as if she had disposed of 1/2 of her entire interest.[86] The redeemed portion of *P*'s interest has a basis of $50 and a value of $120. To preserve the continuing partners' shares of unrealized appreciation, a partial liquidation approach would trigger mandatory section 734(b) adjustments with respect to the partnership's retained property.

The amount of the section 734(b) adjustment would be $70, the difference between the partnership's adjusted basis in the distributed property ($120 cash) and the reduction in the distributee's share of inside basis ($50). After these adjustments, the partnership's post-distribution balance sheet would be as follows:

Assets	Basis	Value	Capital	Basis	Value
Blackacre	$130	$340	*P*	$50	$120
Cash	20	20	*Q*	100	240
Total	$150	$360	Total	$150	$360

[83]*See* Andrews, *supra* note 5, at 65-66; Burke, *supra* note 8, at 710-713. Bifurcated treatment is necessary to maintain proportionality between the continuing partners' shares of unrealized appreciation and their post-distribution percentage interests in the partnership.

[84]*See* Andrews, *supra* note 5, at 66 (noting that only a single adjustment to common basis would be needed to apportion subsequent partnership income correctly).

[85]This example is taken from Abrams, *supra* note 7, at 345.

[86]If a partner's percentage interest in a partnership is reduced from 1/2 to 1/3, the portion of the partner's interest redeemed is 1/2. Thus, a comparison of the distributee's predistribution and post-distribution interests in the partnership can be used to determine the portion of the distributee's interest that is completely redeemed. *See* ALI REPORTERS' STUDY, *supra* note 8, at 310.

Following the distribution, the partnership's built-in gain ($210) would be allocated 1/3 to *P* ($70) and 2/3 to *Q* ($140) in accordance with their continuing interests in the partnership. Thus, *P* would recognize gain of $70 on the distribution and gain of $70 on sale of Blackacre, while *Q* would recognize gain of $140 on sale of Blackacre. Because the partners' post-distribution shares of inside basis, gain, and value are proportional, no special allocations are needed to ensure that each partner is taxed on her share of built-in gain.

The partial liquidation approach illustrates that the flaws in the existing section 734(b) adjustment can be remedied: the method of allocating the adjustment is correct, but the amount of the adjustment is wrong. Although the 1954 Code drafters correctly perceived that the section 734(b) adjustment should function as a common basis adjustment, they can be criticized in hindsight for failing to treat a non-pro rata current distribution as a partial liquidation. Even if they had perceived that partial liquidation treatment would increase the accuracy of the section 734(b) adjustment, however, they might well have considered such a refinement to be unnecessary. After all, they were designing relatively simple rules for partnerships in which distributions of property, while not uncommon, occurred relatively infrequently. Allowing the partners to take advantage of Subchapter K's flexibility to reduce their overall tax burden, however, is clearly no longer warranted.[87]

The partial liquidation approach also works well when appreciated property is distributed.[88] Consider *Example (1)*, above, in which *P* receives a distribution of appreciated Whiteacre (worth $200) and retains a reduced partnership interest (worth $50), reducing *P*'s interest in the partnership from 1/2 to 1/6. If this distribution were treated as a partial liquidation of 4/5 of *P*'s interest ($200/ $250), the reduction in *P*'s share of inside basis would be $80 (4/5 of *P*'s $100 share of inside basis prior to the distribution).[89] Whiteacre would take a basis of $80 in *P*'s hands, triggering a $60 upward section 734(b) adjustment to the basis of Blackacre. After these adjustments, the partnership would have the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Blackacre	$120	$300	*P*	$20	$50
			Q	100	250
			Total	$120	$300

[87]*See id.* at 350.

[88]The partial liquidation approach can be applied to more "irregular distributions" in which the reduction in the distributee's partnership interest is not strictly proportional. Andrews, *supra* note 5, at 73-75; *see also* Cunningham, *supra* note 49, at 81 n.14 (noting that the proposed method of determining the section 734(b) adjustment also reaches the correct result when section 704(c) allocations are present).

[89]If a partner's percentage interest in a partnership is reduced from 1/2 to 1/6, the portion of the partner's interest redeemed is 4/5.

Following the distribution, *P* has a continuing 1/6 interest in the partnership's retained assets ($50/$300), and *Q* has a 5/6 interest in the partnership's retained assets ($250/$300). Each partner's post-distribution share of inside basis, gain, and value is properly aligned with her continuing interest in the partnership. The partnership's post-distribution unrealized appreciation ($180) should be allocated 1/6 to *P* ($30) and 5/6 to *Q* ($150) in accordance with their continuing interests in the partnership. *P*'s remaining share of the partnership's predistribution unrealized appreciation ($120) is preserved in Whiteacre ($200 fair market value less $80 basis in *P*'s hands). Thus, each partner will recognize total gain of $150.[90]

The partial liquidation approach aligns the partners' shares of post-distribution built-in gain in accordance with their continuing interests in the partnership, while a revaluation preserves their predistribution shares of built-in gain. Once this fundamental difference is appreciated, it is quite possible to combine a partial liquidation approach with a revaluation of partnership property at the time of a distribution.[91] Rather than freezing the partners' predistribution shares of unrealized appreciation, the revaluation should reflect the partners' post-distribution shares of inside basis, gain, and value. The partial liquidation approach also works well for non-pro rata current distributions that shift built-in gain but do not trigger a section 734(b) adjustment under existing law.

Example (5). The facts are the same as in *Example (1)*, above, except that the partnership distributes to *P* 2/3 of Blackacre (with a basis of $40 and a value of $200). Under existing law, *P* takes a basis of $40 in the distributed property, reducing her outside basis to $60. Because the basis of the distributed property does not exceed the total basis of *P*'s partnership interest, no section 734(b) adjustment is triggered. If the partnership's assets are revalued in connection with the distribution, the partnership has the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Blackacre	$20	$100	*P*	$60	$50
Whiteacre	140	200	*Q*	100	250
Total	$160	$300	Total	$160	$300

Although *Q* should have $150 of gain inside the partnership equal to her predistribution share, the partnership's total gain is only $140. *P* has $160 of gain outside the partnership ($200 value of Blackacre less $40 basis) and should apparently have a $10 loss inside the partnership. While remedial allocations would eliminate these disparities, it is not clear to what properties the remedial

[90] *P* has $120 gain outside the partnership ($200 value of Whiteacre less $80 basis) and $30 gain inside the partnership, while *Q* has $150 gain inside the partnership.

[91] Indeed, a revaluation is likely to be essential to determine the redeemed portion of the distributee's interest.

[92] *See* Andrews, *supra* note 5, at 65 (rejecting use of so-called "spectral" section 704(c) allocations to deal with this problem).

allocations should attach.[92]

By contrast, a partial liquidation approach would treat the distribution as a liquidation of 4/5 of *P*'s interest by value ($200/$250). The distributed property would take a basis of $80 in *P*'s hands (4/5 of *P*'s $100 share of inside basis prior to the distribution), triggering a $40 downward adjustment to the basis of the partnership's retained property.[93] The downward adjustment would be allocated to Blackacre ($5) and Whiteacre ($35) in proportion to their bases in the partnership's hands.[94] Thus, Blackacre would have a basis of $15 and Whiteacre would have a basis of $105. After these adjustments, the partnership would have the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Blackacre	$15	$100	*P*	$20	$50
Whiteacre	105	200	*Q*	100	250
Total	$120	$300	Total	$120	$300

The partnership's post-distribution unrealized appreciation ($180) would again be allocated 1/6 to *P* ($30) and 5/6 to *Q* ($150). *P*'s remaining $120 share of unrealized appreciation is fully preserved in the distributed portion of Blackacre ($200 value less $80 basis in *P*'s hands).

Abrams' proposed fix to section 734(b) would apparently leave this problem unaddressed. No special allocation of the section 734(b) adjustment is possible because the distribution does not trigger section 734 in the first place. Even if the distribution of 2/3 of Blackacre triggers remedial income of $80 to *Q* (1/2 of $160 appreciation), offset by a remedial loss of $80 to *P*, remedial allocations have no effect on the common basis of partnership property.[95] Thus, there would be a $20 shortfall in inside basis; *Q*'s outside basis of $180 ($100 plus $80 remedial income) would exceed the total inside basis of $160 ($20 basis in Blackacre and $140 basis in Whiteacre).[96] The shortfall in inside basis can be remedied only if the distribution is treated as a deemed sale of *Q*'s interest in the distributed property, triggering appropriate basis adjustments.[97]

B. *Partially Mandatory Adjustments*

Congress was concerned that certain tax-shelter transactions sought to exploit

[93]The downward adjustment is equal to the excess of 2/3 of Blackacre's basis in *P*'s hands ($80) over 2/3 of Blackacre's basis in the partnership's hands ($40) prior to the distribution. As this example illustrates, the partial liquidation approach might provide opportunities for inflating basis when low-basis property is distributed in partial liquidation of a partner's interest. *See id.* at 66.

[94]*See* Reg. § 1.755-1(c)(2)(i).

[95]*See* Reg. § 1.704-3(d)(4).

[96]Under Abrams' proposal, *P*'s remedial loss exceeds her outside basis by $20 ($100 less $40 basis of distributed property less $80 remedial loss); the excess $20 of loss would be converted into a deferred basis increase in Whiteacre for the benefit of *P*. In other words, the required inside basis adjustment ($20) is allocated to the wrong property (Whiteacre rather than Blackacre), to *Q*'s detriment.

[97]In this event, *Q* would recognize $80 of gain, and the basis of the distributed portion of Blackacre would be increased from $40 to $120 immediately prior to the distribution. Following the distribution, the partnership would be entitled to a $20 positive section 734(b) adjustment allocated to Blackacre and Whiteacre in proportion to their unrealized appreciation. *See* Reg. § 1.755-1(c)(2)(i).

the electivity of basis adjustments to duplicate losses in connection with partnership distributions.[98] Rather than make section 734(b) adjustments mandatory for all partnership distributions, the 2004 legislation adopts a targeted approach aimed specifically at duplication of built-in losses. The mandatory adjustment rule is triggered only to the extent that a section 754 election (if one were in effect) would result in a net downward adjustment, under section 734(b)(2), to the partnership's retained property in excess of $250,000.[99] If there is a net upward adjustment (or the substantial basis reduction threshold is not satisfied), inside basis continues to be adjusted only if the partnership has a section 754 election in effect.

The legislative history provides an example of the type of abuse curtailed by the mandatory section 734(b) adjustment.[100] In the example, *A* and *B* each contribute $2.5x and *C* contributes $5x to a newly-formed partnership; the partnership uses the cash to purchase LMN stock for $3x and XYZ stock for $7x. When the value of the LMN and XYZ stock has each declined to $1x and no section 754 election is in effect, the partnership distributes the LMN stock to *C* in liquidation of *C*'s partnership interest. *C* takes a basis of $5x in the LMN stock equal to *C*'s outside basis. Thus, *C* would recognize a $4x loss if the LMN stock were sold immediately.

Under amended section 734(a), the partnership is required to reduce the basis of the retained XYZ stock because the distribution satisfies the substantial basis reduction threshold of section 734(d). In *C*'s hands, the basis of the LMN stock is inflated by $2x, the excess of *C*'s outside basis ($5x) over the partnership's predistribution basis ($3x). Accordingly, the partnership must reduce the basis of the retained XYZ stock (worth $1x) from $7x to $5x, leaving *A* and *B* with post-distribution inside loss ($4x) equal to their predistribution share. In the absence of the mandatory section 734(b) adjustment, *A* and *B* would be left with a $6x inside loss, or $2x more than their predistribution share. Thus, the mandatory adjustment ensures that a distribution of low-basis property to a departing partner (*C*) will not leave the continuing partners (*A* and *B*) with higher net built-in loss (or less net built-in gain) than before distribution.[101]

Only a liquidation of a partner's interest can give rise to loss recognition or basis inflation, triggering a net downward adjustment under section 734(b)(2).[102] If the distributee remains a partner, regardless of the percentage reduction in her partnership interest, the mandatory adjustment rule is irrelevant. For example, assume that the partnership distributes 2/3 of the XYZ stock (with a basis of $4.67x and a value of $.67x) to *C* in a non-pro rata current distribution. *C*'s basis in the distributed XYZ stock is $4.67x, and *C*'s basis in her remaining partner-

[98]*See* H.R. CONF. REP. No. 108-755, at 623 (2004).
[99]*See* I.R.C. § 734(a), (d).
[100]*See* H.R. CONF. REP. No. 108-755, at 625.
[101]*See id.* at 623.
[102]*See* I.R.C. §§ 731(a)(2), 732.

ship interest is reduced to $.33x. If *C* were to sell the XYZ stock immediately, she would recognize a $4x loss. Thus, the distribution carries out *C*'s entire $4x share of inside loss, leaving her with a tax and book capital account equal to $.33x. Although *C* should have no share of the remaining inside loss of $4x, the existing regulations may fail to achieve this result.

If the partnership revalues its assets in connection with the current distribution to *C*, it will have the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Basis	Value
LMN stock	$3x	$1x	*A*	$2.5x	$.5x
XYZ stock	2.33x	.33x	*B*	2.5x	.5x
			C	.33x	.33x
Total	$5.33x	$1.33x	Total	$5.33x	$1.33x

Since the basis of the distributed property is unchanged in *C*'s hands, no inside basis adjustment would be permitted even if the partnership had a section 754 election in effect. On an immediate sale of the retained property, the remaining $4x inside loss ($5.33x value less $1.33x basis) would apparently be divided equally between the nondistributee partners (*A* and *B*) and the distributee (*C*) in the same manner as the unrealized loss was previously booked up.[103] In this event, however, $2x of inside loss will be shifted from the other partners to *C*. While *C* has insufficient outside basis to absorb the 2x loss, this shortfall can be easily remedied by having the partnership borrow $2x allocable entirely to *C*, leaving her with an outside basis of $.33x ($.33x plus $2x liability less $2x loss on sale).[104]

Following the sale, *A* and *B* withdraw from the partnership in exchange for a cash distribution of $.5x each; assume that a nominal partner is admitted so that the partnership does not terminate.[105] Since *A* and *B* each have an outside basis of $1.5x ($2.5x less $1x loss on sale), the liquidating distribution triggers a recognized loss of $2x. Under amended section 734(a), the basis of the partnership's retained property must be reduced to reflect the $2x loss recognized by *A* and *B*. Because the partnership's only asset consists of $2.33x cash ($2x borrowed cash plus *C*'s $.33x share of the sales proceeds), however, the downward basis adjustment is deferred until the partnership acquires property of the required character (*i.e.*, capital gain property). A statutory change may be needed to trigger immediate gain recognition to the extent that a mandatory

[103]Under an expanded § 704(c)-type approach, the partnership's excess basis of $4x should be allocated entirely to *A* and *B* to reflect the corresponding disparity between their tax and book capital accounts.

[104]While *C*'s book capital account would remain $.33x, her tax capital account would be reduced to negative $1.66x ($.33x less $2x share of loss).

[105]*Cf.* Prop. Reg. § 1.707-7, 69 Fed. Reg. 68,845 (2004) (disguised sales of partnership interests).

[106]In 2004, Congress added section 755(c), aimed at tax-shelters designed to take advantage of the interaction between the partnership basis adjustment rules and corporate nonrecognition under section 1032. *See* I.R.C. § 755(c)(2) (requiring immediate gain recognition if section 755(c) results in a prevented section 734(b) adjustment).

section 734(b) adjustment is prevented.[106]

The built-in gain of $2x inherent in *C*'s partnership interest may be deferred indefinitely or perhaps even permanently eliminated. If the partnership subsequently acquires a nondepreciable capital asset worth $2.33x and reduces its basis to $.33x to reflect the prevented section 734(b) adjustment, *C*'s built-in gain will be triggered when the property is eventually sold. If, prior to sale of the partnership's property, *C* sells her partnership interest for $.33x cash and assumption of liabilities, she will recognize taxable gain of $2x attributable to relief of the excess liabilities allocated to her.[107] If a section 754 election were in effect, the purchaser would be entitled to a section 743(b) adjustment sufficient to eliminate the built-in gain in the partnership's property.[108] If instead *C* retains her partnership interest until death, the combined effect of sections 1014 and 743(b) may eliminate the $2x of inside gain inherent in *C*'s former partnership interest.[109] Thus, *C* receives the benefit of the duplicated loss without any tax cost to her successor.

More broadly, the 2004 statutory fix fails to address the problem of disproportionate current distributions that leave the continuing partners with altered shares of inside basis, gain, and value. The current distribution of 2/3 of the XYZ stock reduces *C*'s interest in the partnership from 1/2 to 1/4 ($.33x/$1.33x). In terms of value, the distribution represents 2/3 of *C*'s partnership interest ($.67x/$1x); the corresponding reduction in *C*'s share of inside basis is $3.33x (2/3 of *C*'s $5x share of inside basis prior to the distribution). Under a partial liquidation approach, the basis to *C* of the distributed portion of the XYZ stock would be reduced from $4.67x to $3.33x, triggering an upward section 734(b) adjustment of $1.33x to the partnership's retained property.[110]

If the partnership immediately sold the retained property (with an aggregate basis of $6.66x and an aggregate value of $1.33x), the partnership would recognize a loss of $5.33x ($6.66x basis less $1.33x value) allocated 3/4 to *A* and *B* ($2x each) and 1/4 to *C* ($1.33x), in accordance with their post-distribution percentage interests. Thus, the nondistributee partners would recognize their predistribution share of inside loss ($4x), while *C*'s share of such loss would be either recognized ($1.33x) or preserved in the distributed property ($2.67x). Unless a non-pro rata current distribution is treated as a partial liquidation,

[107]The gain of $2x represents the excess of *C*'s amount realized ($2.33x) over her outside basis ($.33x).

[108]The purchaser's section 743(b) adjustment ($2x) is equal to the excess of her outside basis ($2.33x) over her share of the partnership's inside basis, that is, her share of previously taxed capital (negative $1.67 tax capital account inherited from *C*) plus her share of partnership liabilities ($2x).

[109]Because of the section 743(b) adjustment, the fair market value of *C*'s interest should presumably not be discounted to reflect the lurking inside gain. *Cf.* Reg. § 1.755-1(b)(4)(i) (disallowing adjustment for IRD items).

[110]Thus, the aggregate basis of the partnership's retained assets would be $6.66x ($3x basis of LMN stock plus $2.33x basis of undistributed XYZ stock plus $1.33x positive section 734(b) adjustment), the same as the predistribution basis of the partnership's assets ($10x) less the basis assigned to the distributed portion of the XYZ stock in *C*'s hands ($3.33x).

coupled with corresponding mandatory basis adjustments, any comprehensive solution to the problem of shifting of built-in gains and losses is likely to prove elusive.

C. *Future Prospects*

In 2004, Congress provided for partially mandatory inside basis adjustments, while preserving electivity generally to avoid administrative burdens.[111] By contrast, the Senate version of the 2004 legislation would have required mandatory sections 734(b) and 743(b) adjustments in all circumstances other than transfers of partnership interests by reason of death, which "may involve unsophisticated taxpayers."[112] It remains to be seen whether Congress will extend mandatory section 734(b) adjustments to distributions (liquidating and nonliquidating) that shift gains as well as losses.

As originally proposed, the targeted approach of the 2004 legislation was criticized by opponents as "misguided, overbroad, and just plain poor tax policy."[113] These critics maintained that mandatory section 734(b) adjustments were unnecessary, since the section 701 anti-abuse regulations adequately dealt with the problem of duplicated loss when the elective feature of section 754 was inconsistent with the intent of Subchapter K.[114] In one example, a withdrawing partner receives a distribution of assets with a higher basis in the partner's hands than in the partnership's hands; by failing to make a section 754 election, the partnership retains an artificially high basis in its remaining assets.[115] The example concludes that the transaction should be respected because the partnership was formed for a bona fide purpose and the ultimate tax consequences are clearly contemplated by section 754. By contrast, another example applies the anti-abuse rules to recast a transaction involving a plan to duplicate a loss inherent in contributed property by avoiding a section 754 election in connection with a subsequent distribution.[116] In light of the Enron investigation, Congress concluded that the anti-abuse regulations failed to deter aggressive shelter pro-

[111]*See* H.R. Rep. No. 108-548, at 283 (2004) (preserving the "simplification aspects of the current partnership rules" for transactions involving built-in losses of less than $250,000). Congress provided alternative rules for "electing investment partnerships" (transfers of interests) and "securitization partnerships" (both distributions and transfers of interests). *See* I.R.C. §§ 743(e), (f), 734(e).

[112]S. Rep. No. 108-192, at 190 (2004); *see id.* at 189 (rejecting electivity of basis adjustments as "anachronistic" and recognizing the need to address mismeasurement of income in both "gain and loss situations"). The Senate version would have repealed the special rule of section 732(d). *See id.* at 190.

[113]Monte A. Jackel & Robert G. Honigman, *The Proposed Abusive Tax Shelter Shutdown Act of 2001*, 4 J. Passthrough Entities 5, 9 (2001).

[114]*See id.* at 6-7.

[115]*See* Reg. § 1.701-2(d), Ex. (9).

[116]*See id.*, Ex. (8) (concluding that Congress did not contemplate the elective feature of section 754 with respect to partnerships formed for a tax-avoidance purpose).

[117]*See supra* note 1. If the substantial basis reduction threshold is satisfied, amended section 734(a) would impose mandatory inside basis adjustments in both examples. *See* I.R.C. § 734(a), (d); *see also* I.R.C. § 704(c)(1)(C) (requiring built-in loss to be allocated solely to the contributing partner and eliminating any remaining built-in loss when the contributing partner's interest is transferred or liquidated).

moters from exploiting the electivity of the basis adjustment rules.[117]

If shifting of built-in gains and losses following a non-pro rata distribution is viewed as a serious problem, one solution would be to rely on expanded section 704(c)-type allocations to cure the problem. Since contributions and distributions involve similar shifting of built-in gains and losses, it is difficult to justify the existing disparities between the treatment of contributed and revalued property.[118] By contrast, the partial liquidation approach, coupled with mandatory inside basis adjustments, would permit simplified partnership tax accounting following a non-pro rata distribution by properly aligning inside basis, gain, and value. In 2000, critics easily deflected attention from the Clinton administration's proposal for partial liquidation treatment as unworkable and an attempt to dismantle the flexibility of Subchapter K.[119] While more narrowly targeted, the 2004 legislation adds complexity without addressing the underlying problem of shifting of built-in gains as well as losses upon a disproportionate distribution of partnership property.[120]

VI. CONCLUSION

In providing for optional common basis adjustments, the drafters of the 1954 Code could hardly have envisaged the problems that have arisen under section 734(b). As Abrams suggests, a revaluation undermines the concept of a common basis adjustment for the benefit of all of the partners (including the distributee who retains a reduced interest) following a non-pro rata current distribution. But the common basis approach is not merely a flawed historical anachronism; if a partial liquidation approach were adopted, the section 734(b) adjustment would properly align the partners' shares of inside basis, gain, and value. Absent a partial liquidation approach, the revised section 734(b) regulations should coordinate the common basis approach with section 704(c) allocations following a revaluation of partnership property.[121] Fifty years after the enactment of section 734(b), the central enigma remains: why should an adjustment to prevent duplication of loss and shifting of built-in gain be (mostly) elective rather than mandatory?

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[118]As a technical matter, section 704(c)(1)(C) apparently does not prohibit shifting of built-in losses arising from revaluations of existing partnership property in connection with distributions or admission of new partners.

[119]*See generally* Burke, *supra* note 5.

[120]A more radical approach would eliminate the need for section 734(b) adjustments entirely by taxing the distributee on a proportionate share of inside gain attributable to the distributee's redeemed interest and repealing the carryover basis rule for distributed property. *See* Burke, *supra* note 8, at 696-98.

[121]*See* Burke, *supra* note 5, at 1431 (suggesting that the strongest argument for an expanded approach under section 704(b) and (c) is that Subchapter K "has already grown so complex that only relatively minor changes would be needed").