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Taxing Hot Asset Shifts

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*Karen C. Burke**

I. INTRODUCTION

Notice 2006-14 invites comments concerning proposals to simplify and rationalize the treatment of disproportionate distributions that rearrange the partners' shares of unrealized appreciation in ordinary income and capital gain assets ("hot asset distributions").¹ Specifically, the Notice requests comments concerning whether to adopt the "hot asset sale" approach in lieu of the imputed exchange mechanism under the current section 751(b) regulations.² Upon a current nonprorata distribution, the hot asset sale approach would be coupled with a revaluation of partnership property and special allocations to preserve shares of built-in hot asset gain to the extent possible. Although enacted in 1954, section 751(b) has remained largely unchanged.³ Indeed, the regulations issued in 1956 have never been updated to reflect the modern concept of revaluations and section 704(c) allocations.⁴ While section 751(b) is sometimes viewed mainly as concerned with the character of income, it also has a significant impact on the timing of gain recognition.⁵

*Warren Distinguished Professor, University of San Diego School of Law. The author thanks Professor William D. Andrews for helpful comments and suggestions. The author has benefited from her participation in the ABA Section on Taxation's working group on I.R.S. Notice 2006-14. The views expressed here are solely those of the author and should not be attributed to the ABA or other participants in the working group

1. See Notice 2006-14, 2006-8 I.R.B. 498. The Notice uses the term "hot assets" to refer to "unrealized receivables as defined in § 751(c) and substantially appreciated inventory as defined in § 751(b)(3) and (d)." *Id.*

2. For recent commentary, see William D. Andrews, Comments on Notice 2006-14 (Nov. 28, 2006), BNA Daily Tax Report No. 230, at G-10 (Nov. 30, 2006) [hereinafter Andrews Comments]; NYSBA Tax Section, Report Responding to Notice 2006-14 Relating to the Treatment of Partnership Distributions Under § 751(b) (Nov. 28, 2006) [hereinafter NYSBA Report], 2006 TNT 230-8.

3. Since 1954, the definition of hot assets has been expanded to include items such as depreciation recapture. See IRC § 751(c).

4. See Reg. § 1.751-1(b). By contrast, the Treasury has extensively revised the § 743 regulations to reflect § 704(c) allocations. See Martin J. McMahon, Jr., *Optional Partnership Inside Basis Adjustments*, 52 Tax Law. 35 (1998).

5. See William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 Tax L. Rev. 3, 46 (1991).

Section 751(b) is only one of several provisions that are intended to prevent a distribution or sale of partnership interests from shifting built-in ordinary income or capital gain among partners.⁶ The collapsible partnership rules of sections 751(a) and 751(b) and the inside basis adjustment rules of sections 743(b) and 734(b) represented the culmination of intensive study by the American Bar Association (ABA) and American Law Institute (ALI) leading to the 1954 codification of Subchapter K.⁷ While sections 743(b) and 751(a) dealing with sales of partnership interests generally function relatively well, sections 734(b) and 751(b) are subject to important defects that impair their ability to prevent shifting of built-in gain.⁸ These defects stem mainly from Congress' failure to follow through on the 1954 ALI proposals for treating a nonprorata current distribution as a partial liquidation of the distributee's interest, coupled with mandatory inside basis adjustments.⁹ To avoid inadvertently undermining the purpose of section 751(b), the hot asset sale approach needs to be coordinated with section 734(b) adjustments.

Part II of this Commentary considers the general operation of the hot asset sale approach when partnership property is revalued.¹⁰ Part III considers the relationship between sections 734(b) and 751(b), focusing on the 1954 ALI proposals and Professor Andrews' more recent proposals to reform the treatment of hot asset distributions and inside basis adjustments.¹¹ Part IV explores the hot asset sale approach in the context of liquidating distributions

6. These provisions include §§ 731 and 732 (gain recognition and basis), 735 (character preservation), 734(b) and 743(b) (inside basis adjustments), 751(a)-(b) (collapsible partnership provisions) and 755 (basis allocation rules).

7. For an overview of the ABA/ALI proposals, see Stanley S. Surrey & William C. Warren, *The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers*, 66 *Harv. L. Rev.* 1161 (1953); 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 (1954).

8. See generally Andrews, *supra* note 5. For recent proposals to repair § 734(b) adjustments, see Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 *Tax Law.* 343 (2004); Karen C. Burke, *Repairing Inside Basis Adjustments*, 58 *Tax Law.* 639 (2005).

9. Although the 1954 reformers apparently never considered the possibility of reverse § 704(c) allocations for distributed property, they did thoroughly explore § 704(c) allocations for contributed property. See Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson's Quest*, in *Business Tax Stories* 207, 214-16 (Steven A. Bank & Kirk J. Stark eds., 2005).

10. When partnership property is revalued, the partnership must allocate any built-in gain (or loss) in the revalued property in accordance with § 704(c) principles. See IRC § 704(c)(1)(A); Reg. §§ 1.704-1(b)(4)(i), 1.704-3(a)(2), and 1.704-3(a)(6).

11. See *infra* notes 33-60 and accompanying text.

that trigger section 734(b) because of insufficient shares of outside (or inside) basis. Part V addresses nonprorata current distributions that reduce the distributee's interest in the partnership, leaving the distributee with a retained interest that may be insufficient (by value) to support booked-up hot asset gain. Part VI suggests the need to restore conformity between sections 751(a) and 751(b) by extending the hot asset sale approach to shifts of tepid asset gain. While the hot asset sale approach represents a significant improvement, this Commentary concludes that section 751(b) should continue to play an essential gain-recognition function.¹²

II. HOT ASSET SALE APPROACH AND REVALUATIONS

Under the hot asset sale approach, any partner whose share of hot assets is reduced (selling partner) would be treated as receiving the relinquished hot assets as a distribution and then selling them back to the partnership for fair market value.¹³ The basis of distributed (or retained) hot assets would be increased to reflect ordinary income recognized by the selling partner. Thus, a current hot asset distribution would generally trigger section 751(b) only if the nondistributee partners were previously allocated a share of booked-up gain in distributed hot assets.¹⁴ The nondistributee partners whose predistribution share of hot asset gain is thereby reduced would be treated as the selling partners. On liquidation of a partner's interest, the selling partners would be either the continuing partners or the distributee (but not both), depending on whether the distribution carries out more or less than the distributee's predistribution share of hot asset gain.¹⁵ Section 751(b) would often be inapplicable when a current distribution consists entirely of cash or other nonhot assets (cold assets), since a revaluation preserves the partners' shares of ordinary income.

*Example (1):*¹⁶ The ABC partnership purchases land for \$210 which appreciates in value to \$300. Each partner has a basis of \$120 in her partnership interest. When the partnership also has zero-basis receivables worth \$90 and cash of \$150, C receives a cash distribution of \$90, reducing her interest in the

12. See Andrews, *supra* note 5, at 46 (stressing that § 751(b) has now come to play an important gain-recognition function under Subchapter K).

13. See Notice 2006-14, *supra* note 1.

14. If § 704(c) principles are taken into account in measuring hot asset shifts, "significantly fewer distributions would trigger § 751(b)." *Id.* It is assumed throughout that a partnership revalues all of its assets immediately prior to the distribution. See Reg. § 1.704-1(b)(2)(iv)(f) (election to revalue); see also Reg. § 1.704-1(b)(2)(iv)(e)(1).

15. By comparison to current distributions, liquidating distributions are much simpler to handle under § 751(b), since the distributee is left with no outside basis, tax capital account, or share of inside basis.

16. This example is derived from Notice 2006-14, *supra* note 1, Example 1.

partnership from one third to one fifth. Immediately before the distribution, the partnership's assets are restated to reflect fair market value and the partners' capital accounts are increased to reflect their shares of unrealized appreciation in the partnership's assets. Accordingly, the *ABC* partnership has the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$120	\$180
Receivables	0	90	<i>B</i>	120	180
Land	<u>210</u>	<u>300</u>	<i>C</i>	<u>30</u>	<u>90</u>
Total	\$270	\$450	Total	\$270	\$450

Since the book-up preserves each partner's predistribution share of hot asset gain and value, section 751(b) does not apply.¹⁷ Special allocations (so-called "reverse" section 704(c) allocations) would be necessary, however, to ensure proper allocation of the tax gain corresponding to the booked-up gain.

When the partnership holds zero-basis hot assets, a revaluation may often avoid section 751(b) even under the existing regulations.¹⁸ Under current law, however, a revaluation may fail to prevent a hot asset shift when the partnership holds non-zero basis hot assets and the distributee receives solely cold assets.¹⁹ Even though a revaluation freezes the distributee's share of hot asset gain, the distributee's share of the gross value of hot assets will nevertheless be reduced, potentially triggering section 751(b). Because disproportionality is measured in terms of shifts in the gross value of hot assets, section 751 may not even achieve its intended purpose of preventing shifts in ordinary income.²⁰ Notice 2006-14 would eliminate this underlying flaw in the

17. Applying § 704(c) principles, *C* has a one-ninth share (\$30/\$270) and the nondistributee partners have an eight-ninths share (\$240/270) of the basis of each retained asset. Thus, *C* has the following share of inside basis, gain and value:

<i>Assets</i>	<i>Basis</i>	<i>Gain</i>	<i>Value</i>
Cash	\$6.67	\$ 0	\$6.67
Receivables	0	30	30
Land	<u>23.33</u>	<u>30</u>	<u>53.33</u>
Total	\$30	\$60	\$ 90

Since *C*'s share of hot asset gain (\$30) and value (\$30) are both unchanged, § 751(b) should not apply even under the existing regulations.

18. See Monte A. Jackel & Avery I. Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, Tax Notes 1557, 1577 (Mar. 10, 2003); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 Fla. Tax Rev. 677, 701 (1998).

19. See Jackel & Stok, *supra* note 18, at 1581; Burke, *supra* note 18, at 703-04.

20. See Notice 2006-14, *supra* note 1.

measurement of hot asset shifts by focusing on shifts in hot asset gain (rather than gross value).

In effect, the hot asset sale approach treats a partnership's section 751 property as consisting of (1) a zero-basis hot asset with a fair market value equal to the amount of potential hot asset gain and (2) a non-section 751 asset consisting of the rest of the property.²¹ For example, assume that a partnership's section 751 property consists of inventory with a basis of \$10 and a fair market value of \$15. The section 751 property would be bifurcated into two assets: a hot asset (zero basis, \$5 value) and a cold asset (\$10 basis, \$10 value). If hot asset gain is treated as separable from the basis portion of hot assets, a revaluation would often avoid section 751(b) even though a distribution reduces the distributee's share of the basis (and hence gross value) of retained hot assets.²² Treating hot asset gain as separable from the underlying hot assets is consistent with the legislative history of section 751(b), which emphasizes the "income rights" of the partners and suggests that such income rights may be treated as severable for purposes of taxing partners in a similar manner as individual entrepreneurs.²³

Under the existing regulations, one of the chief sources of complexity is the need to identify specific cold assets deemed exchanged for an increased share of hot assets.²⁴ The hot asset sale approach eliminates this problem, since the selling partners would be treated as selling hot assets for cash. For example, assume that a withdrawing partner receives a liquidating distribution consisting entirely of cold assets, thereby relinquishing a share of hot assets. The withdrawing partner would be treated as selling the relinquished hot assets to the partnership for cash and then recontributing the cash to the partnership.²⁵ The deemed hot asset sale would trigger ordinary income to the selling partner and appropriate adjustments to inside basis and outside basis.

The hot asset sale approach should be simplified by eliminating the fiction of a deemed distribution of relinquished hot assets to the selling partner and imputed cash consideration on the sale. This fiction is quite unnecessary

21. The § 751(b) regulations already require similar treatment for depreciable property subject to recapture. See Reg. § 1.751-1(c)(5).

22. Thus, the hot asset sale approach would avoid the need to determine a partner's share of the gross value of partnership assets. Similarly, a partner's share of partnership liabilities would generally be irrelevant, except to the extent that a shift in liabilities may affect a partner's share of hot asset gain.

23. S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954).

24. See Andrews, *supra* note 5, at 45.

25. Notice 2006-14, *supra* note 1, would apparently treat the selling partner as receiving cash directly from the partnership (rather than from the purchasing partners). By contrast, the method of computing gain under § 751(b) reflects a strict aggregate approach. See S. Rep. No. 1622, 83d Cong., 2d Sess. 98-99 (1954).

and may produce unintended results when an actual distribution of hot assets would trigger other partnership provisions.²⁶ By analogy, section 704(c)(1)(B) already provides for deemed sale treatment on certain distributions, coupled with appropriate adjustments to inside and outside basis (the “section 704(c)(1)(B) approach”).²⁷ The selling partners would be deemed to realize ordinary income equal to the net reduction in their share of hot asset gain. Any recognized gain would trigger appropriate adjustments to inside and outside basis.

The section 704(c)(1)(B) approach accomplishes the same result as Notice 2006-14 without imputing a circular flow of cash from the partnership to the selling partner (as consideration on the sale) and from the selling partner back to the partnership (as a contribution). Under the section 704(c)(1)(B) approach, the credit to the selling partner’s book capital account for the value of the relinquished hot assets substitutes for imputed cash consideration on the sale.²⁸ It might be argued that the section 704(c)(1)(B) approach ignores the statutory language of section 751(b) which refers to a “sale or exchange.” Since every disproportionate distribution is an implicit exchange of properties between the distributee and the nondistributee partners, however, the only relevant issue should be the extent to which the exchange is taxable to both parties.

The hypothetical sale approach provides an accurate measurement of the partners’ shares of hot asset gain. Indeed, a hypothetical sale approach is already applied under other partnership provisions, including sections 743(a), 751(a), and 755.²⁹ A partner’s predistribution share of hot asset gain should equal the amount of such gain that would be allocated to the partner upon a hypothetical sale of the partnership’s assets. The net reduction in a partner’s share of hot asset gain would be determined by comparing the partner’s pre- and post-distribution shares of hot asset gain.³⁰ A partner’s post-distribution share of hot asset gain should include any booked-up share of hot asset gain in retained partnership assets and any hot asset gain in distributed hot assets

26. See Andrews Comments, *supra* note 2.

27. See NYSBA Report, *supra* note 2, at 49 (recommending similar “deemed gain” approach); Daryll K. Jones, *Simplifying Section 751(b): You Can’t Get There From Here*, 111 Tax Notes 99, 104 (Apr. 3, 2006).

28. See Andrews, *supra* note 5, at 46.

29. The hypothetical sale should take into account any special § 704(c) allocations and basis adjustments under §§ 734(b) and 743(b). See NYSBA Report, *supra* note 2, at 40-43 (treating § 743(b) adjustments in the same manner as a share of common basis).

30. Presumably, the net reduction in a partner’s share of hot asset gain should take into account built-in ordinary losses as well as built-in ordinary income.

(determined before taking section 751(b) into account).³¹ Both current and liquidating distributions would be treated in a similar manner, except that a liquidated partner has no continuing share of unrealized appreciation inside the partnership, thereby simplifying the mechanics of section 751(b).

III. RELATIONSHIP BETWEEN §§ 734(b) AND 751(b)

When section 751(b) applies, the partnership receives a “cost” basis in purchased hot (or cold) assets, regardless of whether the partnership has a section 754 election in effect.³² Indeed, sections 751(b) and 734(b) were both enacted in 1954 to address different facets of disproportionate distributions. Under the 1954 ALI proposals, the more complex rules of section 751(b) applied to distributions by partnerships with substantially appreciated hot assets, while section 734(b) governed all other distributions that reduced a partner’s interest in partnership profits.³³ Both provisions treated a distribution that redeems a portion of a partner’s interest as a partial liquidation.³⁴ For example, a distribution that reduced a partner’s interest from one third to one fifth was treated as a complete liquidation of one half of the distributee’s interest; the distributee’s interest was bifurcated into a redeemed and a continuing interest. Partial liquidation treatment was considered essential to preserve parity of treatment between sales of partnership interests and disproportionate distributions.

Following a distribution, section 734(b) basis adjustments serve a dual function: adjusting inside basis to reflect the “cost” of acquiring the distributee’s interest and preserving shares of unrealized appreciation for the

31. For purposes of determining hot asset gain in distributed assets, the distributee’s basis would initially be determined under the transferred basis rules of § 732.

32. See Reg. § 1.751-1(b)(3)(ii)-(iii). Consistent with the hot asset sale approach, any increase in the basis of retained partnership property should generally benefit the purchasing partners.

33. See Surrey & Warren, *supra* note 7, at 1174. The ALI partnership proposals and explanation are contained in American Law Institute, Federal Income Tax Statute: February 1954 Draft, Vol. II, 86-119, 353-411 (1954) [hereinafter 1954 ALI Draft]; see *id.* at 116-19, 408-11, § X761 (collapsible partnerships), and *id.* at 101-04, 392-95, § X757 (noncollapsible partnerships).

34. The ALI proposals defined a current distribution as one other than upon winding up of the partnership or “as the result of a sale by the distributee of part or all of his interest in partnership property to the other partners.” See 1954 ALI Draft, *supra* note 33, at 97, § X754; *cf.* Reg. § 1.761-1(d) (defining a current distribution as any distribution that does not completely terminate a partner’s interest).

continuing partners.³⁵ In the case of a cash liquidating distribution, section 734(b) adjustments function in a manner similar to adjustments under section 743(b), the conceptually simpler provision relating to sales of partnership interests. Since the continuing partners are in effect acquiring the distributee's interest, the implicit purchase price should be reflected in their basis in the partnership's assets. On a nonrecognition exchange, section 734(b) adjustments to common basis preserve the continuing partners' shares of unrealized appreciation inherent in retained partnership property, analogous to other nonrecognition provisions.³⁶

The ALI's 1954 solution to the collapsible partnership problem was modeled closely on the basis adjustment provisions of section 734(b) for noncollapsible partnerships.³⁷ To preserve the distributee and nondistributee partners' shares of hot (and cold) asset gain following a disproportionate distribution, the ALI looked to reallocation of inside basis between distributed and retained assets.³⁸ Accordingly, the distributee was treated as realizing any hot and cold asset gain attributable to the redeemed partnership interest (or portion thereof) as if the partnership had sold all of its assets immediately before the distribution. Such realized gain was deferred, however, to the extent that the distributee received hot or cold assets of sufficient value to absorb any required basis adjustments. Any increases or decreases to the basis of the partnership's retained property affected both the distributee and nondistributee partners in proportion to their continuing interests in the partnership. Gain (or loss) was triggered to the extent of any prevented basis adjustments.

In 1954, the Senate ultimately rejected the ALI's proposed collapsible partnership rule as excessively complex and substituted the flawed approach of

35. See Andrews, *supra* note 5, at 18 ("In a sense, it is quite remarkable that a single adjustment, defined in one way, can serve two such distinct purposes as reflecting cost on a purchase and preserving taxability . . . in a nonrecognition disposition.")

36. Until recently, the main difference was that § 734(b) adjustments were entirely optional. Since 2004, § 734(a) has provided that § 734(b) adjustments are mandatory if the partnership has a § 754 election in effect or "there is a substantial basis reduction." See American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1589, 1591-92 (2004) (amending §§ 734 and 743). The regulations under § 755 now permit "wrong-way" adjustments that increase the disparity between basis and fair market value to preserve shares of unrealized gain (or loss) for future taxation. See Reg. § 1.755-1(c).

37. The collapsible partnership rules were needed to prevent conversion of ordinary income into capital gain through the "simple device of a disproportionate distribution." Surrey & Warren, *supra* note 7, at 1172.

38. See *id.* at 1172-75.

current section 751(b).³⁹ It also rejected other key elements of the ALI proposals, including mandatory section 734(b) adjustments and partial liquidation treatment when the distributee's interest was reduced but not entirely eliminated.⁴⁰ Thus, section 751(b) was transformed into mainly a gain-recognition provision, while section 734(b) adjustments survived only as an elective means of adjusting the common basis of retained partnership assets following a non-section 751(b) distribution. Moreover, the scope of section 734(b) was radically curtailed: distributions in partial liquidation of a partner's interest were treated as current rather than liquidating distributions.⁴¹ Under the transferred basis rule of section 732(a) applicable to current distributions, the distributee generally retains the partnership's predistribution basis in distributed property, mooting any section 734(b) adjustments.⁴² Thus, section 734(b) adjustments are most likely to be triggered in connection with liquidating distributions when distributed property receives an exchanged basis determined, under section 732(b), by reference to the distributee's outside basis.

In 1992, Professor Andrews proposed thoroughgoing reforms that would essentially refine and perfect the treatment of partnership distributions as envisaged under the ALI's 1954 proposals. The Andrews proposals start from the premise that section 734(b) is defective because it is (mostly) optional.⁴³ Even when it applies, section 734(b) often produces the wrong adjustment because is determined by reference to outside basis rather than shares of inside basis.⁴⁴ Under the Andrews proposals, section 734(b)

39. In Senate hearings in March 1954, the ABA endorsed the ALI's approach to the collapsible partnership provision. See Report Hearings Before the Committee on Finance, United States Senate on H.R. 8300, 83d Cong. 2d Sess. (Part I), at 476-77. The ABA criticized the House proposals for failing to recognize that a nonprorata distribution "truly represents an exchange of the interests of the continuing partners in the distributed property for an interest of the distributee in the remaining partnership property." *Id.* at 476.

40. One objection was that the ALI's partial liquidation approach would have triggered mandatory § 734(b) adjustments whenever a nonprorata distribution altered the partners' interests in the partnership. See S. Rep. No. 1622, 83d Cong., 2d Sess. 393-94 (1954).

41. See *id.* at 94-96.

42. Under § 732(c), the basis of distributed hot assets can never be higher than the partnership's basis in such assets. This basis limitation largely cured the problem of conversion of ordinary income into capital gain that arose under the House version of the distribution provisions. See *id.* at 95-96.

43. See Andrews, *supra* note 5, at 8.

44. See *id.* at 12-13. The § 743(b) regulations already employ shares of inside basis to determine the amount of the purchaser's adjustment following a sale of a partnership interest. See Reg. § 1.743-1(d). A partner's share of inside basis is equal to

adjustments would be mandatory and a distribution that redeems a portion of a partner's interest would be treated as a partial liquidation.⁴⁵ Mandatory inside basis adjustments, coupled with partial liquidation treatment, would align the continuing partners' (including the distributee's) post-distribution shares of inside basis, gain and value. The Andrews proposals would modify the imputed exchange mechanism of section 751(b) and expand the categories of section 751(b) property to include tepid asset gain.⁴⁶ The method of allocating basis adjustments under section 755 would also be modified to prevent shifting of basis from cold to tepid assets.⁴⁷

Consistent with the ALI's 1954 proposals, the Andrews proposals would reformulate section 751(b) to preserve the partners' shares of unrealized gain through basis reallocation.⁴⁸ Gain (or loss) would be triggered only to the extent of any prevented basis adjustments.⁴⁹ Specifically, the Andrews proposals would replace the imputed exchange mechanism of section 751(b) with a hot asset sale approach.⁵⁰ The imputed exchange mechanism often needlessly triggers recognition of capital gain to those partners whose shares of hot asset gain increase as a result of a disproportionate distribution (the "purchasing" partners).⁵¹ Taxing the purchasing partners immediately results "from following through relentlessly on the logic of an imputed exchange."⁵² While the taxable exchange model is understandable in light of the legislative history of § 751(b), it is conceptually flawed. Since Subchapter K generally allows maximum deferral of gain on an exchange of cold assets, the imputed exchange may not serve any sensible tax policy.

her share of previously-taxed capital plus her share of partnership liabilities. *Id.* Since partnership liabilities cancel out, the amount of the § 743(b) adjustment may be determined by comparing the amount of cash and the basis of property distributed with the distributee partner's interest in partnership capital computed on a tax (rather than book) basis. See Andrews, *supra* note 5, at 13 n.45.

45. See Andrews, *supra* note 5, at 65-66

46. Tepid assets would consist essentially of § 1250 real property.

47. See *id.* at 53-54.

48. Section 751(b) would be modified to require each partner and the continuing partnership to make such basis adjustments as needed to preserve their respective predistribution shares of unrealized gain (or loss) in the partnership's hot assets and other property. See Andrews, *supra* note 5, at 55.

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49. See *id.* at 37, 39.

50. See *id.* at 46-47.

51. See *id.* at 46 (noting that § 751(b) imposes "a tax [on the purchasing partners] . . . whose purpose is wholly obscure." Indeed, this senseless capital-gain tax stems from the Senate's hasty attempt to convert essentially a basis reallocation provision that preserved gain for future taxability into an imputed exchange that triggered immediate taxation to the purchasing and selling partners alike.

52. *Id.*

Professor Andrews recognized that shifting of unrealized appreciation could, in theory, be dealt with through partnership revaluations and extended section 704(c)-type allocations. Nevertheless, he rejected such “spectral” section 704(c) allocations as extraordinarily cumbersome.⁵³ When appreciated property leaves the partnership in a nonprorata distribution, reverse section 704(c) allocations would often require producing “gains for the nondistributee partners in excess of what partnership basis will permit at the partnership level.”⁵⁴ Thus, the section 704(c) approach is an “unwieldy way to deal with the problem” of preserving shares of unrealized appreciation.⁵⁵ As under the 1954 ALI proposals, basis reallocation and partial liquidation treatment represent the key to achieving simple partnership accounting for unrealized gain following a nonprorata distribution that alters the partners’ interests in the partnership.⁵⁶

Under the Andrews proposals, the hot asset sale approach is intended to minimize recognition of capital gain and obviate the need to identify specific cold assets relinquished in the section 751(b) exchange. A hot asset shift would always be treated as a one-sided sale, triggering ordinary income to the selling partner.⁵⁷ The two-sided exchange mechanism of section 751(b) would be eliminated, and the purchasing partners would be treated as if they had paid cash for their increased share of hot assets. While a one-sided sale of hot assets may leave a distributee with insufficient outside basis to absorb the increased inside basis of hot assets, Professor Andrews concluded that “this is not a convincing defense of the exchange rule, which imputes gain (or loss) in many cases where there is no problem of insufficient outside basis, and fails to correct many other cases of insufficient outside basis.”⁵⁸ Rather, basis shortfalls would be handled by requiring gain recognition to the extent of any prevented basis adjustments.⁵⁹

Under the Andrews proposals, a distributee with insufficient outside basis to absorb the partnership’s basis in distributed hot assets would generally recognize capital gain immediately, unless the distributee elected to reduce the

53. The § 704(c) approach gives rise routinely to ceiling-rule problems that could conceivably be cured by complex remedial § 704(c) allocations. See *id.* at 63; Reg. § 1.704-3(d).

54. See Andrews, *supra* note 5, at 65.

55. See *id.* (“Fortunately, inside basis adjustment under § 734 offers a much more satisfactory approach.”)

56. See *id.* at 75 (noting that proposals would allow “simple accounting . . . by maintaining proportionality between profit shares and shares of unrealized gain in the partnership,” without the need for complex § 704(c) allocations).

57. See *id.* at 46-47.

58. *Id.* at 47.

59. Cf. Reg. § 1.755-1(c)(4) (deferring § 734(b) adjustment if partnership lacks property of the proper class or has insufficient basis).

basis of distributed hot assets.⁶⁰ Such gain recognition would be the implicit cost to the distributee of retaining the partnership's increased inside basis in distributed hot assets. By contrast, Notice 2006-14 would not require gain recognition to remedy basis shortfalls even if the partnership has a section 754 election in effect. Instead, the distributee could elect to recognize capital gain when necessary to preserve hot asset basis. Moreover, nonliquidating distributions would continue to be treated as current distributions even if nearly all of the distributee's interest in the partnership is redeemed. Without some form of line-drawing between current and liquidating distributions, a distributee who receives excess cold assets might often be able to circumvent section 751(b) simply by retaining an insignificant interest (by value) in the partnership's revalued hot assets. Unless these problems are addressed, the hot asset sale approach may undermine the function of section 751(b) in curbing unwarranted deferral.

IV. LIQUIDATING DISTRIBUTIONS

Following a liquidating distribution, a revaluation and reverse section 704(c) allocations cannot preserve the distributee's predistribution share of hot asset gain in retained assets. Similarly, any predistribution gain in distributed hot assets is shifted to the distributee. Thus, a liquidating distribution may trigger recognition of hot asset gain to either the distributee or the continuing partners (but not both). Notice 2006-14 illustrates the hot asset sale approach in two examples involving liquidating distributions of excess hot and cold assets that potentially trigger section 734(b) adjustments to retained partnership assets. The interaction between the section 734(b) adjustment and the hot asset sale approach may lead to surprising and unwarranted results.

*Example (2):*⁶¹ The *ABC* partnership holds one hot asset and one cold asset, each with a basis of zero and value of \$150. Each partner has a zero basis in her partnership interest and a \$50 share of both hot and cold asset gain, and the partnership has a section 754 election in effect. The *ABC* partnership distributes two thirds of the hot asset (worth \$100) to *A* in liquidation of *A*'s interest. Prior to the distribution, the partnership's assets are revalued and each partner's restated book capital account is increased to \$100. Accordingly, the *ABC* partnership has the following predistribution balance sheet:

60. See Andrews, *supra* note 5, at 53; see *id.* at 37, 39 (allowing reduction to basis of "hotter" property to avoid immediate gain recognition).

61. This example is derived from Notice 2006-14, *supra* note 1, Example 3.

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Hot Asset	\$0	\$150	<i>A</i>	\$0	\$100
Cold Asset	<u>0</u>	<u>150</u>	<i>B</i>	0	100
Total	\$0	\$300	<i>C</i>	<u>0</u>	<u>100</u>
			Total	\$0	\$300

Since their share of hot asset gain is reduced from \$100 to \$50, *B* and *C* are deemed to sell \$50 worth of zero-basis hot assets. Accordingly, *B* and *C* recognize total ordinary income of \$50, increasing their total outside basis and the basis of the distributed portion of the hot asset to \$50. Under section 732(c), *A*'s basis in the distributed hot asset is limited to *A*'s outside basis (zero), or \$50 less than the partnership's predistribution basis. The distribution thus triggers a \$50 upward section 734(b) adjustment to the partnership's retained hot asset, potentially allowing the continuing partners to escape \$50 of booked-up hot asset gain.⁶²

Under the statutory ordering rule, the section 734(b) adjustment arises only after the tax consequences of the deemed section 751(b) exchange are determined.⁶³ If the hot asset shift is measured before the section 734(b) adjustment arises, *B* and *C* would apparently be treated as having retained a \$50 share of hot asset gain pursuant to the book-up, even though the subsequent section 734(b) adjustment eliminates the corresponding tax gain. To prevent this unintended result, it would seem necessary to disallow the section 734(b) adjustment entirely or change the statutory ordering rule. Without a section 734(b) adjustment to cold assets, however, the continuing partners would be improperly taxed on *A*'s share of cold asset gain remaining in the partnership. What is needed is a \$50 upward basis adjustment to cold (not hot) assets to reflect the reduction in *A*'s share of cold asset gain.

Under the Andrews proposals, the problem of basis insufficiency would be remedied generally by requiring gain recognition in the event of a prevented basis adjustment. *A*'s \$50 share of cold asset gain cannot be preserved through basis adjustments, since *A* receives no cold assets whose basis can be reduced.

62. The *BC* partnership has the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Hot Asset	\$50	\$50	<i>B</i>	\$25	\$100
Cold Asset	<u>0</u>	<u>150</u>	<i>C</i>	<u>25</u>	<u>100</u>
Total	\$50	\$200	Total	\$50	\$200

63. See Reg. § 1.751-1(b)(1)(iii) (applying rules of § 751(b) before the rules of §§ 731-736); Jackel & Stok, *supra* note 18, at 1579; *id.* at 1579 n.79 (noting that ordering rule may not reach the "correct [result] from a tax policy standpoint").

Thus, *A* would be required to recognize \$50 of capital gain immediately, unless *A* elected to take a reduced basis in the distributed hot assets. *A*'s recognized gain would increase the partnership's basis in retained cold assets and *A*'s outside basis. Since *A* would have sufficient outside basis to absorb the stepped-up basis of the distributed hot asset, section 734(b) would not apply.

Notice 2006-14 suggests that *A* could elect, or be required, to recognize \$50 of cold asset gain to preserve the stepped-up basis in the distributed hot asset. Under the statutory authority of section 751(b), *A* should be required to recognize capital gain of \$50 immediately, unless *A* elects to take a reduced basis in the distributed hot asset. *A* has relinquished a \$50 share of cold asset gain in exchange for an increased interest in hot assets. The basis of the partnership's retained cold asset would be adjusted upward by the amount of *A*'s recognized gain (\$50) and the basis of the retained hot asset would remain zero.⁶⁴ The continuing partners would have a \$100 share of cold asset gain and a \$50 share of hot asset gain inside the partnership.⁶⁵ Alternatively, if *A* foregoes a cost basis in the purchased portion of the partnership's hot assets, *A* would have additional ordinary income of \$50 outside the partnership, and the continuing partners could be allowed a \$50 increase to the basis of retained cold assets.

Where problems of basis insufficiency do not arise, the hot asset sale approach works properly. For example, assume that the facts are the same as in *Example (2)* except that the partnership owns an additional cold asset with a basis of \$150 and a fair market value of \$150, and each partner has an outside basis (\$50) equal to one third of the partnership's inside basis. On the liquidating distribution, *A* again receives two thirds of the zero-basis hot asset (worth \$100) and one third of the unappreciated cold asset (worth \$50). *B* and *C* would again recognize hot asset gain of \$50, and *A* would take a basis of \$50 in the distributed hot asset, reducing *A*'s outside basis to zero. Since *A*'s remaining outside basis (zero) is less than the inside basis of the distributed cold asset (\$50), the partnership would be entitled to an upward section 734(b)

64. The *BC* partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Hot Asset	\$ 0	\$ 50	<i>B</i>	\$25	\$100
Cold Asset	<u>50</u>	<u>150</u>	<i>C</i>	<u>25</u>	<u>100</u>
Total	\$50	\$200	Total	\$50	\$200

65. Without a basis increase of \$50 to the retained cold asset, the continuing partners' share of cold asset gain would increase from \$100 to \$150 (\$150 value of retained cold asset less zero basis), triggering a corresponding capital loss of \$50 on liquidation.

basis adjustment, eliminating \$50 of cold asset gain inside the partnership.⁶⁶ The inside basis increase properly reflects the nondistributee partners' cost of acquiring *A*'s former share of the partnership's retained cold asset. *A* recognizes no capital gain immediately, since *A*'s \$50 share of cold asset gain is preserved in the distributed cold asset whose basis is stepped down from \$50 to zero in *A*'s hands.⁶⁷

Example (3):⁶⁸ The facts are the same as in *Example (2)*, except that *A* receives a liquidating distribution of two thirds of the cold asset with a value of \$100. Since *A*'s share of hot asset gain is reduced to zero, *A* is deemed to sell \$50 worth of zero-basis hot assets to *B* and *C*. Accordingly, *A* recognizes \$50 of ordinary income, increasing *A*'s outside basis and the partnership's basis in the retained hot asset to \$50. Under section 732(b), the distributed cold asset takes a basis of \$50 in *A*'s hands equal to *A*'s outside basis, triggering a downward section 734(b) basis adjustment to the partnership's retained cold asset. The section 734(b) adjustment is suspended, however, because the partnership's basis in the retained cold asset cannot be reduced below zero.⁶⁹ Thus, Notice 2006-14 states that capital gain of \$50 is "potentially eliminated from the system."⁷⁰ Of course, the capital gain does not actually disappear but rather is preserved in the nondistributee partners' outside bases.

In *Example (3)*, *B* and *C* should be required, under the authority of section 751(b), to recognize immediately capital gain of \$50 equal to the amount of the prevented section 734(b) adjustment. Prior to the distribution, the partnership's basis in the distributed cold asset would thus be increased from

66. The *BC* partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Hot Asset	\$ 0	\$ 50	<i>B</i>	\$75	\$150
Cold Asset #1	50	150	<i>C</i>	75	150
Cold Asset #2	<u>100</u>	<u>100</u>	Total	\$150	\$300
Total	\$150	\$300			

67. In effect, *A* has relinquished a \$50 interest in inside basis (a cold asset) in exchange for a \$50 interest in cold asset gain (and value).

68. This example is derived from Notice 2006-14, *supra* note 1, Example 2.

69. The *BC* partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Hot Asset	\$50	\$150	<i>B</i>	\$0	\$100
Cold Asset	<u>0</u>	<u>50</u>	<i>C</i>	<u>0</u>	<u>100</u>
Total	\$50	\$200	Total	\$0	\$200

70. *Id.* The nondistributee partners will eventually recognize capital gain of \$50 on liquidation of the partnership or sale of their partnership interests.

zero to \$50. Since the inside basis of the distributed cold asset would be the same as *A*'s outside basis (\$50), no section 734(b) adjustment would be triggered. *B* and *C* should not be permitted to enjoy the benefit of an increased basis in the retained hot asset, unless they recognize \$50 of capital gain immediately. Without such gain recognition, the continuing partners' outside bases (zero) would be less than the inside basis of the retained hot asset (\$50). Immediate gain recognition restores parity between the continuing partners' outside bases and shares of inside basis.⁷¹

Although the relationships of the distributee and nondistributee partners are interchanged, *Examples (2)* and *(3)* should produce similar results. In *Example (2)*, the distributee (*A*) receives excess hot assets and should recognize capital gain immediately to preserve a stepped-up basis in the distributed hot assets. In *Example (3)*, the nondistributee partners (*B* and *C*) retain excess hot assets and should also recognize capital gain immediately to preserve a stepped-up basis in the partnership's retained hot assets.⁷² Both examples represent exchanges of hot and cold asset gain and, under section 751(b), should be taxed accordingly. The tax consequences should not depend on the often purely formal distinction concerning the identity of the partners receiving or retaining assets. Indeed, the transaction in *Example (3)* could easily be rearranged so that *B* and *C* are the withdrawing partners who have insufficient outside bases to absorb the partnership's increased basis in distributed hot assets.

Examples (2) and *(3)* both represent situations in which recognition of capital gain to the purchasing partners should be required as a condition of preserving a stepped-up basis in the partnership's distributed or retained hot assets. Under the existing regulations, section 751(b) often taxes capital gain unnecessarily to the purchasing partners. If shifts in hot asset gain are measured accurately, however, the capital-gain side of the transaction should be taxed whenever the distributee or continuing partners would otherwise wind up with insufficient basis to absorb their share of the stepped-up basis of the partnership's hot assets. Alternatively, the problem of basis insufficiency could be dealt with by requiring the purchasing partners to forego the benefit of a stepped-up basis in distributed or retained hot assets.

71. The *BC* partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Hot Asset	\$50	\$150	<i>B</i>	\$25	\$100
Cold Asset	<u>0</u>	<u>50</u>	<i>C</i>	<u>25</u>	<u>100</u>
Total	\$50	\$200	Total	\$50	\$200

72. If the partnership's retained cold assets had sufficient basis to absorb the required \$50 downward adjustment, the continuing partners would not recognize capital gain.

V. NONLIQUIDATING DISTRIBUTIONS

The goal of the 1954 ALI proposals was to preserve unrealized gain (or loss) through mandatory reallocation of basis among distributed and retained assets, while triggering gain recognition only to the extent of any prevented basis adjustments.⁷³ When Congress rejected partial liquidation treatment, it removed one of the major assumptions underlying the operation of section 751(b) – namely, that the distributee had relinquished a “proportionate share” of partnership assets in exchange for distributed property.⁷⁴ Since it was virtually impossible to determine which assets were relinquished in a nonprorata current distribution, contemporaries quickly expressed doubt as to whether section 751(b) should even apply to current distributions.⁷⁵ Limiting section 751(b) to liquidating distributions would leave a wide gap in the collapsible partnership rules: a distribution of cash or appreciated cold assets that reduces a partner’s interest in the partnership from 99% to 1% would avoid section 751(b), even though such a distribution clearly represents a partial liquidation of the distributee’s interest.

The modern concept of a revaluation makes it possible, in theory, to track precisely each partner’s pre- and post-distribution shares of hot and cold asset gain. Without a revaluation, the partners’ respective shares of inside basis, gain and value would often be quite difficult to determine. Thus, a revaluation allows tagging of predistribution hot (and cold) asset gain for later recognition. Nevertheless, a revaluation of partnership property is not an adequate replacement for section 751(b), since a nonprorata current distribution of appreciated property alters the spread between inside basis and value. Following the distribution, the value of the distributee’s retained interest may thus no longer be capable of supporting the distributee’s remaining share of inside basis and booked-up hot (and cold) asset gain.

To the extent that the distributee receives a current distribution of excess hot assets, the hot asset sale approach generally works well. The nondistributee partners would recognize ordinary income equal to the net reduction in their share of hot asset gain, and a distributee with sufficient outside basis would receive the benefit of the partnership’s stepped-up basis in

73. While the ALI proposals were the forerunner of current § 751(b), they bore little relationship to the provision as enacted. *Cf.* Gergen, *supra* note 9, at 224 (attributing complexity of existing § 751(b) approach to ALI proposals).

74. See S. Rep. No. 1622, 83d Cong., 2d Sess. 401-02 (1954).

75. See, e.g., Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954* (pts. 1 & 2), 10 *Tax L. Rev.* 161 & 335 (1955) (“With respect to . . . current distributions, it may well be that although the section seems to apply, the serious complexities and unreasonable tax results obtained under the section may outweigh the desirability of closing what seems to be a relatively minor tax loophole.” *Id.* at 189).

distributed hot assets.⁷⁶ A current distribution of excess cold assets would generally not trigger section 751(b) because a revaluation preserves the partners' shares of hot asset gain inside the partnership. If the distributee's share of booked-up hot asset gain exceeds the value of the distributee's retained partnership interest, however, section 751(b) should apply. Following a current distribution that leaves the distributee with a retained partnership interest of insufficient value to support booked-up hot asset gain, section 704(c) special allocations cannot adequately substitute for immediate gain recognition under section 751(b).⁷⁷

A. Distributions of Excess Hot Assets

On a distribution of excess hot assets, the hot asset sale approach would greatly improve the operation of section 751(b). As illustrated by *Example (4)* below, the one-sided sale of hot assets would trigger ordinary income to the nondistributee partners whose share of hot asset gain is reduced. Absent a shortfall in outside basis, however, no capital-gain tax would be triggered to the distributee partner who receives excess hot assets. On a current distribution, a revaluation would thus serve to minimize any hot asset shift and corresponding gain recognition.

Example (4): Assume that *C* receives a distribution of two thirds of the *ABC* partnership's hot asset (\$20 basis, \$80 value), when the *ABC* partnership has the following predistribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Value</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$ 90	\$160
Land	180	300	<i>B</i>	90	160
Receivables	<u>30</u>	<u>120</u>	<i>C</i>	<u>90</u>	<u>160</u>
Total	\$270	\$480	Total	\$270	\$480

Immediately before the distribution, the partnership's assets are revalued. Each partner is allocated one third (\$40) of the partnership's total cold asset gain and one third (\$30) of the partnership's total hot asset gain. Since the hot asset gain inherent in the distributed property (\$60) exceeds *C*'s total predistribution share of hot asset gain (\$30), a revaluation cannot prevent a hot asset shift. Thus, *A* and *B* should recognize ordinary income of \$30, increasing the basis of the distributed hot asset from \$20 to \$50 and preserving *C*'s hot asset gain of \$30 (\$80 value less \$50 basis). *C* recognizes no capital gain, since *C* has sufficient

76. As on a liquidating distribution, a current distribution of excess hot assets should trigger capital gain only to the extent of any basis shortfall.

77. See Andrews Comments, *supra* note 2.

outside basis to absorb the increased basis of the distributed hot asset. The partnership has the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$105	\$160
Land	180	300	<i>B</i>	105	160
Receivables	<u>10</u>	<u>40</u>	<i>C</i>	<u>40</u>	<u>80</u>
Total	\$250	\$400	Total	\$250	\$400

The book value of *C*'s retained interest (\$80) equals *C*'s share of the partnership's inside basis (\$40) and booked-up cold asset gain (\$40). *C*'s share of hot asset gain is reduced to zero. The book value of the nondistributee partners' interest (\$320) reflects their share of the partnership's inside basis (\$210) and booked-up hot (\$30) and cold (\$80) asset gain.

The hot asset sale approach works properly in *Example (4)*. *C* should not be required to recognize capital gain, since *C* has essentially exchanged a share of inside basis (\$30) for an increased interest in hot assets (\$30). When the distributee has sufficient outside basis to absorb the partnership's stepped-up basis in hot assets, a single tax to the selling partners on their relinquished ordinary income is entirely appropriate. Although the basis rules under section 732(a) seek to preserve the partnership's predistribution basis in distributed property, the hot asset sale approach would leave the distributee with a stepped-up basis in distributed hot assets that reflects the ordinary income recognized by the selling partners whose share of hot asset gain is reduced. Thus, the distributee would, quite sensibly, obtain a fair market value basis in distributed hot assets reduced by the distributee's preserved share of hot asset gain.

In order to minimize the impact of section 751(b), the partnership should allocate booked-up gain in distributed hot assets disproportionately to the distributee. Booking-up the gain in this manner generally reflects the economics of the transaction, since the distributee alone will be taxed on the hot asset gain shifted outside the partnership.⁷⁸ The partners should be permitted flexibility in determining how to book-up hot asset gain attributable to particular partnership assets, as long as each partner's share of total hot asset gain is preserved or recognized. Thus, section 751(b) would generally apply to a distribution of hot assets only if the partnership fails to book up its assets or, alternatively, the partnership allocates booked-up gain in distributed hot assets to the nondistributee partners.

Assume that the *ABC* partnership's assets consist of \$60 cash and two hot assets: Asset #1 (\$180 basis, \$300 value) and Asset #2 (\$30 basis, \$120 value), and the partnership allocates predistribution gain from each asset ratably

78. Since a distribution shifts any unrealized gain in distributed assets to the distributee, the § 704(b) regulations should generally treat such special allocations as in accordance with the partners' interests in the partnership. See Reg. § 1.704-1(b)(3).

among the partners.⁷⁹ The partnership distributes two thirds of Asset #2 (\$20 basis, \$80 value) to *C*. Before the distribution, *A*, *B* and *C* are each allocated \$40 of book gain from Asset #1 and \$30 of book gain from Asset #2. Although not entirely clear, it appears that *A*, *B*, and *C* would each have a one third share of reverse section 704(c) gain in each retained asset following the distribution.⁸⁰ Thus, the distribution shifts \$40 of the hot asset gain (two thirds of \$60) in distributed Asset #2 from *A* and *B* to *C*, reducing the nondistributtee partners' share of hot asset gain from \$140 to \$100. Under the existing regulations, section 751(b) does not apply because the partnership has no cold assets. Because the hot asset sale approach treats inside basis (like cash) as a cold asset, however, the distribution should be subject to section 751(b).⁸¹ *A* and *B* should immediately recognize ordinary income of \$40 equal to the shifted hot asset gain, and *C* should be allowed a \$40 increase in the basis of distributed Asset #2, preserving *C*'s \$20 share of hot asset gain (\$80 less \$60 basis).⁸²

B. Distributions of Excess Cold Assets

If reverse section 704(c) allocations trump the application of section 751(b), current distributions of cold assets would generally no longer trigger the collapsible partnership rules, regardless of the value of the distributee's

79. The *ABC* partnership has the following predistribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$ 90	\$160
Hot Asset #1	180	300	<i>B</i>	90	160
Hot Asset #2	<u>30</u>	<u>120</u>	<i>C</i>	<u>90</u>	<u>160</u>
Total	\$270	\$480	Total	\$270	\$480

80. This result seems strange because the distribution alters the partners' shares of inside basis and value; while the book-up locks in predistribution gain in the partners' predistribution sharing ratios, any subsequent gain will be allocated in accordance with their post-distribution interests in partnership capital.

81. In effect, the *ABC* partnership owns zero-basis hot assets with a value of \$210 and cold assets with a basis and value of \$270 (\$60 cash plus \$210 basis of other assets).

82. The *ABC* partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$110	\$160
Hot Asset #1	180	300	<i>B</i>	110	160
Hot Asset #2	<u>10</u>	<u>40</u>	<i>C</i>	<u>30</u>	<u>80</u>
Total	\$250	\$400	Total	\$250	\$400

C's remaining share of inside basis (\$30) and booked-up hot asset gain (\$40 in retained Asset #1 and \$10 in retained Asset #2) equals the value of *C*'s retained interest (\$80).

retained interest.⁸³ Notice 2006-14 requests comments concerning the application of the hot asset sale approach when the distributee's share of booked-up hot asset gain exceeds the distributee's post-distribution interest in partnership capital. The issue is not simply a technical one: it implicates the scope of the nonrecognition rules generally under Subchapter K, as well as the relationship between sections 751(a) and 751(b) which were intended to parallel each other. As illustrated by *Example (5)* below, there may be significant constraints on the Treasury's authority to revise the operation of a statutory provision that was conceived when revaluations were not prevalent.

Example (5): Assume that *C* receives a distribution of one half of the *ABC* partnership's cold asset (\$90 basis, \$150 value), when the *ABC* partnership has the same predistribution balance sheet as in *Example (4)*.⁸⁴ Immediately before the distribution, the partnership's assets are revalued and each partner is allocated one third (\$40) of the partnership's total cold asset gain and one third (\$30) of the partnership's total hot asset gain. The *ABC* partnership has the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$ 90	\$160
Land	90	150	<i>B</i>	90	160
Receivables	<u>30</u>	<u>120</u>	<i>C</i>	<u>0</u>	<u>10</u>
Total	\$180	\$330	Total	\$180	\$330

Ignoring section 751(b), *C* takes a transferred basis (\$90) in the distributed cold asset, leaving *C* with cold asset gain of \$60 outside the partnership (\$20 more than *C*'s total predistribution share). *C*'s booked-up hot asset gain (\$30) exceeds *C*'s post-distribution interest in partnership capital (\$10). The nondistributee partners' total share of booked-up cold asset gain (\$80) also exceeds the actual tax gain (\$60) inherent in the retained cold asset, giving rise to potential ceiling-rule problems.

83. In terms of the 1954 ALI proposals, the reduction in the value of the distributee's partnership interest clearly represents a partial liquidation, though it may be quite difficult in partnerships with varying profit-sharing ratios to determine precisely the portion of the distributee's interest redeemed. See Andrews, *supra* note 5, at 73-75.

84. Thus, the *ABC* partnership has the following predistribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Value</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$ 90	\$160
Land	180	300	<i>B</i>	90	160
Receivables	<u>30</u>	<u>120</u>	<i>C</i>	90	160
Total	\$270	\$480	Total	\$270	\$480

In *Example (5)*, *C*'s excess booked-up hot asset gain of \$20 would apparently be recognized regardless of whether the partnership sells the retained assets or *C* sells her partnership interest. If the partnership sold its retained assets for their fair market value, each partner would be allocated one third of the partnership's ordinary income (\$30 each) and *A* and *B* should presumably be allocated the partnership's entire cold asset gain (\$60). On liquidation of the partnership, *C* would recognize a capital loss of \$20 (\$10 distribution less \$30 outside basis) and *A* and *B* would recognize an offsetting capital gain of \$20 (\$320 distribution less \$300 outside basis).⁸⁵ Similarly, if *C* sold her partnership interest for \$10, *C* would recognize \$30 of ordinary income under the section 751(a) regulations, and an offsetting capital loss of \$20.⁸⁶ Rather than attempt to allocate a portion of the selling partner's amount realized and adjusted basis to section 751(b) property, the section 751(a) regulations adopt a hypothetical sale approach under which *C* recognizes ordinary income as if the partnership sold its assets. Under a literal interpretation of section 751(a), however, the actual amount realized on the sale of *C*'s interest (\$10) arguably sets a cap on *C*'s realized ordinary income, potentially allowing hot asset gain of \$20 to disappear.⁸⁷

Given the parallel purpose of sections 751(a) and 751(b), it would clearly be inappropriate to interpret one provision in a manner that defeats the other. Thus, if the section 751(b) regulations were to take the position that no hot asset shift occurs even though the distributee's share of booked-up hot asset gain exceeds the value of the distributee's retained interest, the section 751(a) regulations ought to require that any reverse section 704(c) allocations be taken into account upon a subsequent transfer of the distributee's partnership interest. In light of the language of section 751(a), however, a court might nevertheless conclude that Treasury's exercise of its regulatory authority under section 751(a) was unreasonable. Indeed, the government could very well be whipsawed: a distributee might fail to report ordinary income on a hot asset shift, while the purchasing partners could later claim that they were entitled to a stepped-up basis in purchased hot assets. In revising the section 751(a) regulations in 1999, the drafters could not have anticipated the full extent to which hot asset gain might be deferred through a revaluation without triggering section 751(b). Thus, the Treasury's interpretation of section 751(a) may need to be reevaluated in light of any changes to the section 751(b) regulations.

The contrary view is that reverse section 704(c) allocations should override application of section 751(b) even though the distributee's booked-up share of hot asset gain exceeds the distributee's post-distribution interest in

85. See IRC § 731(a).

86. See Reg. § 1.751-1(a)(2).

87. See Jackel & Stok, *supra* note 18, at 1581

partnership capital.⁸⁸ Under this view, the section 751(a) regulations provide an adequate safeguard to ensure that the distributee cannot avoid booked-up ordinary income upon a subsequent sale of the distributee's partnership interest. To the extent that any uncertainty exists, the Treasury should clarify the operation of section 751(a) or provide bright-line rules so that taxpayers are aware of transactions subject to any special rules. Such special rules would address the situation in which "a partner's reverse section 704(c) hot asset gain vastly exceeds the partner's interest in partnership capital" following a distribution.⁸⁹ Under this anti-abuse approach, section 751(b) would seldom (if ever) apply to a current distribution of excess cold assets, since even a low-value retained partnership interest would generally suffice to preserve the distributee's booked-up share of hot asset gain.⁹⁰

The Treasury should reject such an anti-abuse approach as fundamentally inconsistent with the language and purpose of section 751(b). Despite early concerns about the application of section 751(b) in a nonliquidating situation, it has been well accepted for half a century that the provision applies to current as well as liquidating distributions.⁹¹ Moreover, there are important policy reasons why section 751(b) should apply when the distributee's retained interest in partnership capital is no longer consistent with the economic assumptions underlying the booked-up hot asset gain allocable to the distributee. Given the myriad ways in which such excess built-in ordinary income may disappear on a subsequent nonrecognition transfer, the potential for tax-avoidance is quite high. For example, the distributee may transfer the low-value retained partnership interest to a controlled corporation, thereby deflecting ordinary income while relinquishing property of negligible value. Since current distributions are defined expansively as any distribution that does not terminate a partner's interest (or the partnership), section 751(b) is necessary to limit deferral of gain when a partner's interest is partially

88. According to the NYSBA, "there is not an obvious and principled way of defining a point at which reverse 704(c) concepts should no longer apply and § 751(b) should be triggered." NYSBA Report, *supra* note 2, at 33.

89. *Id.* at 33.

90. See *id.* at 3 (recommending that Congress repeal § 751(b) outright or revise the provision to function as an anti-abuse rule).

91. Cf. Dale E. Anderson & Melvin A. Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (pts. 1 & 2), 15 *Tax L. Rev.* 285 & 497 (1960) ("Perhaps the reason the legislative history sheds no light on the proportionate share problem is that Congress did not intend the collapsible rules to apply to a current distribution." *Id.* at 531).

liquidated.⁹² Recently, Subchapter K has moved further in the direction of limiting the scope of the nonrecognition rules.⁹³

While the Treasury clearly has authority to update the section 751(b) regulations to reflect revaluations and section 704(c) allocations, it does not have *carte blanche* to rewrite the existing statute. The principle underlying section 751(b) is that a distribution in partial liquidation of the distributee's interest is essentially an exchange of the continuing partners' interests in the distributed property for the distributee's interest in the remaining partnership property. Because the language of section 751(b) focuses on an increase or decrease in a partner's proportionate share of hot or cold assets, the hot asset sale approach cannot entirely ignore a reduction in the distributee's interest in partnership capital, even if the goal is to minimize gain recognition. Indeed, under the language of the 1954 Senate bill, section 751(b) was triggered whenever a distributee received "more than his proportionate share of the value" of either hot or cold assets.⁹⁴ Thus, the Senate bill introduced the concept of shifts in a partner's proportionate share of hot or cold assets measured by the *value* of such assets. While the Conference Committee's revised statutory language deleted the reference to value, this change was not intended to eliminate the proportionate share concept.⁹⁵

Consistent with the statutory language and purpose, section 751(b) should apply when the distributee's interest in partnership capital is no longer sufficient to support the distributee's booked-up share of hot asset gain. To avoid triggering section 751(b), the distributee's post-distribution book capital account should be at least equal to the distributee's remaining share of inside basis plus the distributee's booked-up hot asset gain.⁹⁶ If a distribution of

92. Cf. NYSBA Report, *supra* note 2, at 32 (suggesting that Congress in 1954 was not concerned about deferral of hot asset gain).

93. See Christopher H. Hanna, Partnership Distributions: Whatever Happened to Nonrecognition?, 82 KY. L.J. 465 (1993-94) (comparing the scope of nonrecognition under the 1954 provisions and current law).

94. H.R. 8300, 83d Cong., 2d Sess. § 751(b) (1954) (as amended by the Senate).

95. See H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 65 (1954). Since hot asset gain is simply the spread between basis and value, both basis and value should remain relevant in applying § 751(b). See Andrews, *supra* note 5, at 75 ("As in the treatment of § 751(b), the final key is to focus primarily neither on *basis* nor on *value*, but on the spread between the two or *unrealized gain*.").

96. Indeed, the distributee might be required to retain an interest in partnership capital in excess of this minimum amount. See Andrews Comments, *supra* note 2 (suggesting that some "considerable cushion" in excess of the distributee's share of

excess cold assets exhausts the distributee's share of inside basis, the distributee would recognize ordinary income equal to the "excess booked-up hot asset gain," *i.e.*, booked-up hot asset gain in excess of the book value of the distributee's retained interest.⁹⁷ In *Example (5)*, *C* would thus recognize \$20 of hot asset gain immediately equal to the excess of *C*'s booked-up hot asset gain (\$30) plus *C*'s remaining share of inside basis (zero) over the value of *C*'s retained interest (\$10). Immediate recognition of ordinary income of \$20 eliminates the capital loss of \$20 that *C* would otherwise recognize upon liquidation of the partnership. In effect, the built-in capital loss signifies that *C* has retained a share of inside basis and booked-up hot asset gain in excess of the value of *C*'s retained interest.

Ignoring section 751(b), the distribution in *Example (5)* exhausts *C*'s share of outside basis (\$90 outside basis less \$90 transferred basis of land). The corollary of a zero outside basis should be a zero share of inside basis. In fact, *C*'s share of previously taxed capital is apparently negative \$20, *i.e.*, the book value of *C*'s retained interest (\$10) less *C*'s booked-up hot asset gain (\$30).⁹⁸ Outside Subchapter K, gain recognition is routinely required to prevent negative basis.⁹⁹ Indeed, even Subchapter K generally requires gain recognition when a cash distribution exceeds a partner's entire outside basis, since the lurking gain can no longer be preserved.¹⁰⁰ If *C* recognizes hot asset gain of \$20, *C*'s share of inside basis is restored to zero (\$10 book value less \$10 remaining share of hot asset gain).¹⁰¹

The nondistributee partners (*A* and *B*) should also be required to recognize cold asset gain of \$20, the amount of unrealized appreciation in the distributed cold asset in excess of *C*'s total predistribution share of cold asset gain. *C* has given up \$20 worth of zero-basis hot assets and received, in exchange therefor, an additional \$20 worth of zero-basis cold assets. The partnership's stepped-up basis of \$20 in the retained hot asset reflects the cost of acquiring *C*'s former share of hot asset gain (and value). While *C* could perhaps be deemed to sell \$20 worth of hot assets to herself, it makes much better sense to treat the nondistributee partners (*A* and *B*) as the purchasing

inside basis plus booked-up hot asset gain might be required). The distributee's share of inside basis would be determined net of liabilities. See note 44 *supra*.

97. "Exhausted basis" distributions are precisely the type of distributions that ought to trigger § 734(b) adjustments. See Andrews, *supra* note 5, at 56-57.

98. See Reg. § 1.743-1(d).

99. See, e.g., IRC §§ 351(b), 1031; see also Andrews, *supra* note 5, at 67 (characterizing proportional gain recognition rule on a nonprorata current distribution as "mild by comparison" to other boot rules)

100. See IRC § 731(a).

101. Although *C*'s outside basis is increased by the recognized gain of \$20, *C*'s basis in the distributed property is also increased by \$20; thus, *C*'s outside basis (zero) equals *C*'s share of inside basis.

partners, exactly as if they had paid cash for *C*'s share of hot asset gain.¹⁰² With respect to *A* and *B*, the result is the same as if they had sold their relinquished share of cold asset gain for cash. Thus, *C* recognizes \$20 of ordinary income and *A* and *B* together recognize \$20 of capital gain. Immediately prior to the distribution, the basis of the distributed cold asset is increased from \$90 to \$110. Since *C*'s outside basis is also increased from \$90 to \$110, *C* takes a stepped-up basis of \$110 in the distributed cold asset, preserving *C*'s \$40 share of cold asset gain.¹⁰³

Following the distribution, the continuing partners' shares of inside basis, gain and value are properly aligned:

	<i>C</i>	<i>A and B</i>
Share of Inside Basis	\$0	\$200
Hot Asset Gain	10	60
Cold Asset Gain	<u>0</u>	<u>60</u>
Total	\$10	\$320

By contrast, ignoring section 751(b) creates havoc under the partnership accounting rules, since the partners' section 704(b) capital accounts no longer properly reflect their shares of inside basis and booked-up appreciation. The partnership's balance sheet would "balance" only if *C* were treated as having a negative basis hot asset (negative \$20 basis, zero value) and *A* and *B* were treated as having a mirroring positive basis cold asset (\$20 basis, \$20 value).¹⁰⁴

102. If *C* is treated as selling the hot assets to herself, *C*'s remaining outside basis would be \$20, and *C*'s basis in the distributed cold asset would be only \$90; thus, *C* would apparently have a built-in loss of \$20 in her partnership interest (\$20 outside basis increased by \$10 built-in gain less \$10 value of interest).

103. Accordingly, the partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$100	\$160
Land	90	150	<i>B</i>	100	160
Receivables	<u>50</u>	<u>120</u>	<i>C</i>	<u>0</u>	<u>10</u>
Total	\$200	\$330	Total	\$200	\$330

104. Ignoring § 751(b), the partners would have the following shares of inside basis, gain and value following the distribution:

The imbalance in the partnership's balance sheet reflects the failure to properly account for the shift of hot and cold asset gain (and value).

C. Tension Between § 704(c) Approach and § 751(b)

Allowing reverse section 704(c) allocations to support an unlimited amount of hot asset gain goes well beyond a simple "fix" to improve the measurement of hot assets shifts. Except in the case of current distributions of excess hot assets and liquidating distributions, this approach would effectively nullify section 751(b). While earlier proposals have sought to limit section 751(b) to liquidating distributions or tax-avoidance situations, Congress has thus far retained section 751(b).¹⁰⁵ For example, the 1984 ALI proposals sought to limit application of section 751(b) concepts to cash liquidating distributions in which the distributee would be treated as if she had disposed of her share of the underlying partnership assets in a fully taxable sale.¹⁰⁶ With respect to many common types of partnership distributions, the 1984 ALI proposals resulted in substantially less than full fragmentation. Thus, full fragmentation was not required for (1) any distribution of cash in partial liquidation of a partner's partnership interest, or (2) any current or liquidating distribution in which the distributee received both cash and other cold assets (or solely cold assets).¹⁰⁷

Importantly, the 1984 ALI proposals were directed toward legislative reform of section 751(b), not revision of the statute through Treasury regulations. The 1984 ALI proposals urged repeal of section 751(b) on the ground that "it is extraordinarily complex" and "produces too harsh a result for the policy that it is intended to enforce."¹⁰⁸ If the only purpose of making the section 751(b) exchange taxable was to prevent income-shifting, the ALI reasoned that this purpose might have been accomplished by "tainting" the

	<i>C</i>	<i>A and B</i>
Share of Inside Basis	\$ 0	\$180
Hot Asset Gain	30	60
Cold Asset Gain	<u>0</u>	<u>60</u>
Share of Value (§ 704(c))	30	300
Negative/Positive Basis Asset	<u>(20)</u>	<u>20</u>
Booked-up Value (§ 704(b))	\$10	\$320

105. Despite proposals to eliminate § 751(b), legislation introduced in 1960 retained the section virtually intact. See H.R. 9662, 86th Cong., 2d Sess. 27-30, 148-150 (1960); see also Arthur B. Willis, *Willis on Partnership Taxation* 17-18 (1971) (discussing Congress' failure to enact proposed revisions).

106. See American Law Institute, *Federal Income Tax Project: Subchapter K, Proposals on the Taxation of Partners* 8, 30, 53 (1984).

107. See *id.* at 35, 45.

108. *Id.* at 51.

distributed (or retained) property.¹⁰⁹ During the 1990's, proposals again resurfaced to repeal section 751(b) outright or retain the provision only as an anti-abuse rule.¹¹⁰ These proposals contrast starkly with more fundamental reform of Subchapter K, along the lines of the Andrews proposals, that would require partial liquidation treatment and mandatory basis reallocation.¹¹¹

The tension between reverse section 704(c) allocations and section 751(b) reflects the failure of Subchapter K to treat a disproportionate distribution as a partial liquidation of the distributee's interest, requiring either immediate gain recognition or reallocation of inside basis to preserve existing shares of unrealized appreciation. While section 704(c) is designed to deal with the problem of income-shifting on a contribution of partnership property, a distribution in partial liquidation of a partner's interest removes both value and unrealized appreciation from the partnership. Thus, preserving shares of unrealized appreciation may no longer be possible because the partnership's retained assets lack sufficient unrealized appreciation or the distributee retains an insufficient interest in partnership capital. In these situations, the regulatory concept of reverse section 704(c) principles should give way to the specific statutory requirements of section 751(b).

Nevertheless, section 751(b) may appear to tax hot asset gain needlessly to a distributee who receives a current distribution of excess cold asset gain and retains a positive share of inside basis. In *Example (5)*, assume that, prior to the distribution of land to C, each partner's tax capital account (and outside basis) is \$110 (rather than \$90) and the value of each partner's interest is \$180 (rather than \$160).¹¹² The unrealized hot and cold asset gain

109. See *id.* at 50. The ALI proposals emphasized that "the purpose of [§ 751(b)] is not to impose a tax merely because a partner is exchanging an interest in one asset for an interest in another asset." *Id.*

110. See, e.g., William B. Brannan, *The Subchapter K Reform Act of 1997*, 75 *Tax Notes* 121, 135-36 (1997) (treating a disproportionate distribution as a taxable event only if it "significantly" shifted potential ordinary income and had a "principal purpose" of tax avoidance).

111. For an analysis of the Clinton administration's proposals to require partial liquidation treatment and mandatory § 734(b) adjustments, see Karen C. Burke, *Reassessing the Administration's Proposals for Reform of Subchapter K*, 86 *Tax Notes* 1423 (Mar. 6, 2000); Ernst & Young LLP, *Analysis of the Administration's Partnership Proposals*, 84 *Tax Notes* 103 (July 5, 1999).

112. Thus, the ABC partnership has cash of \$120 (rather than \$60) and the following predistribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Value</i>
Cash	\$120	\$120	A	\$110	\$180
Land	180	300	B	110	180
Receivables	<u>30</u>	<u>120</u>	C	<u>110</u>	<u>180</u>
Total	\$330	\$540	Total	\$330	\$540

inherent in the partnership's assets is unchanged, since total inside basis and value are increased by an equal amount. If the distribution of excess cold asset gain is treated as taxable to the nondistributee partners, there is no reason to tax C's hot asset gain immediately. The basis of the distributed land would be increased from \$90 to \$110 in C's hands to reflect the nondistributee partners' recognized capital gain of \$20. Following the distribution, C's share of inside basis would be reduced to zero (\$110 less \$110 basis of distributed property) and the value of C's retained interest (\$30) would equal C's booked-up hot asset gain (\$30).¹¹³ C's share of hot assets would not be diminished, since C would be treated as having exchanged a \$20 share of inside basis for an increased interest in cold assets worth \$20.¹¹⁴

When partnership property is revalued, retained partnership property may no longer suffice to produce actual tax gain corresponding to the nondistributee partners' shares of booked-up cold asset gain. At a minimum, the partnership should be required to allocate booked-up cold asset gain in a manner that eliminates or reduces any shift in cold asset gain as a result of a nonprorata current distribution. While immediate taxation of cold asset shifts may appear startling, both sections 734(b) and 751(b) were expressly designed to prevent income-shifting through partial liquidation treatment and mandatory basis reallocation. Although it has taken Congress fifty years to recognize the need for (mostly) mandatory section 734(b) adjustments to inside basis,¹¹⁵ extending section 751(b) to cold asset shifts is long overdue.

113. The ABC partnership would have the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$120	\$120	A	\$120	\$180
Land	90	150	B	120	180
Receivables	<u>30</u>	<u>120</u>	C	<u>0</u>	<u>30</u>
Total	\$240	\$390	Total	\$240	\$390

114. If the cold asset shift does not trigger gain recognition to the nondistributee partners, C would be left with a \$20 share of inside basis (and a \$90 basis in the distributed land). Thus, the book value of C's retained interest (\$30) would be insufficient to support C's booked-up share of hot asset gain (\$30) and share of inside basis (\$20).

115. See note 36 *supra*. Although Congress retained electivity of § 734(b) basis adjustments in transactions not involving substantial built-in losses, the Senate version of the 2004 legislation would have required mandatory § 734(b) basis adjustments in virtually all situations. See S. Rep. No. 108-192, at 189-190 (2004) (rejecting electivity of basis adjustments as "anachronistic").

VI. RESTORING CONFORMITY BETWEEN §§ 751(A) AND 751(B)

Section 751(b) was originally intended to function as a backstop to section 751(a). Nevertheless, section 751(a) has been amended to require full fragmentation regardless of whether the partnership's inventory is substantially appreciated.¹¹⁶ Thus, a selling partner generally recognizes the same amount of ordinary income on a sale of a partnership interest as if the partnership had disposed of its assets. Even more significantly, section 751(a) applies a look-through approach when a partnership owns tepid assets, primarily unrecaptured section 1250 gain.¹¹⁷ The failure to extend section 751(b) to tepid asset shifts creates an important disparity between the operation of these two provisions.

Example (6): Assume that the ABC partnership has the same balance sheet as in *Examples (4) and (5)*, except that the partnership owns depreciated section 1250 property (rather than a hot asset) with unrecaptured section 1250 gain of \$90. Thus, the ABC partnership has the following predistribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Value</i>
Cash	\$ 60	\$ 60	<i>A</i>	\$ 90	\$160
Land	180	300	<i>B</i>	90	160
§ 1250 Property	<u>30</u>	<u>120</u>	<i>C</i>	<u>90</u>	<u>160</u>
Total	\$270	\$480	Total	\$270	\$480

C receives a current distribution of one half of the land (\$90 basis, \$150 fair market value) and cash of \$5.

Ignoring § 751(b), the partnership has the following post-distribution balance sheet:

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$55	\$55	<i>A</i>	\$ 90	\$160
Land	90	150	<i>B</i>	90	160
§ 1250 Property	<u>30</u>	<u>120</u>	<i>C</i>	<u>0</u>	<u>5</u>
Total	\$175	\$325	Total	\$180	\$325

Thus, *C*'s outside basis of \$85 (\$90 reduced by the \$5 cash distribution) is no longer sufficient to preserve the partnership's \$90 basis in the distributed land. Since the distribution carries out inside basis in excess of the distributee's outside basis, it triggers an upward section 734(b) adjustment to the

116. See IRC § 751(a).

117. See Reg. § 1.1(h)-1(b)(2)(ii) and 3(ii), -1(c) (defining look-through capital gain).

partnership's retained cold assets.¹¹⁸ Under the section 755 regulations, the inside basis adjustment (\$5) is allocated to the land and section 1250 property in proportion to their unrealized appreciation.¹¹⁹ Since the section 734(b) adjustment affects the common basis of the partnership's property, it eliminates tax gain corresponding to previously booked-up gain. Thus, it is not entirely clear how the remaining tax gain inherent in the partnership's cold assets should be allocated.¹²⁰ Even though the section 734(b) adjustment eliminates tepid asset gain, section 751(b) does not apply.

If the section 1250 property were instead section 1245 property, the section 751 regulations would treat the partnership as owning a hot asset to the extent of the depreciation recapture (zero basis, \$90 value) and a residual cold asset (\$30 basis, \$30 value). The section 755 regulations would allocate the entire section 734(b) adjustment to the partnership's only appreciated cold asset (the land), thereby preventing the inside basis adjustment from eliminating booked-up ordinary income or generating future depreciation deductions. Under the section 755 regulations, an upward section 734(b) adjustment to section 1245 property is allowed only if the partnership's section 1245 property has unrealized appreciation in excess of the total recapture amount or the upward section 734(b) adjustment exceeds the entire unrealized appreciation in the partnership's retained cold assets. When a partnership owns depreciated section 1245 property, a current distribution of excess cold assets raises two problems: It is necessary to identify (1) the reduction in the distributee's share of potential recapture income and (2) whether all of the continuing partners (including potentially the distributee) should benefit from any increase to the basis of the partnership's retained section 1245 property.¹²¹

The proper solution is to tax immediately the distributee's excess booked-up hot asset gain (including recapture) and to allocate the benefit of any basis increase to section 1245 property to the nondistributee partners, who have effectively purchased the distributee's relinquished share of hot asset gain.

118. The upward § 734(b) adjustment is necessary to eliminate the disparity of \$5 in the partnership's basis in its assets and the continuing partners' outside bases.

119. Thus, the basis of the land would be increased by \$2 ($\$60/\$150 \times \5) and the basis of the § 1250 property would be increased by \$3 ($\$90/\$150 \times \5).

120. Following a revaluation, an upward section 734(b) adjustment should arguably benefit exclusively the distributee partner who recognizes gain on a nonprorata distribution. See Abrams, *supra* note 8, at 364-65.

121. An upward § 734(b) adjustment to depreciable property serves two functions: (1) it displaces gain inherent in the partnership's retained assets and (2) it gives rise to future depreciation deductions. As a result, any § 734(b) adjustment should generally be shared for purposes of book depreciation in the same ratio as the partners' post-distribution percentage interests. See Burke, *supra* note 8, at 653. In accordance with § 704(c) principles, tax depreciation would be allocated in a manner that eliminates book-tax disparities.

Because *C*'s share of booked-up hot asset gain is \$30 and the value of *C*'s retained interest in only \$5, *C* should be required to recognize ordinary income of \$25 immediately, increasing *C*'s outside basis to \$110 (\$115 less \$5 cash distributed). *C* should take a basis of \$110 in the distributed land (\$90 inside basis plus \$20 capital gain recognized or deferred by nondistributee partners), preserving *C*'s share of cold asset gain (\$40). *C*'s outside basis (and share of inside basis) would be reduced to zero, and *C*'s remaining share of hot asset gain would be reduced to \$5.¹²²

The purchasing partners (*A* and *B*) should generally enjoy the benefit of future depreciation deductions attributable to the \$25 increase in the basis of the partnership's section 1245 property. In effect, *A* and *B* have purchased \$25 worth of *C*'s interest in the partnership's section 1245 property in exchange for the shifted cold asset gain in the distributed land (\$20) plus cash (\$5). Thus, if *A* and *B* recognize capital gain of \$20 immediately, they should be entitled to the equivalent of a cost basis in the purchased portion of the section 1245 property.¹²³ Accordingly, the *ABC* partnership would have the following post-distribution balance sheet:¹²⁴

<i>Assets</i>	<i>Basis</i>	<i>Value</i>	<i>Capital</i>	<i>Tax</i>	<i>Book</i>
Cash	\$55	\$55	<i>A</i>	\$100	\$160
Land	90	150	<i>B</i>	100	160
§ 1245 Property	<u>55</u>	<u>120</u>	<i>C</i>	<u>0</u>	<u>5</u>
Total	\$200	\$325	Total	\$200	\$325

If *A* and *B* are instead permitted to defer recognition of capital gain, they should be denied a corresponding \$20 upward adjustment to the basis of the partnership's section 1245 property to avoid inflating depreciation deductions.¹²⁵

122. *C*'s initial outside basis of \$90 would be increased by \$25 gain recognized and reduced by \$5 cash and \$110 basis of distributed property.

123. In the case of depreciable property, any reverse § 704(c) gain (including potential recapture) will be eliminated over time as the property is depreciated. See NYSBA Report, *supra* note 2, at 33-34.

124. Following the distribution, the continuing partners' shares of inside basis, gain and value would be properly aligned:

	<i>C</i>	<i>A and B</i>
Share of Inside Basis	\$0	\$200
Hot Asset Gain	5	60
Cold Asset Gain	<u>0</u>	<u>60</u>
Total	\$5	\$320

125. On a subsequent sale of the § 1245 property, the amount of recapture income could be limited to avoid overstating the continuing partners' ordinary income.

Example (6) reveals the flaw in the operation of section 751(b) when the distributee relinquishes a share of tepid asset gain: section 751(b) does not apply to unrecaptured section 1250 gain and the section 755 basis allocation rules permit reallocation of basis from distributed cold assets to retained tepid assets. The Andrews proposals would fix both flaws: for purposes of both sections 751(b) and 755, tepid assets would be treated as belonging to an intermediate class on the continuum between hot and cold assets. Under current law, sale of a partnership interest triggers tepid asset gain under rules similar to those applicable to hot asset gain.¹²⁶ Tepid asset gain is taxed as if the partnership sold the underlying assets and allocated such gain to the partners in accordance with their profit-sharing ratios. Since sections 751(a) and 751(b) were intended to operate in tandem, there is no policy reason to carve out tepid asset gain solely for purposes of § 751(a). Extending hot asset sale treatment to tepid assets is thus essential to restore parity between sections 751(a) and 751(b).

Example (7): Assume that the equal AB partnership has cash of \$100 and zero-basis section 1250 property worth \$100, and each partner has an outside basis of \$50. If *A* receives a cash distribution of \$75, *A* recognizes capital gain of \$25, triggering an upward section 734(b) adjustment. Since *A* has effectively sold three-fourths of *A*'s partnership interest for cash, it might appear that section 751(a) – the provision governing sales of partnership interests – would apply to tax *A*'s recognized capital gain of \$25 at the rate applicable to unrecaptured section 1250 gain. Nevertheless, the overall statutory scheme, historical background, and existing regulations make it clear that section 751(b) rather than section 751(a) is the controlling provision for recharacterizing gain on a partnership distribution (whether current or liquidating).¹²⁷ But, unlike section 751(a), section 751(b) applies only to hot (not tepid) asset shifts. Worse yet, the upward section 734(b) basis adjustment potentially eliminates \$25 of tepid asset gain inside the partnership and generates future depreciation deductions.

As a policy matter, *A*'s gain should be taxed in the same manner as if *A* had sold her interest in a portion of the partnership's section 1250 property, regardless of whether section 751(a) or section 751(b) applies. Indeed, it is quite clear that Congress originally intended sections 751(a) and 751(b) to reach essentially the same result: A nonprorata current distribution that alters

126. The sale of a partnership interest with a long-term holding period may result in a combination of ordinary income, collectibles gain (taxed at 28%), § 1250 capital gain (taxed at 25%), and long-term capital gain (taxed at 15%). See Reg. § 1.1(h)-1(b)(2)(ii) and 3(ii), -1(c).

127. See William S. McKee et al., *Federal Income Taxation of Partnerships and Partners* ¶ 16.02[1] (3d ed. 1997); Reg. § 1.731-1(a)(3); see also NYSBA Report, *supra* note 2, at 48-49 (noting that, by analogy to § 751(a), the Treasury could permit or require recharacterization of gain under § 731(a)).

the partners' percentage interests in the partnership is economically equivalent to a sale of a ratable portion of the distributee's partnership interest to the continuing partners. Since section 751(a) now requires section 1250 gain to be determined separately on sale of a partnership interest, however, the two provisions are not longer congruent. Thus, unrecaptured section 1250 gain may be taxed more lightly on a cash distribution in liquidation (or partial liquidation) of a partner's interest than on sale of a partnership interest. Yet, the continuing partners receive the same beneficial treatment as a third-party purchaser to the extent that any upward section 734(b) adjustment eliminates section 1250 gain inside the partnership.

In connection with revision of the section 751(b) regulations, the Treasury should consider whether it has authority to expand the hot asset sale approach to shifts in tepid asset gain. Indeed, a more far reaching proposal would be to dispense with section 751(b) entirely and instead specify gain (or loss) recognition and basis consequences entirely under sections 731 and 732.¹²⁸ In terms of gain (or loss) recognition, the distributee and nondistributee partners would be required to recognize hot, cold, and tepid asset gain (or loss) to the extent that such gain (or loss) cannot be preserved for later recognition in distributed and retained property. Because of administrative concerns based on valuation difficulties, Congress in 1954 drafted the basis rules of section 732 to avoid the need to value distributed property. When partnership property is revalued, however, there is no longer any reason why a distributee's basis in distributed property should not reflect the fair market value of such property less the distributee's predistribution share of built-in gain (or loss) allocable to such property. Thus, any distributed property should generally be assigned a fair market value basis in the distributee's hands, less the distributee's preserved share of hot, tepid, and cold asset gain (or loss). Indeed, Congress has recently revised the basis allocation rules of section 732(c) to take into account discrepancies between basis and fair market value of distributed property.¹²⁹

VII. CONCLUSION

The hot asset sale approach would remedy flaws under existing section 751(b), but only at the cost of substantially increased complexity under section 704(c). When the selling partner's share of hot asset gain is reduced, the hot asset sale approach generally minimizes recognition of capital gain. Nevertheless, the purchasing partners may be left with insufficient outside bases (or shares of inside basis) to absorb the stepped-up basis of distributed and retained hot assets. Under the authority of section 751(b), the problem of basis insufficiency should be dealt with generally by requiring the purchasing

128. See Andrews, *supra* note 5, at 55 n.178.

129. See IRC § 732(c).

partners to recognize capital gain as the implicit cost of benefitting from a stepped-up basis in the partnership's hot assets. A current distribution of excess cold assets would generally not trigger section 751(b), unless the distributee's retained interest in partnership capital is insufficient to support booked-up hot asset gain. When built-in gain of the proper character can no longer be preserved, section 751(b) should continue to play an important gain-recognition function.

The hot asset sale approach should be coordinated with basis adjustments under sections 734(b) and 743(b). When section 751(b) applies, the nondistributee partners are treated essentially as if they had acquired the distributee's interest in retained partnership assets; thus, section 751(b) adjustments have much in common with section 743(b) adjustments that benefit exclusively the purchaser of a partnership interest.¹³⁰ By contrast, section 734(b) adjustments to common basis potentially benefit all partners (including the distributee whose interest is partially redeemed). While the hot asset sale approach may exacerbate defects inherent in the section 734(b) adjustment, the more fundamental problem is that the concept of a common-basis adjustment is quite difficult to reconcile with revaluations and reverse section 704(c) allocations.¹³¹ Thus, when sections 734(b) and 751(b) apply, the Treasury needs to provide guidance concerning the interaction between inside basis adjustments and the operation of reverse section 704(c) allocations.¹³²

Many of the problems that arise in connection with hot asset distributions can be traced directly to Congress' rejection of the 1954 ALI proposals to require partial liquidation treatment and reallocation of inside basis to preserve unrealized shares of built-in gain. Congress rejected those proposals essentially on grounds of complexity, and instead implemented the flawed approach of current section 751(b) and elective inside basis adjustments under section 734(b). As the Andrews proposals suggest, however, partial liquidation treatment and mandatory inside basis adjustments may actually represent a simpler method of dealing with shifts in unrealized appreciation than revaluations and reverse section 704(c) allocations.¹³³ Even if a perfect solution to the problem of partnership distributions remains elusive, the hot assetsale approach represents much needed improvement of section 751(b).

130. Whether the solution is perceived as requiring special allocations of basis or gain, the different approaches under §§ 743(b) and 751(b) are essentially interchangeable. Thus, § 751(b) adjustments could be handled in the same manner as § 743(b) adjustments to the extent they reflect cost on a purchase.

131. A revaluation distorts the allocation of § 734(b) adjustments because the revaluation concept arbitrarily bifurcates pre- and post-distribution sharing of gains and losses; by contrast, the concept of § 734(b) adjustments to common basis is premised on partial liquidation treatment. See Burke, *supra* note 8, at 650-51.

132. See NYSBA Report, *supra* note 2, at 24.

133. See notes 53-56 *supra* and accompanying text.

Perhaps Subchapter K may yet evolve back toward the conceptually more straightforward treatment of partnership distributions that Congress rejected in 1954.

