December 13, 2023

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20220

William Paul
Principal Deputy Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20220

CC: Thomas West, Deputy Assistant Secretary, Domestic Business Tax
Department of the Treasury

Krishna P. Vallabhaneni, Tax Legislative Counsel
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Internal Revenue Service

Sarah Haradon, Attorney-Advisor
Department of the Treasury

Roger Pillow, Attorney-Advisory
Department of the Treasury

**Re: Suggestions for Partnership Regulations**

Dear Assistant Secretary Batchelder, Commissioner Werfel, and Principal Deputy Chief Counsel Paul,

Please find enclosed suggestions for partnership regulations.

The Tax Law Center at NYU Law is a public interest initiative that seeks to improve the integrity of the tax system. Our staff has broad experience in tax administration, private practice, and the tax legislative process.

We would be pleased to discuss these recommendations with you or your staff.

Sincerely,

Chye-Ching Huang
Executive Director, The Tax Law Center at NYU Law
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Enclosure

**Overview**[1]

The IRS has recently announced several initiatives to increase the audit rate of large and complex partnerships but, as many practitioners and academics have noted, there is also a need to update and reform the substantive provisions of Subchapter K. Any meaningful reform will require statutory and regulatory changes and will presumably be a long and somewhat difficult process. The IRS, however, could take two relatively simple steps to help start this process.

The first step would be to finalize a number of the currently proposed Subchapter K regulations. The IRS has already initiated this step by including the finalization of many of the proposed partnership regulations in the 2023-2024 Priority Guidance Plan. Finalizing these regulations would be helpful for several reasons. First, the regulations provide useful and needed guidance, but taxpayers generally cannot rely on proposed regulations unless there is an express statement in the preamble.[2] Second, several of the proposed regulations also have important anti-abuse provisions that are proposed to be effective as of the date the proposed regulations were issued, but the more time that passes between the proposed and final regulations, the harder it might be for the IRS to retain the retroactive effective date. Finally, as a general matter, leaving regulations unfinalized for a significant period of time does not benefit taxpayers or the IRS.

In addition to finalizing these proposed regulations, the IRS could take the unusual step of issuing an "omnibus" regulation package that includes specific additions or amendments to one or more of the current final regulations. Although proposed regulations usually address only one or two specific Code sections in depth, rather than amending a wide range of existing regulations, there are several current regulations that might greatly benefit from some isolated changes and updates. This omnibus regulation could serve as a sort of substantive "technical correction" package for existing partnership regulations. Outlined below are six potential regulations that could be included in such a package, four of which should be uncontroversial good housekeeping and two of which are more substantive.

The recently issued proposed regulation that would amend the outdated partnership loss regulations in Treas. Reg. § 1.267(b)-1(b) and Temp Reg. § 1.267(a)-2T(c) (Answers 2 & 3) is an excellent example of this type of corrective regulation.[3] The IRS and practitioners have known for decades that these regulations needed to be amended, but perhaps not surprisingly, such a project has often fallen to the bottom on the regulatory to-do list. This welcome technical fix is especially commendable given the current burden on the IRS to issue regulations in such complex areas as the IRA energy credits, CAMT, and crypto broker reporting.

## Six Potential Regulations to Include in "Omnibus" Reg Package

### 1. Treas. Reg. § 1.1245-1(e)(3): Outdated Section 1245 Recapture Regulation

[1] The principal authors of this letter are partnership tax specialist and Senior Attorney Advisor John Rooney and Tax Law and Policy Fellow Grace Henley.

[2] Internal Revenue Manual 32.1.1.2.2(2).

[3] Transactions Between Related Persons and Partnerships, 88 Fed. Reg. 82792 (November 27, 2023).

Treas. Reg. §1.1245-1(e)(3) provides separate rules for allocating section 1245 recapture gain among partners in situations where (i) a partner has a special basis adjustment under section 743 in any section 1245 property or (ii) the partnership had a section 754 election in effect on the date the partner acquired its partnership interest. Under this special rule, if a partner acquires its interest when a section 754 election was in effect, any depreciation that was allocated to the transferring partner does not carry over to the transferee partner. As a result, the transferee partner does not recognize any recapture gain with respect to this prior allocated depreciation.[4]

This special rule will generally ensure that the transferee partner is allocated the proper amount of recapture gain. For example, suppose A and B form a partnership and each contributes $100. The partnership buys depreciable property for $200. A subsequently sells its interest to C for $100 at a time when the property has a basis of $0 and a fair market value of $200. A will recognize $100 of ordinary income on the sale of its interest under section 751(a) and, if the partnership has a section 754 election in place, C will have a special basis adjustment of $100 in the property. If the property were then immediately sold, C would recognize no recapture gain on the sale because, under the special rule in Treas Reg. § 1.1245-1(e)(3)(ii), the $100 of depreciation that was previously allocated to A is not attributed to C. The end result is appropriate because C has not been allocated any depreciation on the property and A has already recognized the full $100 of recapture gain on the sale of its interest to C.

The problem arises because the special rule in Treas. Reg. § 1.1245-1(e)(3)(ii) can conceivably be read as applying to *any* transfer of a partnership interest, including nonrecognition transfers, as long as a section 754 election was in place at the time of the transfer. There is no requirement that the section 754 election actually resulted in a basis adjustment; the special rules of Treas. Reg. § 1.1245-1(e)(3)(ii) seem to apply as long as a section 754 election was made. As a result, if A in the previous example transferred her interest to a wholly-owned S corporation instead of selling it to C, a very literal reading of Treas. Reg. § 1.1245-1(e)(3)(ii) would seem to suggest that none of the prior $100 of depreciation allocated to A would be attributable to the S corporation as long as a section 754 election was in place at the time of the transfer, even though the section 754 election did not result in a basis adjustment. Under this interpretation, when the property is sold by the partnership, the S corporation transferee would recognize $100 of gain, but none of this gain would be treated as section 1245 recapture because the S corporation's recomputed basis in the property is $0.

Treas. Reg. § 1.1245-1(e)(3) was promulgated in 1965—well before many of the current statutory Subchapter K provisions, such as section 704(c), were enacted and well before many of the most important partnership regulations were issued. This regulation should be updated to remove any uncertainty as to the treatment of nonrecognition transfers on the allocation of recapture gain. Treasury and the IRS are aware of the need for this update. In the 1994 preamble to the proposed section 751(b) regulations, the IRS noted:

> The IRS and the Treasury Department are aware that the regulations under § 1.1245-1(e)(3) (concerning the interaction of section 1245 and section 743), and § 1.1250-1(f), by reference to § 1.1245-1(e)(3), are out of date. The intent of the

[4] See third sentence of Treas. Reg. § 1.1245-1(e)(3)(ii) providing that "[i]f on the date he acquired his partnership interest by way of a sale or exchange the partnership owned such property and an election under section 754 was in effect, then for purposes of the preceding sentence *the amount of the adjustments reflected in the adjusted basis of such property on such date shall be deemed to be zero*." (emphasis added).

> regulations under § 1.1245-1(e)(3) is, in part, to ensure that a transferee partner does not recognize ordinary income with respect to section 1245 property to the extent a section 743 adjustment has displaced that ordinary income. . . . However, the regulations under § 1.1245-1(e)(3) have not been amended to take into account changes to subchapter K, including the regulations under section 751, resulting in issues and uncertainties. The IRS and the Treasury Department are studying these issues and request comments in this area.[5]

Practitioners have also noted that the regulation needs to be updated. In their comment on the proposed section 751(b) regulations, the New York State Bar Association Tax Section noted that:

> The Preamble requests comments on updating Treas. Reg. § 1.1245-1(e)(3), which generally deals with the determination of the share of recapture in a partnership's assets for a transferee of an interest in the partnership. The changes contained in Prop. Treas. Reg. § 1.743-1(f)(2) address some of the concerns with Treas. Reg. § 1.1245-1(e)(3) for transfers in substituted basis transactions; however, other concerns remain, including situations involving purchases of partnership interests at a deep discount and situations where there is a section 754 election in effect but no section 743(b) adjustments are made. While we believe the regulation should be updated to address the concerns, the issues involved are beyond the scope of this report.[6]

In its suggested priorities for the IRS 2023-2024 priority guidance plan, the AICPA also noted the need to:

> Provide updated guidance concerning the interaction of section 1245 and section 743. The regulations under Treas. Reg. §1.1245-1(e)(3) have not been amended to take into account changes to subchapter K, including the regulations under section 751.[7]

### 2. Section 751(b) regs: Hot asset regulations

The proposed section 751(b) regulations are a necessary update to the current outdated regulations and, while finalizing the entire regulation would provide very helpful guidance, the entire regulation is complex and may require additional time and effort to finalize. In addition to addressing section 751(b), however, these proposed regulations also include a provision related to section 751(a) that could be finalized on its own.[8]

Under section 751(a), the amount received by a partner on the sale of its partnership interest attributable to the unrealized receivables and inventory items of the partnership ("hot assets") is treated as an amount realized from the sale or exchange of property other than a capital asset. In certain circumstances, often due to partnership revaluations and reverse section 704(c) allocations, the amount received by a partner on the sale of its interest can be less than the partner's share of the partnership's hot assets. As the preamble to the proposed regulation notes:

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[5] Certain Distributions Treated as Sales or Exchanges, 79 Fed. Reg. 65151, 65158 (November 3, 2014).
[6] New York State Bar Association Tax Section, *Report No. 1329—Report on the Proposed Regulations Under Section 751(b)* 22 (September 9, 2015).
[7] American Institute of CPAs, *Recommendations for the 2023-2024 Guidance Priority List* (May 9, 2023).
[8] *See* Prop. Treas. Reg. § 1.751-1(a)(2).

> Some commentators interpret section 751(a) as limiting the amount of ordinary income that a transferor partner may recognize upon a transfer of a partnership interest to the amount of any money or property received by the transferor partner, without taking into account the total amount of ordinary income attributable to the partnership interest transferred that relates to section 751 property. However, interpreting section 751(a) as limiting ordinary income in this way would contravene Congress's intent to tax partners on their shares of partnership ordinary income as determined by applying section 704(c) principles.[9]

For example, assume the fair market value of a partner's interest is $100, but the partner's share of gain on the partnership's hot assets is $150. If the partner sold its interest for $100, the amount received by the seller would be only $100 and some practitioners might conclude that the seller should recognize only $100 of hot asset ordinary income, rather than the appropriate $150 of hot asset ordinary income. The proposed section 751(a) regulation would eliminate any argument that the ordinary income recognized on the sale of the partnership interest is limited to the $100 amount realized.

This proposed regulation is intended to be effective for sales on or after November 3, 2014, but given the length of time since the regulation was proposed, there may be some concern that the effective date might be changed to the date of publication of the final regulation This may lead some practitioners to take the position that the amount of ordinary income recognized is still limited to the amount realized until final regulations are issued. The section 751(a) portion of the proposed regulations could be finalized separately with the current proposed retroactive effective date on a stand-alone basis to eliminate any ambiguity.

### 3. Section 704(c)(1)(C): Jobs Act provisions

In January 2014, the IRS issued proposed regulations implementing the changes made by the American Jobs Creation Act of 2004 (the "Jobs Act").[10] As part of these proposed regulations, the IRS also proposed to amend provisions of the current regulations under section 755 addressing certain substituted basis transactions.[11] The preamble noted that the proposed section 755 regulations were needed to prevent certain unintended consequences in some substituted basis transactions, particularly with regard to the "net gain" and "net loss" requirement in Treas. Reg. § 1.755–1(b)(5)(ii). For example, if there is an increase in basis to be allocated to partnership assets, but there is no overall unrealized net gain or net income in the assets, the basis increase cannot be allocated under Treas. Reg. § 1.755–1(b)(5). This portion of the proposed regulations is intended to apply to transfers of partnership interests occurring on or after January 16, 2014, but as in the proposed section 751(a) regulations mentioned above, finalizing these regulations would remove any ability of taxpayers to take a contrary position.

The Jobs Act also added section 755(c), which provides in part that, "in making an allocation . . . of any decrease in the adjusted basis of partnership property under section 734(b), no allocation may be made to stock in a corporation (or any person related (within the meaning of sections

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[9] Certain Distributions Treated as Sales or Exchanges, 79 Fed. Reg. at 65157.
[10] Disallowance of Partnership Loss Transfers, Mandatory Basis Adjustments, Basis Reduction in Stock of a Corporate Partner, Modification of Basis Allocation Rules for Substituted Basis Transactions, Miscellaneous Provisions, 79 Fed. Reg. 3042 (January 16, 2014).
[11] *See* Prop. Treas. Reg. § 1.755-1(b)(5).

267(b) **and** 707(b)(1)) to such corporation which is a partner in the partnership . . . ." (emphasis added). As the preamble to the proposed regulations notes, if section 755(c) applied only to persons treated as related within the meaning of both section 267(b) and section 707(b)(1), the provision would apply in very limited circumstances. The proposed regulations therefore provide that the amended section 755(c) allocation rules apply to persons related under either section 267(b) **or** section 707(b)(1), even though the statute refers to persons treated as related within the meaning of both section 267(b) and section 707(b)(1).[12] Confirming this result in final regulations would be helpful.

### 4. Section 707(a)(2)(B): Disguised Sale of Partnership Interests

Some commentators have argued that section 707(a)(2)(B) does not currently apply to the disguised sale of partnership interests in part because the lead-in phrase to section 707(a)(2) is "under regulations prescribed by the Secretary" and the IRS has not issued such regulations.[13] The IRS did issue proposed regulations addressing the disguised sale of partnership interests in November 2004, but the regulations were heavily criticized and ultimately withdrawn. The IRS is unlikely to reissue comprehensive regulations in this area, but a very short regulation might be beneficial to remove any potential argument that section 707(a)(2)(B) does not currently apply to disguised sales of partnership interests. For example, it might be sufficient for the proposed regulation to simply provide that section 707(a)(2)(B) does apply to the disguised sale of partnership interests and include a simple uncontroversial example such as: Partner A has a 10% common partnership interest worth $100, X contributes $100 for a 10% common interest and, as part of a plan, the $100 is immediately distributed to A in complete redemption of its interest.

### 5. Treas Reg. § 1.707-4(d): Reimbursement of Capital Expenditures

Treas. Reg. § 1.707-4(d) provides that a distribution of money to a partner that has transferred property to the partnership is not treated as part of a disguised sale to the extent that the transfer to the partner is made to reimburse the partner for the amount of capital expenditures that were incurred by the partner with respect to transferred property during the two-year period before the transfer to the partnership. Depending on the value of the contributed property, there may be a limit on the amount of the reimbursement that qualifies for the exception, but the current exception essentially operates as a bright-line safe harbor for extracting cash on a contribution of property to a partnership.

There does not appear to be a solid policy rationale for such a broad exception. There may, however, be a rationale for a much more limited exception. It is quite possible that the exception was originally intended to address timing problems that can arise when a partner is required to purchase property before the actual formation of a partnership. For example, suppose two individuals intend to form a real estate partnership to develop Blackacre. Partner A already has a contract to purchase Blackacre for $100, but the contract requires the sale to close by December 31st and, for various legal reasons or on account of practical delays, the individuals are not able to form their partnership until January 31. In that situation, it is certainly reasonable for Partner A

[12] *See* Prop. Treas. Reg. § 1.755-1(e).
[13] *See, e.g.*, Samuel Grilli, *Can the IRS Currently Contend That There Has Been a Disguised Sale of a Partnership Interest?*, 123 Journal of Taxation 289 (December 2015).

to buy Blackacre for $100, form the partnership with Partner B on January 31, and then have Partner B reimburse Partner A for $50, which is essentially just B's share of the $100 purchase price.

There is some indication that this actually was the original rationale for the exception. First, the preamble to the proposed regulations issued in 1991 notes that this exception was intended to apply to transfers made to "reimburse partners for certain capital expenditures and costs incurred *in anticipation of the formation of a partnership*. . . ."[14] Second, while the proposed regulations did not contain a specific requirement that the expenditure be made in anticipation of formation, the proposed regulation did provide that the exception applies only if the transfer was "made *to reimburse* the partner" for expenditures incurred within *one* year of the contribution to the partnership. The preamble language, along with the use of the word "reimburse" and the original one-year limitation, may well reflect an original intention in the proposed regulations to limit the exception to expenditures that were incurred by the partner with the explicit intention of contributing the property to the partnership. Third, the regulations provided that the fair market value limitation on the exception did not apply if the fair market value of the transferred property did not exceed 120 percent of the partner's adjusted basis in the transferred property at the time of the transfer. Allowing the partner to be fully reimbursed as long as the property was contributed before it had appreciated more than 20 percent may imply that the exception was intended to allow reimbursements for property that was not held by the contributing partner for any substantial period of time.

If this was the original rationale for the exception, then the current regulatory language could be amended to better reflect that intention. For example, the exception could be limited to expenditures incurred by the partner with the intention of contributing the property to the partnership. Of course, intent-based exceptions can be difficult to administer, so as an alternative the exception could be limited to expenditures with a high likelihood of having been incurred in anticipation of contribution, such as expenditures incurred in a much shorter time period before contribution, such as six months, or expenditures incurred before the partnership was actually formed.

### 6. Treas. Reg. § 1.707-5(b)(1): Debt-Financed Distributions

Treas. Reg. §1.707-5(b)(1) provides that, if a partner transfers property to a partnership and the partnership incurs a liability and distributes the proceeds of that liability to the contributing partner within a certain time period, the distribution to the partner is treated as a disguised sale only to the extent that the amount of the distribution exceeds the partner's allocable share of the partnership liability. This exception for debt-financed distributions has given rise to so-called leveraged partnership transactions. As a practical matter, these types of transactions can be very similar in substance to a direct sale of property.

The IRS issued temporary regulations in October 2016 to address leveraged partnership transactions (the "707 Temporary Regulation").[15] Under these regulations, all partnership liabilities were treated as nonrecourse liabilities for purposes of the debt-financed distribution

[14] Treatment of Transactions Between Partners and Partnerships, 56 Fed. Reg. 19055, 19058 (April 25, 1991) (emphasis added).
[15] Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 Fed. Reg. 69282 (October 5, 2016).

exception. The practical effect of this regulatory change was to treat a much greater portion of a leveraged partnership distribution as a disguised sale.

The Second Report to the President on Identifying and Reducing Tax Regulatory Burdens[16] noted that, according to commenters, the 707 Temporary Regulation was issued without adequate consideration of its impact. The IRS stated that the regulation's approach to disguised sale treatment merited further study and that such a far-reaching change should be studied systematically. The IRS ultimately replaced the 707 Temporary Regulation in October 2019 with final regulations that adopted the liability allocation rules that were in place before the 707 Temporary Regulation. The preamble to these final regulations, however, noted that:

> The Treasury Department and the IRS continue to study the merits of the approach in the 707 Temporary Regulations and other approaches, include these final regulations, to determine which results in the most appropriate treatment of liabilities in the context of disguised sales.[17]

Treasury and the IRS have not issued any subsequent regulations on leveraged partnership transactions, but the government appears to continue to be concerned about such transactions. For example, on May 12, 2023, the Department of Justice (DOJ) filed its opening brief in its appeal of the Tax Court's decision in Tribune Media Co. v. Commissioner (T.C. Memo 2021-122). DOJ appears to believe that the taxpayer's partial victory in the Tax Court will allow other taxpayers to use the leveraged partnership transaction to avoid disguised sale treatment without incurring any meaningful economic risk.

The DOJ appeal primarily focuses on the application of the liability allocation anti-abuse rule in Treas. Reg. §1.752-2(j) and the general partnership anti-abuse rule under Treas. Reg. § 1.701-2. Relying on these anti-abuse regulations to prevent disguised sales is problematic at best. If the IRS continues to be concerned about such leveraged partnership transactions, reviving the approach in the 707 Temporary Regulation and issuing a proposed regulation treating all partnership liabilities as nonrecourse liabilities for this purpose would seem to be a better approach than litigating individual cases and attempting to apply the anti-abuse regulations.

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[16] Executive Order 13789 – Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 Fed. Reg. 48013 (October 16, 2017).

[17] Removal of Temporary Regulations on a Partner's Share of a Partnership Liability for Disguised Sale Purposes, 84 Fed. Reg. 54027, 54027 (October 9, 2019).