

## Part I

### Section 704.--Partner's Distributive Share

26 CFR 1.704-3: Contributed property.

(Also: §§ 708, 737, 1.704-1, 1.704-3, 1.704-4, 1.708-1, 1.737-1, 1.737-2, 1.737-3)

Rev. Rul. 2004-43

### ISSUES

1) Does § 704(c)(1)(B) of the Internal Revenue Code apply to § 704(c) gain or loss that is created in an assets-over partnership merger?

2) For purposes of § 737(b), does net precontribution gain include § 704(c) gain or loss that is created in an assets-over partnership merger?

### FACTS

Situation 1. On January 1, 2004, A contributes Asset 1, with a basis of \$200 $\times$  and a fair market value of \$300 $\times$  to partnership AB in exchange for a 50 percent interest. On the same date, B contributes \$300 $\times$  of cash to AB in exchange for a 50 percent interest. Also on January 1, 2004, C contributes Asset 2, with a basis of \$100 $\times$  and a fair market value of \$200 $\times$  to partnership CD in exchange for a 50 percent interest. D contributes \$200 $\times$  of cash to CD in exchange for a 50 percent interest.

On January 1, 2006, AB and CD undertake an assets-over partnership merger in which AB is the continuing partnership and CD is the terminating partnership. At the time of the merger, AB's only assets are Asset 1, with a fair market value of \$900 $\times$ , and \$300 $\times$  in cash, and CD's only assets are Asset 2, with a fair market value of \$600 $\times$  and \$200 $\times$  in cash. After the merger, the partners have capital and profits interests in AB as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent.

The partnership agreements for AB and CD provide that the partners' capital accounts will be determined and maintained in accordance with § 1.704-1(b)(2)(iv) of the Income Tax Regulations, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the

partnership (as set forth in § 1.704-1(b)(2)(ii)(b)(2) and (3)). AB and CD both have provisions in their partnership agreements requiring the revaluation of partnership property upon the entry of a new partner. AB would not be treated as an investment company (within the meaning of § 351) if it were incorporated. Neither partnership holds any unrealized receivables or inventory for purposes of § 751. AB and CD do not have a § 754 election in place. Asset 1 and Asset 2 are nondepreciable capital assets.

On January 1, 2012, AB has the same assets that it had after the merger. Each asset has the same value that it had at the time of the merger. On this date, AB distributes Asset 2 to A in liquidation of A's interest in AB.

Situation 2. The facts are the same as in Situation 1, except that on January 1, 2012, Asset 1 has a value of \$275x, and AB distributes Asset 1 to C in liquidation of C's interest in AB.

## LAW

Under § 704(b) and the regulations thereunder, allocations of a partnership's items of income, gain, loss, deduction, or credit provided for in the partnership agreement will be respected if the allocations have substantial economic effect. Allocations that fail to have substantial economic effect will be reallocated according to the partners' interests in the partnership.

Section 1.704-1(b)(2)(iv)(f) provides that a partnership may, upon the occurrence of certain events (including the contribution of money to the partnership by a new or existing partner), increase or decrease the partners' capital accounts to reflect a revaluation of the partnership property.

Section 1.704-1(b)(2)(iv)(g) provides that, to the extent a partnership's property is reflected on the books of the partnership at a book value that differs from the adjusted tax basis, the substantial economic effect requirements apply to the allocations of book items. Section 704(c) and § 1.704-1(b)(4)(i) govern the partners' distributive shares of tax items.

Section 1.704-1(b)(4)(i) provides that if partnership property is, under § 1.704-1(b)(2)(iv)(f), properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of the property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to the property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for federal tax purposes, with respect to the property. In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to the partners (see § 1.704-1(b)(2)(iv)(g)), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate allocations of these tax items cannot have economic effect under § 1.704-1(b)(2)(ii)(b)(1), and the partners' distributive shares of tax items must

(unless governed by § 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of the property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under § 704(c).

Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Section 1.704-3(a)(2) provides that, except as provided in § 1.704-3(e)(2) and (3), § 704(c) and § 1.704-3 apply on a property-by-property basis.

Section 1.704-3(a)(3)(i) provides that property contributed to a partnership is § 704(c) property if at the time of contribution its book value differs from the contributing partner's adjusted tax basis. For purposes of § 1.704-3, book value is determined as contemplated by § 1.704-1(b). Therefore, book value is equal to fair market value at the time of contribution and is subsequently adjusted for cost recovery and other events that affect the basis of the property.

Section 1.704-3(a)(3)(ii) provides that the built-in gain on § 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted tax basis.

Section 1.704-3(a)(6) provides that the principles of § 1.704-3 also apply to "reverse § 704(c) allocations" which result from revaluations of partnership property pursuant to § 1.704-1(b)(2)(iv)(f).

Section 1.704-3(a)(7) provides that, if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.

Section 704(c)(1)(B) provides that if any property contributed to the partnership by a partner is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within seven years of being contributed: (i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of the property in an amount equal to the gain or loss which would have been allocated to the partner under § 704(c)(1)(A) by reason of the variation described in § 704(c)(1)(A) if the property had been sold at its fair market value at the time of the distribution; (ii) the character of the gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if the property had been sold by the partnership to the distributee; and (iii) appropriate adjustments shall be made to the adjusted basis

of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under § 704(c)(1)(B).

Section 1.704-4(c)(4) provides that § 704(c)(1)(B) and § 1.704-4 do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in § 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. Section 1.704-4(c)(4) also provides that a subsequent distribution of § 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to § 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to § 704(c)(1)(B).

Section 1.704-4(d)(2) provides that the transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of § 704(c)(1)(B) and § 1.704-4 to the extent of the share of built-in gain or loss allocated to the transferee partner.

Section 708(a) provides that, for purposes of subchapter K, an existing partnership shall be considered as continuing if it is not terminated.

Section 708(b)(2)(A) provides that in the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of § 708, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

Section 1.708-1(c)(3)(i) provides that when two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not described in § 1.708-1(c)(3)(ii), any merged or consolidated partnership that is considered terminated under § 1.708-1(c)(1) is treated as undertaking the assets-over form for federal income tax purposes. Under the assets-over form, the merged or consolidated partnership that is considered terminated under § 1.708-1(c)(1) contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.

Section 737(a) provides that, in the case of any distribution by a partnership to a partner, the partner shall be treated as recognizing gain in an amount equal to the lesser of (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of the partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or (2) the net precontribution gain of the partner. Gain recognized under the preceding sentence shall be in addition to any gain

recognized under § 731. The character of the gain shall be determined by reference to the proportionate character of the net precontribution gain.

Section 737(b) provides that for purposes of § 737, the term “net precontribution gain” means the net gain (if any) which would have been recognized by the distributee partner under § 704(c)(1)(B) if all property which (1) had been contributed to the partnership by the distributee partner within seven years of the distribution, and (2) is held by the partnership immediately before the distribution, had been distributed by the partnership to another partner.

Section 1.737-1(c)(1) provides that the distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under § 704(c)(1)(B) and § 1.704-4 if all property that had been contributed to the partnership by the distributee partner within seven years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership.

Section 1.737-1(c)(2)(iii) provides that the transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred.

Section 1.737-2(b)(1) provides that § 737 and § 1.737-2 do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in § 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

Section 1.737-2(b)(3) provides that a subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to § 737 to the same extent that a distribution from the transferor partnership would have been subject to § 737.

## ANALYSIS

Section 1.704-4(c)(4) describes the effect of an assets-over partnership merger on pre-existing § 704(c) gain or loss for purposes of § 704(c)(1)(B). Under § 1.704-4(c)(4), if the transferor partnership in an assets-over merger holds contributed property with § 704(c) gain or loss, the seven year period in § 704(c)(1)(B) does not restart with respect to that gain or loss as a result of the merger. Section 1.704-4(c)(4) does not prevent the creation of new § 704(c) gain or loss when assets are contributed by one partnership to another partnership in an assets-over merger. Section 704(c)(1)(B) applies to this newly created § 704(c) gain or loss if the assets contributed in the merger are distributed to a partner other than the contributing partner (or its successor) within seven years of the merger.

Section 1.737-2(b)(1) and (3) describes the effect of an assets-over partnership merger on net precontribution gain that includes pre-existing § 704(c) gain or loss. Under § 1.737-2(b)(3), if the transferor partnership in an assets-over merger holds contributed property with § 704(c) gain or loss, the seven year period in § 737(b) does not restart with respect to that gain or loss as a result of the merger. Section 1.737-2(b)(3) does not prevent the creation of new § 704(c) gain or loss when assets are contributed by one partnership to another partnership in an assets-over merger. This gain or loss must be considered in determining the amount of net precontribution gain for purposes of § 737 if the continuing partnership distributes other property to the contributing partner (or its successor) within seven years of the merger.

Section 1.704-3(a)(6)(i) provides that the principles of § 1.704-3 apply to reverse § 704(c) allocations. In contrast, the regulations under § 704(c)(1)(B) and § 737 contain no similar rule requiring that the principles of § 704(c)(1)(B) and § 737 apply to reverse § 704(c) allocations. Under those regulations, § 704(c)(1)(B) and § 737 do not apply to reverse § 704(c) allocations.

In both of the situations described above, on the date of the partnership merger, CD contributes cash and Asset 2 to AB in exchange for an interest in AB. Immediately thereafter, CD distributes, in liquidation, interests in AB to C and D. Asset 2 has a basis of \$100x and a fair market value of \$600x upon contribution. Of the \$500x of built in gain in Asset 2, \$100x is pre-existing § 704(c) gain attributable to C's contribution of Asset 2 to CD, and \$400x is additional § 704(c) gain created as a result of the merger. As the transferees of CD's partnership interest in AB, C and D each succeed to one-half of CD's \$400x of § 704(c) gain in Asset 2 (each \$200x). Section 1.704-3(a)(7). Thus, C's share of § 704(c) gain is \$300x, and D's share of § 704(c) gain is \$200x.

The entry of CD as a new partner of AB causes partnership AB to revalue its property. When CD enters as a new partner of AB, Asset 1 has a basis of \$200x and a fair market value of \$900x. Of the \$700x of built-in gain in Asset 1, \$100x is pre-existing § 704(c) gain attributable to the contribution of Asset 1 by A. The revaluation results in the creation of \$600x of reverse § 704(c) gain in Asset 1. This layer of reverse § 704(c) gain is shared equally by A and B (\$300x each). Thus, A's share of § 704(c) gain is

\$400x, and B's share of § 704(c) gain is \$300x. The calculation of § 704(c) gain in each asset is summarized in the following table.

	Adjusted Tax Basis	Value on Date of Contribution	§ 704(c) Gain on Date of Contribution	Value on Date of Merger	§ 704(c) Gain Created by Merger	Total § 704(c) Gain After Merger
Asset 1	\$200x	\$300x	\$100x	\$900x	\$600x	\$700x
Asset 2	\$100x	\$200x	\$100x	\$600x	\$400x	\$500x
Cash	\$500x	\$500x	\$0x	\$500x	\$0x	\$0x
Total	\$800x	\$1,000x	\$200x	\$2,000x	\$1,000x	\$1,200x

The partners' share of § 704(c) gain in each of AB's assets after the merger is summarized in the following table.

	<u>A</u> 's Share of § 704(c) Gain	<u>B</u> 's Share of § 704(c) Gain	<u>C</u> 's Share of § 704(c) Gain	<u>D</u> 's Share of § 704(c) Gain	Total § 704(c) Gain
Asset 1	\$400x	\$300x	\$0x	\$0x	\$700x
Asset 2	\$0x	\$0x	\$300x	\$200x	\$500x
Cash	\$0x	\$0x	\$0x	\$0x	\$0x
Total	\$400x	\$300x	\$300x	\$200x	\$1,200x

In Situation 1, the distribution of Asset 2 to A occurs more than seven years after the contribution of Asset 2 to CD. Therefore, § 704(c)(1)(B) does not apply to the \$100x of pre-existing § 704(c) gain attributable to that contribution. However, the distribution of Asset 2 to A occurs within seven years of the contribution of Asset 2 by CD to AB. The contribution of Asset 2 by CD to AB creates § 704(c) gain of \$400x. As the transferees of CD's partnership interest in AB, C and D each succeed to one-half of the \$400x of § 704(c) gain created by the merger. Section 1.704-3(a)(7). Section 704(c)(1)(B) applies to that § 704(c) gain, causing C and D each to recognize \$200x of gain.

The distribution of Asset 2 to A occurs more than seven years after the contribution of Asset 1 to AB, and A made no subsequent contributions to AB. Therefore, A's net precontribution gain for purposes of § 737(b) at the time of the distribution is zero. AB's \$600x of reverse § 704(c) gain in Asset 1, resulting from a revaluation of AB's partnership property at the time of the merger, is not net precontribution gain. Accordingly, A will not recognize gain under § 737 as a result of the distribution of Asset 2.

In Situation 2, § 704(c)(1)(B) does not apply to the distribution by the continuing partnership of Asset 1 to C on January 1, 2012. The distribution of Asset 1 to C occurs

more than seven years after the contribution of Asset 1 to AB, and § 704(c)(1)(B) does not apply to the reverse § 704(c) gain in Asset 1 resulting from a revaluation of AB's partnership property at the time of the merger. Accordingly, neither A nor B will recognize gain under § 704(c)(1)(B) as a result of the distribution of Asset 1 to C.

The distribution of Asset 1 to C occurs more than seven years after the contribution of Asset 2 to CD. Therefore, C's net precontribution gain at the time of the distribution does not include C's \$100x of pre-existing § 704(c) gain attributable to that contribution. However, the distribution of Asset 1 to C occurs within seven years of the contribution of Asset 2 by CD to AB. The contribution of Asset 2 by CD to AB creates net precontribution gain of \$400x. As the transferees of CD's partnership interest in AB, C and D each succeed to one-half of CD's \$400x of net precontribution gain in Asset 2. Section 1.737-1(c)(2)(iii). Thus, C's portion of CD's net precontribution gain created by the merger is \$200x. The excess of Asset 1's fair market value, \$275x, over the adjusted tax basis of C's interest in AB immediately before the distribution, \$100x, is \$175x, which is less than C's \$200x of net precontribution gain. Therefore, C will recognize \$175x of capital gain under § 737 as a result of the distribution. Because no property is distributed to D and none of the property treated as contributed by D is distributed to another partner, D recognizes no gain under § 737 or § 704(c)(1)(B).

## HOLDINGS

1) Section 704(c)(1)(B) applies to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not apply to newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership.

2) For purposes of § 737(b), net precontribution gain includes newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger, but does not include newly created reverse § 704(c) gain or loss resulting from a revaluation of property in the continuing partnership.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Heather Faught of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Heather Faught at (202) 622-3060 (not a toll-free call).