NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE IMPACT OF LEGISLATIVE CHANGES TO SUBCHAPTER K ON THE PROPOSED "MAY COMPANY" REGULATIONS UNDER SECTION 337(d) AND TECHNICAL RECOMMENDATIONS REGARDING AFFILIATE STOCK

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Report on the Impact of Legislative Changes to Subchapter K on the Proposed "May Company" Regulations under Section 337(d) and Technical Recommendations Regarding Affiliate Stock

I. Introduction

This Report[1] comments on Proposed Treasury Regulation Section 1.337(d)-3 (the "Proposed Regulations"). The Proposed Regulations were promulgated in 1992 based on Notice 89-37.[2] As discussed below, in prior Reports, the Tax Section commented on technical aspects of the Proposed Regulations.[3] This Report considers the impact of legislative changes that have occurred since 1989 on the Proposed Regulations and makes technical comments regarding transactions involving stock of affiliates.

The Proposed Regulations would counteract an end-run around the repeal of the *General Utilities* doctrine. *General Utilities* repeal aims to prevent appreciated assets from leaving corporate solution without corporate level tax. Accordingly, the Proposed Regulations target a type of corporate contraction that relies on the intersection of Subchapter K and Section 1032.[4]

Under the authority of Section 337(d), the Proposed Regulations circumscribe transactions involving a corporate partner's effective exchange of an appreciated asset for the corporate partner's own stock intermediated by a partnership. As an example, the Proposed Regulations target a situation in which a corporate partner contributes an appreciated asset to a

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[1] The principal author of this Report is Deborah L. Paul. Tijana J. Dvornic provided significant contributions. Helpful comments were received from Peter C. Canellos, Tim Devetski, Michael S. Farber, Stephen B. Land, Andrew W. Needham, Michael L. Schler, David H. Schnabel, Eric B. Sloan and Karen Gilbreath Sowell. This Report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

[2] 1989-1 C.B. 679.

[3] NYSBA TAX SECTION, "Report on Notice 89-37" (Nov. 14, 1989), *reprinted in* 89 TNT 240-5 (Nov. 30, 1989) [*hereinafter* 1989 NYSBA Report]; NYSBA TAX SECTION, "Report on Proposed Regulations Implementing Notice 89-37" (Mar. 3, 1993), *reprinted in* 93 TNT 57-27 (Mar. 12, 1993) [*hereinafter* 1993 NYSBA Report].

[4] "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

partnership and another partner contributes cash to the partnership. The partnership uses the cash to buy corporate partner stock,[5] and then, after time has passed, the partnership liquidates, distributing the corporate partner stock to the corporate partner and the appreciated asset to the other partner.[6]

Potentially, in reliance on provisions of Subchapter K and Section 1032, these steps would enable the corporate partner to, in effect, exchange an appreciated asset for its own stock without triggering Section 311(b) gain. If all goes according to plan, the corporate partner will never recognize the gain inherent in the appreciated asset because that gain will have been shifted to the corporate partner's stock and protected against gain recognition under Section 1032. Meanwhile, the other partner will take the appreciated asset with a basis equal to the amount of cash that such partner contributed to the partnership.[7] Thus, the potential to tax the appreciation in the asset will have been eliminated.

The targeted transaction—also known as the "May Company" transaction after a prominent example involving May Department Stores—differs from "mixing bowl" partnerships that do not involve corporate partner stock. In such mixing bowl transactions, each of two persons owns an appreciated asset that they would like to exchange. Each person contributes such person's appreciated asset to a partnership. After a period of time (at least seven years under current law), the partnership liquidates, distributing to each partner the asset that the other partner contributed. In such a transaction, the partners have effectively exchanged appreciated

[5] The partnership could use the cash to buy corporate partner stock on the market or from the corporate partner. If the cash is used to buy corporate partner stock from the corporate partner, rather than on the market, then the transaction is a potential way around Section 1001. 1989 NYSBA Report, Section 2.

[6] Instead of the partnership liquidating, it could distribute the corporate partner stock in redemption of the corporate partner's interest, leaving the other partner owning the asset through the partnership. Alternatively, instead of the partnership liquidating, it could distribute the asset to the other partner, while leaving the corporate partner owning its own stock through the partnership. In all these variations, at the end of the day, the other partner owns the asset (directly or through the partnership), while the corporate partner owns its own stock (directly or through the partnership). While the gain inherent in the appreciated asset is not actually eliminated in the latter variation (because Section 1032 does not come into play until the corporate partner actually receives the corporate partner stock or the partnership sells the corporate partner stock (*see* Rev. Rul. 99-57, 1999-2 C.B. 678)), this is the effective result. For example, the corporate partner could continue to hold its stock through the partnership indefinitely without any economic or tax consequences.

[7] Under Section 732(b), upon a liquidating distribution to a partner, such partner takes a basis in the distributed assets equal to the partner's basis in the partner's partnership interest.

assets without tax. The transaction could be seen as an end-run around Section 1001. The rules permit such a transaction, however, on the theory that the transaction involves deferral of gain for each partner, not elimination of gain. The deferral comes about because, upon the tax-free liquidation of the partnership, each partner will receive the asset contributed by the other partner, generally with the same amount of built-in gain as the partner had in the asset that the partner contributed (disregarding, for purposes of illustration, intervening depreciation or amortization deductions and changes in value).[8] For each partner, therefore, basis and built-in gain are preserved.

The May Company transaction, by contrast, leaves the corporate partner holding such partner's own stock—and the gain inherent in the stock will never be taxed because of Section 1032. Thus, the gain inherent in the appreciated asset contributed by the corporate partner will never be recognized by the corporate partner or by the other partner.

The Proposed Regulations attack the May Company transaction under a "Deemed Redemption Rule," which generally applies to any transaction effected through a partnership that has the economic effect of a redemption, and a "Distribution Rule," which applies upon a distribution of the corporate partner's stock to the corporate partner by the partnership. In the 1989 NYSBA Report and the 1993 NYSBA Report, we endorsed the adoption of the Deemed Redemption Rule and opposed the adoption of the Distribution Rule.

In the twenty years since the Proposed Regulations were issued (and the twenty-three years since Notice 89-37), legislative changes have tightened Subchapter K.[9] These changes have made certain aspects of the transaction targeted by the Proposed Regulations more difficult to accomplish. We do not believe, however, that the legislative changes obviate the need for the Proposed Regulations. As discussed in our prior Reports and in Part IV.B, we believe that gain

[8] *Id.*

[9] As discussed below, Section 704(c)(1)(B) was enacted in 1989 and amended in 1997. Section 737 was enacted in 1992 and amended in 1997. Section 731(c) was enacted in 1994. Section 732(f) was enacted in 1999 and modified pursuant to a technical correction in 2000. *See* T.D. 8949 (June 19, 2001). In 2004, in response to the Enron Report, Congress enacted Section 755(c) and amendments to Sections 734. In 2010, Section 7701(o) was enacted.

should be recognized whenever a "corporate contraction" occurs, which is generally when the partnership acquires stock of the corporate partner or owns such stock on the date that the corporate partner contributes appreciated assets. This is when the economic exchange of an appreciated asset for corporate partner stock occurs. Gain recognition upon such a corporate contraction should not be deferred until later when the partnership distributes the stock or appreciated assets. Because the Deemed Redemption Rule adopts the approach of requiring gain recognition when the corporate contraction occurs, it is at the heart of the Proposed Regulations. As discussed in this Report, the legislative changes to Subchapter K generally police attempts to exit a partnership, not enter it. We therefore reiterate the recommendations of our prior Reports.

We do believe, however, that final regulations should modify the treatment of certain transactions involving stock of affiliates of a corporate partner. To begin with, the Deemed Redemption Rule should apply (as it would under the Proposed Regulations) where a subsidiary contributes an appreciated asset to a partnership and the partnership acquires stock in a direct or indirect parent of the subsidiary. In such cases, a corporate contraction of the parent has occurred. Economically, the parent has disposed of an asset that it indirectly owned (through the subsidiary) in exchange for its own stock (now indirectly owned by the subsidiary). While Section 1032 would not be available to shelter any gain realized by the subsidiary upon the future sale of the parent stock, the parent can easily eliminate the hook stock on a tax-free basis by other means—for example, through a Section 332 liquidation. By eliminating the hook stock, the group would eliminate gain on a tax-free basis on the economic disposition of the appreciated asset for the parent stock.

As a general matter, we do not believe that May Company transactions involving other types of affiliate stock (*i.e.*, stock in a sister or stock in a subsidiary of the corporate partner) should, at least in principle, result in gain recognition because we do not believe that these transactions effect the type of corporate contraction targeted by the Proposed Regulations. For example, if a parent contributes an asset to a partnership and the partnership acquires stock in a subsidiary of the parent, the parent will have economically exchanged an interest in the asset for an interest in the subsidiary stock. Although the transaction must satisfy the usual strictures for mixing bowl partnerships to avoid gain recognition—Sections 704(c)(1)(B), 737, 707—we do not believe it is necessary to impose upfront taxation in order to protect the purposes of *General Utilities* repeal. That said, such an approach would discriminate between different categories of affiliate stock and therefore require monitoring the ultimate disposition of any affiliate stock that did not trigger immediate gain recognition. The approach may introduce too much complexity to justify any departure in final regulations from the simpler approach as set forth in the Proposed Regulations, *i.e.*, to treat all affiliate stock the same as corporate partner stock.

II. Summary of Recommendations

1. The Deemed Redemption Rule should be retained. We believe it remains the centerpiece of the Proposed Regulations. We do not believe that the legislative amendments to the Code since 1989 have obviated the need for the Deemed Redemption Rule.

2. The Distribution Rule should be eliminated, except as a possible transition rule to capture May Company transactions entered into before the effective date of final regulations.

3. As an alternative, the Distribution Rule could be eliminated altogether. For pre-effective date transactions that would have been subject to the Deemed Redemption Rule, the Deemed Redemption Rule could instead apply with a "catch-up" upon the unwind of the partnership, resulting in gain to the corporate partner equal to the full amount of appreciation built into the asset originally contributed to the partnership.

4. As applied to stock of affiliates, we believe the Deemed Redemption Rule is broader than necessary to achieve its stated objective: prevention of the avoidance of *General Utilities* repeal. We believe that the Deemed Redemption Rule properly applies to a subsidiary that becomes a partner in a partnership that owns or acquires stock of such subsidiary's direct or indirect parent. We also believe that the Deemed Redemption Rule properly applies to a corporation that becomes a partner in a partnership that owns or acquires stock from *any* affiliate which stock is newly-issued as part of the transaction. In all other cases (*i.e.*, the partnership owns or acquires stock in a subsidiary or a sister of the corporate partner and such stock is not issued as part of the transaction), we do not believe it is necessary to apply the Deemed Redemption Rule unless and until a subsequent transaction related to such stock occurs the tax

consequences of which are inconsistent with *General Utilities* repeal. Specifically, the Deemed Redemption Rule should apply if:

- after the subsequent transaction, the partnership interest is held by the corporation whose stock is held by the partnership (or by a subsidiary of the corporation whose stock is held by the partnership); or
- after a distribution of affiliate stock, the gain originally inherent in the appreciated asset and transferred to the affiliate stock in the unwind transaction would otherwise be eliminated in reliance on a corporate nonrecognition provision of the Code (*e.g.*, Section 332 or Section 368); rules would be required to coordinate the application of the Deemed Redemption Rule with Section 732(f) if Section 732(f) applied to the distribution of affiliate stock and with Section 755(c) if a distribution of the appreciated asset to the other partner preceded the distribution of affiliate stock.

We recognize that discriminating between different categories of affiliate stock, as described above, is likely to be difficult, as it would require complex tracing of stock basis during future periods with respect to certain classes of affiliate stock but not with respect to others. Accordingly, final regulations might simply apply the Deemed Redemption Rule in its current form to all categories of affiliate stock, perhaps with limited relief for clearly non-abusive transactions. Alternatively, final regulations might suspend the Deemed Redemption Rule only until such time as the affiliate stock is distributed by the partnership, at which time the corporate partner would recognize gain both on any economic exchange attributable to the distribution and on the economic exchange that preceded it.

5. In the case of a partnership acquiring stock in a parent that owns less than 100 percent (by value) of a corporate partner, the Deemed Redemption Rule should only apply to the portion of the corporate asset indirectly disposed of by the parent, taking into account the parent's relative ownership of the corporate partner.

6. The Deemed Redemption Rule should only apply to deemed exchanges that occur after the effective date of final regulations.

Further consideration should be given to the application of these recommendations to transactions involving domestic and foreign entities.

III. <u>Background</u>

As part of the repeal of *General Utilities* in the Tax Reform Act of 1986, Congress enacted Section 337(d). Section 337(d) directs the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986." Such provisions of the Tax Reform Act of 1986 amended Sections 311, 336, 337, 338, and 1374.

Shortly thereafter, the Internal Revenue Service (the "IRS") issued Notice 89-37 to curb May Company transactions. Under the rubric of the repeal of *General Utilities*, the IRS stated that:

> in certain circumstances, the acquisition (or mere ownership) by a partnership of stock in one of its corporate partners (or stock of any member of the affiliated group of which such partner is a member) results in avoidance of *General Utilities* repeal. These circumstances are present to the extent the corporate partner, in substance, relinquishes an interest in appreciated property in exchange for an interest in its stock (or the stock of any member of the affiliated group of which such partner is a member).[10]

Notice 89-37 announced that the IRS and the Department of the Treasury ("Treasury") would promulgate regulations under Section 337(d) and the IRS's and Treasury's general rulemaking authority that would include a "Deemed Redemption Rule" and a "Distribution Rule."

Under the Deemed Redemption Rule, a corporate partner would recognize gain upon entering a transaction that has the "economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock (or the stock of any member of the affiliated group of which such partner is a member) owned or acquired by the partnership."[11] For example, the Deemed Redemption Rule would apply upon a contribution by a corporate partner of an appreciated asset to a partnership that either owns or acquires corporate partner stock. The Deemed Redemption Rule would also apply to many other transactions that effect a

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[10] Notice 89-37, 1989-1 C.B. 679.

[11] *Id.*

similar economic exchange, including a non pro rata distribution by a partnership or even an amendment to the partnership agreement that shifts the relative ownership interests of the partners in the assets of the partnership.[12] Indeed, in the absence of the Distribution Rule, the Deemed Redemption Rule would apply to the ultimate liquidating distribution by the partnership of the stock to the corporate partner and the appreciated asset to the other partner, a transaction that completes the economic exchange of appreciated property for stock between the partners.[13]

Under the "Distribution Rule," the corporate partner would also recognize gain upon the distribution of corporate partner stock (or stock in a member of the affiliated group of which such partner is a member) to the corporate partner.

Both the Deemed Redemption Rule and the Distribution Rule would apply to transactions occurring after March 9, 1989.[14] Thus, the Deemed Redemption Rule would not reach an economic exchange of appreciated property for a corporate partner's stock before March 10, 1989, including the particular transaction involving May Department Stores. However, any such "grandfathered" transactions would be caught by the Distribution Rule if and when the partnership later distributed the corporate partner's stock to the corporate partner.[15] Accordingly, the Distribution Rule would impose tax on the eponymous May Department Stores if and when May Department Stores receives a distribution of its own stock from the partnership after March 9, 1989.

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[12] *Id.*

[13] Proposed Treasury Regulation Section 1. 337(d)-3(h), Example 1, implies that the Distribution Rule trumps the Deemed Redemption Rule upon a distribution of stock by the partnership to the corporate partner.

[14] *Id.*

[15] The Distribution Rule does not apply to a distribution of the appreciated asset to the other partner. Thus, a potential exit strategy might have been to distribute the appreciated asset to the other partner. Such distribution would have triggered the Deemed Redemption Rule, since the distribution would have effected an economic exchange of the portion of the asset and stock that had not been economically exchanged previously (*e.g.*, at the time that the corporate partner's stock was contributed to or purchased by the partnership). Moreover, since the enactment of Section 755(c), a distribution of the appreciated asset would potentially lead to gain recognition. *See* Part IV.A.4 below.

The Tax Section endorsed the Deemed Redemption Rule and opposed the Distribution Rule .[16] The 1989 NYSBA Report also proposed an extension of the Deemed Redemption Rule, the so-called "Modified Distribution Rule." Even after application of the Deemed Redemption Rule, the 1989 NYSBA Report noted that built-in gain could escape taxation because, upon a liquidation of the partnership, basis in the corporate partner stock could be allocated to the appreciated asset under Section 732(c).[17] The Modified Distribution Rule was intended to address that problem.

The Tax Section opposed the Distribution Rule because it relied on an "entity" theory of partnerships, which was inconsistent with the "aggregate" approach of the Deemed Redemption Rule.[18] Under the entity approach of the Distribution Rule, a corporate partner would be required to recognize gain even though it had merely exchanged an indirect interest in its own stock for a direct interest in its own stock.[19] The 1989 NYSBA Report surmised that the unstated

[16] 1989 NYSBA Report.

[17] Although Section 732(c) has been amended since 1989, the result noted in the 1989 NYSBA Report does not appear to have changed. Suppose that the corporate partner ("Corporate Partner") contributes Asset A with basis of $20 and value of $100, while the other partner ("Other Partner") contributes Corporate Partner stock with basis and value of $100 to a 50/50 partnership. Then assume that the partnership later distributes Asset A and the Corporate Partner stock pro rata to the two partners. The Deemed Redemption Rule would apply to the contribution, triggering $40 of gain (equal to $50 amount realized less $10 of basis) to Corporate Partner and increasing the partnership's basis in Asset A to $60 and Corporate Partner's basis in its partnership interest to $60. Upon the distribution, Corporate Partner's aggregate basis in its share of Asset A and the stock is $60. *See* Section 732(b). Tentatively, Asset A and the stock have a basis to Corporate Partner of $30 and $50, respectively, which was their basis in the hands of the partnership. Section 732(c)(1)(B)(i). But, this $80 aggregate basis must be reduced by $20 to equal the Section 732(b) required basis of $60. Since neither asset has any unrealized depreciation, the $20 decrease is allocated 3/8ths to Asset A (or $7.5) and 5/8ths to the stock (or $12.5) resulting in $22.5 basis in Asset A and $37.5 basis in the stock in the hands of Corporate Partner. Section 732(c)(3). This is the same result obtained in the 1989 NYSBA Report under prior law under Section 5.b. entitled "Disappearing Built-in Gain: The Problem." As explained in such Report, gain disappears because Corporate Partner started with $80 of gain in Asset A. $40 was recognized on the contribution. Of the $40 that should remain after the distribution, only $27.5 remains (equal to the $50 value of the half of Asset A distributed to Corporate Partner less Corporate Partner's $22.5 basis in such asset). The balance has been shifted to the basis of the Corporate Partner stock and will not be recognized under Section 1032.

[18] *Id.*

[19] To illustrate the point, the 1989 NYSBA Report set out an example involving a partnership that used cash contributed pro rata by Corporate Partner and Other Partner to purchase Corporate Partner stock. After receiving a dividend distribution with respect to such stock and after the stock appreciated, the partnership liquidated, with each partner receiving its pro rata share of the appreciated stock and the dividend proceeds. In this example, the Distribution Rule would result in Corporate Partner recognizing capital gain in the amount of the appreciation inherent in its partnership interest. However, as the gain inherent in such partnership interest simply corresponds to the appreciation in Corporate Partner's own stock, the *General Utilities* doctrine is not implicated and Section 1032

purpose of the Distribution Rule may have been "to cover, on a facially nonretroactive basis, the [May Company transactions] that had already 'begun' by March 9, 1989".[20] Under the Distribution Rule, the tax consequences would approximate the tax consequences that would have occurred had the Deemed Redemption Rule applied to both legs of the transaction.[21] The Tax Section did not oppose the Distribution Rule so long as it was confined to transactions that straddled the effective date of the Proposed Regulations.

The Proposed Regulations proposed the Deemed Redemption Rule and Distribution Rule and rejected the Modified Distribution Rule as too complicated.[22]

Notice 93-2[23] later modified the relevant definition of "affiliate." Under the Proposed Regulations, a corporation would be treated as an affiliate of a corporate partner if the two corporations were members of the same affiliated group *after* the deemed redemption or distribution. Testing affiliation after the transaction may have been aimed at covering not only May Company transactions, but also a structure in which a partnership contributes assets to a corporation and distributes the corporation to a corporate partner and then the distributed

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would properly prevent gain recognition in such a case. *Id.* While parties might be able to avoid the result described above by distributing stock to Other Partner and selling the stock attributable to Corporate Partner, the example illustrates the potential for overtaxation inherent in the Distribution Rule. *See* Rev. Rul. 99-57, 1999-2 C.B. 678 (holding that Section 1032 provides for non-recognition for a corporate partner on its share of gain resulting from a sale by the partnership of the corporate partner's stock).

[20] 1989 NYSBA Report.

[21] Assume that Corporate Partner and Other Partner formed a partnership before the effective date of the Proposed Regulations, and that Corporate Partner contributed an appreciated asset with value of $100 and basis of $0, while Other Partner contributed Corporate Partner stock with value and basis of $100. Economically, Corporate Partner has exchanged 50 percent of the appreciated asset for $50 of its own stock. Because the exchange occurred before the effective date of the Deemed Redemption Rule, however, Corporate Partner did not recognize any gain. Now assume that after the Proposed Regulations became final, the partnership liquidated, distributing Corporate Partner stock to Corporate Partner and the appreciated asset to Other Partner. At the time of the liquidation, Corporate Partner will have economically exchanged its remaining 50 percent interest in the appreciated asset (that was not exchanged in the initial contribution) for another $50 of its own stock. Although the Deemed Redemption Rule would tax Corporate Partner on the $50 of gain realized in the liquidation, it would not tax Corporate Partner on the original $50 of gain realized upon formation. The Distribution Rule, on the other hand, would tax the Corporate Partner on the entire $100 of gain inherent in Corporate Partner's partnership interest on liquidation.

[22] Partnership Transaction Involving Equity Interests of a Partner, 57 Fed. Reg. 59, 324 (Dec. 15, 1992).

[23] 1993-1 C.B. 292.

corporation liquidates into the corporate partner.[24] This latter structure has since been curtailed by the enactment of Section 732(f), discussed in Part V.B below. Notice 93-2 narrowed the scope of the Proposed Regulations by providing that a corporation would be treated as an affiliate of a corporate partner only if the two corporations were members of the same affiliated group *before* the deemed redemption or distribution. The Notice left the structure later addressed by Section 732(f) for another day, noting that the IRS was aware of certain transactions that rely on Sections 731, 732 and 332 and were intended to avoid gain recognition on appreciated property.

In 1993, the Tax Section commented on the Proposed Regulations, continuing to oppose the Distribution Rule and advocate the Modified Distribution Rule.[25]

IV. <u>Continuing Relevance of the Deemed Redemption Rule</u>

We believe that the Deemed Redemption Rule remains the primary safeguard against attempts to circumvent the repeal of the *General Utilities* doctrine through the use of a partnership. Some have argued that legislative changes over the years have rendered the Deemed Redemption Rule obsolete and unnecessary, particularly if the Distribution Rule is finalized. We are not persuaded, however, that either the Distribution Rule or legislative developments obviate the need for the Deemed Redemption Rule.

For purposes of the analysis, it is helpful to note that May Company transactions generally involve two stages: a going-in stage and an exit stage. In the going-in stage, a corporate partner contributes an appreciated asset to a partnership that acquires or owns stock in the corporate partner (or an affiliate). In the exit stage, the partnership distributes some or all of the appreciated asset to the other partner, some or all of the corporate stock to the corporate partner, or both.

[24] *See* Barksdale Hortenstine, Steven E. Klig, & Gregory J. Marich, *Partnerships and Section 337(d): A Study in Regulatory Backlash*, 52 N.Y.U. INSTITUTE 15-1, at 15-12 (1994).

[25] 1993 NYSBA Report.

Thus, the argument that the Deemed Redemption Rule is no longer necessary starts with the premise that the going-in stage of the transaction is not the proper occasion to impose tax and that both the Distribution Rule and legislative developments since 1989 make it very difficult for the parties to effect the exit stage of the transaction on a tax-free basis.[26] We believe that the proper occasion to impose corporate level tax is at the going-in stage because this is when the economic redemption of stock for appreciated property actually occurs. In addition, as discussed in Part IV.A below, although we agree that the Distribution Rule and legislative developments make exit more difficult, many escape hatches remain. Indeed, as described in this Report, the complexities of Subchapter K create a myriad of escape possibilities, only some of which have been serially eliminated by changes in law. We are also concerned that other yet unforeseen escape opportunities may emerge.

A. Blocking the Exits

The Distribution Rule and legislative changes make the exit stage of a May Company transaction more challenging than it once was:

> ***Example 1. Distribution of Stock to the Corporate Partner or Distribution of Asset to the Other Partner.*** Partnership is a 50/50 partnership between Corporate Partner and Other Partner. Corporate Partner contributes an appreciated asset ("Asset A") with a basis of $20 and a value of $100. Other Partner either (a) contributes Corporate Partner stock with a basis and value of $100 or (b) contributes $100 of cash, which Partnership uses to buy Corporate Partner stock either on the open market or from Corporate Partner. If the Corporate Partner stock is distributed to Corporate Partner, the Distribution Rule (and possibly Sections 731(c) and 737) would apply to cause gain recognition to Corporate Partner. In addition, if such distribution occurs within two years of the contribution (or later, depending on the facts and circumstances), Section 707(a)(2)(B) could also result in gain recognition to Corporate Partner. Further, if Asset A is distributed to Other Partner within seven years of the contribution, Section 704(c)(1)(B) would cause gain recognition to Corporate Partner.

While the Distribution Rule and other rules impede the exit stage, we do not believe that those rules are tight enough to block all exits.

[26] As noted above, the Deemed Redemption Rule applies not only to the going-in stage, but also in other circumstances. *See* Part III above. However, as the going-in stage is a key application, the discussion in this Part IV focuses primarily on the application of the Deemed Redemption Rule to the going-in stage.

1. Anti-Mixing Bowl Provisions: Section 704(c)(1)(B)

A proponent of the view that the Deemed Redemption Rule is no longer necessary on the theory that the "exits" have been blocked by subsequent legislation might first point to Sections 704(c)(1)(B) (enacted in December 1989 and amended in 1997) and 737 (enacted in 1992 and amended in 1997). Under Section 704(c)(1)(B), if appreciated (or depreciated) property that was contributed to a partnership is subsequently distributed to a partner other than the contributing partner within seven years of being contributed, the contributing partner recognizes gain (or loss) as if the property had been sold at fair market value at the time of the distribution. Under this rule, if the appreciated asset contributed by Corporate Partner is distributed to Other Partner within seven years of the contribution, Corporate Partner recognizes gain at the time of the distribution. Accordingly, Section 704(c)(1)(B) does impede an exit when it applies. However, if the distribution occurs more than seven years after the contribution, Section 704(c)(1)(B) does not apply. Thus, Section 704(c)(1)(B) permits an exit if the parties are willing to wait seven years. While that Code section is an impediment to parties wishing to avoid Section 311(b) or Section 1001, it does not prevent the core abuse that the Deemed Redemption Rule seeks to address.

2. Anti-Mixing Bowl Provisions: Section 737

For similar reasons, Section 737 does not prevent May Company transactions. Under Section 737, if a partnership distributes property to a partner who contributed other appreciated property to the partnership within the previous seven years, the partner recognizes the lesser of the "net precontribution gain" (which is the gain the partner would have recognized under Section 704(c)(1)(B) had its property been distributed to another partner) and the excess of the fair market value of the distributed property over the partner's basis in the partner's partnership interest. Under this rule, if the Corporate Partner stock held by the partnership were distributed to Corporate Partner within seven years of Corporate Partner contributing the appreciated asset to the partnership, Corporate Partner would recognize gain at the time of the distribution. But, like Section 704(c)(1)(B), if the distribution occurs more than seven years after the contribution, Section 737 would not apply.[27] Like Section 704(c)(1)(B), Section 737 impedes, but does not prevent, the abuse that the Proposed Regulations target. We do not believe that the seven-year waiting periods of Sections 704(c)(1)(B) and 737 obviate the need for the Deemed Redemption Rule.

One could argue that Sections 704(c)(1)(B) and 737 represent Congress's comprehensive policy on deemed exchanges of assets through a partnership and that insofar as a May Company transaction is an arguable end-run around Section 1001, rather than Section 311(b)—because the Corporate Partner stock is purchased from the Corporate Partner itself—the transaction should avoid tax as long as it falls within the parameters of Sections 704(c)(1)(B) and 737. But, this argument disregards the potential for gain elimination inherent in May Company transactions. In a May Company transaction, the Corporate Partner's gain may never be taxed because of Section 1032. Mixing bowl transactions result in deferral of gain, not gain elimination. Thus, we believe that May Company transactions raise policy issues beyond those addressed by Sections 704(c)(1)(B) and 737.

3. Marketable Securities: Section 731(c)

Section 731(c), enacted in 1994, is another possible deterrent to May Company transactions. Section 731(c) defines money generally to include "marketable securities" for purposes of Sections 731(a)(1) and 737. Marketable securities are financial instruments, such as shares of stock, that are "actively traded" on the date of the distribution.[28] Thus, if the Corporate Partner stock held by the partnership is a marketable security, Section 731(c) would appear to cause Corporate Partner to recognize gain if the partnership distributed Corporate Partner stock to Corporate Partner, even if the seven year waiting period of Section 737 had passed.[29]

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[27] If the Distribution Rule were finalized, then it would apply to such a distribution, regardless of when it occurred.

[28] Section 731(c)(2).

[29] The amount of such gain would equal the excess of the fair market value of the distributed Corporate Partner stock over Corporate Partner's basis in its partnership interest under Section 731(a)(1). Section 731(c)(3)(B) reduces such gain by the Corporate Partner's predistribution share of the gain inherent in the distributed stock. It is unclear how this rule interacts with Section 1032 and Rev. Rul. 99-57 (see *infra* note 39).

But the reach of Section 731(c) is limited. To begin with, it is unclear whether Section 1032 would trump the application of Section 731(c), i.e., whether Section 731(c) would cause gain recognition on a distribution of marketable securities in the corporate partner to whom the securities are distributed. Further, Section 731(c) would not apply if Corporate Partner were privately held or, even if Corporate Partner were a publicly traded corporation, with respect to any stock of such Corporate Partner that was not a marketable security. Indeed, Other Partner or the partnership could purchase non-marketable stock from Corporate Partner. In that event, Section 731(c) would not apply to the distribution of the Corporate Partner stock to Corporate Partner. [30] Accordingly, we do not believe that 731(c) obviates the need for the Deemed Redemption Rule.

4. 2004 Enron Report Amendments to Sections 734 and 755

In 2004, Congress amended Sections 734 and 755 in response to the Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations[31] (the "Enron Report"). One could argue that those amendments obviate the need for the Deemed Redemption Rule. While we believe this argument involves a closer call than those discussed above, on balance, we believe that the 2004 legislative amendments also do not protect against May Company transactions.

Among those amendments was Section 755(c). Section 755(c) provides that in the case of a distribution of partnership property to a partner, if the distributee partner takes the property with a basis greater than the basis of the property in the hands of the partnership or recognizes a loss on the distribution and, as a result, the partnership is required to decrease basis in its remaining assets under Section 734 (*e.g.*, because the partnership has a Section 754 election in effect), then in allocating the decrease in inside partnership basis under Section 755(a), the decrease may not be allocated to stock in a corporation that is a partner (or to any person related

[30] If the Distribution Rule were finalized, then it would apply to such a distribution, as the Distribution Rule is not subject to any of the limitations of Section 731(c).

[31] JOINT COMMITTEE ON TAXATION, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, JCS-3-03 (Feb. 2003) [*hereinafter* Enron Report].

to such partner). Moreover, the partnership must recognize gain to the extent that the required basis decrease exceeds the basis of partnership property other than the stock of the corporate partner. Meanwhile, the 2004 amendments to Section 734 require a partnership to reduce its basis in partnership property even if it does not have a Section 754 election in effect if the partnership distributes property to a partner and there is a "substantial basis reduction" (*i.e.*, an increase in basis of the distributed property in excess of $250,000).

Like the Proposed Regulations, the 2004 amendments to Section 755 were intended to counteract unintended tax results from transactions involving the interaction between the partnership allocation and basis rules and Section 1032.[32] As stated in the House Committee Report:

> The Joint Committee on Taxation staff's investigative report of Enron Corporation [footnote omitted] revealed that certain transactions were being undertaken that purported to use the interaction of the partnership basis adjustment rules and the rules protecting a corporation from recognizing gain on its stock to obtain unintended tax results. These transactions generally purported to increase the tax basis of depreciable assets and to decrease, by a corresponding amount, the tax basis of the stock of a partner. Because the tax rules protect a corporation from gain on the sale of its stock (including through a partnership), the transactions enable taxpayers to duplicate tax deductions at no economic cost. The provision precludes the ability to reduce the basis of corporate stock of a partner (or related party) in certain transactions.[33]

However, the particular type of transaction targeted by Section 755(c) differs from the May Company transaction. Section 755(c) is directed at transactions that seek to step up the basis of an asset to be held by the corporate partner. The Proposed Regulations are directed at transactions that seek to avoid tax on a disposition of an appreciated asset by a corporation in exchange for an interest in the corporation's own stock. As discussed below, the Enron transactions resulted in a pure basis shift. A May Company transaction generally results in a corporate contraction. While Section 755(c) may impede May Company transactions, as

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[32] H.R. REP. NO. 108-548, pt. 1. *See also* Enron Report, at 215; Blake D. Rubin, Andrea M. Whiteway & Jon G. Finkelstein, *New Legislation Tightens Partnership Tax Rules*, 83 TAXES 31 (May, 2005) [*hereinafter* Rubin].

[33] H.R. REP. NO. 108-548, pt. 1.

described below, it is possible to do a May Company transaction after the enactment of Section 755(c).

Enron Corp.'s ("Enron") Project Condor was one of the transactions that led to Section 755(c). Using a partnership, Enron sought to increase basis in a depreciable asset with an offsetting decrease in the basis of its own stock with the ensuing gain in the stock not subject to tax under Section 1032.[34] Specifically, the transaction involved an existing partnership ("Whitewing") between Enron and a third-party investor (the "Osprey Investors"). Whitewing held Enron preferred stock. A subsidiary of Enron ("HPL") contributed appreciated assets (minimal basis; value approximately $930 million) (the "Bammel Assets") to Whitewing.[35] The partnership provided that all income and loss allocations in respect of the Bammel Assets would be made to Enron and Enron's subsidiary, HPL, none to the Osprey Investors. In particular, all depreciation deductions were allocable to Enron. Further, the partnership adopted the "remedial method" under Section 704(c) with respect to the Bammel Assets.[36] Thus, over the depreciation period of 15 years, approximately $930 million of deductions would be allocated to Enron and $930 million of income would be allocated to HPL.[37] (Enron intended to avoid a Section 704(d) limitation on its ability to deduct the $930 million of deductions by purchasing the interest of the Osprey Investors or contributing cash to Whitewing.)[38] The allocations of $930 million of remedial depreciation deductions and $930 million of remedial income offset each other in the Enron consolidated group and thus had no impact on Enron's tax liability. However, the allocations of income to HPL would increase HPL's basis in its Whitewing partnership interest.

The strategy envisioned that Whitewing would eventually distribute the Bammel Assets to HPL in complete liquidation of HPL's interest. HPL would take a basis in the Bammel Assets equal to $930 million, its basis in Whitewing, and then depreciate such basis in the Bammel Assets. By reason of a Section 754 election at Whitewing, Whitewing would be required to

[34] Enron Report, at 208-221.

[35] *Id.* at 208.

[36] A similar result might have been able to be achieved using the curative method.

[37] *Id.* at 212.

[38] *Id.* at 209.

reduce basis in its only remaining asset, the Enron preferred stock. The resulting built-in gain in the Enron preferred stock would be avoided, likely in reliance on Section 1032.[39]

Enron's Projects Tammy I and Tammy II also involved attempts to provide an Enron entity with high basis in a depreciable asset through a distribution of partnership assets to an Enron partner with a high basis in the partner's partnership interest. Such a distribution was to be made at a time when the only other asset of the partnership was Enron preferred stock. As a result, the basis step-down in partnership assets corresponding to the basis step-up in the distributed depreciable asset would be made in the Enron preferred stock. As in Project Condor, the Enron entities would avoid recognizing the resulting built-in gain in the Enron preferred stock.[40]

The Enron Report recommended:

> further guidance . . . to address the interaction of the partnership basis rules with the corporate nonrecognition of gain rules under section 1032. Of particular concern is gain being excluded by virtue of section 1032 that is attributable to a downward basis adjustment mandated by a section 754 election.
>
> The Joint Committee staff recommends that either (1) section 1032 limit the nonrecognition of any realized gain allocated to the corporate partner to the extent that the gain is attributable to an economic benefit accruing to the corporate partner, or (2) that the partnership basis rules should be altered to preclude an increase in basis to an asset if the offsetting basis reduction would be allocated to stock of a partner (or related party).[41]

Section 755(c) took a different tack by precluding a basis reduction in the stock of the corporate partner and triggering gain to the extent the partnership held no other assets with basis to reduce. It is noteworthy that the Enron Report went on to say that the staff:

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[39] *Id.* at 209 ("Enron Corp. could use one of several strategies" to avoid recognizing gain on the preferred stock). *Id.* at 220. In Revenue Ruling 99-57, the IRS confirmed that no gain would be recognized by a corporate partner under Section 1032 on income allocated to the corporate partner resulting from a taxable disposition of the corporate partner's stock that was contributed to the partnership by the corporate partner. 1999-2 C.B. 678.

[40] Enron Report, at 221.

[41] *Id.* at 220-221.

> believes that the proposed regulations under section 337, relating to partnership acquisitions of stock of a corporate partner, would preclude taxpayers from engaging in these types of transactions. The Joint Committee staff recommends that final regulations on this subject should be issued expeditiously.

It is not clear whether the drafters of the Enron Report believed that the finalization of the Proposed Regulations was necessary to counteract the types of transactions outlined in the Enron Report if the other recommendations in the Enron Report were taken.

The 2004 amendments impede May Company transactions, as illustrated in the following example:

> ***Example 2. Liquidating Distribution to the Other Partner.*** Same facts as Example 1 except that, instead of distributing Corporate Partner stock to Corporate Partner, Partnership distributes Asset A to Other Partner in liquidation of Other Partner's partnership interest more than seven years after the contribution of Asset A to Partnership. Under Section 732(b), Other Partner's basis in Asset A is $100. As a result, since Asset A's basis in the hands of the partnership was $20, there is a "substantial basis reduction" of $80 under Section 734(b)(2)(B) and (d).[42] Thus, under Section 734(a), Partnership is generally required to reduce basis in Partnership property. The only property remaining in Partnership is Corporate Partner stock. Under Section 755(c), Partnership is not permitted to reduce basis in Corporate Partner stock. Instead, Partnership recognizes gain of $80 under Section 755(c). This gain would presumably be allocated to Corporate Partner.[43]

Thus, the 2004 amendments trigger gain recognition to Corporate Partner if Corporate Partner and Other Partner go their separate ways by having the partnership distribute Asset A to Other Partner.

But, the transaction structure could be adjusted in ways that those rules would not catch. First, the rules only apply to liquidating distributions to Other Partner. If Asset A is distributed to Other Partner in a non-liquidating distribution, Other Partner would take a carry-over basis in

[42] For purposes of this illustration, the example ignores the $250,000 *de minimis* exception of Section 734(d)(1).

[43] It is not clear whether the gain would be allocated to the Corporate Partner. However, in order to have the appropriate deterrent effect and to reach the right conceptual result, the gain should be allocated to the Corporate Partner as it represents the appreciation built into Asset A.

Asset A, rather than increasing the basis in Asset A to Other Partner's outside basis. In such a case, Section 755(c) would not apply:

> ***Example 3. Non-Liquidating Distribution to the Other Partner.*** Same facts as Example 2, except that, instead of distributing Asset A to Other Partner in liquidation of Other Partner's partnership interest, the distribution of Asset A to Other Partner is a non-liquidating distribution. Other Partner continues to hold a small interest in Partnership after the distribution. Under Section 732(a)(1), Other Partner's basis in Asset A is $20. Neither Section 734 nor 755(c) applies.

That example effectively transfers the built-in gain inherent in Asset A to Other Partner. Other Partner might be reluctant to enter into the transaction, because Other Partner invested $100 and winds up with basis of only $20. However, the transaction would be viable if Other Partner were indifferent to Other Partner's basis in Asset A. Other Partner may be indifferent if, for example, (a) Asset A is not depreciable and Other Partner has no immediate plans to sell Asset A, (b) Other Partner is tax-exempt, (c) Other Partner has net operating losses, (d) Other Partner is foreign and Asset A is not used in a U.S. trade or business or subject to FIRPTA or (e) Other Partner reports income on a mark-to-market basis.

Indeed, even if Other Partner is sensitive to Other Partner's basis in Asset A, the transaction still might be viable because of the timing benefit. Corporate Partner is able to avoid recognition of the $80 of gain in Asset A at the cost of Other Partner inheriting the $20 basis in Asset A. If Asset A is depreciable, then the cost of the lower basis (*i.e.*, basis of $20, rather than $100) is the present value of the foregone depreciation deductions of $80 that Other Partner would have had if Other Partner had purchased Asset A from Corporate Partner. Because Corporate Partner is saving tax up front on $80 and Other Partner is suffering lower depreciation deductions over time of $80, Corporate Partner could compensate Other Partner for the low basis and still come out ahead relative to a straight sale.

Another potential way around Section 755(c) is for the partnership to own properties other than Asset A and Corporate Partner stock. Section 755(c) does not prevent a reduction in basis in assets other than Corporate Partner stock:

> ***Example 4. Liquidating Distribution to the Other Partner; Partnership Holds Other Assets.*** Same facts as Example 2, except that, upon formation of the

partnership, Corporate Partner contributes both Asset A and another asset, Asset B. Asset B has basis and value of $100. As in Example 2, upon the liquidating distribution of Asset A to Other Partner, Other Partner takes a basis of $100 in Asset A under Section 732(b). As in Example 2, under Section 734(a), Partnership is required to reduce basis in Partnership property. Under Section 755(c), Partnership is not permitted to reduce basis in Corporate Partner stock. Thus, Partnership reduces basis in Asset B from $100 to $20.

If Asset B is a depreciable asset, then Corporate Partner has traded upfront gain on the sale of Asset A for additional tax over the period that Asset B would have been depreciated.[44] If Asset B is not depreciable, then the decrease in basis in Asset B may never lead to a cost to Corporate Partner. In that connection, Section 755(c) treats stock of a corporation related under Section 267 to Corporate Partner in the same manner as stock in Corporate Partner. Thus, Section 755(c) gain recognition would apply if Asset B were stock in a subsidiary of Corporate Partner.[45] But, other types of non-depreciable property could absorb the basis decrease.

Indeed, it is possible that even a partnership interest could serve this purpose, although the matter is not free from doubt. Consider the following example:

Example 5. Liquidating Distribution to the Other Partner; Partnership Holds Other Assets. Same facts as Example 4. Asset B is a partnership interest in Lower-Tier Partnership ("LTP"). The other partner in LTP is a subsidiary of Corporate Partner. As in Example 4, Asset B (which, in this example, is the LTP interest) has a basis and value of $100. LTP owns depreciable assets with a value (throughout this example) of $100. As in Example 4, upon the liquidating distribution by Partnership of Asset A to Other Partner, Other Partner takes a basis of $100 in Asset A under Section 732(b).

As in Example 4, under Section 734(a), Partnership is required to reduce basis in Partnership property. Under Section 755(c), Partnership is not permitted to reduce basis in Corporate Partner stock. Thus, Partnership reduces basis in the LTP interest from $100 to $20.[46]

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[44] Presumably, the reduction in basis in Asset B is for the account of Corporate Partner, although this may not be entirely clear.

[45] *See* Rubin, *supra* note 32 (identifying ambiguities in "related" person concept in Section 755(c)).

[46] To the extent that the LTP holds unrealized receivables, Treas. Regs. § 1.755-1(a)(1) may require the upper tier partnership's interest in LTP to be bifurcated into a capital asset portion and an ordinary portion attributable to the unrealized receivables for purposes of Section 755(c). Section 751(f) may require the same in respect of inventory. *See* 24.09 n.186 and 25.07[1] n.118 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE,

If each of Partnership and LTP had a valid Section 754 election in effect, a decrease in the basis of Partnership's share of any capital assets held by LTP would be required.[47] However, it is unclear whether such decrease would be required in the absence of a Section 754 election with respect to LTP.[48] If it is not required, then the application of Section 755(c) in this case may not result in any additional current cost to the Corporate Partner. Section 704(d) would prevent Partnership from taking deductions in excess of Partnership's $20 basis in the LTP interest. However, Corporate Partner and Partnership could address the Section 704(d) limitation by having Corporate Partner contribute cash to Partnership, which contributes that cash to LTP, or by having LTP incur new debt, which, to the extent allocable to Partnership, would also increase Partnership's basis in the LTP interest.

Even if a Section 755(c) basis decrease in a lower-tier partnership interest must be pushed down to the lower-tier partnership's assets, the use of other non-depreciable property remains a viable alternative. Thus, while Section 755(c) makes the transactions targeted by the Proposed Regulations more complex and potentially more expensive, Section 755(c) does not prevent such transactions.

This is not entirely surprising as the purpose of the Enron transactions differed from the purpose of the transactions targeted by the Proposed Regulations. The Enron transactions sought

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FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (4th ed. 2007); Gary R. Huffman & Barksdale Hortenstine, *Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships*, 86 TAXES 179, 210 (2008).

[47] *See* Rev. Rul. 92-15, 1992-1 C.B. 215 (holding that a distribution of an asset by an upper-tier partnership, coupled with a related adjustment to the basis of the upper-tier partnership's interest in a lower-tier partnership under Sections 754 and 734(b), triggers a Section 734(b) basis adjustment with respect to the upper-tier partnership's share of the lower-tier partnership's assets where the lower-tier partnership also has a Section 754 election in effect). *See also* Rev. Rul. 87-115, 1987-2 C.B. 163 (applying a similar look-through approach to conclude that a transfer of an interest in an upper-tier partnership results in an adjustment to the basis of the property of a lower-tier partnership under Section 734(b), if, and only if, both partnerships have made an election under Section 754).

[48] Revenue Ruling 92-15 was issued before the legislative amendments to Section 734(b) mandating an adjustment to the basis of partnership property when there is a "substantial basis reduction" arising from a distribution of partnership property to a partner. In such a case, it appears that the application of Revenue Ruling 92-15 does not depend on whether the upper-tier partnership has a Section 754 election in effect. However, it is not clear whether such an adjustment should be pushed down to the assets of a lower-tier partnership if the lower-tier partnership does *not* have a Section 754 election in effect. *See* 25.07[1] MCKEE, NELSON & WHITMIRE, *supra* note 46; Huffman & Hortenstine, *supra* note 46 at 209-10; Tanya O. Thomas & David M. Kaplon, *Issues Associated with §§ 743(b) and 734(b) Adjustments in Tiered Partnership Structure*, 48 TM Memorandum (BNA) Vol. 18 (Sept. 3, 2007).

to create depreciable basis in an asset within the Enron consolidated group. A May Company transaction seeks to avoid gain recognition on a disposition to a third party of an appreciated asset held by the corporate partner. In some sense, the Enron transactions could be viewed as analogous to the May Company transactions involving a primary issuance of stock by the corporate partner. In both cases, basis is created at the "expense" of a largely irrelevant basis decrease in another asset—the taxpayer's own stock. In the May Company case, the basis is the basis in the cash received on issuance of the stock. But the Enron transactions are not analogous to the May Company transactions involving a secondary purchase of corporate partner stock as the latter involve a corporate contraction, while the Enron transactions did not. As a result, Section 755(c) does not prevent every May Company transaction. That Section 755(c) only applies to liquidating distributions, where the distributee partner generally takes a stepped-up basis in the distributed asset equal to such partner's outside basis, makes sense from the perspective of counteracting Enron's transactions, but leaves open the possibility that a corporation seeking to avoid gain on a disposition of an appreciated asset could use the structure set out in Example 3, the non-liquidating distribution to Other Partner, where Other Partner is willing to take the asset with a low basis. Example 4 (and possibly 5) illustrate shortcomings of Section 755(c) as an effective deterrent to May Company transactions.

B. No Exit

We believe that the going-in stage of a May Company transaction is the right time to tax:

> ***Example 6. No Exit.*** Partnership is a 50/50 partnership of Corporate Partner and Other Partner. Corporate Partner contributes Asset A with a basis of $20 and a value of $100. Other Partner either (a) contributes Corporate Partner stock with a basis and value of $100 or (b) contributes $100 of cash, which Partnership uses to buy Corporate Partner stock either on the open market or from Corporate Partner. The parties have no plan to unwind Partnership and do not in fact unwind Partnership.

Economically, Corporate Partner has exchanged a 50 percent interest in Asset A for $50 of Corporate Partner stock, akin to a redemption of $50 of Corporate Partner stock for 50 percent of the appreciated asset (or, if Partnership uses cash to buy stock from Corporate Partner, akin to a sale of 50 percent of Asset A for $50 of cash). Of course, every Section 721 exchange involves an economic exchange of assets between the partners.[49] Indeed, any time one partner contributes an appreciated asset to a partnership and another partner contributes cash, the transaction could be viewed as a partial sale of the asset for cash. In general, however, Subchapter K does not tax this exchange.

When the asset in question is stock of Corporate Partner, however, there are compelling reasons to treat the transaction differently.[50] First, when a partnership purchases stock of a corporate partner, the corporate partner acquires an indirect interest in itself in exchange for a portion of its share of the remaining assets of the partnership.[51] Unlike the purchase of any other asset by a partnership, the purchase of stock of a corporate partner depletes the corporate tax base. In Example 6, the fair market value of the assets of Corporate Partner declined by $50 at the moment it contributed Asset A to the partnership, just as would have occurred had the corporate partner instead distributed one-half of Asset A to a shareholder in redemption of $50 of its outstanding stock.

This can also be seen by considering the perspective of a hypothetical creditor of Corporate Partner. Before the going-in transaction, the creditor could look to all the assets of Corporate Partner, whatever those may be, including Asset A, the asset to be contributed to the partnership.[52] After the going-in transaction, the creditor can look to all the assets other than Asset A and, in Example 6, indirectly half of Asset A (*i.e.*, the Corporate Partner's share of Asset A). The Corporate Partner's share of the Corporate Partner stock that is also in the partnership provides no assets to support the creditor beyond the assets that the creditor already has access

[49] So too do most Section 351 transactions and nondivisive corporate reorganizations. The investment company rules of Sections 351, 721 and 368 are intended to prevent these types of economic exchanges from occurring in certain circumstances.

[50] *See* Stephen B. Land, *Strange Loops and Tangled Hierarchies*, 49 TAX L. REV. 53, 56 (1993) (viewing "indirectly self-owned interests as a distinct type of corporate asset, somewhat like treasury stock") [*hereinafter*, Land].

[51] *Cf.* Treas. Regs. § 1.108-2 (acquisition of debt by a related person results in cancellation of debt income).

[52] Peter C. Canellos, *Acquisition of Issuer Securities by a Controlled Entity: Peter Pan Seafoods, May Department Stores, and McDermott*, 45 TAX LAW. 2, 2-5 (1991-1992) (analyzing circular stock ownership from the perspective of a "hypothetical unrelated creditor" of the issuer).

to, because it represents only a stake in Corporate Partner. The perspective of the hypothetical creditor to the Corporate Partner illustrates that the structure causes half of Asset A to leave the corporate tax base (assuming that the other partner is not a corporation).[53] Section 337(d) was intended to prevent assets from leaving the corporate tax base without corporate level tax.

Second, a corporate partner's share of its own stock in a partnership is analogous to treasury stock in that, from an economic perspective, the stock is no longer outstanding. The corporation has eliminated an economic owner of the corporation. Like treasury stock, the stock has little economic consequence while in the partnership. The stock could, in effect, be reissued—in the case of a May Company structure by the corporate partner issuing new stock to a third party. Indeed, suppose that in Example 6, instead of a pro rata partnership, the partnership agreement allocated 90 percent of the income and loss associated with the shares to the Corporate Partner and 10 percent to the Other Partner, while allocating 90 percent of the income and loss associated with Asset A to the Other Partner and 10 percent to the Corporate Partner. With such an arrangement, the economic exchange of 90 percent of Asset A for 90 percent of the Corporate Partner stock has occurred and there may be little incentive for the parties ever to unwind the partnership.

It is true that the shares in the partnership are not identical to treasury shares, as illustrated from the perspective of a hypothetical creditor of the partnership. From a creditor's perspective, a corporate partner's shares are a valuable asset of the partnership. The creditor of the partnership would be in a different position if the shares of the corporate partner were removed from the partnership, because fewer assets would support the partnership debt. The partnership's ownership of the corporate partner stock resembles a pledge by a shareholder of the corporation of stock in the corporation (although a pledge would give the creditor secured rights to the shares, whereas ownership by the partnership of the corporate partner stock would not give any particular creditor a greater claim over the corporate partner stock than any other creditor of the partnership). While shares in a partnership of a corporate partner are therefore not identical

[53] An entity theory of the partnership would suggest otherwise, because an entity theory would lead to the view that the Corporate Partner exchanged Asset A for an interest in the partnership. But, we believe the aggregate theory is more appropriate in this context.

to treasury shares, we do not believe this distinction should outweigh the policy considerations that disfavor the structure. Like treasury shares, shares owned or acquired by a corporate partner through a partnership are no longer outstanding as an economic matter (unless or until any foreclosure by a creditor).

Third, the use of corporate partner stock suggests a lack of business purpose. Section 721 is intended to provide nonrecognition on the view that people are mixing their assets for a non-tax purpose: "Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."[54] Corporate partner stock cannot be used for operations and would seem to be a peculiar type of investment asset to contribute to a partnership. In general, there seems to be little reason for corporate partner stock to go into a partnership other than to effect an economic redemption of the stock.

An argument could be made that the corporate partner stock was contributed to the partnership for a non-tax business purpose, namely, to strengthen the partnership's balance sheet. For example, the stock could facilitate a borrowing by the partnership by providing an additional asset in the partnership for partnership creditors to rely on. But, this argument does not seem plausible. Recall that in Example 6 it is Other Partner, not Corporate Partner, that contributes Corporate Partner stock—or cash that is used to acquire Corporate Partner stock. Such stock is not a unique asset as to Other Partner. Other Partner's cash could be invested in any other asset to strengthen the partnership's balance sheet. It seems unlikely that the only asset available would be Corporate Partner stock.

Even if there were a non-tax purpose for the use of corporate partner stock in a particular case, we do not believe that the rules should provide leeway. We do not believe that the rules should be limited to abusive cases, have an exception for "good" purposes, or provide for a private letter ruling exception. *General Utilities* repeal is a structural and economic concept—an analysis that tax should be imposed because appreciated assets are leaving corporate solution—

[54] Treas. Regs. § 1.701-2(a).

not dependent on the taxpayer's good or bad purposes.[55] Section 311(b) does not depend on purposes and applies in non-abusive cases. Thus, we do not believe that the application of the Deemed Redemption Rule should depend on the taxpayer's purposes.[56]

In sum, we believe that the going-in transaction does raise *General Utilities* concerns that justify the application of the Deemed Redemption Rule.

C. Other Anti-Abuse Rules

1. Codification of Economic Substance Doctrine: Section 7701(o)

It could also be argued that the recent codification of the economic substance doctrine[57] has obviated the need for the Deemed Redemption Rule. However, we believe that the abuses at which the rule is aimed generally would be better addressed through the Deemed Redemption Rule.

First, we believe that the enactment of Section 7701(o) leaves much of the economic substance analysis unchanged relative to the law prior to enactment. New Section 7701(o) applies to any transaction where the economic substance doctrine is "relevant." The statute specifically provides that the determination as to whether the economic substance doctrine is "relevant" for purposes of Section 7701(o) is meant to be analyzed as if Section 7701(o) had never been enacted.[58] Further, where it applies, Section 7701(o) disallows tax benefits if the transaction lacks either economic substance (because the transaction does not change the taxpayer's economic position in a meaningful way) or business purpose. Prior to enactment, circuits were split as to whether that test was disjunctive or conjunctive. Some circuits held that in order to have economic substance, the transaction had to change the taxpayer's economic

[55] It is true that the elimination of gain does not occur until the stock is actually sold or distributed by the partnership, but we do not believe that this justifies deferring the time to tax.

[56] In so concluding, however, we take no position on the *de minimis* and inadvertence exceptions contained in the Proposed Regulations.

[57] Section 7701(o).

[58] Section 7701(o)(5)(C).

position *and* the taxpayer had to have a business purpose,[59] while others held that the transaction had to change the taxpayer's economic position *or* the taxpayer had to have a business purpose.[60] Many May Company transactions do change the taxpayer's economic position in that the transaction effects an economic exchange of appreciated assets for corporate partner stock. Thus, assuming that the economic substance doctrine is relevant, its application would likely turn on whether the taxpayer had a business purpose. But, this is no different from the analysis that would have applied prior to codification in the circuits that required both a change in position and a business purpose in order for a transaction to pass muster.

Second, the result of the economic substance doctrine is difficult to predict. For instance, depending on how broadly the transaction that is to be tested is defined,[61] Section 7701(o) may not be applicable to situations involving a partnership that also conducts business operations.

Third, in light of the strict liability penalty for failure to satisfy economic substance,[62] the IRS has instituted procedures intended to limit the universe of transactions to which the IRS will seek to apply Section 7701(o).[63] We welcome the IRS's approach in this regard as we believe that the economic substance doctrine should be narrowly construed and should not become a broad general anti-abuse rule. The adoption of the Proposed Regulations to target the specific abuses arising in a May Company transaction context, rather than reliance on the codified economic substance doctrine, furthers this policy objective.

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[59] *See, e.g., Illes v. Comm'r*, 982 F.2d 163, 165 (6th Cir. 1992) ("To be valid, an asserted deduction must satisfy both components of a two-part test. The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[60] *See, e.g., Rice's Toyota World v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.").

[61] *See generally*, David P. Hariton, *The Frame Game: How Defining the "Transaction" Decides the Case*, 63 TAX LAWYER 1 (2009).

[62] A taxpayer that engages in a transaction that lacks economic substance is subject to a strict liability penalty of 20 percent, or, in the case of undisclosed transactions, 40 percent of any related underpayments. Sections 6662(b)(6), 6662(i), 6664(c), (d) and 6676.

[63] *See* IRS Directive, LB&I-4-0711-015 (July 15, 2011); IRS Directive, LMSB-20-0910-024 (Sept. 14, 2010); Notice 2010-62, 2010-40 I.R.B. 411 (Sept. 13, 2010).

In light of the above, we believe that the enactment of Section 7701(o) does not obviate the need for the Deemed Redemption Rule.

2. Partnership Anti-Abuse Rule

For similar reasons, we believe that the partnership anti-abuse rules of Treasury Regulation Section 1.701-2 are not well-suited to the task of monitoring May Company transactions. Those rules, like the economic substance doctrine, are difficult to predict and the IRS has generally exercised restraint in relying on these rules in order to minimize uncertainty to taxpayers. It is notable that the partnership anti-abuse rules were promulgated in 1994, but the Enron transactions happened after that. We believe that it will serve proper administration to have specific rules addressing May Company transactions. In addition, we believe that the fundamental theoretical issue raised by the May Company transaction—namely, whether the aggregate or the entity theory of partnerships is more appropriately applied in this context—should be addressed directly through specific regulations.

V. <u>Affiliate Stock</u>

The Proposed Regulations would apply if the stock involved is stock of an affiliate of a corporate partner.[64] A corporation is an affiliate of a partner for this purpose if the corporation and the partner are members of the same affiliated group as defined in Section 1504(a) (without regard to the exceptions in Section 1504(b)). Under Notice 93-2, affiliation is tested before the deemed redemption or distribution by the partnership.[65]

As illustrated by the examples in this section, the inclusion of *all* stock of affiliates will result in gain recognition in many transactions that involve neither a corporate contraction nor gain elimination attributable to discontinuities between the rules of Subchapter K and the rules of Subchapter C. Although some of these transactions may represent a first step in a series of later transactions that ultimately effect the type of economic exchange targeted by the Proposed Regulations, others may not. If the issuer of the affiliate stock is a subsidiary or sibling

[64] Prop. Treas. Regs. § 1.337(d)-3(c).

[65] 1993-1 C.B. 292. *See supra* note 23 and accompanying text.

of the corporate partner, therefore, we believe that the Deemed Redemption Rule should be suspended until those later transactions actually occur.

We recognize that this "wait and see" approach is not without its drawbacks. First and foremost, the approach would add significant complexity relative to the regime envisioned under the Proposed Regulations, which is to impose immediate tax if the stock in question is stock of the corporate partner or stock of an affiliate, regardless of what type of affiliate. Applying different rules to different categories of affiliate stock and tracking the consequences of the future disposition of any affiliate stock that did not trigger immediate gain recognition would ensure that the Deemed Redemption Rule only reaches transactions that would otherwise circumvent *General Utilities* repeal, but *only* if this alternative regime is administrable in practice. Second, some would argue that leaving the transaction open may facilitate indefinite gain deferral by permitting affiliated groups to shift the gain inherent in appreciated assets to stock of other group members that will never be realized.[66] If necessary to avoid undue complexity, therefore, it may be appropriate to finalize the Proposed Regulations in their current form, even as applied to affiliate stock. Alternatively, the final regulations might suspend the Deemed Redemption Rule only until such time as the partnership distributes the affiliate stock, triggering full gain recognition at that time.

If final regulations adopt either of these latter two approaches, we recommend appropriate exceptions for transactions that are clearly non-abusive. For example, if multiple members of an affiliated group contribute stock of one or more members to a partnership owned solely by the other members, the Proposed Regulations should not require immediate gain recognition.

Complexity aside, the treatment of affiliate stock under the Proposed Regulations raises fundamental questions about the proper scope of the Deemed Redemption Rule. To illustrate, it is instructive to return to the basic principle behind the application of the Deemed Redemption Rule: if a corporate partner contributes an appreciated asset to a partnership that acquires stock of the corporate partner from a third party, the corporate partner will contract because the

[66] *See* the discussions accompanying Examples 9 and 11 below.

contribution removes a portion of the asset from corporate solution in exchange for an interest in the corporation's own stock. The economic exchange is therefore subject to tax under the Deemed Redemption Rule. On the other hand, if the partnership acquires newly-issued stock *from* the corporate partner, no corporate contraction occurs because the corporate partner will receive the cash proceeds from the sale of its stock for an interest in an appreciated asset.[67] The absence of any contraction in the latter case raises the question whether Treasury Regulations under Section 337(d) are the appropriate place to police such transactions. We believe it is appropriate to apply Section 337(d) to such transactions because we believe *General Utilities* repeal serves two purposes: first, to protect the corporate tax base by preventing appreciated assets from being removed from corporate solution without corporate level tax; and second to serve as a backstop to Section 1001.[68] Thus, in the case of corporate partner stock, the Deemed Redemption Rule applies if there is a corporate contraction (*i.e.*, the case of corporate partner stock purchased from a third party) or if the corporate partner receives cash as part of the transaction (*i.e.*, the case of newly-issued stock).

Applying those principles now to stock of affiliates, in the case of certain affiliates, the corporate contraction is readily apparent. A corporate contraction occurs if the corporation whose stock is in the partnership directly *or indirectly* contributed the appreciated asset to the partnership, even if the corporation is not the actual partner. Thus, if a subsidiary corporation ("Subsidiary") is a partner in the partnership, Subsidiary contributes an appreciated asset to the partnership and the partnership acquires stock in the parent ("Parent") of Subsidiary, the Deemed

[67] It is possible, however, to view even the purchase of stock from the corporate partner as a form of corporate contraction. For example, if an unrelated third party were to purchase newly-issued stock of a corporation for $100 and then sell the stock to a partnership in which the issuer of the stock is a partner, the sale of shares to the partnership would result in a corporate contraction of the issuer even though the shares purchased by the partnership from the unrelated third party were newly issued. In substance, the corporation issued shares for $100 and then redeemed a portion of the shares in exchange for partnership assets removed from corporate solution. This implicit redemption is a form of corporate contraction. As an economic matter, the same form of contraction would occur if the partnership were to purchase the newly-issued shares directly from the corporate partner.

[68] *General Utilities* repeal serves as a backstop to Section 1001 by causing a corporation to recognize gain if the corporation issues stock for cash, the buyer of the stock then sells the stock to another buyer and the corporation then redeems such second buyer in exchange for an appreciated asset. From the corporation's perspective, the corporation received cash (from the first buyer) and disposed of an appreciated asset (to the second buyer) without any marginal change in the number of shares outstanding. The scenario is not a corporate contraction, because the corporation received cash of equal value to the appreciated asset.

Redemption Rule should apply: the contribution by Subsidiary of the appreciated asset results in a contraction of Parent because Parent indirectly owned 100 percent of the appreciated asset through Subsidiary before the contribution. We do not believe that the application of the Deemed Redemption Rule should depend on whether Parent holds the appreciated asset directly or through Subsidiary. As discussed more fully below, therefore, we believe that the Deemed Redemption Rule should apply at the time that Subsidiary contributes the appreciated asset and the partnership acquires Parent stock.

By contrast, if Parent is a partner in the partnership, Parent contributes an appreciated asset to the partnership and the partnership acquires stock in Subsidiary, whether there has been a corporate contraction is less clear. In this case, neither Parent nor Subsidiary contracts on a separate company basis. Rather, Parent has economically exchanged an interest in the asset for an interest in the Subsidiary stock, an asset that Parent did not own before the contribution. Although the transaction must satisfy the usual strictures for mixing bowl partnerships—Sections 704(c)(1)(B), 737, 707—it does not appear to require upfront taxation in order to protect the principles of *General Utilities* repeal.

From another perspective, however, a corporate contraction *has* occurred (assuming that the other partner in the partnership is not itself a corporation). As discussed in Part V.B below, after the contribution, the "real" assets (*i.e.*, assets other than corporate stock) in corporate solution have been reduced on an aggregate basis. On an aggregate basis, therefore, a contraction of the corporate tax base has occurred. Because this transaction does not depend on Section 1032 or any other provision of Subchapter C to avoid gain recognition, however, we do not believe the Deemed Redemption Rule should apply. We believe the purpose of the Deemed Redemption Rule is to curb transactions involving partnerships that rely on discontinuities between the rules of Subchapter K and the rules of Section 1032 (or other corporate nonrecognition rules) to eliminate gain upon a disposition of an asset.

In summary, therefore, we believe that the Deemed Redemption Rule should apply if a corporation contributes an appreciated asset to a partnership and the partnership acquires stock in the direct or indirect owner of the corporation. Conversely, the Deemed Redemption Rule should not apply if the partnership instead acquires stock in a subsidiary or sister of the corporate partner that contributed the appreciated asset, because, in such a case, the issuer of the stock did not directly or indirectly contribute any asset to the partnership.

In cases where the corporation whose stock is in the partnership owns, directly or indirectly, less than 100 percent of the corporate partner, we also believe that only a proportionate amount of gain should be recognized. For example, if the corporation whose stock is in the partnership owns only 70 percent of the corporate partner, then the Deemed Redemption Rule would apply to the portion of 70 percent of the asset that is economically exchanged by virtue of the contribution.

In cases where the Deemed Redemption Rule does not apply at inception, we believe that certain subsequent transactions should trigger gain recognition.[69] For example, as described above, if Parent contributes an appreciated asset to a partnership that owns or acquires Subsidiary stock, the Deemed Redemption Rule should not apply. If Parent later contributes the partnership interest to Subsidiary in a Section 351 contribution, however, the Deemed Redemption Rule should apply at that time to cause gain recognition on the portion of the asset exchanged at the time of the contribution to the partnership. Moreover, if, after the partnership unwinds, a corporate restructuring results in the elimination of gain originally inherent in the contributed asset—for example, a Section 332 liquidation causes Subsidiary stock received from the partnership to disappear—we believe the Deemed Redemption Rule should apply to tax the built-in gain that would otherwise be eliminated in the restructuring.

Another special rule would be necessary in the case of stock of a sister or subsidiary of the corporate partner. If the stock of the affiliate is *issued* as part of the transaction, we believe that the Deemed Redemption Rule should apply immediately. For example, assume Parent contributed an appreciated asset to the partnership, Subsidiary issued stock for cash to a third party and the third party then contributed the Subsidiary stock to the partnership. We believe the Deemed Redemption Rule should apply at the time of the contribution. Such a case is akin to the single corporation case where the partnership acquires corporate partner stock issued to the

[69] Whether or not the corporate stock in the partnership is "affiliate stock" would be determined immediately before the triggering subsequent transaction in accordance with Notice 93-2.

partnership as part of the transaction. In the example, the corporate group has the cash and the partnership has the asset, just as it would if the corporate partner had itself issued the stock acquired by the partnership. In both cases, the transaction seeks to circumvent Sections 1001, 704(c)(1)(B), 737 and 707 while relying on Section 1032 to avoid tax on the receipt of cash by Subsidiary. Moreover, although Section 732(f) might apply to an eventual distribution of the stock of Subsidiary to the corporate partner, we believe the appropriate time to tax is at the time the corporate group receives the cash.

Each of the following examples is intended to illustrate how and when we believe the Deemed Redemption Rule should apply (if at all) to various partnership transactions involving stock of different types of affiliates.

A. Subsidiary is Partner; Partnership Owns Parent Stock

Consider the following example:

> ***Example 7. Liquidating Distribution of Parent Stock to Subsidiary Partner.*** Parent owns 100 percent of the stock of Subsidiary. Subsidiary and Other Partner enter into 50/50 Partnership. Subsidiary contributes Asset A with a basis of $20 and a value of $100 to Partnership. Other Partner (a) contributes Parent stock with a basis and value of $100 or (b) contributes $100 of cash, which Partnership uses to buy Parent stock on the open market or from Parent. After seven years, Partnership makes a liquidating distribution of Parent stock to Subsidiary.

Subsidiary has exchanged an interest in an appreciated asset for an interest in Parent, creating so-called "hook stock."[70] Thus, Parent has indirectly exchanged Asset A for Parent stock, resulting in a contraction of Parent, a *General Utilities* concern.

The tax effect of the transaction differs from a transaction involving corporate partner stock in that the built-in gain in Asset A of $80 is preserved in the Parent stock held by

[70] *See* Land, *supra* note 50, at 54. The transaction results in a contraction of Subsidiary because a portion of the value of the Parent stock is attributable to Subsidiary. However, the extent of such contraction depends on the facts. For example, suppose Parent's assets other than Subsidiary stock are *de minimis*. In such a case, the contraction of Subsidiary would be the same whether Partnership acquires Parent stock or Subsidiary stock because both represent an interest in the same pool of underlying assets. On the other hand, if Parent owns valuable assets other than stock of Subsidiary, the acquisition of the Parent stock is much closer to a value for value exchange for Asset A.

Subsidiary.[71] Section 1032 would not apply to preclude gain recognition on a subsequent disposition by Subsidiary of the Parent stock.[72] However, recognition of the gain inherent in the Subsidiary stock could be avoided by having Subsidiary hold the Parent stock indefinitely.

Alternatively, the gain could be eliminated in a future liquidation of Subsidiary into Parent:

> ***Example 8. Liquidating Distribution of Parent Stock to Subsidiary Partner followed by Liquidation of Subsidiary into Parent.*** Same as Example 7, except that, at the end, after an appropriate waiting period, Subsidiary liquidates into Parent pursuant to Sections 332 and 337. In the liquidation, the Parent stock held by Subsidiary is no longer outstanding.

The gain in the Parent stock will not be recognized by Parent or Subsidiary upon the liquidation of Subsidiary under Sections 332 and 337.[73] Thus, overall, Parent will have acquired $100 of its stock in exchange for an appreciated asset (albeit one that it held indirectly through Subsidiary) without the recognition of gain, a corporate contraction of Parent that raises the same *General Utilities* concern that a May Company transaction involving corporate partner stock raises.[74] While the built-in gain in the asset has been transferred to the Parent stock held by

[71] Section 732(b).

[72] *See* Treas. Regs. § 1.1032-2(c) and 1.1032-3(c).

[73] Indeed, after the liquidation of Subsidiary, Parent could contribute Subsidiary's former assets (other than the Parent stock) to a new subsidiary, resulting in little change to the corporate structure other than the elimination of the Parent stock. Such steps would be candidates for tax-free treatment as a Section 368(a)(1)(C) or (D) reorganization followed by a Section 351 contribution. Section 368(a)(2)(C) (permitting dropdowns after C reorganization); Treas. Regs. § 1.368-2(k) (permitting dropdowns after reorganizations); Treas. Regs. § 1.368-2(k)(2), Example 6 (permitting dropdowns after nondivisive D reorganizations).

[74] Another approach taxpayers have used to disentangle hook stock involves Parent forming a controlled corporation to which Parent contributes assets and liabilities and then Parent distributing the controlled corporation to the subsidiary ("Hook Stock Owner") that owns Parent stock in a Section 355 split-off. *See* PLR 200731025 (Apr. 23, 2007). Indeed, one could question why such split-offs should be tax-free while May Company transactions should not be, as both transactions may involve Parent disposing of low-basis assets in exchange for Parent stock. However, in the Section 355 case, the assets that Parent disposed of (*i.e.*, the assets in the controlled corporation) end up deeper in the corporate structure than where they started, since they end up owned by the controlled corporation which is a subsidiary of Hook Stock Owner which is a subsidiary (generally an indirect subsidiary) of Parent. Thus, the Section 355 split-off does not appear to be a case of avoidance of *General Utilities* repeal. Further, Hook Stock Owner's basis in the controlled corporation stock is the same as the basis that Hook Stock Owner had in its stock in Parent, so gain at that level is not eliminated. Nor is the gain in the appreciated assets eliminated because the controlled corporation would hold the appreciated assets at the same basis they had in the hands of Parent. Finally, this type of Section 355 split-off does not involve disposing of Parent assets to a third party, which is the classic May Company transaction.

Subsidiary, this gain can be easily eliminated. We believe the Deemed Redemption Rule should apply in Example 7 upon formation of the partnership. Where, as in Example 7, there has been a corporate contraction of Parent at the time the partnership is formed, we do not believe that the application of the Deemed Redemption Rule should be deferred until Subsidiary liquidates into Parent.

B. Parent is Partner; Partnership Owns Subsidiary Stock

Next consider transactions in which Parent is a partner in the partnership and the partnership owns Subsidiary stock. On their face, these transactions do not raise *General Utilities* concerns.

> ***Example 9. Liquidating Distribution of Subsidiary Stock to Parent Partner*.** Parent owns 90 percent of the stock of Subsidiary. Partnership is a 50/50 partnership of Parent and Other Partner. Parent contributes Asset A with a basis of $20 and a value of $100 to Partnership. Other Partner contributes the remaining 10 percent of the stock of Subsidiary with a basis and value of $100. After seven years, Partnership distributes Subsidiary stock to Parent in liquidation of Parent's interest.

At the time of formation, Parent has economically exchanged a 50 percent interest in appreciated Asset A for $50 of Subsidiary stock. Unlike Parent stock, Subsidiary stock owned by a third party is a valuable asset in Parent's hands. Thus, even on a pure aggregate theory, this transaction does not resemble a redemption by Parent of its stock in exchange for an appreciated asset. There has been no corporate contraction of Parent or Subsidiary. Rather, Parent has exchanged an appreciated asset, Asset A, for another asset, the stock of Subsidiary. While this may raise Section 1001 policy concerns, as long as the transaction complies with the usual rules intended to police economic exchanges through the use of partnerships (*e.g.*, Section 704(c)(1)(B), Section 721, Section 737), the status of the asset in question as affiliate stock does not appear to raise any special concerns.

Moreover, Subsidiary stock does not provide the same opportunity for avoidance of Section 311(b) as those available with corporate partner stock because Section 1032 does not apply to gain allocated to Parent from a sale of Subsidiary stock. Nor would it apply to a sale by Parent of Subsidiary stock. Further, basis is preserved. Upon the liquidating distribution of the

Subsidiary stock to Parent, Parent would take the Subsidiary stock with a $20 basis under Section 732. Thus, the transaction does not involve a corporate contraction and does not eliminate any built-in gain.

By the same token, if in Example 9, instead of Partnership distributing Subsidiary stock to Parent, Partnership distributed Asset A to the Other Partner, the transaction does not appear to implicate *General Utilities* repeal. Economically, Parent has exchanged Asset A for a 10 percent stake in Subsidiary, raising mixing bowl concerns, but not *General Utilities* concerns.

One could argue, however, that a corporate contraction has taken place by reference to the aggregate assets in corporate solution,[75] rather than the assets held by Parent and the assets held by Subsidiary. In Example 9, Parent exchanges the appreciated asset for an interest in the stock of the Subsidiary. While Parent has exchanged fair value for fair value, the aggregate assets in corporate solution have been reduced (assuming Other Partner is not a corporation), because the stock in Subsidiary acquired by Parent does not add any "real" assets to the corporate tax base. Suppose that in Example 9, private equity fund owned Parent and private equity fund owned the 10 percent stake in Subsidiary not owned by Parent. Following Example 9, suppose Parent contributes an appreciated asset to a partnership and the fund contributes the 10 percent stake in Subsidiary to the partnership. Then, the partnership unwinds, distributing the Subsidiary stock to Parent and the appreciated asset to the fund. The appreciated asset has left corporate solution. Although the 10 percent stake in Subsidiary moved into corporate solution, no new underlying assets have entered corporate solution. Parent has a substituted basis in the 10 percent stake in the Subsidiary. Arguably, the right time to tax would be upon formation of the partnership.

However, on balance, we are not convinced that corporate contractions of this kind should be subject to current tax. First, the contraction does not rely on Section 1032 or any other nonrecognition provision under Subchapter C to avoid tax. The same contraction of the corporate tax base would occur if the fund contributed *any* corporate stock. Second, the

[75] A similar argument could be made by reference to the aggregate assets of the affiliated group of which Parent is the common parent.

phenomenon is not limited to transactions involving partnerships, as a contraction of the corporate tax base occurs whenever a corporation buys corporate stock for cash from an individual. The cash leaves the corporate tax base, while no new “real” assets enter the corporate tax base. Since the Code does not generally impede such corporate contractions, understood in this broad sense, we do not believe that the Proposed Regulations should do so.

It could be argued that the conversion of built-in gain in an asset into built-in gain in stock should give rise to a current tax under the Deemed Redemption Rule. First, asset basis is usually depreciable or amortizable and is therefore more valuable than stock basis. But the status of stock as a nondepreciable asset is true of all stock, not just affiliate stock. Second, a corporation is less likely to dispose of subsidiary stock, resulting in greater potential for permanent deferral of gain. The potential for permanent gain deferral is a concern. Although we believe it is a close call as to whether the Deemed Redemption Rule should apply to Example 9, we do not believe the potential for permanent deferral justifies imposing tax under the rubric of Section 337(d), because, as discussed, there has been no corporate contraction in the traditional sense, the transaction does not rely on Section 1032 or any other corporate non-recognition rule and the built-in gain is preserved.

Some might argue, however, that Parent’s ability to liquidate Subsidiary tax-free under Section 332 justifies the immediate application of the Deemed Redemption Rule. A future liquidation under Section 332 would render Parent’s basis in Subsidiary stock meaningless (thus effectively rendering Parent’s basis in its partnership interest as well as its original basis in Asset A meaningless as well). Indeed, we believe that if Parent does effect a restructuring such as a liquidation or merger of Subsidiary into Parent under Section 332 or 368 such that the built-in gain that was inherent in Asset A is eliminated, the Deemed Redemption Rule should apply at that time.[76] The premise of not taxing the going-in transaction was that, like a normal mixing bowl transaction, gain would be preserved. If the gain is eliminated in reliance on a corporate nonrecognition provision of the Code, such as Section 332 or 368, tax should be imposed. While

[76] Because Parent would recognize gain, there should be a corresponding increase in the basis in Asset A to avoid a result harsher than under the Deemed Redemption Rule. This basis increase could be difficult to administer, however, in that Asset A would be owned at such time by a third party.

there has not been a corporate contraction, the transaction is of greater concern than typical mixing bowl transactions, because it exploits the nonrecognition provisions of Subchapter C to eliminate the gain inherent in the appreciated asset originally held by Parent. Before an actual liquidation of Subsidiary, we would not apply the Deemed Redemption Rule. Neither the going-in transaction nor the exit results in a corporate contraction from the perspective of Parent, relies on corporate nonrecognition provisions, effects an elimination of corporate level gain or increases the basis in Subsidiary's assets.

We note that it is possible that Section 732(f) could apply to the transaction at the time that the Subsidiary stock is distributed to Parent. Under Section 732(f), if stock of a corporation is distributed by a partnership to a corporate partner, and, after the distribution, the corporate partner controls the distributed corporation (*i.e.*, owns stock meeting the requirements of Section 1504(a)(2)),[77] then the basis of the assets of the distributed corporation must be reduced by an amount equal to the excess of (i) the partnership's basis in the stock of the distributed corporation immediately before the distribution over (ii) the corporate partner's basis in the stock of the distributed corporation immediately after the distribution. However, under Section 732(f)(3)(A), the basis of the distributed corporation's assets need not be reduced below the corporate partner's basis in the stock of the distributed corporation.[78] Further, the basis of the assets of the distributed corporation may not be reduced below zero. To the extent that the distributed corporation's aggregate basis in its assets is less than the otherwise required basis reduction, the corporate partner must recognize gain equal to the amount of such excess. In Example 9, Parent would take the Subsidiary stock distributed to Parent with a basis of $20, as compared to the $100 basis that Partnership had in the Subsidiary stock. Thus, Subsidiary would generally be required to reduce Subsidiary's basis in its assets by $80 (but not below $20) or gain would be required to be recognized to the extent that $80 (or such otherwise required basis

[77] The corporate partner must either (1) control the distributed corporation immediately after the distribution or (2) demonstrate that the distribution was not part of a plan to acquire control of the distributed corporation. Section 732(f)(2).

[78] The amount of such reduction cannot exceed the excess of (i) the sum of the aggregate basis of the property of the distributed corporation and the amount of cash held by such corporation over (ii) the corporate partner's basis in its partnership interest. Section 732(f)(3)(A).

reduction) exceeds Subsidiary's basis in its assets. In such a case, Parent's built-in gain of $80 in Asset A would be preserved in Subsidiary's assets.

If Section 732(f) applied to the distribution of Subsidiary stock to Parent upon the unwind of the partnership, then there may be no need in every case to apply the Deemed Redemption Rule upon a liquidation of Subsidiary into Parent, as Section 732(f) would appear to preserve the built-in gain in Asset A in the assets of Subsidiary.[79] However, the precise interaction between Section 732(f) and the Deemed Redemption Rule would need to be considered further to ensure that the built-in gain in Asset A is not eliminated altogether without tax. For example, Section 732(f) has no effect if Subsidiary's basis in its assets is lower than Parent's basis in the stock of Subsidiary. In such event, it appears that Section 732(f) does nothing to preserve or tax the gain in Asset A.

One might argue that because Section 732(f) imposes tax before any subsequent internal restructuring actually results in the elimination of gain embedded in Subsidiary stock, it is, by analogy, not appropriate to defer application of the Deemed Redemption Rule. In effect, this would support imposition of tax at the time the partnership is formed or perhaps when the affiliate stock is distributed by the partnership to the corporate partner. As noted, imposing tax at the time of formation or the time of distribution would avoid the tracing complexities associated with an approach that defers tax until built-in gain is actually eliminated.

Assuming that final regulations do not apply the Deemed Redemption Rule when Parent becomes a partner in a partnership that owns Subsidiary stock, consider a case where we believe a subsequent transaction does raise the specter of avoidance of *General Utilities* repeal:

> ***Example 10. Parent Contributes its Interest in Partnership to Subsidiary Followed by a Liquidating Distribution of Subsidiary Stock Held by the Partnership to Subsidiary.*** Same facts as Example 9, except that after an

[79] Similarly, Section 755(c) could apply if Asset A is distributed to Other Partner. Specifically, Section 755(c)(1) provides that the required basis decrease may not be allocated to corporate partner stock or to stock in "any person related (within the meaning of sections 267(b) and 707(b)(1)) to such corporation." To the extent Section 755(c) did apply to a distribution of Asset A to Other Partner where the partnership owns stock of the corporate partner's affiliate, the interaction between the Deemed Redemption Rule and Section 755(c) would need to be considered to ensure that the gain in Asset A is preserved or recognized, but not taxed twice.

> appropriate waiting period following the formation of Partnership, Parent contributes its interest in Partnership to Subsidiary in exchange for Subsidiary stock in a Section 351 transaction. After an additional waiting period (more than seven years after the original contributions to Partnership), Partnership distributes Subsidiary stock to Subsidiary in liquidation of its Partnership interest.

From Parent's perspective, this transaction, like Example 9, does not appear to implicate *General Utilities* repeal. Parent has not contracted. Parent has exchanged Asset A for an additional interest in Subsidiary in a manner that does not run afoul of the mixing bowl rules. The subsequent Section 351 contribution does not appear to affect this conclusion because Parent's economic position has not changed in any meaningful sense. Rather, Parent merely exchanged its direct interest in the partnership for an indirect interest held through Subsidiary.

From the perspective of Subsidiary, however, the analysis is more nuanced. Applying the aggregate approach to partnerships relied upon by the Deemed Redemption Rule, at the time of the Section 351 contribution, Subsidiary acquires indirectly a 50 percent interest in Asset A and a five percent interest (50 percent of 10 percent) in its own stock. Viewed from the Subsidiary's perspective alone, the transaction is arguably not akin to a redemption, because Subsidiary is not giving up an interest in any asset that it owned in exchange for an interest in Subsidiary stock. Thus, one might conclude that there is no deemed exchange that implicates *General Utilities* repeal at the time of the Section 351 contribution, because the deemed exchange occurred at the time of the formation of the partnership—when Parent economically exchanged 50 percent of Asset A for 50 percent of the Subsidiary stock contributed by Other Partner.

However, we believe that this analysis would allow corporate subsidiaries to avoid the Deemed Redemption Rule. Suppose that the sequence of steps in Example 10 was changed so that (1) Parent first contributed appreciated Asset A to Subsidiary in a Section 351 transaction and (2) Subsidiary then entered into the partnership with Other Partner directly by contributing Asset A to the partnership. So modified, the transaction evokes the May Company transaction albeit with a newly acquired low-basis asset of Subsidiary rather than a historic asset of Subsidiary. The Deemed Redemption Rule would apply to step (2). If the Deemed Redemption Rule did not apply at the time of the Section 351 transaction in (original) Example 10, parties could avoid the Deemed Redemption Rule by simply changing the order of the steps. Thus, the primary concern in Example 10 is not corporate contraction, but the potential for gain elimination under Sections 351 and 1032.[80] A corporate contraction would occur if Subsidiary held the asset historically and then entered into the partnership. Upon the Section 351 contribution that occurs in Example 10, the value of Subsidiary increases by the value of its share of the interest in Asset A held through the partnership. Nonetheless, once the contribution occurs, the potential for gain elimination is enhanced, and the transaction becomes of greater concern than a typical mixing bowl transaction.

We note that in Example 10, built-in gain is preserved in the stock in Subsidiary received by Parent in the Section 351 contribution. One could argue that this preservation of built-in gain should be sufficient to avoid gain recognition at the time of the Section 351 contribution, noting that, with respect to Example 9, we viewed the preservation of built-in gain in affiliate stock as a sufficient justification for continued deferral of the gain. But we view Examples 9 and 10 differently. As mentioned above, Example 9 does not depend on Section 1032, while Example 10 does, as Section 1032 protects Subsidiary against gain recognition in respect of the Subsidiary stock. Example 10 also raises the sequencing issue described above, while Example 9 does not.

Another caveat applies to the notion that the Deemed Redemption Rule should not apply if Parent becomes a partner in the partnership which acquires Subsidiary stock. Specifically, if Subsidiary issues the stock as part of the transaction, we believe the Deemed Redemption Rule should apply. As discussed, Section 311(b) is meant not only to police corporate contractions, but to backstop Section 1001 as well. If Subsidiary issues its own stock as part of the transaction, the transaction is an end-run around Section 1001, because the corporate group obtains cash tax-free ostensibly under Section 1032, while also disposing of an appreciated asset. Given the ease with which cash can be moved around the group, this transaction seems as troubling as the single corporation case involving a primary issuance by the corporate partner. We therefore believe the Deemed Redemption Rule should apply.

[80] We note that gain would be preserved in Parent's basis in Subsidiary stock. Unlike Example 9, however, Example 10 takes advantage of Section 1032 to eliminate gain and thus seems closer to the heart of the Proposed Regulations.

Accordingly, we continue to believe that, as a conceptual matter, the Deemed Redemption Rule should not apply where Parent becomes a partner in a partnership that owns Subsidiary stock. However, the Proposed Regulations should clarify that when Subsidiary becomes a partner in a partnership that owns Subsidiary stock (whether by virtue of a Section 351 contribution of the partnership interest to Subsidiary by Parent or otherwise), the Deemed Redemption Rule will apply at such time as if the Subsidiary contributed the appreciated asset in question at that time. We do not believe that it is appropriate to wait until the Subsidiary stock is distributed to Subsidiary. At that time, the Distribution Rule, if it were finalized, would apply. However, we do not believe that Example 10 merits more lenient treatment than situations where only one corporation is involved. Finally, we believe that if the Subsidiary stock is issued as part of the transaction, the Deemed Redemption Rule should apply. Further, if after the unwind of the partnership, the built-in gain is eliminated in reliance on a corporate nonrecognition provision, the Deemed Redemption Rule should also apply to cause recognition of the built-in gain inherent in Asset A at the time of contribution to the partnership.

C. Subsidiary is Partner; Partnership Owns Sibling Stock

The principles that should apply to transactions involving brother-sister subsidiaries are generally extensions of those applicable to parents and subsidiaries. In these transactions, one subsidiary is a partner, while the partnership owns stock in the other. Consider the following example.

> ***Example 11. Brother-Sister; Other Partner.*** Parent directly owns 100 percent of the stock of Subsidiary One and 90 percent of the stock of Subsidiary Two. Partnership is a 50/50 partnership of Subsidiary One and Other Partner. Subsidiary One contributes Asset A with a basis of $20 and a value of $100. Other Partner contributes 10 percent of the stock of Subsidiary Two to Partnership worth $100. After seven years, Partnership distributes the Subsidiary Two stock to Subsidiary One in liquidation of Subsidiary One's partnership interest.

Example 11 is similar to Example 9. At the time of formation of the partnership, Subsidiary One has economically exchanged a 50 percent interest in Asset A for $50 of Subsidiary Two stock. Subsidiary One is entitled to no special nonrecognition treatment in relation to Subsidiary Two stock. Furthermore, there has been no corporate contraction (at least looked at from the perspective of Parent, Subsidiary One and Subsidiary Two separately). The transaction does not resemble a redemption. Rather, the transaction is again a typical mixing bowl transaction and does not appear to raise any special concerns.

However, as was the case with respect to the transactions in which Parent is a partner and the partnership owns Subsidiary stock (discussed in Part V.B above), a subsequent transaction may raise the specter of avoidance of *General Utilities* repeal. For example, suppose that after the formation of Partnership (and before the distribution of the Subsidiary Two stock by Partnership), Subsidiary One and Subsidiary Two merge. The end result is a classic May Company transaction, where a partnership owns the stock of its corporate partner. Or, suppose instead that, after the formation of Partnership, Parent either (1) contributes the stock of Subsidiary One to Subsidiary Two or (2) Subsidiary Two is merged into Parent. In either case, the end result is identical to Example 7, namely, where Subsidiary is a partner in a partnership that owns Parent stock.

On a strict application of the aggregate theory, it appears that none of these subsequent transactions result in an economic exchange of Asset A for stock of Subsidiary Two (or its successor) because this economic exchange already took place when Partnership was formed. However, the subsequent transactions for the first time present the possibility of avoidance of *General Utilities* appeal through the interaction of the regular partnership rules with Section 1032. Further, these subsequent transactions result in structures that, had the order of the steps been reversed, would clearly implicate the abuse that the Proposed Regulations aim to prevent, such as, Example 7 and the classic May Company transaction itself. We believe that the failure to apply the Deemed Redemption Rule at the time that a subsequent transaction of this nature is effected would make it too easy for members of affiliated groups to circumvent the Deemed Redemption Rule.

By the same token, suppose that no restructuring occurs while the partnership exists but that after the partnership distributes the 10 percent of Subsidiary Two to Subsidiary One, Subsidiary Two merges into Subsidiary One in a Section 368(a)(1)(A), (C) or (D) reorganization. Subsidiary One's stock in Subsidiary Two disappears, along with the potential to tax the built-in gain inherent in the appreciated asset. This seems like an appropriate time to tax. While the transaction did not raise corporate contraction concerns, the reliance on corporate nonrecognition provisions to eliminate the gain inherent in the appreciated asset makes the overall transaction more of a concern than a typical mixing bowl.

On the other hand, not all subsequent transactions that shift the ownership of the Partnership interest among group members raise the same concerns. For example, suppose that, after the formation of Partnership, Parent either (1) contributes stock of Subsidiary Two to Subsidiary One or (2) Subsidiary One is merged into Parent, with Parent receiving Subsidiary One's interest in Partnership in the merger. The end result in either alternative is Example 9, namely where a parent is a partner in a partnership that owns stock of a subsidiary. As discussed above in connection with Example 9, the potential for the abuse that the Proposed Regulations are aimed at does not arise at this stage, in part because Section 1032 is not yet available to secure the permanent elimination of gain (although, as discussed, further subsequent transactions may change this result).

Accordingly, we believe that final regulations should modify the affiliate stock rules of the Proposed Regulations so that the Deemed Redemption Rule would apply when a subsidiary invests in a partnership that holds or acquires stock of the subsidiary's direct or indirect parent. This situation involves the indirect economic exchange by the parent of an appreciated asset for its stock. The only difference from the classic May Company transaction is that both the asset and the stock are indirectly owned by the parent. In general, the Deemed Redemption Rule should not apply if a corporation enters into a partnership that holds or acquires stock of the corporation's subsidiary or sister, unless and until it is triggered by a subsequent intragroup transaction that places the partnership interest in the hands of the issuer of the corporate stock or of a subsidiary of the issuer or, in reliance on Subchapter C nonrecognition provisions, eliminates the built-in gain originally inherent in the appreciated asset.

Assuming that the Proposed Regulations are modified to incorporate these principles, the Deemed Redemption Rule should apply to certain cases where a corporation contributes an asset to a partnership which acquires stock in a *partial* owner of the corporation. In such cases, we believe that the Deemed Redemption Rule should apply to the gain inherent in the portion of the appreciated asset indirectly disposed of by the parent shareholder. Consider the following example:

Example 12. Partial Parent. Parent directly owns 90 percent of the stock of Subsidiary One and 30 percent of the stock of Subsidiary Two. Subsidiary One directly owns the remaining 70 percent of Subsidiary Two. Partnership is a 50/50 partnership of Subsidiary Two and Other Partner. Subsidiary Two contributes Asset A with a basis of $20 and a value of $100. Other Partner contributes 10 percent of the stock of Subsidiary One. After seven years, Partnership distributes the Subsidiary One stock to Subsidiary Two in liquidation of Subsidiary Two's partnership interest.

Although Subsidiary One only owns 70 percent of Subsidiary Two, Subsidiary Two is considered an affiliate of Subsidiary One for purposes of the Deemed Redemption Rule because, immediately before the relevant transaction, Subsidiary One and Subsidiary Two are members of the same affiliated group as defined in Section 1504(a).[81] We believe that the formation of the partnership in this example is the appropriate time to apply the Deemed Redemption Rule as it involves a subsidiary partner in a partnership (Subsidiary Two) that owns stock of its parent (Subsidiary One). However, in this case, tax should not be imposed on 50 percent of the appreciation in Asset A as in the other examples. In this example, Subsidiary Two has economically exchanged 50 percent of Asset A for $50 of Subsidiary One stock. However, only 70 percent of this exchange is indirectly effected by Subsidiary One. In other words, Subsidiary One has economically exchanged only its 70 percent indirect interest in one half of Asset A (or 35 percent of Asset A) for an indirect interest in $35 of its stock. The remainder of the exchange is indirectly attributable to Parent, which merely exchanged its indirect interest in a portion of one appreciated asset (30 percent of Asset A) for an indirect interest in a portion of another appreciated asset, Subsidiary One stock, of the same value.

D. All-in-the-Family

Finally, consider transactions effected entirely within an affiliated group:

Example 13. Parent-Subsidiary Partnership; Subsidiary Stock. Parent directly owns 100 percent of the stock of Subsidiary. Partnership is a 50/50 partnership of Subsidiary and Parent. Subsidiary contributes Asset A with a basis of $20 and a value of $100. Parent contributes stock of Subsidiary. After seven years, Partnership distributes the stock of Subsidiary to Subsidiary in liquidation of Subsidiary's partnership interest.

[81] *See* Notice 93-2, 1993-1 C.B. 292.

Because the value of Subsidiary has decreased, this transaction raises the same concerns as the classic May Company transaction even though it effects the contraction entirely among related entities. Accordingly, we do not believe that any special rules are necessary. Under the Deemed Redemption Rule, Subsidiary will be taxed on the deemed exchange of 50 percent of Asset A for $50 of its stock. The exchange of Subsidiary's remaining 50 percent interest in Asset A for the other $50 of its stock (assuming no change in values) will be caught by the Deemed Redemption Rule at the time of the liquidating distribution by Partnership.[82]

Consider next the converse of Example 13:

> **Example 14: *Parent-Subsidiary Partnership; Parent Stock*.** Parent directly owns 100 percent of the stock of Subsidiary. Partnership is a 50/50 partnership of Subsidiary and Parent. Parent contributes Asset A with a basis of $20 and a value of $100. Subsidiary contributes stock of Parent. After seven years, Partnership distributes the stock of Parent to Parent in liquidation of Parent's Partnership interest.

At first blush it appears that this example, like Example 13, involves a classic May Company transaction that should trigger the immediate application of the Deemed Redemption Rule (even if the rule were limited in the affiliate context in accordance with our discussion above in this Part V). Under the aggregate theory, it does seem that Parent has exchanged 50 percent of Asset A for $50 of its stock. But, this is not entirely correct because, assuming the stock was a historic asset of Subsidiary, Parent owned such stock even before Partnership was formed, albeit indirectly through its ownership of Subsidiary. In addition, Parent continues to own Asset A indirectly. Thus, Parent has not contracted. Moreover, Subsidiary has not contracted in that Subsidiary exchanged an interest in Parent stock for Asset A. As to whether the transaction raises any special Section 1001 concerns, note that Parent could have simply contributed Asset A to Subsidiary in a Section 351 transaction. Subsidiary would have taken the asset with a carryover basis, while in Example 14, Subsidiary would generally take a basis equal

[82] It may be appropriate to allow the gain recognized at formation and upon distribution to be deferred under the consolidated return regulations. Absent a special rule to this effect, however, neither transaction would qualify for deferral because a partnership cannot be a member of a consolidated group. *See* Treas. Regs. § 1.1502-13(b)(1)(i). Yet, the theory for imposing tax under the Deemed Redemption Rule is that the partnership is a mere aggregate of its member partners, both of whom *are* members of a consolidated group in this example.

to Subsidiary's basis in the Parent stock that was contributed. Thus, if Subsidiary had a high basis in the Parent stock, the transaction could be a way to shift that high basis to the asset. By the same token, Section 1032 would protect Parent against gain recognition on the Parent stock in the Partnership. Thus, despite the fact that Example 14 does not appear to involve a corporate contraction, it does appear to warrant the usual application of the Deemed Redemption Rule upon formation.

Finally, an example involving an all-in-the-family brother-sister partnership:

> ***Example 15. Brother-Sister; no Other Partner.*** Parent directly owns 100 percent of the stock of each of Subsidiary One and Subsidiary Two. Partnership is a 50/50 partnership of Subsidiary One and Parent. Subsidiary One contributes Asset A with a basis of \$20 and a value of \$100. Parent contributes the stock of Subsidiary Two. After seven years, Partnership distributes Subsidiary Two to Subsidiary One in liquidation of Subsidiary One's Partnership interest.

As in Example 11, the application of the Deemed Redemption Rule does not, in general, seem appropriate with respect to any of the steps of this transaction. The transaction involves a partnership mixing bowl situation. While it arguably circumvents Section 311(b) because Subsidiary One's interest in Asset A has been transferred to Parent without recognition of gain, this result did not depend on Parent contributing stock of a member of the affiliated group, as compared with any other type of asset. The same result could have been obtained if Parent had contributed land or operating assets, rather than stock of Subsidiary Two. Thus, in the case of members filing a consolidated return, this transaction seems better policed by Treasury Regulation Section 1.1502-13, the intercompany transaction regulations. Indeed, Treasury Regulation Section 1.1502-13(h) contains an anti-abuse rule requiring adjustments to be made to carry out its purposes if a transaction "is engaged in or structured with a principal purpose to avoid the purposes" of the Regulation. Treasury Regulation Section 1.1502-13(h), Example 4, sets forth an example of a partnership mixing bowl that does not pass muster.[83]

[83] Treas. Regs. § 1.1502-13(h), Example 4 (transfer of low basis intangible from one member to partnership followed by distribution of intangible to other member with putatively high basis).

In the case of related corporations not filing a consolidated return, Treasury Regulation Section 1.1502-13(h) would of course not apply. A transaction that could be of concern would be Example 15 where Subsidiary One and Subsidiary Two are foreign, while Parent is domestic. In that case, the transaction would effect a repatriation of Asset A without tax. This result does not seem appropriate, but, again, the transaction does not hinge on Parent contributing stock of an affiliated corporation, as opposed to any other type of asset and thus seems better handled by a more general rule.

VI. <u>**Effective Date and Transition Considerations**</u>

As noted above in Part III, Notice 89-37 proposed that the Proposed Regulations would be effective for transactions occurring after March 9, 1989. While such an effective date might have been reasonable at the time, we do not believe that such extreme retroactivity is appropriate. We believe that the Deemed Redemption Rule should apply to transactions occurring after the Proposed Regulations are finalized, or, if the IRS and Treasury repropose the regulations, then we believe it would be appropriate to apply the Deemed Redemption Rule to transactions occurring after the date of the reproposal. Thus, assume the Proposed Regulations are reproposed on August 31, 2012. We believe it would be appropriate for the Deemed Redemption Rule to apply to economic exchanges of appreciated assets for corporate stock occurring after August 31, 2012.

Further, now that so much time has passed since Notice 89-37, we believe that the Distribution Rule might no longer be needed, even as a transition rule. As noted above, we oppose the Distribution Rule as a general matter but stated in the 1989 NYSBA Report that we did not oppose the Distribution Rule as a transition rule to catch transactions, as described above, where the going-in phase occurs before the effective date of the Deemed Redemption Rule and the exit phase occurs afterwards ("Straddle Transactions").

While we continue to believe that the Distribution Rule could reasonably be applied as a transition rule, another approach—the Deemed Redemption Rule with a catch-up—could be conceptually clearer. The Deemed Redemption Rule can apply to a non pro rata distribution by a partnership, namely, where the non pro rata distribution effects an economic exchange by a corporate partner of an appreciated asset for corporate stock. Thus, if the exit phase occurs by either a distribution of the corporate partner stock to the corporate partner or a distribution of the appreciated asset to the other partner, the Deemed Redemption Rule will apply by its terms. To catch Straddle Transactions, the Deemed Redemption Rule could apply with a catch-up. Instead of taxing only the appreciation in the portion of the asset exchanged upon the non pro rata distribution, for Straddle Transactions, the Deemed Redemption Rule could also apply to the appreciation in the portion of the appreciated asset exchanged in the going-in phase.

Assume again that the Proposed Regulations are reproposed on August 31, 2012 and effective for transactions after that date. An economic exchange of appreciated assets for corporate stock (*e.g.*, a going-in transaction) occurring on or before August 31, 2012 would not be covered. However, if the parties unwind that partnership by causing the partnership to distribute corporate partner stock to the corporate partner after August 31, 2012, the Distribution Rule could apply to such distribution. Alternatively, if the parties unwind the partnership (assume it is a 50/50 partnership) by causing the partnership to distribute corporate partner stock to the corporate partner or the appreciated asset to the other partner after August 31, 2012, the Deemed Redemption Rule would apply to those distributions, and such rule could be applied to capture not only the gain on the half of the asset deemed exchanged upon the distribution but also the gain on the half of the asset deemed exchanged upon the going-in transaction. A virtue of the latter approach is that it would apply equally whether the exit is effected via a distribution of the corporate stock or a distribution of the asset,[84] while the Distribution Rule only applies to a distribution of stock.

Given that the Deemed Redemption Rule will apply in any event to the exit stage of a Straddle Transaction, the question whether to impose the Distribution Rule or the Deemed Redemption Rule with a catch-up, as compared to having no special rule for Straddle Transactions, relates to how much gain will be taxed upon the exit. Both the Distribution Rule and the Deemed Redemption Rule with a catch-up aim to capture the total amount of gain in the appreciated asset at the time it was contributed.

[84] *Cf.* Treas. Regs. § 1.731-2(h)(2) (permitting a distribution of substantially all the assets of a partnership other than marketable securities and money to be treated as a distribution of marketable securities).