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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
MEMORANDUM FOR ASSOCIATE AREA COUNSEL

FROM: ASSOCIATE CHIEF COUNSEL
CC:PSI

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated October 31, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

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LEGEND

Partnership =

Property =

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City =

Company 1 =

Upper-Tier 1 =

Upper-Tier 2 =

Individual 1 =

Individual 2 =

Individual 3 =

Company 2 =

Bank =

Lower-Tier 1 =

Lower-Tier 2 =

a =

b =

c =

d =

ISSUES

1. When the Partners' interests in their upper-tier partnerships, Upper-Tier 1 and 2, are liquidated through distributions that include interests in subsidiary Partnership, whether an exchange occurs with respect to the distributed interests in Partnership that results in a termination of Partnership under § 708(b)(1)(B) of the Internal Revenue Code and a step-up in the basis of its Property?
2. Whether Partnership's distribution of partnership interests in Lower-Tier 1 and 2, which held newly acquired short-term Debt Instruments contributed by Partnership, should be treated as a distribution of property for purposes of § 731(a) and whatever adjustment is made in Partnership's inside basis in its Property under § 734?

CONCLUSIONS

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1. Based upon the information provided, we conclude that the liquidation of Upper-Tier 1 and 2 by distributions that included interests in subsidiary Partnership resulted in the termination of Partnership under § 708(b)(2)(B), resulting in a deemed contribution by terminated Partnership of its Property, the basis of which is determined under § 723, to a deemed new Partnership.
2. Based upon the information provided, we conclude that Partnership's distribution of partnership interests in Lower-Tier 1 and 2, which held short-term Debt Instruments, should be treated as a distribution of marketable securities under § 731(c) for which the Partners must recognize any gain. We also conclude that any adjustment to Partnership's inside basis in its Property under § 734 would be appropriate.

FACTS

Partnership was formed in _____ for the sole purpose of owning and operating property, Property, located in City. The relevant transactions for purposes of this memorandum involved a liquidation of two upper-tier partnerships holding interests in Partnership followed by Partnership's distribution of interests in lower-tier partnerships holding newly acquired short-term instruments.

Prior to the liquidating event on a, Partnership was owned as follows: Upper-Tier 1, _____ percent limited partner, and Upper-Tier 2, _____ percent limited partner ("Upper-Tier Partnerships"); and Company 1, _____ percent general partner. Upper-Tier 1, a general partnership with no direct liabilities and no assets other than its interest in Partnership, was owned by Individual 1, Individual 2, and Individual 3, each with a _____ percent interest. Upper-Tier 2, a partnership with no direct liabilities and no assets other than its interest in Partnership, was owned by Company 2, with a _____ percent interest; and Individual 1, with a _____ percent interest. Company 1 is wholly owned by Individual 1. Company 2 is partially owned by Individual 1 and Individual 2.

On a, both Upper-Tier Partnerships liquidated by distributing their respective interests in Partnership to their partners. After the liquidation, Partnership was owned as follows: Company 1, _____ percent general partner; Company 2, _____ percent limited partner; Individual 1, _____ percent limited partner; Individual 2, _____ percent limited partner; and Individual 3, _____ percent limited partner ("Partners"). The Partners determined the bases in their interests in Partnership to be the same as their respective bases in their interests in the Upper-Tier Partnerships.

Following the liquidation of the Upper-Tier Partnerships, Partnership borrowed \$b from the Bank on c. Partnership used the loan proceeds to purchase short-term (nine-month) debt instruments issued by the Bank. Partnership immediately contributed \$d of the debt instruments ("Debt Instruments") to two newly formed subsidiary partnerships, Lower-Tier 1 and Lower-Tier 2 ("Lower-Tier Partnerships").

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Partnership then distributed its interests in the Lower-Tier Partnerships to the Partners.

Partnership had a cost basis in the Debt Instruments contributed to the Lower-Tier Partnerships, so Partnership received a carryover basis in its interests in the Lower-Tier Partnerships. The Partners had a significantly lower aggregate basis in their interests in Partnership. The Partners have taken the position that the distribution of the interests in the Lower-Tier Partnerships should be treated as a distribution of property subject to the limitation of § 732(a)(2). This treatment results in a § 734 adjustment to increase the basis in the remaining property held by Partnership, Property.

LAW AND ANALYSIS

Issue 1

Section 708(b)(1)(B) provides that for purposes of § 708(a), a partnership is considered terminated if within a 12 month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Section 1.708-1(b)(1) of the Income Tax Regulations provides, in part, that a partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

Section 1.708-1(b)(2) provides, in part, that a partnership shall terminate when 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such a sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this § 1.708-1(b)(2). Moreover, if the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.

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Section 1.708-1(b)(4) provides, in part, that if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with § 1.708-1(b)(1)(i). This § 1.708-1(b)(4) applies to terminations of partnerships under § 708(b)(1)(B) occurring on or after May 9, 1997.

Section 761(e) provides that except as otherwise provided in regulations, for purposes of § 708 (relating to continuation of partnership), § 743 (relating to optional adjustment to basis of partnership property), and any other provision of subchapter K specified in regulations prescribed by the Secretary, any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

In Rev. Rul. 92-15, 1992-1 C.B. 215, the Service ruled on two situations in which there are distributions of property to a partner from a partnership that owns an interest in another partnership and both entities have optional basis adjustment elections under § 754 in effect. In the second situation, an upper-tier partnership, UTP, distributes its partnership interest in a lower-tier partnership, LTP, in order to reduce the 50 percent interest in UTP of A, a partner, to 33 percent. The distribution reduces the value of A's partnership interest in UTP to 80x dollars. The ruling holds that if partnership UTP distributes its interest in LTP to a partner of UTP while both partnerships have § 754 elections in effect, and if § 732(a)(2) applies to the distributed partnership interest, UTP increases the basis of its undistributed property to the extent provided in § 734(b)(1)(B). Relevant to the issue in this case, the ruling's analysis recognizes that under § 761(e) UTP's distribution of its interest in LTP is treated as an exchange of a 10 percent interest in LTP for purposes of the partnership termination provisions in § 708. It also notes that the reduction of A's interest in UTP is not considered a sale or exchange for purposes of section § 708.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at the time.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

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The Upper-Tier Partnerships in this case distributed in liquidation their partnership interests in Partnership to the distributee Partners. The distribution of the interests in Partnership should be treated as an exchange under § 761(e) for purposes of § 708. Because more than 50 percent of the total interests in Partnership capital and profits were exchanged in the distribution, Partnership terminated pursuant to § 708(b)(2)(B).

As a result of its termination under § 708(b)(2)(B), Partnership is deemed to have contributed all of its assets and liabilities to a new Partnership in exchange for an interest in new Partnership. Immediately thereafter, the terminated Partnership is deemed to have distributed its interests in new Partnership to the Partners in proportion to their respective interests in the terminated Partnership in liquidation of the terminated Partnership. Under § 723, the adjusted basis of Property contributed to new Partnership by terminated Partnership should be the adjusted basis of the Property to the contributing partner, terminated Partnership, at the time of the deemed contribution. The Partners' bases in their interests in Partnership should be the same as their respective bases in their interests in the Upper-Tier Partnerships under § 732(b).

Issue 2

Section 732(a)(1) provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in § 732(a)(2), be its adjusted basis to the partnership immediately before the distribution. Section 732(a)(2) provides that the basis to the distributee partner of property to which § 732(a)(1) is applicable shall not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

Section 734(a) provides that the basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in § 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership.

Section 734(b) provides that in the case of a distribution of property to a partner, a partnership, with respect to which the election provided in § 754 is in effect, shall—

(1) increase the adjusted basis of partnership property by—

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under § 731(a)(1), and

(B) in the case of distributed property to which § 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before

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the distribution (as adjusted by § 732(d)) over the basis of the distributed property to the distributee, as determined under § 732, or

(2) decrease the adjusted basis of partnership property by—

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under § 731(a)(2), and

(B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under § 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by § 732(d)).

Section 734(b)(1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in § 754 is not in effect.

Section 731(a)(1) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to the partner, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Any gain recognized under § 731(a) shall be considered as gain from the sale or exchange of the partnership interest of the distributee partner.

Section 731(c)(1) provides that for purposes of § 731(a)(1) and § 737, (A) the term "money" includes marketable securities, and (B) the securities shall be taken into account at their fair market value as of the date of distribution. Section 731(c)(2)(A) provides that for purposes of § 731(c), the term "marketable securities" means financial instruments and foreign currencies that are, as of the date of distribution, actively traded (within the meaning of § 1092(d)(1)). Section 731(c)(2)(B)(ii) provides that the term marketable securities includes any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities. Section 731(c)(2)(B)(v) provides that the term also includes, except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of the entity consist (directly or indirectly) of marketable securities, money, or both.

Section 1.731-2(c)(3) provides that for purposes of § 731(c)(2)(B)(v) and § 1.731-2, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

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Section 731(c)(5) provides that §§ 733 and 734 shall be applied as if no gain were recognized, and no adjustment were made to the basis of property, under § 731(c).

Section 734(a) provides that the basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in § 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to the partnership. Section 734(b)(1)(A) provides that in the case of a distribution of property to a partner, a partnership, with respect to which the election provided in § 754 is in effect, shall increase the adjusted basis of partnership property by the amount of any gain recognized to the distributee partner with respect to the distribution under § 731(a)(1).

The Debt Instruments that were contributed to the Lower-Tier Partnerships had a nine-month term and were to be paid off shortly after the distribution of the interests in the Lower-Tier Partnerships. Therefore, while the Debt Instruments themselves might not be actively traded, they should be treated as financial instruments that were readily convertible into money within the meaning of § 731(c)(2)(B)(ii). Furthermore, because the Debt Instruments would be treated as marketable securities, the interests in the Lower-Tier Partnerships should themselves be treated as marketable securities under § 731(c)(2)(B)(v) rather than property. Thus, the distributions of interests in the Lower-Tier Partnerships should be treated as distributions of money that would potentially subject the distributee Partners to gain recognition under § 731(a)(1). If, as a result of § 731(c), the distributee Partners recognize gain under § 731(a), then, assuming a § 754 election is in effect, no basis adjustment under § 734(b)(1)(A) results from the gain recognized. See § 731(c)(5). However, there would be a basis adjustment under § 734(b)(1)(B) because the distribution of property would be recognized.

Partnership in this case distributed high-basis interests in the Lower-Tier Partnerships to distributee Partners with low bases in their interests in Partnership. Thus, Partnership is claiming a § 734(b)(1)(B) adjustment that increases the basis in its remaining asset, the Property. In this case it appears that the Partnership used the § 754 adjustment to defer gain by allowing the distributee Partners to shift their appreciation from the Partnership's primary asset, the Property, to the distributed property, the interests in the Lower-Tier Partnerships, before any sale of the Property. However, the distribution of the interests in the Lower-Tier Partnerships should be treated as distributions of money under § 731(c) that may result in gain to the distributee Partners under § 731(a). With little or no appreciation in the Debt Instruments, it appears that the gain limitation under § 731(c)(3)(B) would not apply. Any adjustment under § 734(b)(1)(B) to Partnership's basis in its remaining Property as a result of the distribution would be appropriate.

The concern in this case is that it appears the Partners used the rules under subchapter K to defer gain by shifting their appreciation in the Property to the interests in the Lower-Tier Partnerships without recognizing gain. If the distribution

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of the interests in the Lower-Tier Partnerships were not treated as a distribution to which § 731(c) applies, it might be appropriate to apply the anti-abuse rule of § 1.701-2. In addition it might be appropriate to question the validity of the Lower-Tier Partnerships on the grounds that they lack any apparent business purpose and, therefore, economic substance. See ACM Partnership, 73 TCM 2189 (1997); aff'd, rev'd and rem'd TC, ACM Partnership v. Commissioner, 157 F3d 231 (3d Cir. 1998). However, given the litigating hazards in applying the anti-abuse rule of § 1.701-2, we recommend first asserting the special anti-abuse rule under the § 731 regulations.

If the Debt Instruments do not to satisfy the technical meaning of marketable securities under § 731(c)(2), then Section 1.731-2(h) contains an anti-abuse rule that requires the provisions of the statute and regulation to be applied consistently with the purpose of § 731(c) and the substance of the transaction. Under this anti-abuse rule, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of § 731(c), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of § 731(c). Whether a tax result is inconsistent with the purpose of § 731(c) must be determined based on all the facts and circumstances. In this case, the Partnership distributed interests in the Lower-Tier Partnerships, the only assets of which were short term-term Debt Instruments. Because the short-term Debt Instruments were essentially a cash equivalent, it is appropriate to treat them (and the interests in the Lower-Tier Partnerships themselves) as marketable securities under § 731(c)(2)(B)(ii). If, however, § 731(c)(2)(B)(ii) were not applicable by its terms, then it would be appropriate to apply the anti-abuse rule of § 1.731-2(h) in order to prevent avoidance of § 731(c).

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Please call if you have any further questions.

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