FLORIDA TAX REVIEW

VOLUME 3 1998 NUMBER 12

Partnership Distributions: Options for Reform

*Karen C. Burke**

I. INTRODUCTION 678
II. HOT ASSET EXCHANGES: THE STATUTORY FRAMEWORK 680
A. *Goals and Shortcomings of Section 751(b)* 680
B. *Repeal of Section 751(b) and Optional Basis Adjustments* 686
C. *1982 ALI Proposals: Full Fragmentation* 690
III. REPLACING SECTION 751(b) WITH A FULL-RECOGNITION MODEL 693
A. *Extending the Subchapter S Model* 693
B. *Deemed-Sale Approach* 695
C. *Hot Asset Exchanges and Partnership Revaluations* 699
IV. PRESERVING NONRECOGNITION TREATMENT THROUGH BASIS ADJUSTMENTS 704
A. *Hot Asset Exchanges and Inside Basis Adjustments* .. 704
B. *Complete or Partial Liquidations Involving Hot Asset Exchanges* 708
1. *Complete Liquidations* 708
2. *Partial Liquidations* 710
3. *Cash Distributions* 712
4. *Limit on Gain Recognized* 712
C. *A Compromise Proposal: More Gain Recognition* ... 713
V. PROSPECTS FOR THE FUTURE OF SECTION 751(b) 717
A. *Radical Simplification: Repeal of Section 751(b)* 717
B. *Mandatory Revaluation and Gain Recognition* 720
C. *Expanding the Section 704(c) Approach* 725
VI. CONCLUSION 728

* Professor of Law, University of Minnesota Law School. Professor Burke is a Consultant to the American Law Institute's Federal Income Tax Project—Taxation of Pass-Through Entities. Although she has benefited from discussions in connection with the ALI Project, none of the views expressed here should be attributed to the ALI or other participants in the Project.

I. INTRODUCTION

The rise of new forms of limited liability business entities, coupled with changes in the federal tax rules for classifying such entities, has precipitated an influx of businesses that are treated as partnerships for federal tax purposes.[1] Some commentators welcome what they perceive as a process of de facto integration that promises eventually to make an elective regime of pass-through taxation available for all nonpublicly-traded businesses.[2] To the extent that the partnership model, as currently embodied in Subchapter K, represents a coherent and well-functioning body of law, such a sanguine view may be justified. However, as the preliminary work of the American Law Institute (ALI) project on pass-through entities suggests, the intricate provisions of Subchapter K may be "dysfunctional" in important respects.[3]

Indeed, Subchapter K may have reached an important turning point. The 1954 Code drafters stressed simplicity and flexibility while allowing partners considerable latitude in allocating tax benefits and burdens among themselves.[4] With the benefit of hindsight, this tolerant attitude toward shifting tax consequences among partners appears to undermine broader tax policy goals. Concern about the flexibility of partnership taxation—particularly the ease of entry and exit—has led some partnership reformers to veer in the opposite direction.[5] Recent legislative attempts to confine the broad nonrecognition policy of section 721—especially with respect to contributions of property with built-in gain or loss, disguised sales, and distributions of

---

1. See generally William A. Klein & Eric M. Zolt, Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?, 66 U. Colo. L. Rev. 1001 (1995); Karen C. Burke, The Uncertain Future of Limited Liability Companies, 12 Am. J. Tax Pol'y 13 (1995); Susan Pace Hamill, The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question, 95 Mich. L. Rev. 393 (1996); George K. Yin, The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the Box" Regulations, 51 SMU L. Rev. 125 (1997).

2. See generally Jerome Kurtz, The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan, 47 Tax L. Rev. 815 (1992).

3. See American Law Institute, Federal Income Tax Project—Taxation of Pass-Through Entities, Tentative Draft Memorandum No. 2, at 2 (1996) [hereinafter ALI, Pass-Through Entities, Tentative Draft Memorandum No. 2].

4. Beyond stressing the need for "clarification," the 1954 Code drafters emphasized the goals of "simplicity, flexibility, and equity as between the partners." S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4722.

5. For contrasting views on the need for fundamental structural reform, compare Mark P. Gergen, Reforming Subchapter K: Contributions and Distributions, 47 Tax L. Rev. 173 (1991) [hereinafter Gergen, Contributions and Distributions] with John P. Steines, Jr., Commentary—Unneeded Reform, 47 Tax L. Rev. 239 (1991) [hereinafter Steines, Unneeded Reform].

previously contributed property—signal Congressional ambivalence about Subchapter K's unrivaled flexibility.[6]

While contributions and distributions often present different facets of similar problems,[7] the lenient distribution rules of section 731 have, for the most part, escaped similar scrutiny.[8] This relative neglect of partnership distributions is all the more surprising since the "collapsible partnership" rules of section 751(b) represented the 1954 Code's primary bulwark against income-shifting.[9] Because of its daunting complexity and limited enforceability, section 751(b) has been described as the "Achilles heel" of Subchapter K.[10] While section 751(b) is intended to safeguard against the use of distributions to shift ordinary income and capital gain, it also has a significant impact on the timing of recognition. Thus, section 751(b) offers a useful starting point for examining proposed reforms of the partnership distribution rules.

Part II of this article examines the rationale for section 751(b) within the general nonrecognition scheme of the 1954 partnership model and discusses proposals for its modification or repeal. Part III considers whether the nonrecognition policy of section 731 should be replaced, as some writers have suggested, with entity-level taxation or a deemed-sale approach.[11] Part IV explores an alternative approach based on mandatory basis adjustments to prevent partners from manipulating partnership distributions to shift unrealized appreciation.[12] Finally, Part V suggests that section 751(b)-type

---

6. See IRC §§ 704(c)(1), 707(a)(2)(B), 737; see also Regs. § 1.701-2 (warning against use of partnership rules to accomplish results inconsistent with the "intent" of Subchapter K). Unless otherwise indicated, all IRC citations refer to the Internal Revenue Code of 1986, as amended through August 31, 1997.

7. See Gergen, Contributions and Distributions, supra note 5, at 182 ("Why different generations have focused on different parts of a single problem is puzzling.").

8. In 1997, the allocation rules of § 732(c) for distributed property were amended. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34 [hereinafter 1997 Act], § 1061, 111 Stat. 945; see also IRC § 731(c) (requiring gain recognition on certain distributions of marketable securities). For an overview of recent proposals to reform Subchapter K, see Staff of the Joint Committee on Taxation, 105th Cong., 1st Sess., Review of Selected Entity Classification and Partnership Tax Issues (Comm. Print 1997) [hereinafter Selected Partnership Tax Issues].

9. See IRC § 751(b). In 1997, Congress amended § 751(a) but left § 751(b) substantially intact. See IRC § 751(a) (as amended by the 1997 Act, § 1062, 111 Stat. at 946) (eliminating the "substantial appreciation" requirement for inventory).

10. See James S. Eustice, Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals), 39 Tax L. Rev. 345, 383 (1984).

11. See generally Curtis J. Berger, W(h)ither Partnership Taxation?, 47 Tax L. Rev. 105 (1991); Philip F. Postlewaite et al., A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners, 75 Geo. L.J. 423, 464-89 (1986); see also Gergen, Contributions and Distributions, supra note 5, at 202-10.

12. See generally William D. Andrews, Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions, 47 Tax L. Rev. 3 (1991); Noël B. Cunningham, Needed Reform, Tending the Sick Rose, 47 Tax L. Rev. 77 (1991).

treatment be extended to all non-pro rata distributions of partnership assets through mandatory revaluations and special allocations. The Article concludes that improvement of the existing nonrecognition regime, rather than a radical shift toward entity-level taxation, is both practicable and desirable.

II. HOT ASSET EXCHANGES: THE STATUTORY FRAMEWORK

A. *Goals and Shortcomings of Section 751(b)*

In 1954, the ALI identified several major policy objectives concerning the treatment of partnership distributions.[13] It was considered desirable to defer recognition of gain whenever a liquidating distribution consisted mainly of property other than cash, on the ground that immediate taxation might impede flexibility in the choice of business form.[14] To avoid possible "confusion," the ALI considered that distributions in partial liquidation of a partner's interest should be treated under the same rules as current distributions that do not reduce a partner's interest.[15] Another major objective was to prevent the use of partnership distributions as a technique for converting ordinary income into capital gain.[16] Finally, the ALI sought to ensure consistent taxation of a disposition of a business interest by providing similar treatment for a sale of a partnership interest and a sale of partnership assets followed by a distribution.[17]

From the outset, the disproportionate distribution rules of section 751(b) represented the most significant exception to the broad nonrecognition scheme for current and liquidating distributions. Section 751(b) generally treats a distribution that alters the partners' interests in so-called "hot assets" (defined, for this purpose, as unrealized receivables and substantially appreciated inventory) as a deemed exchange between the partnership and the distributee partner.[18] Section 751(b) serves two related

---

13. The ALI described partnership taxation under the 1939 Code as "one of the most complex and confused subjects in the entire area of the income tax." J. Paul Jackson et al., A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft, 9 Tax L. Rev. 109, 112 (1954) [hereinafter Jackson et al., Proposed Revision].

14. See id. at 154.

15. J. Paul Jackson et al., The Internal Revenue Code of 1954: Partnerships, 54 Colum. L. Rev. 1183, 1211 (1954) [hereinafter Jackson et al., Partnerships] (noting that "[a] rule requiring recognition of gain or loss every time a distribution reduced a partner's interest would be complex to apply").

16. See Jackson et al., Proposed Revision, supra note 13, at 154.

17. See id.

18. See IRC § 751(c), (d). The Budget Reconciliation Act of 1993 amended the "substantial appreciation" test and added a new anti-abuse rule for inventory acquired for a "principal purpose" of manipulating the test. See Pub. L. No. 103-66, § 13206(e)(1), 107 Stat. 467 (amending § 751(d)(1)). The 1997 Act eliminated the substantial appreciation requirement

purposes: (1) to prevent the conversion of ordinary income into capital gain and (2) to prevent shifting of ordinary income among partners.[19]

The legislative history indicates that section 751(b) was originally intended primarily as a backstop to section 751(a), which requires a selling partner to treat a portion of her gain as ordinary income on a sale of a partnership interest.[20] Although the House version of section 751 applied to both sales and cash liquidating distributions,[21] the Senate added a separate provision, section 751(b), applicable to "certain distributions treated as sales or exchanges."[22] Section 751(b) was apparently added in response to objections that the House version applied to cash distributions, but not to in-kind distributions of section 751 property.[23]

In the case of a cash liquidating distribution, section 751(b) serves much the same function as section 751(a), the conceptually simpler provision relating to sales of partnership interests. Where applicable, section 751(b) requires that the distributee partner treat a portion of the liquidating distribution as ordinary income just as if she had sold her partnership interest to an outsider or to the continuing partners.[24] Since the continuing partners are in effect acquiring the distributee's interest, the implicit purchase price should be reflected in their basis in the partnership's assets. Any partnership assets involved in the section 751(b) exchange take a "cost" basis in the

---

in connection with sales of partnership interests. See IRC § 751(a), (b) (as amended by the 1997 Act). The definition of unrealized receivables includes certain recapture items. See IRC § 751(c) (flush language).

19. See William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 21.01[2], at 21-4 (3d ed. 1997).

20. See IRC § 751(a); see also Dale E. Anderson & Melvin A. Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (Second Installment), 15 Tax L. Rev. 497, 525-28 (1960).

21. According to the House Report, "[t]he treatment thus provided upon the sale of an interest in [ordinary income assets] is also extended to any distribution by the partnership to a partner which has the same effect as a sale of such ordinary income [assets]." See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 71 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4097.

22. See S. Rep. No. 1622, supra note 4, at 98-99 (1954), reprinted in 1954 U.S.C.C.A.N. at 5034; see also Anderson & Coffee, supra note 20, at 528 ("In effect, the Senate prevented the avoidance of the rules of section 751(a) by a distribution of section 751 property to one partner.").

23. The American Bar Association (A.B.A.) commented that the House version would permit significant tax avoidance if the partnership's ordinary income assets were distributed to a low-bracket taxpayer. See Anderson & Coffee, supra note 20, at 527.

24. Indeed, the transaction could be structured as a distribution of cash to the continuing partners immediately following a purchase of the retiring partner's interest. See Andrews, supra note 12, at 11. This article does not address special problems that may arise if liquidating payments are made to a retiring partner over a period of years. See IRC § 736. See generally James E. Tierney, Reassessing Sales and Liquidations of Partnership Interests After the Omnibus Budget Reconciliation Act of 1993, 1 Fla. Tax Rev. 681 (1994).

hands of the partnership as constituted following the distribution. If the partnership has a section 754 election in effect, the optional basis adjustment provisions of section 734(b) ensure that "inside" basis[25] is adjusted to reflect any gain (or loss) recognized by the distributee on the nonsection 751(b) portion of the distribution.[26]

For example, assume that C receives a cash liquidating distribution of $300 when the equal ABC partnership has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$300	$300	A	$200	$300
Inventory	150	300	B	200	300
Land	150	300	C	200	300
Total	$600	$900	Total	$600	$900

Under section 751(b), C is treated as if she had received her proportionate share of the hot asset (worth $100) in a current distribution; under section 732(a), C takes a basis of $50 in her one-third share of the hot asset, reducing her outside basis to $150. On the deemed exchange of her share of the hot asset for cash, C recognizes $50 of ordinary income ($100 fair market value less $50 basis) and the partnership takes a cost basis in the purchased portion of the hot asset. Finally, the partnership is treated as distributing to C in liquidation of the rest of her partnership interest the remaining $200 of cash, triggering $50 of capital gain to C.[27] If the partnership has a section 734(b) election in effect, the basis of the partnership's land will be increased to $200 to reflect the $50 of gain recognized by C on the nonsection 751(b) portion of the distribution.[28] The continuing partners thus receive a cost basis in C's former share of the partnership's hot asset and land, preserving their respective shares of ordinary income ($50) and capital gain ($50). But for section 751(b), C would recognize $100 of capital gain ($300 cash less $200

25. "Inside" basis refers to the partnership's basis in its assets; "outside" basis refers to the partner's basis in her partnership interest.

26. See IRC §§ 734(b), 754. On a cash liquidating distribution, § 734(b) plays a role analogous to § 743(b). See Andrews, supra note 12, at 11-12. Since the continuing partners have made a pro rata purchase, a single adjustment to the common basis of the partnership's property accomplishes the desired result. Cf. IRC § 743(b) (flush language) (adjustment is personal to the transferee partner).

27. See IRC § 731(a)(1) (recognizing gain on cash distribution in excess of outside basis).

28. Under the optional basis adjustment rules, a partnership may adjust the basis of retained partnership property if, as a result of a distribution, the distributee recognizes gain (or loss) or takes a basis different from the partnership's basis in distributed property. See IRC §§ 734(b), 754. Allocation of the basis adjustment is governed by § 755. See IRC § 755.

basis), thereby effectively shifting her $50 share of ordinary income to the continuing partners.[29]

As illustrated by the above example, section 751(b) serves to forestall potential rate arbitrage among partners. While the 1986 Act reduced the rate difference between ordinary income and capital gain, the 1997 Act has restored a substantial capital gains preference.[30] Nevertheless, section 751(b) may be too complex to warrant its retention merely as a safeguard against shifting of ordinary income and capital gain. In the absence of section 751(b), other provisions of Subchapter K would generally prevent permanent elimination of ordinary income in connection with a disproportionate distribution.[31] Whatever the original purpose of section 751(b), however, it has arguably come to play an important role in the timing of recognition as well as in the characterization of income.[32] Under current law, the principal impact of section 751(b) is to accelerate recognition of ordinary income when there is a shift in the partners' interests in section 751 property, thereby preventing excessive deferral.

One commentator has described section 751(b) as "[o]ne of subchapter K's least understood and most widely ignored provisions."[33] The reputation of section 751 as "the most complex part of Subchapter K"[34] relates mainly to its operation in connection with distributions of property other than cash. In these situations, section 751(b) gives rise to a hypothetical exchange between the partnership (as constituted after the exchange) and the distributee. In the deemed exchange, the partnership is treated as transferring the "excess" property (i.e., the disproportionate part of the distribution consisting of hot assets or other partnership property) to the distributee, and the distributee is treated as surrendering property of equal value but of a different class from the class of the excess property received. As a result of the deemed exchange, both the distributee and the partnership may recognize gain or loss, and both the excess property and the other property surrendered take a cost basis.

---

29. The basis allocation rules of § 755 would prevent any basis adjustment to the partnership's ordinary income assets as a result of gain recognized on the liquidating distribution. See Regs. § 1.755-1(b)(1)(ii); Prop. Regs. § 1.755-1(c)(1)(ii); infra notes 66-68 and accompanying text.

30. See IRC § 1(h).

31. See IRC §§ 732(c) (providing that a distributee partner's basis in distributed inventory and unrealized receivables cannot exceed the partnership's basis for such assets), 735 (preserving ordinary character of gain or loss on distributed unrealized receivables and inventory).

32. See Andrews, supra note 12, at 46; Cunningham, supra note 12, at 89-90.

33. See Berger, supra note 11, at 147.

34. American Law Institute, Federal Income Tax Project: Subchapter K, Proposals on the Taxation of Partners 8 (1984) [hereinafter ALI Tax Project].

To illustrate the operation of section 751(b) in a nonliquidating distribution, assume that the ABC partnership in the above example distributes one-half of its land (worth $150) to C, reducing her interest in the partnership from one-third to one-fifth.[35] As revealed by the "partnership exchange table" in the margin,[36] C has relinquished an interest in section 751 assets worth $40 for an equivalent amount of nonsection 751 assets. In the deemed exchange, the partnership is treated as transferring $40 worth of land (with a basis of $20) to C, and C is treated as surrendering $40 worth of hot assets (with a basis of $20). As a result of the deemed exchange, C recognizes $20 of ordinary income attributable to her share of hot assets relinquished and the partnership's basis in the hot assets is increased to $170; on the deemed exchange of the land, the partnership recognizes $20 of capital gain allocated equally among the non-distributee partners (A and B),[37] increasing their outside bases. Finally, the partnership is treated as making a current distribution to C of land (with a fair market value of $110 and a basis of $55). C takes a basis of $95 in the land ($40 cost basis plus $55 basis of distributed land); C's outside basis is reduced to $125 ($200 basis less $20 basis allocated to C's share of hot assets deemed distributed and $55 basis of distributed land).[38]

---

35. Prior to the distribution, the fair market value of C's partnership interest ($300) represented one-third of the fair market value of all of the partnership's assets ($900). After the distribution to C of land worth $150, the fair market value of C's partnership interest ($150) represents one-fifth of the fair market value of the remaining partnership assets ($750).

36. To determine the assets involved in the deemed § 751(b) exchange, C's pre-distribution interest in partnership assets must be compared with the total of C's post-distribution interest in the remaining partnership assets and the assets distributed:

Partnership Exchange Table

	Gross Value of C's Post-distribution 1/5 Interest	+	Gross Value of Assets Distributed	-	Gross Value of C's Pre-distribution 1/3 Interest	=	Increase (Decrease) in C's Interest
Non § 751 Assets							
Cash	$60		$ 0		$100		($40)
Land	30		150		100		80
Total	$90		$150		$200		$40
§ 751 Assets							
Inventory	$60		$ 0		$100		($40)

See McKee et al., supra note 19, ¶ 21.03[3], at 21-14 to 21-16.

37. See Regs. § 1.751-1(b)(2)(ii).

38. The partnership's post-distribution balance sheet would be as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$300	$300	A	$210	$300
Inventory	170	300	B	210	300
Land	75	150	C	125	150
Total	$545	$750	Total	$545	$750

The hypothetical section 751(b) exchange imposes a tax "whose purpose is totally obscure" on those partners who are treated as surrendering nonsection 751 assets in the deemed exchange.[39] Rather than serving any discernible policy goal, exchange treatment is apparently an unintended consequence of the particular statutory mechanism chosen by Congress in 1954.[40]

More recently Congress has attempted to prevent shifting of built-in gain or loss by mandating deemed-sale treatment for certain distributions of section 704(c) property.[41] The consequences of these distributions are determined as if such property had actually been sold for cash at fair market value,[42] with appropriate adjustments to inside and outside basis.[43] If, in the example above, C were treated as selling her relinquished share of hot assets for fair market value, C would recognize $20 of ordinary income, increasing her outside basis and the basis of the partnership's hot assets. The deemed sale would trigger no gain to A and B, since their share of the partnership's hot assets has not decreased.[44]

Because disproportionality is measured by shifts in the gross value of hot assets, rather than hot asset appreciation, section 751 may not even achieve its intended purpose of preventing shifts in potential ordinary income.[45] For example, assume that the equal ABC partnership owns cash plus two items of property: Inventory #1 with a basis of $30 and a fair market value of $30, and Inventory #2 with a basis of zero and a fair market value of $60. If A receives a liquidating distribution of her share of the cash and Inventory #1, section 751(b) is not triggered even though the distribution leaves the remaining partners with a disproportionate share of the partner-

---

The partnership may elect to revalue its assets in connection with the distribution. See Regs. § 1.704-1(b)(2)(iv)(f); see also infra notes 139-53 and accompanying text. In the absence of a general revaluation, the partnership must adjust the partners' capital accounts to reflect the fair market value of any distributed property as if such property had been sold for its fair market value. See Regs. § 1.704-1(b)(2)(iv)(e)(1).

39. See Andrews, supra note 12, at 46.

40. See Cunningham, supra note 12, at 92.

41. See IRC § 704(c)(1)(B). This provision applies to a distribution of § 704(c) property within the seven-year period following its contribution. Id. If such a distribution is made to a partner other than the contributing partner, the contributing partner will recognize gain or loss to the extent of the property's built-in gain or built-in loss. Id.

42. See IRC § 704(c)(1)(B)(i).

43. See IRC § 704(c)(1)(B)(iii); Regs. § 1.704-4(e)(1) & (2).

44. Since A and B should each remain liable for $50 of the partnership's hot asset gain, C must be allocated $30 of the remaining appreciation of $130 ($300 fair market value less $170 basis) inherent in the partnership's hot assets. Thus, C should obtain the entire benefit of the $20 adjustment to the basis of the partnership's hot assets. See infra notes 139-53, 136-38 and accompanying text.

45. See McKee et al., supra note 19, ¶ 21.01[2], at 21-6.

ship's built-in ordinary income.[46] This apparent flaw could be eliminated by requiring that disproportionality be measured in terms of the hot asset gain that would be recognized by the partners if the partnership sold all of its section 751 property immediately before the distribution.[47]

Although section 751(b) has been roundly criticized for its complexity and potential inequity, commentators express sharply differing views concerning its continued role within Subchapter K. Some recommend that section 751(b) be repealed outright or retained merely as a backstop to section 751(a).[48] Others propose that any non-pro rata distribution (current or liquidating) be treated as a constructive sale,[49] with the result that gain would be triggered whenever a partner relinquished an interest in some partnership assets for other partnership assets, even if no hot assets were involved. A less radical proposal would preserve and extend the current role of section 751(b) in preventing excessive deferral, while simplifying and rationalizing its operation.[50]

B. *Repeal of Section 751(b) and Optional Basis Adjustments*

Shortly after enactment of section 751(b), the 1957 Advisory Group on Subchapter K recommended its repeal.[51] The Advisory Group considered that income-shifting was already possible under section 704 and could be addressed adequately through anti-avoidance rules.[52] Some shifting of ordinary income and capital gain among partners was viewed as a reasonable price for significant simplification of the distribution provisions.[53] The

---

46. See Regs. § 1.751-1(b)(1)(ii), (g) ex. (3)(c).

47. See infra notes 159-61 and accompanying text.

48. See ALI Tax Project, supra note 34, at 51-55; A.B.A. Tax Section Recommendation No. 1974-11, reprinted in 27 Tax Law. 839, 842 (1974); Staff of the Joint Committee on Internal Revenue Taxation, Summary of the Subchapter K Advisory Group Recommendations on Partners and Partnerships 158 (1959) [hereinafter Advisory Group].

49. See Postlewaite et al., supra note 11, at 597-98, 606-07; see also Berger, supra note 11, at 154-55.

50. See Andrews, supra note 12, at 6, 52-55.

51. According to the Advisory Group, § 751 needed to be "simplified even though in so doing some of the theoretically correct results of [§ 751(b)] may be lost." Advisory Group, supra note 48, at 158.

52. See id. at 160. In the legislative hearings, Arthur B. Willis indicated that "[w]e would rather see . . . an in terrorem provision put in as a club against the misuse of the distribution area, and eliminate . . . the complexities that we have under present section 751(b)." Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code: Hearings Before the Committee on Ways and Means, House of Representatives, 86th Cong. 73 (1959) (statement of Arthur B. Willis, chairman of the Advisory Group) [hereinafter Hearings]; see also Anderson & Coffee, supra note 20, at 539.

53. See Advisory Group, supra note 48, at 160.

Advisory Group believed, however, that repeal of section 751(b) should not open new opportunities for converting ordinary income into capital gain.[54]

Under pre-1954 law, it was possible to obtain a step-up in the basis of ordinary income property by distributing such property in exchange for all or a portion of a partner's interest.[55] For example, if inventory with a basis of $4,000 and a fair market value of $10,000 was distributed in liquidation to a partner with an outside basis of $10,000, the basis of the inventory was stepped up to fair market value. Thus, the distributee would recognize no ordinary income on sale of the inventory and the other partners might be left with only appreciated capital gain assets. To close this loophole, the 1954 Code drafters enacted section 732(c), which prevents the distributee from taking a basis in unrealized receivables or inventory in excess of the partnership's basis in such assets.[56] The 1954 Code also established carryover-basis treatment under section 732 as the general rule for other distributed property, eliminating the so-called "proportional allocation" rule under the pre-1939 Code.[57] In addition, section 735 was enacted to preserve the ordinary income character of distributed hot assets in the hands of the distributee.[58]

The 1957 Advisory Group felt that these provisions were generally adequate to deal with the problem of conversion of ordinary income into capital gain.[59] It recognized that, in the absence of section 751(b), partners could reduce their overall tax burden by distributing ordinary income assets to a low-bracket partner who could then sell such assets.[60] Although the Advisory Group was willing to tolerate this type of income-shifting as the price for eliminating section 751(b), it proposed to amend the basis allocation rules of section 755. Under the proposed revision, any upward basis adjustments under section 734(b) would be allocated solely to nonsection 751 assets.[61] Thus, the withdrawing partner would be eligible for capital gain treatment on a distribution of cash in exchange for section 751 assets, but the

---

54. See id. at 147.

55. See G.C.M. 20,251, 1938-2 C.B. 169, 169 (partner's outside basis allocated among distributed assets in proportion to their fair market value at time of distribution).

56. See IRC § 732(c).

57. See 2 American Law Institute, Federal Income Tax Statute: February 1954 Draft 358 (1954); H.R. Rep. No. 1337, supra note 21, at 69, reprinted in 1954 U.S.S.C.A.N. at 4095 (carryover-basis rule "avoids the complexities of present law which requires that a portion of the basis of the distributee for his interest in the partnership be assigned to property distributed").

58. See IRC § 735(a) (five-year taint for inventory; permanent taint for unrealized receivables).

59. See supra notes 51-53 and accompanying text.

60. See Advisory Group, supra note 48, at 158.

61. See id. at 158, 170-71.

continuing partners would receive no basis step-up in the partnership's hot assets.

The Treasury strenuously opposed repeal of section 751(b) on the ground that it would provide greater latitude for income-shifting from high-bracket to low-bracket taxpayers.[62] Moreover, the proposed amendments to the basis allocation rules were open to the criticism that they would allow "upward adjustments . . . to the basis of depreciable [capital] assets of the partnership in connection with a distribution of section 751 assets."[63] Under these proposals, upward basis adjustments could be allocated to any non-section 751 asset, which included depreciable capital assets. Thus, it would be possible to boost the basis of depreciable capital assets, thereby generating higher depreciation deductions. Both the Treasury and the organized bar also objected to the repeal of section 751(b) and the proposed changes to sections 734(b) and 755, on the ground that this would introduce an unwarranted disparity in the tax treatment of redemptions and sales of partnership interests.[64] In spite of the recommendations of the Advisory Group, legislation introduced in 1960 retained section 751(b) virtually intact.[65]

Under current law, section 755 governs the allocation of optional basis adjustments among partnership assets. Section 755 contains both a general rule and a special rule: the general rule requires that any adjustment be allocated "in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties,"[66] while the special rule requires that adjustments attributable to capital gain assets be allocated solely to capital gain assets and adjustments attributable to other assets be allocated to such assets.[67] The special rule, sometimes referred to as the "basis segregation rule,"[68] is intended to prevent the shift of basis from capital gain to ordinary income assets.

---

62. Hearings, supra note 52, at 657 (Jay Glasmann, representing the Treasury); see also Anderson & Coffee, supra note 20, at 538-39.

63. See Anderson & Coffee, supra note 20, at 539-40. The Treasury's objections stemmed from the proposed elimination of the "basis segregation rule" of § 755, which divides property into (1) capital assets and § 1231 assets and (2) other property. See infra notes 66-68 and accompanying text.

64. The A.B.A. recommended limiting § 751(b) to cash liquidating distributions. See Hearings, supra note 52, at 995 (legislative recommendations of A.B.A.).

65. See H.R. 9662, 86th Cong., 2d Sess. 27-30, 148-50; see also Arthur B. Willis, Willis on Partnership Taxation 17-18 (1971) (discussing Congress' failure to enact proposed revisions).

66. See IRC § 755(a); see also Regs. § 1.755-1(a); Prop. Regs. § 1.755-1(c)(2).

67. See IRC § 755(b); see also Regs. § 1.755-1(b)(1)(i); Prop. Regs. § 1.755-1(c)(1)(i). If a distribution triggers recognition of gain (or loss), the § 734(b) adjustment must be allocated solely to capital gain assets. See Regs. § 1.755-1(b)(1)(ii); Prop. Regs. § 1.755-1(c)(1)(ii).

68. See Andrews, supra note 12, at 26.

In focusing narrowly on the character of gain from a sale as ordinary or capital, Congress apparently overlooked the potential for shifting basis from nondepreciable capital assets to depreciable capital assets.[69] Because depreciable property generates ordinary deductions, inflating the basis of such property presents the same conversion potential that the basis segregation rules are presumably intended to prevent.[70] For example, consider an equal three-member partnership which owns section 1250 real property with a fair market value of $1,000 and a basis of $100; the partnership's only other assets consist of $1,000 cash and nontraded securities with a basis and fair market value of $1,000. The partnership uses the cash to redeem one partner whose outside basis is $700, triggering $300 of capital gain under section 731(a) and a corresponding section 734(b) upward adjustment to the basis of the depreciable property. The continuing partners benefit from the higher basis of the real property through increased depreciation deductions. This basis-shifting technique is feasible because unrecaptured section 1250 gain is not treated as a separate noncapital asset for purposes of section 751 or the basis segregation rules of section 755.[71] By contrast, if the partnership owned section 1245 property, the cash distribution would trigger recognition of hot asset gain equal to the reduction in the distributee's share of section 1245 recapture.[72]

Although section 755 generally prevents outright shifts of basis between capital gain assets and ordinary income assets, it is fair to describe the basis allocation rules as "complex and not wholly rational."[73] One

---

69. See id. at 35-37. In certain limited circumstances, the regulations under § 732(d) may prevent shifting of basis from nondepreciable property to depreciable property. See IRC § 732(d); Regs. § 1.732-1(d)(4). These rules apply, however, only to distributions occurring after the purchase or inheritance of a partnership interest. See supra.

70. See Andrews, supra note 12, at 36. Section 732(c) affords similar potential for shifting basis from capital assets to depreciable property in connection with a partnership distribution. See IRC § 732(c) (allocating basis among distributed assets in accordance with fair market value rather than relative bases); Prop. Regs. § 1.732-1(c). The 1997 Act changes to § 732(c) may lessen the need for mandatory § 732(d) basis allocations.

71. Assuming that the real property has been depreciated under the straight-line method, the recapture provisions will be inapplicable. See IRC §§ 168(b)(3) (denying accelerated depreciation for residential and nonresidential real property), 1250(a)(1) (generally limiting depreciation recapture to the excess of accelerated over straight-line depreciation). The 1997 Act created a special statutory rate of tax on so-called "unrecaptured § 1250 gain." See IRC § 1(h)(6); see also infra note 225 and accompanying text.

72. Section 751(c) bifurcates depreciable property subject to recapture into (1) a § 751(c) unrealized receivable with a zero basis and a fair market value equal to the potential recapture and (2) the rest of the property. See Regs. § 1.751-1(c)(5) and McKee et al., supra note 19, ¶ 21.05[1], at 21-45 to 21-46; see also Regs. § 1.1245-1(e)(2) (allocations of depreciation recapture).

73. See Eustice, supra note 10, at 386 n.206.

commentator has suggested that repeal of the optional basis adjustment provisions would permit repeal of section 751(a) and (b).[74] While eliminating section 734(b) would move Subchapter K closer to an entity model, the basis adjustment provisions serve an important function, under an aggregate model, in preserving unrealized gain or loss for later taxation. The existing optional basis adjustment rules are defective, however, because a partnership generally makes such adjustments only when they are beneficial. Of course, once a section 754 election is in effect, the partnership will generally be required to make section 734(b) and section 743(b) adjustments, even if such adjustments are detrimental. Although Congress clearly recognized that failure to make basis adjustments could give rise to distortions, the elective system was intended to provide administrative simplicity.[75] Several commentators have suggested that section 734(b) adjustments be mandatory rather than elective, in order to eliminate the current bias in favor of taxpayers.[76] In connection with mandatory section 734(b) adjustments, it would also be desirable to amend section 755 to prevent shifting of basis from nondepreciable to depreciable property.[77]

C. *1982 ALI Proposals: Full Fragmentation*

In its 1982 study, the ALI urged repeal of section 751(b) on the ground that it "is extraordinarily complex" and "produces too harsh a result for the policy it is intended to enforce."[78] The ALI argued that a "full-fragmentation approach" would be "easier to understand than" existing section 751 and thus more likely to be observed in practice.[79] Under the full-fragmentation approach, the character of the transferor (distributee) partner's gain or loss would be determined as if she had disposed of her share

---

74. See E. George Rudolph, Collapsible Partnerships and Optional Basis Adjustments, 28 Tax L. Rev. 211, 222 (1973).

75. See ALI Tax Project, supra note 34, at 195-96; see also Regs. § 1.701-2(d) ex. 9 (failure to make § 754 election is "consistent with the intent of subchapter K"; anti-abuse rules inapplicable even though "principal purpose" for selection of distributed assets was to achieve particular basis result).

76. See ALI Tax Project, supra note 34, at 217-18 (recommending mandatory § 734(b) adjustments only in the case of a cash liquidating distribution). For a more far-reaching proposal, see Andrews, supra note 12, at 22-24 (suggesting that Congress repeal § 734(a) and make § 734(b) adjustments compulsory). See also Richard G. Cohen & Lori S. Hoberman, Partnership Taxation: Changes for the 90's, 71 Taxes 882, 885-86 (1993); Selected Partnership Tax Issues, supra note 8, at 32-33, 36-37.

77. See infra notes 178-81 and accompanying text.

78. See ALI Tax Project, supra note 34, at 51-52.

79. See id. at 23.

of the underlying partnership assets.[80] The ALI considered that the problem of valuation would be no greater under full fragmentation than under existing law. In 1954, the ALI had rejected the full-fragmentation approach in order to minimize the number of partnerships subject to section 751.[81] By expanding the category of unrealized receivables to include depreciation recapture, however, Congress greatly increased the intrusiveness of section 751.[82] The ALI predicted that repeal of section 751(b) would have little impact on revenue, since the narrowing of rate differences lessened the incentive to shift income from high-bracket to low-bracket partners.[83] Because other provisions of Subchapter K would prevent conversion of ordinary income to capital gain, the ALI viewed the deterrence of income-shifting as an insufficient justification for retaining section 751(b).[84] On balance, the ALI concluded that "the complexity [section] 751(b) introduces into Subchapter K appears to overshadow its benefits."[85]

The full-fragmentation rule applied only to sales of partnership interests and cash liquidating distributions, thereby apparently restoring the 1954 version of section 751 as it existed prior to the Senate amendment.[86] Perhaps the most striking feature of the full-fragmentation approach was that it resulted in substantially less than "full" fragmentation when applied to many common types of partnership distributions.[87] For example, the full-fragmentation rule was inapplicable to (1) any distribution of cash in partial liquidation of a partner's partnership interest, and (2) any current or liquidating distribution in which the distributee partner received both cash and other property (or solely other property). In the case of a three-person partnership holding appreciated inventory and land, the ALI noted that the full-fragmentation rule would have no operative effect if one partner's interest were completely liquidated in exchange for the partnership's land.[88] The distribution would be nontaxable under section 731, even though the ordinary

---

80. See id. at 40-41. Thus, both a direct sale of a business and an indirect sale through disposition of a partnership interest would be subject to the fragmentation rule of Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945).

81. See Jackson et al., Proposed Revision, supra note 13, at 145-46.

82. See ALI Tax Project, supra note 34, at 53. Depreciation recapture was not enacted until 1962. See Revenue Act of 1962, Pub. L. No. 87-834, § 12, 26 Stat. 960, 1032.

83. See ALI Tax Project, supra note 34, at 52 (noting that, "[i]n the absence of very substantial tax saving," business considerations could be expected to impede tax-motivated non-pro rata distributions of nonfungible property among partners).

84. See id. at 55 n.11.

85. Id. at 52.

86. See supra notes 21-23 and accompanying text.

87. See ALI Tax Project, supra note 34, at 35.

88. See id. at 54-55.

income attributable to the appreciated inventory was shifted entirely to the nondistributee partners.

In a critical assessment of the ALI's 1982 study, one commentator has suggested that the ALI's description of its proposal as requiring "full" fragmentation represents a remarkable "understatement."[89] Upon closer examination, however, the ALI's 1982 proposals seem entirely congruent with a narrow conception of section 751(b) as a backstop to section 751(a). The 1982 ALI study emphasized that "the purpose of [section 751] is not to impose a tax merely because a partner is exchanging an interest in one asset for an interest in another asset."[90] The only purpose of making the section 751(b) exchange taxable was to prevent income-shifting, a purpose which might have been accomplished by "tainting" the distributed (or retained) property.[91] Although immediate taxation was considered administratively simpler than complex tracing rules, this approach was never intended to replace nonrecognition principles generally by treating all economic exchanges of partnership property as taxable.[92]

In 1982, the ALI considered but rejected several reforms to Subchapter K based on concerns about administrability and potential noncompliance with overly complex rules.[93] In light of recent statutory provisions aimed at income-shifting in other areas, however, the 1982 ALI study's tolerant attitude toward income-shifting in connection with section 751(b) distributions may seem anachronistic. Nevertheless, proposals to repeal section 751(b) continue to surface, as shown by a recent proposal to substitute a tax-avoidance standard for the existing statutory provision.[94] This proposal would treat a disproportionate distribution as a taxable event only if it resulted in a "significant" shift in potential ordinary income and had a "principal purpose" of tax avoidance.[95] While such a tax-avoidance standard would likely reach only the most egregious cases, the revenue loss might be relatively insignificant given the apparently low level of compliance

89. See Postlewaite et al., supra note 11, at 596.

90. ALI Tax Project, supra note 34, at 50.

91. See id.

92. See id. at 50-51.

93. For example, the ALI considered but rejected a "deferred-sale" approach to contributions of appreciated property, as finally enacted by Congress in 1984. See id. at 136-38; see also IRC § 704(c) and Regs. § 1.704-3; Gregory J. Marich & William S. McKee, Sections 704(c) and 743(b): The Shortcomings of the Existing Regulations and the Problems of Publicly Traded Partnerships, 41 Tax L. Rev. 627, 635-36 (1986). See generally Laura E. Cunningham & Noël B. Cunningham, Simplifying Subchapter K: The Deferred Sale Method, 51 SMU L. Rev. 1 (1997).

94. See William B. Brannan, The Subchapter K Reform Act of 1997, 75 Tax Notes 121, 135-36 (1997).

95. See id. at 136; cf. Regs. § 1.701-2 (general anti-abuse rules).

with existing section 751(b).[96] If the permissiveness of the current nonrecognition rules is a cause for unease, however, a simpler solution is available: Congress could repeal section 751(b) and require gain recognition whenever a distribution results in an economic exchange among the partners.

III. REPLACING SECTION 751(b) WITH A FULL-RECOGNITION MODEL

A. *Extending the Subchapter S Model*

By comparison to Subchapter K, Subchapter S treats property distributions much less favorably. Perhaps influenced by the experience with section 751(b), the 1958 drafters of Subchapter S opted to treat a distribution of appreciated property as a taxable event.[97] Recently, Curtis J. Berger has proposed that Subchapter S principles be extended to Subchapter K.[98] In general, Berger would require recognition of gain or loss whenever a partnership distributes appreciated or depreciated property.[99] Moreover, any disproportionate distribution that reduces a partner's interest in the partnership would be treated "as a taxable exchange, in the corporate fashion."[100]

Berger's approach is premised on his choice of the S corporation model as the preferred form of organization for small business.[101] In seeking to harmonize the distribution rules of Subchapters S and K, he considers "the corporate rule, or some slight variant thereof, by far the more defensible."[102] He would continue to treat partnership contributions as tax-free, under section 721, in order to "facilitate the creation and growth of joint business ventures."[103] Once the partnership's business has commenced,

---

96. See Cunningham, supra note 12, at 93 (commenting, in another context, that "[s]ince § 751(b) is virtually ignored under current law, as a practical matter, there is no downside risk"); see also ALI, Pass-Through Entities, Tentative Draft Memorandum No. 2, supra note 3, at 137 (remarking on low level of compliance with § 751(b)).

97. See Eustice, supra note 10, at 383. Of course, S corporations remain subject to § 341, the collapsible corporation provision. See IRC § 341; A.B.A. Tax Section, Comm. on S Corporations Subcomm. on the Comparison of S Corporations and Partnerships, Report on the Comparison of S Corporations and Partnerships (pt. 2), reprinted in 44 Tax Law. 813, 855 (1991) (proposing to exempt S corporations from § 341).

98. See Berger, supra note 11, at 108.

99. See id. at 109.

100. See id. at 153.

101. See id. at 107 (referring to Subchapter K as "the Code's fair haired child"); cf. Kurtz, supra note 2, at 832 (suggesting that proposed changes are unnecessary because limited liability companies will become the "vehicle of choice").

102. See Berger, supra note 11, at 154.

103. See id.; see also Daniel N. Shaviro, An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, 48 Tax L. Rev. 1, 49 (1992) (arguing that § 721 nonrecognition treatment may be "efficient" because contributions "may have little

however, he finds the rationale for continued nonrecognition treatment less compelling, and upon liquidation the justification for nonrecognition "virtually disappears" given the unlikelihood that the existing business will continue to be carried on.[104] Thus, Berger would treat a distribution of partnership property as a taxable event on the theory that it represents a partial disinvestment. To avoid deterring the formation of partnerships, he would nevertheless allow a tax-free distribution of contributed property to the contributing partner, but only to the extent of any pre-contribution gain (or loss).[105]

Although Berger apparently would retain section 751(a), he claims that his proposal "would make [section] 751(b) almost redundant."[106] A non-pro rata current or liquidating distribution of cash could nevertheless give rise to shifting of ordinary income and capital gain.[107] Moreover, cash liquidating distributions and sales of partnership interests would no longer be treated equivalently. In the absence of a section 734(b) adjustment, inside basis would not be adjusted to reflect the "purchase" of the withdrawing partner's interest following a liquidating distribution of cash. As a result, both the distributee and the continuing partners would be taxed twice on unrealized appreciation in partnership assets attributable to the redeemed interest.[108] Perhaps such temporary "double taxation" might be viewed as roughly offsetting the conversion of a withdrawing partner's share of ordinary income into capital gain on a cash liquidating distribution.[109]

Berger also proposes to adopt section 302-type rules for "substantially disproportionate" distributions in redemption of a partner's interest.[110] The rationale for this aspect of the proposal remains unclear. The corporate rules attempt to distinguish redemptions treated as taxable exchanges under

---

nontax significance and be highly tax elastic"; hence, taxing contributions would be "futile"). But cf. Postlewaite et al., supra note 11, at 465-73 (arguing that gain or loss should be recognized on contributions); David R. Keyser, A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation, 5 Am. J. Tax Pol'y 269, 288-95 (1986) (arguing that "pooling" of assets should be treated as a sale).

104. See Berger, supra note 11, at 154-55.

105. See id. at 155-56. Berger predicts that the partnership form would continue to survive, even if stripped of most of its tax advantages, because it would still offer greater flexibility than the corporate form. See id. at 171.

106. See id. at 156.

107. See id. at 156 n.214.

108. The continuing partners would eventually recognize less gain (more loss) upon sale or liquidation of their partnership interests.

109. See Rudolph, supra note 74, at 223-24 (noting potential double taxation). Although Berger asserts that his proposals would "eliminate the need for the §§ 754-734(b) election," this claim is overly broad. See Berger, supra note 11, at 156.

110. See Berger, supra note 11, at 153.

section 302 from those treated as dividends under section 301.[111] In the pass-through regime of Subchapter S, sophisticated tax advisors readily grasp the advantages of obtaining favorable section 301 treatment by structuring a redemption to avoid the section 302(b) safe harbor for distributions not "essentially equivalent" to a dividend.[112] To the extent that a redemption does not trigger exchange treatment under section 302(b), it generally produces tax-free basis recovery to the redeemed S shareholder.[113] By reducing the redeemed S shareholder's interest in pre-distribution ordinary income, such a redemption may accomplish "just the sort of shift that section 751(b) seeks to tax in the partnership context."[114]

In focusing on the tax treatment of the distributee partner, Berger fails to discuss the partnership-level tax consequences of a redemption.[115] He also fails to indicate whether he would adopt a full look-through approach in determining the character of any gain (or loss) recognized by the distributee partner. Since Subchapter S does not provide an especially coherent solution to the problem of income-shifting, the corporate model may fall short of its initial promise. Berger would also repeal the liability-sharing rules of section 752 in order to harmonize the outside basis rules of Subchapters S and K.[116] Otherwise, a partnership could circumvent the requirement of gain recognition on distributions of appreciated property relatively easily by borrowing against the property and distributing the proceeds.[117] Since repeal of section 752 seems unlikely, it is necessary to look beyond Berger's amalgam of corporate and partnership principles.[118]

B. *Deemed-Sale Approach*

If full-recognition treatment is viewed as desirable, the most obvious approach would be to treat any distribution that reduces a partner's interest

---

111. See IRC §§ 301, 302.

112. If a redemption is not considered a taxable exchange, § 302(d) provides that the distribution will be treated under the rules of § 301; § 1368 (governing § 301-type distributions by S corporations) provides for tax-free recovery of a shareholder's basis before any gain is recognized. See IRC §§ 301, 302(d), 1368(b). See Eustice, supra note 10, at 383 n.197; Deborah H. Schenk, Federal Taxation of S Corporations § 12.03[2] (rev. ed. 1992).

113. See Eustice, supra note 10, at 383 n.197.

114. See id. at 383.

115. See Gergen, Contributions and Distributions, supra note 5, at 203.

116. See Berger, supra note 11, at 114-15.

117. See id. at 156 n.213.

118. Gergen recommends an approach that is "similar" to but "slightly more complicated" than Berger's proposal. Gergen would require several separate accounts for partnership liabilities in order to preserve nonrecognition treatment for distributions out of partnership borrowing. See Gergen, Contributions and Distributions, supra note 5, at 201, 229-37; cf. Steines, Unneeded Reform, supra note 5, at 245 (Gergen's proposal would "result in exceeding complexity: a thicket of rules and a multitude of accounts").

as a deemed sale of an equivalent portion of the redeemed partner's interest in partnership assets. Deemed-sale treatment is consistent with the approach recommended by Philip F. Postlewaite in his comprehensive critique of the 1982 ALI study. Relying on an "analysis of efficient capital markets," Postlewaite rejects the assumption that "economic realities mandate tax deferral treatment for partnership distributions" and dismisses concerns about lack of liquidity as a justification for continued deferral.[119] Deemed-sale treatment is arguably appropriate because the withdrawing partner presumably could either insist upon a cash liquidating distribution or raise funds to pay the tax by selling (or borrowing against) the distributed property.[120] Therefore, a distributee who retains the distributed assets should be treated as selling her partnership interest for cash and then purchasing the distributed assets for their fair market value.[121]

Under the deemed-sale approach, a current pro rata or non-pro rata distribution of property would be treated as if such property had been sold immediately prior to the distribution, triggering gain (or loss) to the partnership.[122] Pro rata distributions of cash or nonappreciated property would generally be tax free, on the theory that such distributions represent merely the receipt of partnership earnings previously taxed to the partners as a portion of their distributive share of partnership profits or a return of the partner's capital.[123] Line-drawing would be necessary to distinguish between non-pro rata distributions which result in a shift in the partners' proportionate interests in the partnership and a series of non-pro rata distributions which in the aggregate leave the partners' interests in the partnership unchanged. To the extent that other partners do not receive an equivalent amount of partnership property within some reasonable period, the excess portion of any non-pro rata distribution would be treated as a partial liquidation of the recipient's partnership interest, triggering recognition of gain or loss.[124]

Treating a disproportionate distribution as a partial liquidation arguably "reflects the economic realities of the transaction."[125] To avoid economic distortions, the other partners should generally insist on a reduction in the percentage ownership interest of the non-pro rata recipient following a disproportionate distribution, because otherwise partnership allocations in accordance with the partners' pre-distribution percentage interests in the partnership will no longer correspond to their post-distribution economic

---

119. See Postlewaite et al., supra note 11, at 596-97.
120. See id. at 597.
121. See id. at 597-98.
122. See id. at 606-07.
123. See id. at 607.
124. See id. at 606.
125. Id.

interests.[126] Full-fragmentation and gain recognition would eliminate any disparity between the partnership's inside basis and the continuing partners' outside bases.[127] Under the deemed-sale approach, a partially redeemed partner would be treated as owning two separate partnership interests—one redeemed and the other continuing. The redeemed portion would be treated as if sold for its fair market value, triggering proportionate recognition of unrealized gain (or loss) inherent in the partnership's retained assets.[128] Any gain or loss attributable to distributed property would be taken into account immediately before the redemption.

To illustrate the operation of the deemed-sale approach, assume that C receives a distribution of Land #2 when the equal ABC partnership has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$120	$180
Inventory	60	180	B	120	180
Land #1	120	150	C	120	180
Land #2	60	90	Total	$360	$540
Total	$360	$540			

Since the fair market value of the distributed property ($90) is equal to one-half of the value of C's entire partnership interest ($180), the deemed-sale approach would treat one-half of C's interest (one-sixth of the total partnership) as redeemed.[129] The ABC partnership would be treated as if it had "sold" Land #2 to C for $90, triggering $30 of capital gain to be allocated equally among the partners. Each partner would increase her outside basis to reflect her share of the gain recognized. In addition, C would be treated as if she had sold one-half of her interest in the remaining partnership assets (inventory and Land #1), or one-sixth of the total value of each asset. Accordingly, C would recognize $20 of ordinary income and $5 of capital gain (one-sixth of the appreciation inherent in the inventory and Land #1). The ABC partnership would increase its basis in each asset to reflect any gain

126. A mandatory agreement specifying the percentage reduction in the distributee's partnership interest would generally be respected. See id. at 598-99, 610.

127. Deemed-sale treatment would eliminate the need for the § 734(b) basis adjustment provisions. See id. at 620 (§ 734(b) basis adjustments no longer necessary if carryover-basis rule eliminated). Cf. supra note 109 and accompanying text (Berger proposal).

128. See Postlewaite et al., supra note 11, at 604.

129. A redemption of one-half of the value of C's partnership interest reduces her interest in the ABC partnership from one-third to one-fifth.

recognized on the distribution, and C would take a basis of $90 in Land #2, its fair market value.[130]

The ABC partnership's post-distribution balance sheet would be as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$130	$180
Inventory	80	180	B	130	180
Land #1	125	150	C	65	90
Total	$325	$450	Total	$325	$450

Each partner's tax capital account, share of inside basis and share of unrealized appreciation corresponds to her continuing percentage interest in the partnership.[131] Thus, C's remaining tax capital account and share of inside basis is $65, or one-fifth of the partnership's total capital and inside basis. Upon a sale of the partnership's remaining assets, C would be taxed on her remaining one-fifth of the appreciation in the inventory and Land #1, resulting in $20 of ordinary income and $5 of capital gain. The other partners would each be taxed on $40 of ordinary income and $10 of capital gain (two-fifths of the appreciation in the inventory and Land #1). Each partner's pre-distribution share of the partnership's total ordinary income and capital gain is preserved to the extent not recognized immediately.

The deemed-sale approach produces harsher results than if C had instead sold one-half of her partnership interest (with a basis of $60) for its fair market value of $90. Upon a sale of one-half of her interest, C would recognize $20 of ordinary income and $10 of capital gain attributable to her one-sixth share of the inventory and capital assets.[132] By contrast, the deemed-sale approach triggers additional gain of $5 to C because she is deemed to sell one-third (not one-sixth) of her interest in the distributed property (Land #2) plus one-sixth of her interest in the remaining partnership assets.[133] Thus, the deemed-sale approach arguably overtaxes C by eliminating deferral of her share of unrealized appreciation in the distributed property.

---

130. C's outside basis of $120 would be increased by the $35 gain recognized and reduced by the $90 basis of the distributed property in C's hands, leaving C with a remaining outside basis of $65.

131. Each partner's tax capital account initially reflects the tax basis of contributed property; the partnership must maintain separate book capital accounts whenever property is contributed with a basis different from its fair market value (or whenever the partners' capital accounts are restated to reflect the fair market value of partnership property). See Regs. §§ 1.704-1(b)(2)(iv)(d)(3), 1.704-1(b)(2)(iv)(f).

132. See IRC §§ 741 and 751(a).

133. C's one-sixth share ($5) of unrealized appreciation in Land #2 could be preserved by assigning such property a basis of $85 (rather than $90) in C's hands.

C. *Hot Asset Exchanges and Partnership Revaluations*

The deemed-sale approach, modelled on the treatment of partial dispositions outside Subchapter K, is simpler than existing section 751(b). It would ensure that the partners' post-distribution tax capital accounts and shares of unrealized gain (or loss) generally correspond to their continuing percentage interests, thereby simplifying partnership accounting. Notwithstanding these potential advantages, the deemed-sale approach may be viewed as unacceptable by those who believe that nonrecognition treatment serves important policy goals. It is useful, therefore, to consider whether the aggregate approach of existing section 751(b) might be improved and extended.

By contrast to the deemed-sale approach, current Subchapter K does not treat a reduction in a partner's interest as a partial liquidation of a separate interest.[134] While section 751(b) requires fragmentation of a partner's interest, the method of computing gain reflects a strict aggregate approach. In the preceding example, section 751(b) would compute C's gain on the deemed exchange as if she had sold only two-fifths (not one-half) of her interest in the partnership's hot assets.[135] Although the distribution represents one-half of the total value of C's partnership interest, her percentage interest in the partnership has been reduced from one-third (33-1/3%) to one-fifth (20%). Thus, C has transferred 13-1/3% of the partnership's total hot assets (or two-fifths of her original one-third interest) to A and B, and her retained one-fifth interest has absorbed a portion of the hot asset appreciation attributable to her redeemed interest.[136] Consistent with a pure aggregate approach, section 751(b) requires C to pay tax only on her share of hot assets shifted to the other partners.

The current method of computing gain under section 751(b) gives rise to discontinuities among the continuing partners' tax capital accounts, shares of inside basis, and shares of unrealized appreciation. In the deemed section 751(b) exchange, C would be treated as relinquishing two-fifths of her original one-third share of inventory (with a fair market value of $24 and a

---

134. Any distribution other than a liquidating distribution is treated as a current distribution. See Regs. § 1.761-1(d).

135. See Andrews, supra note 12, at 69; S. Rep. No. 1622, supra note 4, at 98-99, reprinted in 1954 U.S.C.C.A.N. at 5045-47.

136. Prior to the redemption, one-third of the total hot asset appreciation ($40) was attributable to C's one-third interest. Consequently, one-sixth of the total hot asset appreciation ($20) was attributable to the redeemed one-half of C's one-third interest. However, upon the redemption, § 751(b) would require C to recognize only $16, or four-fifths ($16/$20), of the total hot asset appreciation attributable to the redeemed interest. Consequently, after the redemption, C's remaining one-fifth interest would be responsible for total hot asset appreciation of $24, i.e., its original one-sixth share ($20) plus one-fifth of the redeemed interest's share ($4). See Andrews, supra note 12, at 69.

basis of $8) in exchange for a commensurate increased interest in Land #2. Accordingly, C would recognize $16 of ordinary income, and the partnership's basis in the inventory would be increased from $60 to $76.[137] Since section 751(b) taxes C on only two-fifths (not one-half) of her original share of the hot asset appreciation, she should remain taxable on her retained three-fifths share (one-fifth of the total). Upon a sale of the inventory, the other partners should apparently receive the entire benefit of the $16 increase in inside basis, requiring a special allocation of gain to distinguish C from the other partners.[138]

The analysis would be different if, in connection with the distribution, the partnership elected to "book up" the partners' capital accounts and revalue its assets.[139] Following a revaluation, section 704(c) principles (so-called "reverse-section 704(c) allocations") govern in determining the allocation of the partnership's tax items with respect to revalued property.[140] The consequences of a general revaluation upon redemption of a partner's interest are thus similar to those in connection with admission of a new partner when a partnership holds appreciated property. Although a general revaluation is optional in connection with redemption of a partner's interest, the section 704(b) regulations warn that the absence of such a revaluation (or an equivalent special allocation of pre-distribution gain or loss) may have

---

137. See Regs. § 1.751-1(b)(3)(iii). Under current § 751(b), the partnership would be treated as exchanging an interest in a portion of Land #2 (with a fair market value of $24 and a basis of $16) for an increased interest in the partnership's hot assets; the partnership's recognized gain of $8 should presumably be allocated entirely to A and B. See Regs. § 1.751-1(b)(3)(ii).

138. Before taking into account the basis adjustment, the partnership has $120 of potential hot asset gain. C's one-fifth share of the remaining hot asset gain ($24) plus her hot asset gain recognized on the distribution ($16) equals her pre-distribution share ($40) of the partnership's hot asset gain. Since A and B should be taxed on total hot asset gain of $80, they must receive the benefit of the entire $16 adjustment to inside basis ($120 hot asset gain less $16 basis adjustment less $24 gain allocated to C). See Andrews, supra note 12, at 69.

139. A revaluation is permitted (i) in connection with a contribution of money or other property to the partnership by a new or existing partner in exchange for a partnership interest; (ii) in connection with a liquidation of the partnership or a distribution of money or other property to a retiring or continuing partner in exchange for all or a portion of her partnership interest; or (iii) in accordance with generally accepted industry practices in the case of securities partnerships. See Regs. § 1.704-1(b)(2)(iv)(f)(5). See generally Richard W. Harris, Federal Taxation of Partnership Asset Revaluations, 14 Va. Tax Rev. 257 (1994).

140. See Regs. § 1.704-1(b)(1)(vi). Once partnership property has been revalued, capital accounts must subsequently be adjusted for the partners' distributive shares of book items with respect to the revalued property, and § 704(c) principles must be applied in determining the partners' distributive shares of tax items with respect to such property to take account of book/tax disparities arising from the revaluation. See Regs. §§ 1.704-1(b)(2)(iv)(f)(1)-(4), 1.704-1(b)(2)(iv)(g).

significant adverse tax consequences.[141] A general revaluation may also be desirable to avoid conferring an unintended economic benefit on those partners whose interests increase when another partner's interest is reduced. A book-up prevents an economic shift by ensuring that any unrealized gain or loss inherent in existing partnership property will be allocated in accordance with the partners' pre-distribution sharing ratios. Any post-distribution gain or loss will be allocated in accordance with their altered sharing ratios.

Since a revaluation effectively "locks in" the partners' pre-distribution shares of net unrealized appreciation, it might be expected to render section 751(b) inapplicable.[142] This will generally be the case whenever the partnership holds only zero-basis section 751 property, such as unrealized receivables and depreciation recapture, and the distributee receives only nonsection 751 property.[143] For example, assume that the ABC partnership purchases land for $210 which appreciates in value to $300. Each partner has a basis of $120 in her partnership interest. When the partnership also has $90 of zero-basis unrealized receivables and cash of $150, C receives a $90 cash distribution which reduces her interest from one-third to one-fifth. Immediately before the distribution, the partnership's assets are restated to reflect fair market value and the partners' capital accounts are increased to reflect their share of unrealized appreciation in the partnership's assets. Accordingly, ABC will have the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 60	$ 60	A	$120	$180
Receivables	0	90	B	120	180
Land	210	300	C	30	90
Total	$270	$450	Total	$270	$450

Since the book-up preserves C's entire pre-distribution share of the partnership's unrealized appreciation in the accounts receivable ($30), there should be no deemed exchange to trigger section 751(b). As a result of the revaluation, the distribution leaves unchanged the partners' respective shares of hot asset appreciation. Special allocations will be required, however, to ensure proper allocation of the tax gain corresponding to the booked-up gain.

Section 704(c) principles presumably require that C's share of the "common" basis of partnership assets be allocated among such assets in proportion to the total inside basis of such assets.[144] Following this approach,

141. See Regs. § 1.704-1(b)(iv)(5) (last sentence).
142. See McKee et al., supra note 19, ¶ 21.03[8], at 21-25.
143. See id.
144. See id. at 21-28.

C should have a one-ninth share ($30/$270) of the basis of each partnership asset; with respect to the unrealized appreciation in each asset, C's share is equal to one-third of the difference between the partnership's common basis and the gross value of each asset. Thus, C has a one-third share of the appreciation inherent in the partnership's unrealized receivables ($30) and land ($30), corresponding to her share of the booked-up gain. Based on these assumptions, C has the following post-distribution interest in the basis, unrealized appreciation and gross value of each partnership asset:

Assets	Basis	+	Appreciation	=	Gross Value	Undivided 1/5 Share
Cash	$ 6.67		$ 0		$ 6.67	$12.00
Receivables	0		30.00		30.00	18.00
Land	23.33		30.00		53.33	60.00
Total	$30.00		$60.00		$90.00	$90.00

C's share of the total gross value of partnership assets ($90) is equal to the gross value of her remaining one-fifth interest ($90). When the individual partnership assets are divided into separate basis and gain components, however, the results seem somewhat strange. Under the section 704(c) approach, C's share of the gross value of individual partnership assets differs from the amount determined as if she owned an undivided one-fifth interest in each asset. Such disparities arise because the revaluation "freezes" C's share of pre-distribution appreciation but cannot prevent changes in her share of the partnership's common basis.[145] C's one-ninth share of the partnership's common basis ($30) represents her pre-distribution one-third share of the partnership's common basis ($120) reduced by the entire basis of the distributed property ($90). Thus, C winds up with less than a one-fifth share of the partnership's post-distribution common basis.[146]

The section 704(c) approach appears to conflict with the "undivided interest" approach which the section 751(b) regulations use to determine the partnership exchange table. The undivided interest approach assumes that C retains a one-fifth interest in the gross value of each partnership asset.[147] As illustrated above, the undivided interest approach is apparently flawed and does not correspond to the results reached under the section 704(c) approach.[148] Until the section 751(b) regulations are revised, however,

145. See id. at 21-25.

146. If the distributed property represented one-half of C's former interest in terms of both basis ($60) and value ($90), C would have exactly a one-fifth share of the partnership's post-distribution common basis ($60/$300).

147. See Regs. § 1.751-1(g) ex. 5.

148. See McKee et al., supra note 19, ¶ 21.03[8], at 21-28 to 21-29.

partners should presumably be entitled to rely on the undivided interest approach to determine the initial consequences of the section 751(b) exchange. Since the section 704(c) approach generally preserves the partners' respective shares of hot asset gain, a book-up should render section 751(b) inapplicable in many common situations.

It would be extremely helpful, however, if the regulations expressly sanctioned the use of a book-up to avoid section 751(b) gain. The only support for the book-up approach is an oblique reference in one example involving admission of a new partner. In the example, partnership property is revalued when the partnership owns depreciable property subject to a nonrecourse debt.[149] Although the admission of the new partner triggers a deemed distribution of cash under section 752, the example provides that no minimum gain chargeback is triggered to the existing partners.[150] While there is no mention of section 751(b), the result would clearly be different if the deemed section 752 distribution were treated as triggering a shift in hot assets.[151] The section 751(b) regulations should also be revised to reflect the consequences of a book-up when a partnership owns hot assets.[152]

Although a book-up may render section 751(b) inapplicable with respect to many distributions of nonsection 751 property, there are situations in which a book-up cannot prevent a section 751(b) shift. Assume that a partnership holds nonzero basis hot assets and the distributee receives only nonsection 751 assets. Even though a revaluation freezes the distributee's share of hot asset appreciation, section 751(b) will nevertheless be triggered if the distributee's share of the *gross* value of the partnership's hot assets is reduced. Under the section 704(c) approach, the distributee's share of the gross value of hot assets depends on her share of common basis plus her share of unrealized appreciation. If a distribution reduces the distributee's percentage share of common basis (but does not alter her share of unrealized appreciation), her share of the gross value of the partnership's assets is

149. See Regs. § 1.704-2(m) ex. 3(ii).

150. Id.; see also Regs. § 1.704-2(d)(4) (decrease in partnership minimum gain attributable to revaluation added back for purposes of determining any net increase (decrease) in partnership minimum gain for current year).

151. See McKee et al., supra note 19, ¶ 21.03[8], at 21-30 to 21-31; cf. Rev. Rul. 84-102, 1984-2 C.B. 119 (disproportionate distribution of cash triggers gain under § 751(b); book-up not addressed). See also Francis J. Emmons & S. Richard Fine, Coping With IRS' Ruling Which Applies Sec. 751 On the Admission of New Partners, 62 J. Tax'n 160 (1985); William T. Carman, Revenue Ruling 84-102—An Erroneous Conclusion?, 2 J. Partnership Tax'n 371 (1986).

152. The existing § 751(b) regulations expressly sanction an agreement to treat a distribution of one class of partnership property as reducing the distributee's interest only in that class of property. See Regs. § 1.751-1(b)(1)(ii). A book-up, which freezes the distributee's interest in hot assets, may have a similar effect.

necessarily reduced.[153] Thus, section 751(b) will be triggered even though the distributee's share of hot asset gain is unchanged. This treatment reflects the underlying flaw in the measurement of hot asset shifts under existing section 751(b). The anomaly would be eliminated if the provision were revised to focus on shifts in hot asset appreciation (rather than gross value).

The examples above assume that the partnership distributes only nonsection 751 assets and the distributee retains an interest in the partnership's remaining hot assets sufficient to avoid triggering section 751(b). If a nonliquidating distribution includes hot assets, a book-up cannot necessarily prevent a section 751(b) shift because a portion of the hot assets are no longer in partnership solution. Similarly, a hot asset shift may occur when a partner's interest is entirely liquidated, since the distributee retains no share of the partnership's remaining assets. Although the section 704(b) regulations virtually mandate a book-up (or equivalent special allocations) when a portion of a partner's interest is relinquished, the partnership is burdened with the need for continuing special allocations. Thus, a revaluation may prove quite cumbersome. Unfortunately, the section 704(b) regulations provide virtually no guidance concerning the effect of a revaluation in connection with a hot asset distribution.

IV. PRESERVING NONRECOGNITION TREATMENT THROUGH BASIS ADJUSTMENTS

A. *Hot Asset Exchanges and Inside Basis Adjustments*

William D. Andrews has recently proposed several changes in the treatment of partnership distributions, ranging from relatively minor technical revisions to far-reaching structural reforms.[154] The general tendency of these proposals is to prevent the use of distributions to shift unrealized appreciation among partners and to remedy defects in the existing basis allocation rules. More specifically, Andrews suggests mandatory section 734(b) basis adjustments to eliminate loss duplication and basis-stripping transactions.[155]

---

153. For example, assume that a distributee's share of the partnership's common basis is reduced from one-third to one-ninth as a result of a cash distribution, when the partnership owns a hot asset with a basis of $30 and a fair market value of $90. The distributee's one-ninth share of the common basis of the hot asset ($3.33) plus her one-third share of the unrealized appreciation ($20) is less than her former one-third share of the asset's gross value ($30). See supra notes 144-46 and accompanying text.

154. See generally Andrews, supra note 12.

155. For an illustration of these transactions, see Louis S. Freeman & Thomas M. Stephens, Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Corporate Business Activities, 68 Taxes 962, 993-95 (1990).

In connection with these proposals, Andrews also suggests revisions in the treatment of hot asset distributions.

The Andrews proposals would modify the definition of hot assets and change the basic statutory mechanism of section 751(b) from "exchange" to "sale" treatment.[156] Hot asset exchanges would trigger gain to the extent that a partner's share of hot asset appreciation cannot be preserved through appropriate basis adjustments. To prevent shifting of basis from nondepreciable to depreciable property, these proposals would modify the method of allocating basis adjustments under section 755. In addition, the categories of section 751(b) assets would be expanded to include a separate class of "tepid" assets.[157]

The Andrews proposals would eliminate the substantial appreciation test and would apply a full look-through approach in determining a partner's share of hot assets.[158] To ensure that section 751(b) achieves its intended purpose, these proposals would focus on shifts in a partner's proportionate share of hot asset appreciation rather than the gross value of hot assets.[159] Furthermore, by treating a disproportionate distribution as a simple "sale" rather than an "exchange,"[160] the Andrews proposals would eliminate unnecessary recognition of gain when a partner's interest in cold assets (rather than hot assets) decreases, thereby simplifying the operation of section 751(b). A partner would recognize gain only to the extent that the net decrease in her share of appreciation in hot (or tepid) assets cannot be preserved through basis adjustments. The transaction would be treated essentially as a sale of the partner's relinquished share of hot (or tepid) asset appreciation for cash, followed by a contribution of the cash consideration to the partnership.[161] The "selling" partner would increase her outside basis and tax capital account by the amount of gain recognized, and the partnership would receive a corresponding increase in its basis in hot (or tepid) assets.

The Andrews proposals would maximize nonrecognition by adjusting the basis of distributed property and the partnership's inside basis to preserve shares of unrealized gain (or loss) of the appropriate character. Section 751(b) would be modified to require each partner and the continuing partnership to make such basis adjustments following a distribution as needed to preserve their respective pre-distribution shares of unrealized gain (or loss) in the

---

156. See Andrews, supra note 12, at 52.

157. See id. at 53-54. Tepid assets would consist essentially of § 1250 real property. See infra notes 178-180 and accompanying text.

158. See Andrews, supra note 12, at 52.

159. See id. at 48.

160. See id. at 46 ("As a conceptual matter, there is no reason to insist on the exchange model.").

161. See id. at 46 n.159; Cunningham, supra note 12, at 92 n.66.

partnership's hot assets and other property.[162] Basis reallocation represents the key to preserving shares of unrealized gain. Following a distribution, each partner's basis in hot assets would be set equal to the fair market value of her share of the distributed (or retained) hot assets less her pre-distribution share of hot asset appreciation (but not less than zero).[163] Gain would be recognized only to the extent that the fair market value of the partner's post-distribution share of hot assets is insufficient to absorb the required basis adjustments.[164]

Under the Andrews proposals, carryover of basis adjustments would no longer be permitted.[165] Basis adjustments that cannot be implemented currently ("prevented adjustments") would result in recognition of gain (in the case of a negative adjustment) or loss (in the case of a positive adjustment).[166] An election would be allowed, however, to reduce the basis of "hotter" property to defer recognition of gain (or increase the basis of "cooler" property to defer recognition of loss).[167] Any basis adjustments would be allocated in the manner prescribed by section 755, which would be revised to parallel more closely other statutory nonrecognition provisions.[168]

Consistent with current law, revised section 755 would allocate basis adjustments initially among property within particular classes so as to eliminate disparities between basis and fair market value.[169] Any remaining basis adjustments would be allocated in proportion to the respective fair

---

162. See Andrews, supra note 12, at 53, 55.

163. See id. at 53. If § 751(b) were eliminated as a separate provision, the rules of §§ 731 and 732 could be revised to specify appropriate gain recognition and basis consequences. See id. at 55 n.178.

164. See id. at 53.

165. Cf. Regs. § 1.755-1(b)(4). Under current law, if a basis adjustment cannot be made because the partnership lacks property of the appropriate character (or there is insufficient basis to absorb a negative adjustment), the adjustment is applied to after-acquired property of the appropriate character. See id. Under these rules, a required basis adjustment may be suspended indefinitely. See also Prop. Regs. § 1.755-1(c)(4) (carryover adjustment).

166. See Andrews, supra note 12, at 37, 39.

167. See id. Rather than recognize loss immediately, the taxpayer could elect to suspend the basis increase for allocation to after-acquired property of the appropriate character. See id.

168. See id. at 17 (comparing inside basis adjustments to recently repealed § 1034(e) which determined the adjustments to basis of new residence); see also IRC §§ 1033 (substitute property in connection with involuntary conversion), 1017 (basis adjustments to avoid cancellation-of-indebtedness income).

169. See Andrews, supra note 12, at 31. Andrews refers to this method of reallocating basis as the "Enlightened Net Adjustment Allocation." See id. at 31-32. He rejects as excessively complex an alternative "proportional reallocation" method that would treat a distribution as an exchange of the continuing partners' interests in the distributed property for the withdrawing partner's interest in the retained partnership assets. See id. at 29-31; see also Cunningham, supra note 12, at 85-86.

market value of the assets (if the adjustment is positive) or in proportion to the respective bases of the assets (if the adjustment is negative). Thus, the current prohibition on adjustments that increase the disparity between basis and fair market value (so-called "wrong-way" adjustments)[170] would be eliminated. This prohibition makes sense in the case of a sale of a partnership interest because the basis adjustments are intended generally to give the purchaser the equivalent of a cost basis.[171] Following a distribution, however, the section 734(b) basis adjustments serve a quite different purpose: basis adjustments that increase the disparity between basis and fair market value may be essential to preserve shares of unrealized gain (or loss) for future taxation.[172]

By making section 734(b) basis adjustments mandatory, the Andrews proposals would eliminate the ability to exploit the current elective regime when the failure to adjust inside basis is beneficial to the continuing partners. These proposals would also cure a technical defect in the existing section 734(b) adjustment.[173] Under current law, the section 734(b) adjustment is determined by reference to the distributee partner's outside basis rather than her share of the partnership's inside basis.[174] Although this formula often works well, it invariably reaches the wrong result when a partner's outside basis differs from her share of inside basis.[175] Under the Andrews proposals, the section 734(b) adjustment would be determined by reference to the partner's share of inside basis, a concept already employed by the section 743(b) regulations.[176] Thus, the section 734(b) adjustment would be

---

170. See Regs. § 1.755-1(a)(1)(iii). But see Andrews, supra note 12, at 28 n.96 (noting that "the blanket prohibition [on wrong-way adjustments] cannot mean what it seems to say"). See also Prop. Regs. § 1.755-1(c)(2) (permitting wrong-way adjustments).

171. See supra note 26 and accompanying text.

172. See Andrews, supra note 12, at 17. Proposed regulations under § 755 recognize the need for separate rules for allocating basis adjustments under §§ 743(b) and 734(b). See Prop. Regs. §§ 1.755-1(b) (§ 743(b) adjustments), 1.755-1(c) (§ 734(b) adjustments).

173. See Andrews, supra note 12, at 13; see also A.B.A. Tax Section Recommendation No. 1974-9, reprinted in 27 Tax Law. 839, 869-72 (1974); Selected Partnership Tax Issues, supra note 8, at 32-33.

174. More technically, the § 734(b) adjustment is determined by reference to §§ 731 and 732, both of which refer to the partner's outside basis. See IRC §§ 731, 732, 734(b).

175. Such a discrepancy is likely to occur, for example, if a partnership interest is acquired by purchase or inheritance when the partnership does not have a § 754 election in effect. In this situation, the § 734(b) adjustment preserves the pre-distribution inequality between the partners' aggregate bases in their partnership interests and the partnership's aggregate basis in its assets. See McKee et al., supra note 19, ¶ 25.01[3], at 25-8.

176. Under the § 743(b) regulations, a partner's share of inside basis is equal to the "sum of [the partner's] interest as a partner in partnership capital and surplus, plus [her] share of partnership liabilities." Regs. § 1.743-1(b)(1); see Prop. Regs. § 1.743-1(d)(1) under which a partner's share of inside basis is equal to the "sum of the transferee's interest as a partner

"equal to the difference between (1) the amount of money plus the inside basis of other property distributed and (2) the reduction in the distributee's share of inside basis resulting from the distribution."[177]

The Andrews proposals would expand the categories of section 751 property from two (hot assets and other property) to three by adding depreciable property as a separate class of "tepid assets."[178] Such property would occupy an intermediate position in the continuum between hot assets (unrealized receivables and inventory) and cold assets (nondepreciable capital gain assets).[179] Since depreciation recapture would continue to be treated as an unrealized receivable, this change would affect primarily section 1250 real property.[180] The purpose of these rules is to "prohibit reallocation of basis from nondepreciable capital assets to depreciable property, as well as reallocation from capital gain to ordinary income property."[181] Although additional categories of assets would permit even finer distinctions to be drawn, the improved accuracy might not warrant the resulting complexity.[182]

The Andrews proposals would also modify the manner in which basis is allocated among distributed assets so that the rules would parallel those for allocating inside basis adjustments.[183] Under proposed section 732(c), each distributed asset would initially take a basis in the distributee's hands equal to its basis in the partnership's hands; any required adjustments to basis would then be allocated under the rules of proposed section 755.[184] Thus, the basis allocation rules of section 732(c) would be conformed to those of section 755.

B. *Complete or Partial Liquidations Involving Hot Asset Exchanges*

1. *Complete Liquidations.*—Although the Andrews proposals are technically complex, they can be illustrated relatively simply in the context

---

in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities." Since partnership liabilities generally cancel out, the amount of the § 734(b) adjustment may be determined by comparing the amount of cash and the basis of property distributed with the distributee partner's interest in partnership capital computed on a tax (rather than book) basis. See Andrews, supra note 12, at 13 n.45.

177. See Andrews, supra note 12, at 22. The proposed method of determining the § 734(b) adjustment also reaches the correct result when § 704(c) allocations are present. See Cunningham, supra note 12, at 81 n.14.

178. See Andrews, supra note 12, at 53-54.

179. See id. at 53.

180. See id. at 53-54; Cunningham, supra note 12, at 92.

181. Andrews, supra note 12, at 38.

182. See id. at 54.

183. See id. at 31, 40.

184. See id. at 40. Accordingly, § 732(c) adjustments would be determined partly by reference to the fair market value of distributed property. See IRC § 732(c) (as amended by the 1997 Act).

of a distribution in complete liquidation of a partner's interest. Assume that the equal ABC general partnership distributes $400 cash and depreciable real property worth $300 to A in complete liquidation of her partnership interest when ABC has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 700	$ 700	A	$ 500	$ 700
Inventory	180	300	B	500	700
Real Property	60	300	C	500	700
Securities	560	800	Total	$1500	$2100
Total	$1500	$2100			

Following the distribution, A and the continuing BC partnership would be required to adjust their bases in the distributed and retained assets to reflect increases (or decreases) in their respective shares of appreciation in each category of assets.[185] Under proposed section 732(c), A would initially take a basis in the real property equal to the partnership's basis in the distributed property ($60). The required section 751 adjustments would be equal to the net increase (decrease) in A's share of unrealized appreciation in each category of property.[186] The $160 positive adjustment for tepid assets would increase A's basis in the real property from $60 to $220, preserving her pre-distribution share of appreciation in tepid assets ($80). Since A received no property other than cash and tepid assets, the prevented negative adjustments for hot and cold assets potentially trigger recognition of income. A must recognize $40 of ordinary hot asset gain.[187] To avoid immediate recognition

185. Prior to any required basis adjustments, the offsetting increases (decreases) in the partners' respective shares of appreciation in each category of assets can be determined as follows:

Exchange Chart

Withdrawing Partner A	Before	After	Increase (Decrease)	Continuing BC Partnership	Before	After	Increase (Decrease)
Hot Assets	$40	$ 0	($ 40)	Hot Assets	$ 80	$120	$ 40
Tepid Assets	80	240	160	Tepid Assets	160	0	(160)
Cold Assets	80	0	(80)	Cold Assets	160	240	80

Compare Cunningham, supra note 12, at 93 ("Appreciation Chart") with McKee et al., supra note 19, ¶ 21.03[3], at 21-14 to 21-15 ("Partnership Exchange Table").

186. The difference between A's outside basis ($500) and the partnership's basis in the distributed property ($460) is equal to the net increase (decrease) in shares of unrealized appreciation with respect to A and the partnership.

187. Under proposed § 755, the basis of "cooler" property may not be reduced to avoid immediate recognition of gain. See Andrews, supra note 12, at 38-39.

of $80 of cold asset gain, however, A may elect to reduce her basis in the real property from $220 to $140.[188]

With respect to the BC partnership, the $40 positive adjustment for hot assets increases the basis of the inventory from to $180 to $220. The $80 positive adjustment for cold asset appreciation increases the basis of the securities from $560 to $640. Since the BC partnership does not hold any tepid assets after the distribution, the $160 negative adjustment to tepid assets triggers gain, unless the partnership elects instead to reduce the basis of the inventory from $220 to $60. Assuming such an election, the BC partnership's post-distribution balance sheet would be as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 300	$ 300	B	$ 500	$ 700
Inventory	60	300	C	500	700
Securities	640	800	Total	$1000	$1400
Total	$1000	$1400			

B and C each continue to have a $200 share of unrealized appreciation in partnership assets (two-thirds of the partnership's pre-distribution unrealized appreciation).

2. *Partial Liquidations.*—The Andrews proposals would treat a redemption of a portion of a partner's partnership interest as a partial liquidation.[189] As under the deemed-sale approach, the distributee's partnership interest would be bifurcated into a redeemed and a continuing interest.[190] While a complete liquidation of a partner's interest leaves the distributee with no outside basis, tax capital account or share of inside basis, a "straight-up" partial liquidation removes only a ratable share of these amounts.[191] The redeemed portion of the distributee's partnership interest would be determined by comparing the value of the distribution to the total value of such interest, and the distributee's outside basis would be reallocated between the distributed property and her continuing partnership interest. The

188. A's outside basis ($500) is increased by the gain recognized ($40) and decreased by the basis of the distributed property in A's hands ($400 cash plus $140 basis of real property). On a sale of the real property, A would recognize gain of $160 ($300 fair market value less $140 basis). Thus, A's pre-distribution gain of $200 is recognized or preserved.

189. See Andrews, supra note 12, at 65-66.

190. Bifurcated treatment is necessary under both models to maintain proportionality between the continuing partners' shares of unrealized appreciation and their post-distribution percentage interests in the partnership.

191. The Andrews proposals may also be applied to more "irregular distributions" in which the reduction in the distributee's partnership interest is not strictly proportional. See Andrews, supra note 12, at 73-75.

partnership's basis in undistributed assets would also be reallocated to the extent necessary to preserve the continuing partners' shares of unrealized appreciation in each class of partnership property.

Assume that C receives a distribution of depreciable real property, reducing her interest in the equal ABC partnership from one-third to one-fifth, when the partnership has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$120	$180
Inventory	60	180	B	120	180
Real Property	60	90	C	120	180
Securities	120	150	Total	$360	$540
Total	$360	$540			

C would be treated as if she had disposed of one-half of her partnership interest based on the value of the distribution. The redeemed portion of C's interest has a basis of $60 and a fair market value of $90; in exchange for the real property, C gives up a one-sixth interest in the partnership's unrealized appreciation in undistributed assets.[192] In C's hands, the basis of the real property would be increased from $60 to $85 to reflect the $25 positive adjustment for tepid assets. Since C receives only tepid assets, the prevented negative adjustment to hot assets triggers $20 of ordinary income. C may elect to reduce her basis in the real property from $85 to $80 to reflect the $5 negative adjustment for cold assets.

With respect to the continuing ABC partnership, the $20 positive adjustment to hot assets increases the basis of the inventory from $60 to $80. The $5 positive adjustment to cold assets increases the basis of the securities from $120 to $125. Since the partnership no longer holds any tepid assets, the $25 negative adjustment for tepid assets will trigger immediate recognition of gain, unless ABC elects instead to reduce the basis of the inventory from $80 to $55. Assuming such an election, the ABC partnership's post-distribution balance sheet would be as follows:

---

192. The pre-and post-distribution appreciation in each asset category attributable to C's redeemed one-sixth interest and to the continuing ABC partnership is as follows:

Exchange Chart

C's Redeemed Interest (1/6)	Before	After	Increase (Decrease)	ABC Partnership (5/6)	Before	After	Increase (Decrease)
Hot Assets	$20	$ 0	$(20)	Hot Assets	$100	$120	$20
Tepid Assets	5	30	25	Tepid Assets	25	0	(25)
Cold Assets	5	0	(5)	Cold Assets	25	30	5

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$120	$180
Inventory	55	180	B	120	180
Securities	125	150	C	60	90
Total	$300	$450	Total	$300	$450

Each partner's post-distribution outside basis, tax capital account and share of inside basis corresponds to her continuing interest in the partnership. The partnership's post-distribution unrealized appreciation of $150 is allocated four-fifths to A and B ($60 each) and one-fifth to C ($30) in accordance with their continuing percentage interests in the partnership.[193]

3. *Cash Distributions.*—Under current law, a cash distribution must exhaust the distributee's entire outside basis before any gain is triggered.[194] The Andrews proposals would dramatically change this result by requiring proportional gain recognition when a cash distribution results in a partial liquidation. While this result "may come as a shock to some who are steeped in the ways of subchapter K,"[195] the current treatment of disproportionate cash distributions is arguably too lenient. Other statutory nonrecognition provisions generally require recognition of gain to the extent of any "boot" received.[196] Therefore, even proportional gain recognition would represent relatively lenient treatment of partnership distributions of cash.[197]

4. *Limit on Gain Recognized.*—The partial-liquidation approach avoids the need for special allocations by preserving proportionality between the partners' shares of unrealized gain (or loss) and their continuing interests. Nevertheless, partial-liquidation treatment may have unexpectedly harsh consequences in the case of a small redemption of a majority partner's interest. The larger the distributee's retained interest in the partnership, the greater the disparity between the amounts of hot asset gain taxed under

193. By contrast, under the deemed-sale approach, the entire appreciation in the distributed property would be taxable immediately, and C would also recognize her redeemed one-sixth share of the unrealized appreciation inherent in the inventory and securities. See supra notes 128-130 and accompanying text.

194. See IRC § 731(a)(1).

195. Andrews, supra note 12, at 67.

196. See IRC §§ 351(b) and 1031(b). But cf. IRC § 356(a)(2). See also Gergen, Contributions and Distributions, supra note 5, at 207-08 (proposing "backloaded" basis recovery).

197. See Andrews, supra note 12, at 67 ("proportional gain recognition rule . . . is mild by comparison" to other boot rules). A proportional gain recognition rule might also eliminate much of the need for the complex disguised sale rules. See id. at 68. See also IRC § 707(a)(2)(B); Regs. § 1.707-4 through -9.

current section 751(b) and the partial-liquidation approach, respectively.[198] To mitigate this problem, the Andrews proposals would limit the amount of recognized gain (or loss) to no more than 150% of the amount "recognized under the method now used under [section] 751(b)."[199] Whenever the section 751(b) limit applied, special allocations would be required to ensure proper allocation of the partnership's subsequent income.[200]

C. *A Compromise Proposal: More Gain Recognition*

The Andrews proposals seek to maximize nonrecognition treatment of disproportionate distributions: hot (or tepid) asset gain would be triggered only to the extent of any prevented basis adjustments. The most obvious objection to the Andrews proposals is that they are too complicated. Indeed, one commentator has suggested that the proposed three-class allocation scheme may "obfuscate" the "elegance and relative simplicity" of the Andrews proposals.[201] Moreover, the opportunity to reallocate basis among partnership assets may give rise to tax-motivated transactions that seek to exploit such rules.

Several of the technical refinements in the Andrews proposals could be implemented even if other proposed reforms were set aside for further study. For example, the basic statutory mechanism of section 751(b) might be modified to permit "sale" rather than "exchange" treatment, even without an expansion of the existing categories of hot assets. Instead of preserving hot asset gain through basis reallocation, it would be possible to require immediate recognition of any net shift in hot asset gain.[202] By limiting opportunities for strategic shifting of asset bases, this approach would mitigate the need for complex basis allocation rules and multiple classes of partnership property. By contrast with current law, hot asset shifts would be measured in terms of unrealized appreciation (rather than gross value).[203]

---

198. See Andrews, supra note 12, at 70. If a minority partner's interest is redeemed, both approaches reach comparable results; for example, § 751(b) treats a redemption of one-half of a one-third partner's interest as a transfer of two-fifths of her interest. See id. at 70 n.225.

199. See id. at 70-71.

200. But see Cunningham, supra note 12, at 102 (questioning whether § 751(b) limit "would be worth the necessary complexity").

201. See id. at 92.

202. American Law Institute, Federal Income Tax Project—Taxation of Pass-Through Entities, Tentative Draft Memorandum No. 3, at 66 (1997) [hereinafter ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3].

203. See id. at 67; see also id. at 69 (eliminating substantial appreciation requirement for inventory).

Under this proposal, it would be necessary first to identify the partnership's hot assets and then to determine the amount of any shift in the distributee's share of net hot asset gain (or loss) as a result of a distribution. For this purpose, the distributee's share of hot asset gain (or loss) at the partnership level would be based on her respective pre- and post-distribution sharing ratios; the distributee's share of hot asset gain (or loss) in distributed hot assets would be determined as if she received a basis in such assets equal to their bases in the partnership's hands.[204] After determining the net increase (or decrease) in the distributee's share of hot asset gain (or loss), the next step would be to determine the tax consequences both to the distributee and to the nondistributee partners.

A disproportionate distribution would trigger recognition of hot asset gain (or loss) to either the distributee or the partnership (allocated entirely to the nondistributee partners), but not both. If the distributee's share of net hot asset gain (or loss) is reduced, the distributee would recognize ordinary income (or loss) equal to such net decrease. Similarly, if the distributee's share of net hot asset gain (or loss) is increased, the partnership would recognize ordinary income (or loss) equal to such net increase. Appropriate adjustments would occur to the partnership's basis in hot assets and the partners' outside bases to reflect any gain (or loss) recognized on the deemed sale; such adjustments would occur immediately before the distribution.

To illustrate, assume that C receives a distribution of Inventory #2, reducing her interest in the equal ABC partnership from one-third to one-fifth, when the partnership has the following balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$120	$180
Inventory #1	60	180	B	120	180
Inventory #2	60	90	C	120	180
Securities	120	150	Total	$360	$540
Total	$360	$540			

Immediately before the distribution, C has a $50 share of the partnership's hot asset gain (one-third of the total). Following the distribution, C has a $24 share of appreciation in Inventory #1 (one-fifth of the total) and Inventory #2 carries out $30 of appreciation ($90 fair market value less transferred basis of $60).[205] Since C's share of net hot asset gain increases from $50 to $54, the nondistributee partners (A and B) must each recognize $2 of ordinary

204. See id. at 69; see also id. at 71 n.169 (bona fide special allocations would be respected).

205. It is assumed that the partnership does not elect to book up its assets or specially allocate the partnership's pre-distribution hot asset gain.

income, increasing their outside bases and the basis of Inventory #2 immediately before the distribution. The basis of Inventory #2 is increased to $64 ($60 basis increased by $4 gain recognized) in C's hands, leaving her with an outside basis of $56 in her continuing partnership interest.[206]

The ABC partnership's post-distribution balance sheet is as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$122	$180
Inventory #1	60	180	B	122	180
Securities	120	150	C	56	90
Total	$300	$450	Total	$300	$450

A and B each have a two-fifths share ($48) of the appreciation in Inventory #1, preserving their $50 share of hot asset gain ($48 plus $2 gain recognized). In addition, C has a one-fifth share ($24) of the appreciation in Inventory #1 plus the unrealized appreciation ($26) inherent in Inventory #2, preserving her $50 share of hot asset gain. The unrealized appreciation in the securities ($30) is allocated four-fifths to A and B ($12 each) and one-fifth to C ($6); thus, the partners' pre-distribution shares of cold asset gain ($10) are overstated or understated.[207] This "temporary" misallocation of cold asset gain would be corrected upon liquidation of the partnership: A and B would each receive a capital loss of $2, while C would report a capital gain of $4.[208]

A distribution that reduces but does not eliminate a partner's interest would be treated as a current distribution rather than a partial liquidation with respect to the distributee.[209] Current distribution treatment preserves the distributee's transferred basis in the distributed property, shifting any basis shortfall (or excess) to her retained interest.[210] It also minimizes the

206. By comparison, the Andrews proposals would require no recognition of gain on the distribution. C would take a basis of $60 in Inventory #2 (offsetting $5 positive adjustment to hot assets and $5 negative adjustment to cold assets), and the partnership would have a $5 negative adjustment to hot assets and a $5 positive adjustment to cold assets. See Andrews, supra note 12, at 71-73.

207. The partners could presumably avoid such distortions by specially allocating the gain inherent in the securities. Indeed, the § 704(b) regulations may require such special allocations. See supra notes 139-53 and accompanying text.

208. With respect to A and B, the capital loss of $2 corresponds to the difference between each partner's two-fifths share of the partnership's common basis ($120) and her outside basis ($122); with respect to C, the capital gain of $4 corresponds to the difference between a one-fifth share of the partnership's common basis ($60) and C's outside basis ($56).

209. See ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 58 (no partial-liquidation rule at the distributee level).

210. Thus, C receives a basis of $64 in Inventory #2, leaving her with a shortfall of $4 in the basis of her retained interest ($56).

likelihood that the distributee will recognize gain on a cash distribution. While a partial-liquidation rule would treat the distributee as surrendering a discrete portion of her partnership interest, the rules of Subchapter K "generally treat an ownership interest as a single, undivided interest, rather than a series of individual interests."[211] Nevertheless, the lack of a partial-liquidation rule may produce peculiar results in terms of the relationship between the distributee's share of unrealized appreciation within the partnership, her outside basis, and the fair market value of her continuing interest.

For example, assume that the ABC partnership above has no hot assets and distributes $90 cash (rather than Inventory #2) to C in redemption of one-half of her interest. C would treat the current distribution of cash as tax-free, reducing her outside basis from $120 to $30. The partnership's post-distribution balance sheet would be as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 30	$ 30	A	$120	$180
Capital Asset #1	60	180	B	120	180
Capital Asset #2	60	90	C	30	90
Capital Asset #3	120	150	Total	$270	$450
Total	$270	$450			

C's remaining partnership interest has a fair market value of $90 and a basis of $30. Although C has a continuing one-fifth interest, she has less than a one-fifth share of the partnership's post-distribution common basis. A partial-liquidation rule would eliminate these distortions by requiring that C recognize gain of $30 on the distribution, i.e., the excess of the cash distribution ($90) over the allocable basis of her redeemed one-half interest ($60). C would end up with a continuing partnership interest having a fair market value of $90 and a basis of $60—half of her former interest in terms of both value and basis. The partnership would also be entitled to increase the basis of its assets by $30, i.e., the excess of the cash distribution ($90) over the reduction in C's share of inside basis ($60).[212] The unrealized appreciation of $150 inherent in the partnership's assets ($450 fair market value less $300 basis) would be allocated four-fifths to A and B ($120) and one-fifth to C ($30), preserving their pre-distribution shares of partnership gain.

The partial-liquidation rule ensures that each partner's tax capital account, share of inside basis, and share of unrealized appreciation correspond

---

211. ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 58.

212. See supra note 177 and accompanying text.

to her continuing interest in the partnership. As a result, no special allocations are necessary to ensure that the partners remain taxable on the proper amounts of gain at the partnership level. In the absence of a partial-liquidation rule, it would be inappropriate to provide an upward adjustment to the partnership's inside basis to reflect the gain that should have been recognized at the distributee level.[213] Although such an upward basis adjustment would ensure that A and B are taxed on only their pre-distribution share of gain ($120), C would be left with too small a share of the gain inside the partnership ($30).[214]

The partial-liquidation rule thus reaches the correct result at both the distributee and partnership level. It may be objected that a partial-liquidation rule would "violate the nonrecognition objective unnecessarily."[215] Without a partial-liquidation rule, however, special allocations would continue to be necessary to properly align the partners' continuing interests in the partnership's cold asset gain. Thus, a partial-liquidation rule seems essential to permit the partnership's accounting to go forward on a simplified basis and minimize the need for special allocations. The compromise proposal is attractive because of its ability to preserve a transferred basis in distributed property in the hands of the distributee, thereby avoiding frequent basis reallocations. This goal is in tension, however, with the need to treat a distribution as a partial liquidation at the distributee level in order to simplify the partnership's post-distribution accounting. If thoroughgoing partial-liquidation treatment is deemed unacceptable, it will be difficult to avoid complex special allocations to preserve the partners' pre-distribution shares of unrealized appreciation.

V. PROSPECTS FOR THE FUTURE OF SECTION 751(b)

A. *Radical Simplification: Repeal of Section 751(b)*

One proposal for radical simplification of the partnership distribution provisions would involve outright repeal of section 751(b). As the 1957 Advisory Group on Subchapter K recognized, repeal of section 751(b) would open the door to shifting of ordinary income and capital gain among partners.

---

213. Compare ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 32 (partial-liquidation treatment at partnership level) with id. at 41-42 (current-distribution treatment at distributee level).

214. While additional gain of $30 would be preserved in C's low basis in her partnership interest, such gain could be deferred until sale of C's interest or liquidation of the partnership.

215. ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 57.

The Advisory Group nevertheless considered that repealing section 751(b) would strike a workable balance between "simplicity" and the desire to minimize tax planning opportunities.[216] Forty years later, while section 751(b) continues to be perceived as monstrously complex, the prospects for outright repeal seem relatively dim. In light of recent attacks on income-shifting within Subchapter K, Congress is unlikely to look favorably on proposals to relax the distribution rules even further. Indeed, the 1997 Act has arguably revitalized the role of section 751(b) by restoring a significant capital gains preference.

It is not surprising, therefore, that most partnership reformers accept the continuing need for some form of section 751(b). In the absence of section 751(b), partners could use distributions to shift the character of income among themselves in a manner that reduces their overall tax burden.[217] Yet the case for retaining section 751(b) may be less strong than it appears at first glance. In other situations, the section 704(b) regulations rely on a general anti-abuse rule to safeguard against "character" allocations intended to improve the partners' overall tax position with little or no economic risk.[218] Thus, the anti-shifting function of section 751(b) might be viewed as statutory "overkill." As a practical matter, it is possible that the in terrorem effect of an anti-abuse rule might be nearly as effective as section 751(b) in curbing abusive income-shifting techniques. Presumably, sophisticated taxpayers who take advantage of income-shifting opportunities are also well aware of the potential scope of a broad anti-abuse rule. For other taxpayers, even existing section 751(b) may not have much of a deterrent effect if the "common assumption" is correct that the provision is "often honored in the bre[a]ch."[219]

It might be objected that repeal of section 751(b) would open the door to conversion of ordinary income into capital gain. The chief potential for such conversion appears to lie in the operation of the basis adjustment provisions of section 755. If section 751(b) were eliminated, the problem would be acute if upward basis adjustments could somehow be allocated to the partnership's hot (or tepid) assets. A relatively simple cure would be to allow upward basis adjustments only for truly "cold" assets, i.e., nondepreciable capital assets.[220] If this change were made, outright repeal of section

---

216. See supra notes 51-61 and accompanying text.

217. See ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 66.

218. See Regs. § 1.704-1(b)(2)(iii)(a) (overall-tax-effect rule).

219. ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 171-72.

220. See id. at 50 (defining term "cold asset"); see also Selected Partnership Tax Issues, supra note 8, at 34-35.

751(b) would not provide an opportunity to convert ordinary income into capital gain or improperly inflate the basis of depreciable property.

Restricting upward basis adjustments to a single class of cold assets, however, might create serious problems in the case of prevented adjustments. Under current law, prevented adjustments are suspended and may never be used because of the prohibition on wrong-way adjustments.[221] Allowing a long-term capital loss for prevented upward adjustments would be too generous to taxpayers with offsetting capital gains, and at the same time would generate potentially unusable capital losses for other taxpayers. If wrong-way adjustments were permitted, the partnership could create an artificial capital loss by purchasing a cold asset to obtain an inflated basis for purposes of a subsequent sale. Thus, it would probably be necessary to provide an arbitrary amortization period for prevented upward basis adjustments.[222]

The argument for retaining section 751(b) might be considerably strengthened if the provision functioned more broadly as a limitation on nonrecognition, rather than as an anti-shifting backstop to section 751(a). Indeed, the most sophisticated defense of section 751(b) is that it has come to represent mainly a timing provision, whatever the 1954 Code drafters may have intended.[223] But that rationale suggests that section 751(b), in its present form, is too narrow, and should be extended to reach cold asset exchanges as well as hot (or tepid) asset exchanges. If section 751(b) is reformulated as a recognition provision, it seems sensible to trigger gain whenever the partners' shares of unrealized appreciation in specific categories of assets cannot be preserved.

The existing classification of partnership property within two broad classes—hot and cold assets—allows considerable potential for manipulation of basis adjustments. While a three-class system would provide more accuracy, it might be argued that even three classes are not enough. Indeed, the 1997 Act has created multiple categories of capital assets: gain from disposition of a capital asset will be taxed at different rates depending on the type of capital asset, the taxpayer's holding period and applicable marginal rate, and the extent of any statutory recapture.[224] In 1997, Congress recognized that the anomalous treatment of section 1250 real property created problems in connection with the restoration of a capital gains preference.

---

221. See supra notes 165 & 170 and accompanying text.

222. See Selected Partnership Tax Issues, supra note 8, at 34 n.72.

223. See supra note 32 and accompanying text.

224. See IRC § 1(h) (as amended by the 1997 Act); see, e.g., IRC § 1(h)(5)(b) ("collectibles gain" upon sale of an interest in a pass-through entity); IRC § 1(h)(6) (unrecaptured § 1250 gain); see also ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 48.

Instead of tightening the recapture rules, however, Congress created a special statutory rate for unrecaptured section 1250 gain.[225] Congress made no corresponding change to include unrecaptured section 1250 gain in the definition of unrealized receivables for purposes of section 751(b).

The 1997 Act highlights the most glaring defect in the existing two-class allocation system: lumping unrecaptured section 1250 gain together with nondepreciable capital assets. This defect could be remedied by treating the section 1250 recapture component of real property as an unrealized receivable for purposes of hot asset classification. If a distribution resulted in a net reduction in a partner's share of unrecaptured section 1250 gain, the relinquished share of appreciation would be taxed immediately as capital gain eligible for the special statutory rate for such gain. Treating depreciable real property in the same manner as other depreciable property might largely eliminate the need for a separate class of tepid assets. Except for this modification, the existing classification of hot and cold assets could be retained. It might then be possible to expand section 751(b) to play a broader role as a recognition provision whenever a distribution results in a net shift in a partner's interest in hot or cold assets.

B. *Mandatory Revaluation and Gain Recognition*

Preserving shares of unrealized appreciation within different categories of assets could be accomplished by requiring a revaluation of partnership property following a distribution, coupled with special allocations. Indeed, the section 704(b) regulations already appear to mandate a similar approach, although they fail to clarify the operation of section 704(c) principles in this context. Requiring a revaluation and appropriate gain recognition would thus seem to represent an alternative to the Andrews approach. Since the section 704(b) regulations virtually mandate a revaluation whenever a partner's interest is relinquished, the proposed change could be viewed as relatively minor. A more far-reaching proposal would be to extend hot asset treatment to exchanges involving nonhot assets: hot or cold asset gain would be recognized whenever a non-pro rata distribution leaves the partners with altered shares of such gain.

The chief drawback of mandatory revaluations is that the partnership would be required to account for pre-distribution gain or loss through special allocations. To illustrate, assume that C receives a distribution of Inventory #2, reducing her interest in the equal ABC partnership from one-third to one-

225. See IRC § 1(h)(1)(B), (h)(6). Under the new provision, the amount of gain that would have been treated as ordinary income if the property had been § 1245 property will be taxed at a special statutory rate (25% maximum).

fifth. Immediately before the distribution, the partnership's assets are revalued:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$120	$180
Inventory #1	60	180	B	120	180
Inventory #2	60	90	C	120	180
Securities	120	150	Total	$360	$540
Total	$360	$540			

The partnership's post-distribution balance sheet is as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$120	$180
Inventory #1	60	180	B	120	180
Securities	120	150	C	60	90
Total	$300	$450	Total	$300	$450

Following the distribution, C has a one-fifth share of the partnership's common basis ($60/$300) and a one-fifth share of the gross value of the partnership's assets ($90/$450). Applying section 704(c) principles, C has a one-third share of the unrealized appreciation in the securities ($10) and a one-sixth share of the unrealized appreciation in Inventory #1 ($20). C's one-sixth share of the partnership's remaining hot asset gain is equal to her pre-distribution one-third share of total hot asset gain ($50) less her preserved share of hot asset gain in distributed Inventory #2 ($30). Since there is no net increase (decrease) in C's share of hot asset gain, the distribution should not trigger section 751(b). The partnership's remaining hot asset gain of $100 ($120 less C's $20 share) should be allocated entirely to A and B, preserving each partner's pre-distribution share of hot asset gain ($50). Each partner would continue to be allocated a one-third share ($10) of the unrealized appreciation in the securities.

Assume that C instead receives a distribution of $90 cash (rather than Inventory #2) and the partnership's assets are revalued immediately before the distribution. The partnership's post-distribution balance sheet is as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 30	$ 30	A	$120	$180
Inventory #1	60	180	B	120	180
Inventory #2	60	90	C	30	90
Securities	120	150	Total	$270	$450
Total	$270	$450			

C has a one-ninth share of the partnership's common basis ($30/$270) and a one-fifth share of the gross value of the partnership's assets ($90/$450).

Since each partner's pre-distribution one-third share of the unrealized appreciation in Inventory #1 ($40), Inventory #2 ($10) and the securities ($10) is unchanged, section 751(b) should be inapplicable.

Hot asset gain (or loss) should be triggered whenever there is a net increase (decrease) in a partner's share of hot asset gain (or loss), taking into account the effect of a revaluation. For example, assume that C instead receives a distribution of one-half of Inventory #1 (with a basis of $30 and a fair market value of $90). Following the distribution, the partnership has unrealized appreciation of $60 in the remaining one-half of Inventory #1 ($90 fair market value less $30 basis) and unrealized appreciation of $30 in Inventory #2 ($90 fair market value less $60 basis). Thus, the partnership's total hot asset gain has been reduced from $150 to $90; $60 of hot asset gain has been shifted to C outside the partnership, i.e., the difference between the fair market value of one-half of Inventory #1 ($90) and one-half of its pre-distribution basis in the partnership's hands ($30).

In determining the consequences of the hot asset shift, C should be treated initially as taking a transferred basis of $30 in Inventory #1. Since there is a net increase of $10 in C's share of hot asset gain ($60 outside the partnership less $50 pre-distribution share), the distribution should trigger ordinary income to A and B equal to the net increase in C's share of hot asset gain. A and B would be treated as selling their relinquished shares of hot asset appreciation in Inventory #1 ($10) for cash, triggering $5 of ordinary income to each partner; A's and B's outside bases and tax capital accounts would be increased to reflect the gain recognized.[226]

Immediately before the distribution, the partnership's basis in the distributed half of Inventory #1 would be increased from $30 to $40 to reflect the gain recognized. Accordingly, C would take a basis of $40 in Inventory #1, leaving her with a $50 share of hot asset gain ($90 fair market value less $40 basis) in Inventory #1. The partnership would have the following post-distribution balance sheet:

Assets	Basis	Value	Capital	Basis	Value
Cash	$120	$120	A	$125	$180
Inventory #1	30	90	B	125	180
Inventory #2	60	90	C	80	90
Securities	120	150	Total	$330	$450
Total	$330	$450			

226. The transaction may be viewed as a sale by the nondistributee partners of a one-sixth interest in the distributed portion of Inventory #1 (with a basis of $5 and a fair market value of $15) for cash, followed by a contribution of the cash consideration to the partnership. See supra notes 160-61 and accompanying text.

Applying section 704(c) principles, the unrealized appreciation in Inventory #1 ($60) and Inventory #2 ($30) should be allocated equally to A and B, preserving their $45 share of hot asset gain inside the partnership. Each partner would continue to be allocated a one-third share ($10) of the unrealized appreciation inherent in the partnership's securities.

The existing section 751(b) regulations focus on a partner's share of the gross value of hot assets following a distribution. In some circumstances, a partner's booked-up share of hot asset appreciation may exceed the gross value of her remaining interest in the partnership, as measured by her post-distribution book capital account. Section 751(b) should be triggered to the extent that the book value of the partner's interest is less than her preserved share of hot asset gain.[227] For example, assume that the equal ABC partnership has $60 cash, inventory worth $150 (with a basis of $75), and nontraded securities worth $90 (with a basis of $15), and each partner has an outside basis of $50 equal to her share of the partnership's common basis. If the partnership's assets are revalued and the securities are distributed to C in redemption of 90% of her partnership interest, the partnership would have the following balance sheet (assuming section 751(b) is inapplicable):

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 60	$ 60	A	$ 50	$100
Inventory	75	150	B	50	100
Total	$135	$210	C	35	10
			Total	$135	$210

C's booked-up share of the partnership's hot asset gain ($25) exceeds the gross value of her remaining partnership interest ($10). If C sold her partnership interest for $10, her recognized ordinary income under section 751(a) would apparently be limited to $10, or $15 less than her $25 share of hot asset gain on sale of the inventory.[228] To eliminate this distortion, C should be required to recognize $15 of ordinary income immediately, increasing the basis of her partnership interest and the partnership's basis in the inventory.

If shifts in cold asset gain were treated as taxable, A and B would each recognize their $25 share of appreciation in the distributed securities immediately. Each partner would increase her outside basis to reflect the gain

---

227. See McKee et al., supra note 19, ¶ 21.03[8], at 21-30 to 21-31.

228. Under § 751(a), C would apparently recognize a capital loss of $35, the excess of her outside basis ($35) over the amount paid for her share of non-§ 751 assets (zero). See Regs. § 1.751-1(a)(2). Alternatively, C could be required to recognize $25 of ordinary income and $50 of capital loss on sale of her partnership interest, preserving the proper character and overall amount of gain. See Prop. Regs. § 1.751-1(a)(2) (apparently reaching proposed alternative result).

recognized, and the basis of the securities would be increased immediately before the distribution. C would take a basis of $65 in the distributed securities equal to their basis in the partnership's hands ($15 basis increased by $50 gain recognized), and C's outside basis would be reduced to zero ($50 increased by $15 ordinary income and decreased by $65 basis of distributed securities). The partnership's post-distribution balance sheet would be as follows:

Assets	Basis	Value	Capital	Basis	Value
Cash	$ 60	$ 60	A	$ 75	$100
Inventory	90	150	B	75	100
Total	$150	$210	C	0	10
			Total	$150	$210

Upon a sale of the inventory, the ordinary income would be allocated $50 to A and B ($25 each) and $10 to C. C's share of cold asset appreciation ($25) would be preserved in the distributed securities.

Although the 1954 Code drafters were apparently concerned mainly with the problem of shifting ordinary income and capital gain, cold asset exchanges present a related problem of deferral. Since most partnerships are likely to have some section 751 assets in any event, the additional burden of determining shifts in cold asset gain seems quite small. Of course, the distributing partnership would be burdened with the need for continuing special allocations, but the section 704(b) regulations already in effect require such allocations. Nevertheless, the complexity of the section 704(c) approach may seem daunting. Indeed, if it were possible to begin with a clean slate, the Andrews proposals would offer a much simpler means of reaching essentially the same result.

While the Andrews proposals may be viewed as perfecting the 1954 model of Subchapter K, they arguably fit less comfortably within the current framework. Under the section 704(b) regulations and recent statutory amendments, mandatory special allocations of gain (or loss) have become ubiquitous. While the Andrews proposals might provide welcome relief from the complexity of such special allocations, they might also cause some unexpected problems. The existing regulations provide virtually no guidance concerning the interaction among section 734(b) adjustments, section 704(c) allocations and other regulatory allocations.[229] Partial-liquidation treatment would increase the likelihood of mandatory basis adjustments among retained and distributed assets. Such adjustments might provide opportunities for inflating basis when low-basis property is distributed in partial liquidation of

229. But see Prop. Regs. § 1.743-1(d) (coordinating §§ 704(c) and 743(b)).

a partner's interest.[230] It might also be necessary to specify when a sale of distributed property should be imputed to the partnership.[231]

In the absence of generous basis reallocation provisions to permit continued deferral, a partial-liquidation rule would give rise to frequent recognition of gain (or loss) on distributions. By contrast, the section 704(c) approach would continue to treat a non-pro rata distribution that reduces (but does not eliminate) a partner's interest as a current distribution. Since basis reallocation itself may prove troublesome, the additional complexity of the section 704(c) approach may be viewed as tolerable, particularly for sophisticated partnerships. If less complex partnerships wish to avoid a revaluation and attendant special allocations, however, the Andrews proposals may well provide an attractive alternative. Thus, mandatory book-ups could be required unless the partners agree to treat a non-pro rata distribution as a partial liquidation at both the distributee and partnership levels.

C. *Expanding the Section 704(c) Approach*

Expanding section 751(b)-type treatment to cold asset shifts may seem an unjustified departure from the general nonrecognition rules of Subchapter K. The distribution provisions are not alone in permitting temporary deflection of income.[232] Nevertheless, it is puzzling why distributions of nonsection 751 assets have remained relatively immune to income-shifting concerns.[233] In connection with contributions of partnership property, section 704(c) applies rigorous assignment-of-income principles to prevent shifting of built-in gain; similarly, reverse-section 704(c) allocations prevent deflection of unrealized appreciation in partnership assets to a newly-admitted partner.[234] The core notion of section 704(c) is that a contribution of partnership property (or admission of a new partner) is an economic

---

230. See Andrews, supra note 12, at 66.

231. See id.; ALI, Pass-Through Entities, Tentative Draft Memorandum No. 3, supra note 202, at 57 (Andrews proposals might give rise to difficult *Court Holding*-type analysis).

232. For example, the substantial economic effect regulations generally ignore time-value-of-money concerns and are likely to invalidate "shifting" and "transitory" allocations only in situations in which tax-avoidance is the dominant motive. See Regs. § 1.704-1(b)(2)(iii)(b)-(c); cf. Mark P. Gergen, Reforming Subchapter K: Special Allocations, 46 Tax L. Rev. 1, 43 (1990) (proposing elimination of special allocations and apportionment of risks and rewards solely through extra-partnership contractual arrangements) [hereinafter Gergen, Special Allocations].

233. See Andrews, supra note 12, at 63; Cunningham, supra note 12, at 103 (failure of the statute and regulations to address book-tax disparities attributable to distributed property); cf. supra notes 140-53 and accompanying text.

234. See John P. Steines, Jr., Partnership Allocations of Built-In Gain or Loss, 45 Tax L. Rev. 615, 615 (1990) [hereinafter Steines, Partnership Allocations].

exchange, even though gain is deferred under section 721.[235] Thus, section 704(c) may be viewed as "vindicating" the nonrecognition policy of section 721 by ensuring that the deferred gain is eventually taxed to the partner to whom such gain was originally attributable. While simple in concept, section 704(c) surely rivals section 751(b) in the complexity of its operation. Simultaneously, concern that section 704(c) lacks adequate "triggers" has led Congress to expand the types of transactions that trigger recognition of built-in gain.[236]

Others have maintained that efforts to expand section 704(c) principles may pose an implicit challenge to the fundamental nonrecognition policies of section 721 and 731, since all contributions and distributions in effect represent economic exchanges.[237] Nonrecognition treatment upon partnership formation adds to the complexity of Subchapter K because of the need to trace contributed property. Similarly, nonrecognition treatment for partnership distributions requires elaborate rules to safeguard against impermissible shifting of unrealized appreciation. Extending section 751(b)-type treatment to cold asset shifts represents an attempt to strike a balance between preserving the general nonrecognition rules of Subchapter K and curbing excessive deferral of gain. Some may view such changes as unnecessary or even counter to the "fundamental premises" of Subchapter K.[238] By contrast, other critics may insist that stronger measures are needed to prevent unwarranted opportunities for deferral that cannot be easily duplicated outside Subchapter K.[239] Thus, defenders of Subchapter K's broader nonrecognition policy may bear a heavy burden of persuasion.

---

235. See id. at 638.

236. See IRC §§ 704(c)(1)(b), 737. Moreover, "ceiling-rule" shifts may prevent built-in gain from being fully taxed to the partner responsible for § 704(c) (or reverse-§ 704(c)) property. See Laura Cunningham, Use and Abuse of Section 704(c), 3 Fla. Tax Rev. 93, 115-17 (1996); cf. Regs. § 1.704-3(a)(10) (anti-abuse rule).

237. See Steines, Partnership Allocations, supra note 234, at 655 ("Section 704(c) reform has unwittingly become a subterfuge for challenging the most basic rules of Subchapter K . . . ."); see also id. at 616 (analyzing proposals for expansion of § 704(c) and concluding that "only a very narrow expansion, if any, is necessary to prevent tax avoidance").

238. See Rebecca S. Rudnick, Enforcing the Fundamental Premises of Partnership Taxation, 22 Hofstra L. Rev. 229, 359 (1993) ("Exchange treatment is counter to Subchapter K's flexibility and fungibility."). According to Rudnick's view, once assets are contributed to the partnership "pool," the bases of partnership assets and the partners' bases in their partnership interests are fungible; thus, there is no need to allocate basis to particular distributed assets and then create a fictional cross-exchange among the partners. See id. at 359 n.542.

239. For example, § 1031 is relatively restrictive concerning the types of exchanges that may qualify for nonrecognition treatment. See, e.g., IRC § 1031(a)(2)(D).

Some commentators seek to rationalize these nonrecognition policies as facilitating efficient "pooling" and "unpooling" of partnership assets.[240] Others argue that the pooling rationale cannot justify nonrecognition treatment when assets leave the partnership solution since the partners have effectively terminated their original investment.[241] Upon liquidation of the partnership (or an individual partner's interest), the nontax benefits are likely to outweigh the tax cost of immediate recognition. Thus, requiring gain recognition in this situation might not significantly impair efficient pooling or risk-sharing during formation or operation of a partnership.[242] Nevertheless, it might be necessary to apply a similar rule to current distributions of partnership property to avoid distorting the choice between current and liquidating distributions.[243]

In the case of current distributions, nonrecognition treatment may be justified by the relatively easy "avoidability of the tax through alternative arrangements."[244] Assume that one partner wishes to own a particular asset but that the other partners are unwilling to incur tax on the distribution. Without a formal distribution of the property, the partnership could use special allocations, leasing arrangements, and other comparable techniques to achieve the desired economic result at lower tax cost.[245] Thus, more stringent recognition rules might merely encourage retention of property in partnership solution when the property could be deployed more efficiently outside the partnership.[246] Of course, there may be limits on the extent to which partners can shift the economic incidents of ownership without triggering the general anti-abuse rules or disguised sale rules.[247] These rules

---

240. See Rudnick, supra note 234, at 355-60 (arguing that liberal rules for "unpooling" transactions are economically efficient).

241. See supra notes 104-05 & 119-21 and accompanying text.

242. See Berger, supra note 11, at 155 n.208 (arguing that, for most investors, the prospect of an eventual tax upon liquidation is not likely to loom large at the outset).

243. See ALI, Pass-Through Entities, Tentative Draft Memorandum No. 2, supra note 3, at 148.

244. Shaviro, supra note 103, at 50.

245. See id.; Rudnick, supra note 238, at 361-62; see also Gergen, Special Allocations, supra note 232, at 34.

246. Because a current distribution of property would trigger gain to the nondistributee partners, they might have an incentive to prevent such distributions or extract concessions from the distributee partner. See generally Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 Va. L. Rev. 211 (1991).

247. See Regs. § 1.701-2; IRC § 707(a)(2)(B); see also Regs. § 1.707-3(b)(2)(viii) (warning that "distributions, allocations or control of partnership operations . . . designed to effect an exchange of the burdens and benefits of ownership of property" may be evidence of a disguised sale); Regs. § 1.707-3(f), ex. 8 ("mixing bowl" transaction; rebutting presumption that transfers occurring more than two years apart are outside the disguised sale rules); Notice 90-56, 1990-2 C.B. 344 (attacking installment sale transaction).

are relatively blunt instruments, however, and it may be extremely difficult to "unscramble" such transactions, particularly when the actual distribution of property is delayed for several years.[248]

It may seem somewhat opportunistic to defend the permissiveness of the distribution rules on the ground that stricter rules would be self-defeating due to their easy avoidability. Indeed, dissatisfaction with the flexibility of partnership allocations generally, as well as with the perceived shortcomings of the disguised sale rules, may fuel more radical proposals to curb the permissiveness of the distribution rules.[249] Unless Subchapter K is restructured along much more restrictive lines, however, requiring full gain recognition on partnership distributions is likely to place additional stress on the existing rules that permit flexible tailoring of economic arrangements.

VI. CONCLUSION

The permissive partnership distribution rules have only recently begun to receive sustained critical attention. Although section 751(b) has long been viewed as a bulwark against income-shifting, its potential benefits are undermined by complexity and noncompliance. Some commentators assert that the "futile attack" on income-shifting could be abandoned if section 751(b) were simply repealed.[250] Although the rationale for retaining section 751(b) in its present form is hardly compelling, expanded section 751(b)-type treatment for all non-pro rata distributions of partnership assets would help to curb excessive deferral. Because partnerships are already generally required to revalue property in connection with relinquishment of a partner's interest, existing section 704(c) principles could be adapted to accomplish this goal. If more thoroughgoing reform is considered desirable, the Andrews proposals offer a promising avenue for those who seek to refine and improve the existing nonrecognition regime.

While the 1954 Code drafters viewed flexibility as a hallmark of Subchapter K, critics have recently expressed concern that such flexibility creates a need for anti-abuse rules. Moreover, as illustrated by the recent experience with the section 701 regulations, such rules may be complex and imprecise at the same time. If Subchapter K is viewed as "an impenetrable tax-avoidance machine,"[251] eliminating nonrecognition treatment may seem to offer the only satisfactory solution to existing anomalies in the partnership distribution rules. Even such a radical change is unlikely to prove satisfactory,

---

248. See McKee et al., supra note 19, ¶ 13.02[3][b], at 13-17 to 13-18.

249. See generally Berger, supra note 11; Gergen, Contributions and Distributions, supra note 5; Gergen, Special Allocations, supra note 232.

250. See, e.g., Eustice, supra note 10, at 383-84.

251. Steines, Unneeded Reform, supra note 5, at 245.

however, since other features of Subchapter K might be exploited to subvert a recognition rule.

While some reformers may relish the prospect of curtailing the flexibility of Subchapter K, others believe that Subchapter K "for the most part, has it right"[252] and that only incremental reform is needed. For many—perhaps most—reformers, the main challenge is to make simplified forms of business taxation available to those who need them most, while preserving the structure of Subchapter K for those who desire its flexibility and accuracy. Although no single approach is likely to command unanimous support, the current proposals represent a solid foundation for future reform.

252. Kurtz, supra note 2, at 821.