

Partnership Transactions Involving Long-term Contracts

Notice 2002-37

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) intend to publish regulations addressing partnership transactions involving contracts accounted for under a long-term contract method of accounting.

BACKGROUND

Concurrently with this Notice, the IRS and Treasury are issuing final regulations under § 460 of the Internal Revenue Code to address a mid-contract change in taxpayer engaged in completing a contract accounted for under a long-term contract method of accounting. In general, the regulations divide the rules regarding a mid-contract change in taxpayer engaged in completing this type of contract into two categories—constructive completion transactions and step-in-the-shoes transactions. The regulations provide that a transfer described in § 721(a) of a long-term contract to a partnership and a transfer of a partnership interest are step-in-the-shoes transactions. The IRS and Treasury intend to publish regulations addressing these and other partnership transactions involving contracts accounted for under a long-term contract method of accounting. This Notice describes the special rules that will apply to such transactions.

DESCRIPTION OF REGULATIONS RELATING TO PARTNERSHIPS

The IRS and Treasury believe that step-in-the-shoes treatment generally is appropriate for contributions of contracts to partnerships in transactions subject to § 721(a). Accordingly, the contribution of a contract accounted for under a long-term contract method of accounting to a partnership in a transaction subject to § 721(a) is a step-in-the-shoes transaction.

The regulations will require a partner that contributes a contract accounted for under a long-term contract method of accounting to a partnership to increase the

basis of the partnership interest by the amount of gross receipts that the partner has recognized with respect to the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. However, the partner may not reduce the basis of the partnership interest below zero, but must recognize income to the extent that the basis of the partnership interest would be reduced below zero. The regulations will provide that, in applying a long-term contract method of accounting to the contributed contract, the partnership must reduce its total contract price (or gross contract price) by the amount of income recognized by the contributing partner. These rules follow provisions in the final mid-contract change in taxpayer regulations regarding transfers of long-term contracts in certain corporate transactions qualifying for step-in-the-shoes treatment.

Section 704(c) generally provides that income, gain, loss, or deduction attributable to property that is contributed to a partnership must be allocated to the contributing partner. The purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. The regulations will apply § 704(c) principles to income or loss attributable to a contributed contract accounted for under a long-term contract method of accounting. The amount of income or loss subject to § 704(c) will be (i) the amount that would be taken into account (under the constructive completion rules) if, immediately before the contribution of the contract to the partnership, the partner disposed of the contract for its fair market value in a fully taxable transaction, reduced by (ii) the amount of income, if any, that the partner is required to recognize as a result of the contribution. The regulations will provide additional guidance on the manner of applying § 704(c) to income or loss from a contributed contract. The regulations will provide that for periods prior to the date that the regulations are published, taxpayers must apply § 704(c) to such income or loss in any manner that

reasonably accounts for the § 704(c) income or loss over the life of the contract.

Section 741 provides that gain or loss recognized on the sale or exchange of an interest in a partnership shall be considered as gain or loss from a capital asset, except as provided in § 751. Section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or any part of the partner's interest in the partnership attributable to unrealized receivables (as defined in § 751(c)) or inventory items (as defined in § 751(d)) of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset. In Rev. Rul. 79-51, 1979-1 C.B. 225, the IRS ruled that where a partner sold the partner's entire interest in a partnership, amounts received in exchange for the partner's interest attributable to the value at the time of sale of the partnership's partially completed contracts, the income from which was being accounted for on the completed contract method, were taxed under § 751(a).

The transfer of an interest in a partnership engaged in a contract accounted for under a long-term contract method of accounting is a step-in-the-shoes transaction. The regulations will provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of § 751(c). The amount of ordinary income or loss attributable to a contract under the regulations will be the amount of income or loss that the partnership would take into account (under the constructive completion rules) if, at the time of a transfer of a partnership interest or a distribution to a partner (as the case may be), the partnership disposed of the contract for its fair market value in a fully taxable transaction.

The IRS and the Treasury do not believe that step-in-the-shoes treatment is appropriate for distributions of long-term contracts by a partnership to a partner in a transaction subject to § 731(a). In these transactions, a step-in-the-shoes rule may not produce appropriate results if the partner's basis in the contract (including the

uncompleted property, if applicable) that is distributed by a partnership is not equal to the partnership's basis in the contract (including the uncompleted property, if applicable). The regulations will provide that a distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner is a constructive completion transaction. In determining the partnership's income on the constructive completion transaction under § 1.460-4(k)(2), the fair market value of the contract will be treated as the amount paid for the contract.

Section 751(b)(1) provides that to the extent a partner receives in a distribution — (A) partnership property which is (i) unrealized receivables or (ii) inventory items which have appreciated substantially in value, in exchange for all or a part of the partner's interest in other partnership property (including money), or (B) partnership property (including money) other than property described in § 751(b)(1)(A)(i) or (ii) in exchange for all or part of the partner's interest in partnership property described in § 751(b)(1)(A)(i) or (ii), the transaction shall be considered a sale or exchange of the property between the distributee partner and the partnership. Because the distribution of a contract accounted for under a long-term contract method of accounting is treated as a constructive completion transaction, a distribution of the contract causes the partnership to recognize all of the ordinary income or loss attributable to the contract. Although no income or loss remains in the contract after the constructive completion, the partnership may hold other assets that may cause § 751(b) to apply. Therefore, the regulations will require a partnership that distributes a contract accounted for under a long-term contract method of accounting to apply the constructive completion rules before applying the rules of § 751(b) to the distribution.

Where a partnership that holds a contract accounted for under a long-term contract method of accounting makes a distribution to a partner that has the effect of reducing that partner's share of ordinary income or loss from the contract, the regulations generally will not require a constructive completion of the entire contract. However, consistent with the gen-

eral principles of subchapter K, § 751(b) may apply to such a transaction.

Section 732 determines the basis of property (other than money) distributed by a partnership to a partner. Section 734(b) provides for an adjustment to the basis of partnership property as a result of certain distributions from partnerships that have a § 754 election in effect. The regulations will provide that if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then for purposes of determining the partner's basis in the contract (including the uncompleted property, if applicable) under § 732, and the amount of any basis adjustment under § 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution will be the partnership's allocable contract costs (including transaction costs), increased (or decreased) by the amount of income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), and decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

In addition, the regulations will provide that if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, in computing the total contract price for the new contract under § 1.460-4(k)(2)(iii), the partner's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under § 732) will be deemed to be the consideration paid by the partner for the contract. Thus, the total contract price of the new contract will be reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

EFFECTIVE DATES

The regulations will be effective for contributions of long-term contracts to partnerships, distributions by partnerships engaged in long-term contracts, and transfers of interests in partnerships that are engaged in long-term contracts occurring on or after May 15, 2002.

Comments are requested on the scope and substance of the regulations. Direct all written comments to Internal Revenue Service, Attn: CC:ITA:RU (NT 2002-37), Room 5226, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. and 5:00 p.m. to: CC:ITA:RU (NT 2002-37), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or submitted electronically to: Notice.Comments@m1.irs.counsel.treas.gov. Please submit all comments by August 12, 2002. All submissions will be open to public inspection.

DRAFTING INFORMATION

The principal author of this Notice is Richard T. Probst of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from Treasury and the IRS participated in its development. For further information regarding this Notice, contact Mr. Probst at (202) 622-3060 (not a toll-free call).