

Section 704(c), Installment Obligations and Contributed Contracts

REG-160330-02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the tax treatment of installment obligations and property acquired pursuant to a contract under sections 704(c) and 737. The proposed regulations affect partners and partnerships and provide guidance necessary to comply with the law.

DATES: Written and electronic comments and requests for a public hearing must be received no later than February 23, 2003.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-160330-02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-160330-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christopher L. Trump, 202-622-3070;

concerning submissions and the hearing, Robin Jones, 202-622-3521 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

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

Under section 704(c)(1)(B) and the regulations thereunder, any partner that contributes section 704(c) property to a partnership must recognize gain or loss on the distribution of such property to another partner within 7 years of its contribution. The amount of gain or loss recognized is the amount of gain or loss that would have been allocated to such partner under section 704(c)(1)(A) if the property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution.

Under section 737(a) and the regulations thereunder, any partner that contributes section 704(c) property to a partnership may recognize gain on a distribution of property (other than money) by the partnership to that partner. The amount of gain recognized is the lesser of: (1) the amount by which the fair market value of the distributed property exceeds the distributee partner's adjusted tax basis in the partner's partnership interest, or (2) the net precontribution gain of the partner. Section 737(b) defines the net precontribution gain of the partner as the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) if all property that (1) had been contributed to the partnership by the distributee partner within 7 years of the distribution and (2) is held by such partnership immediately before the distribution, had been distributed by such partnership to another partner.

For purposes of section 704(c)(1)(A) and (B) and section 737, if a partnership disposes of section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of

section 7701(a)(42)) is treated as section 704(c) property with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership. See §§1.704-3(a)(8), 1.704-4(d)(1), and 1.737-2(d)(3).

If a partnership disposes of property in an installment sale, income is taken into account under the installment method unless the partnership elects otherwise. See section 453. Upon the satisfaction of an installment obligation at other than its face value or the distribution, transmission, sale, or other disposition of an installment obligation, a taxpayer is generally required, under section 453B, to recognize gain or loss. Section 453B does not apply, however, on the disposition of an installment obligation in certain situations where the Internal Revenue Code (Code) otherwise provides for nonrecognition of gain or loss. For example, §1.453-9(c)(2) provides that no gain or loss results under section 453(d) (now section 453B) in the case of a contribution to or distribution from a partnership under sections 721 or 731.

In addition, if a partnership acquires property pursuant to a contract such as an option, a forward contract, or a futures contract, the partnership may recognize no gain or loss on the acquisition of the property.

Explanation of Provisions

The proposed regulations amend §1.704-3(a)(8) to clarify that, if a partnership disposes of section 704(c) property in exchange for an installment obligation, the installment obligation is treated as the section 704(c) property. The proposed regulations also clarify that, if a partner contributes a contract that is section 704(c) property to a partnership, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, the acquired property is treated as the section 704(c) property for purposes of sections 704(c) and 737. For this purpose the term contract includes, but is not limited to, options, forward contracts, and futures contracts.

The proposed regulations amend §1.704-4(d)(1) to provide that an installment obligation received by a partnership and property acquired pursuant

to a contributed contract are treated as section 704(c) property for purposes of section 704(c)(1)(B) to the extent that the installment obligation or the acquired property is section 704(c) property under §1.704–3(a)(8). As a result, if the installment obligation or property acquired pursuant to a contributed contract is distributed by a partnership to a partner other than the contributing partner within 7 years of the contribution, the contributing partner may recognize gain or loss under section 704(c)(1)(B). The proposed regulations include a similar rule under §1.737–2(d)(3).

No inference is intended as to the treatment of these transactions under prior law.

Proposed Effective Date

These regulations are proposed to apply to installment obligations received by a partnership on or after November 24, 2003, in exchange for section 704(c) property and to property acquired on or after November 24, 2003, by a partnership pursuant to a contract that is section 704(c) property.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed

rules, how they can be made easier to understand and the administrability of the rules in the proposed regulations. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Christopher L. Trump of the Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from Treasury and the IRS participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.704–3 is amended as follows:

1. The paragraph heading for (a)(8) is revised.

2. The text of paragraph (a)(8) is redesignated as paragraph (a)(8)(i).

3. A paragraph heading for newly designated paragraph (a)(8)(i) is added.

4. The first sentence of newly designated paragraph (a)(8)(i) is amended by removing the language “in which no gain or loss is recognized”.

5. Paragraphs (a)(8)(ii) and (a)(8)(iii) are added.

6. Paragraph (f) is amended by:
a. Amending the first sentence of paragraph (f) by removing the language “of paragraph (a)(11)” and adding “of paragraphs (a)(8)(ii), (a)(8)(iii) and (a)(11)” in its place.

b. Adding two sentences at the end of paragraph (f).

The revisions and additions read as follows:

§1.704–3 Contributed property.

(a) * * *

(8) *Special rules*—(i) *Disposition in a nonrecognition transaction.* * * *

(ii) *Disposition in an installment sale.*

If a partnership disposes of section 704(c) property in an installment sale as defined in section 453(b), the installment obligation received by the partnership is treated as the section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The allocation method for the installment obligation must be consistent with the allocation method chosen for the original property.

(iii) *Contributed contracts.* If a partner contributes to a partnership a contract that is section 704(c) property, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, then the acquired property is treated as the section 704(c) property with the same amount of built-in gain or loss as the contract (with appropriate adjustments for any gain or loss recognized on the acquisition). For this purpose, the term contract includes, but is not limited to, options, forward contracts, and futures contracts. The allocation method for the acquired property must be consistent with the allocation method chosen for the contributed contract.

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(f) *Effective date.* * * * Paragraph (a)(8)(ii) applies to installment obligations received by a partnership in exchange for section 704(c) property on or after November 24, 2003. Paragraph (a)(8)(iii) is effective for property acquired on or after November 24, 2003, by a partnership pursuant to a contract that is section 704(c) property.

Par. 3. Section 1.704–4 is amended as follows:

1. The paragraph heading for (d)(1) is revised.

2. The text of paragraph (d)(1) is redesignated as paragraph (d)(1)(i).

3. A paragraph heading for newly designated paragraph (d)(1)(i) is added.

4. Paragraphs (d)(1)(ii) and (d)(1)(iii) are added.

5. Revising paragraph (g).

The revisions and additions read as follows:

§1.704-4 Distribution of contributed property.

* * * * *

(d) *Special rules*—(1) *Nonrecognition transactions, installment obligations and contributed contracts*—(i) *Nonrecognition transactions.* * * *

(ii) *Installment obligations.* An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section to the extent that the installment obligation received is treated as section 704(c) property under §1.704-3(a)(8). See §1.737-2(d)(3) for a similar rule in the context of section 737.

(iii) *Contributed contracts.* Property acquired by the partnership pursuant to a contract that is section 704(c) property is treated as the section 704(c) property for purposes of section 704(c)(1)(B) and this section, to the extent that the acquired property is treated as section 704(c) property under §1.704-3(a)(8). See §1.737-2(d)(3) for a similar rule in the context of section 737.

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(g) *Effective date.* This section applies to distributions by a partnership to a partner on or after January 9, 1995, except that paragraphs (d)(1)(ii) and (iii) apply to distributions by a partnership to a partner on or after November 24, 2003.

Par. 4. Section 1.737-2 is amended as follows:

1. The paragraph heading for (d)(3) is revised.
2. The text of paragraph (d)(3) is redesignated (d)(3)(i).
3. A paragraph heading for newly designated (d)(3)(i) is added.
4. Paragraphs (d)(3)(ii) and (d)(3)(iii) are added.

§1.737-2 Exceptions and special rules.

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(d) * * *

(3) *Nonrecognition transactions, installment sales and contributed contracts*—(i) *Nonrecognition transactions.*

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(ii) *Installment sales.* An installment obligation received by the partnership in an installment sale (as defined in section 453(b)) of section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the installment obligation received is treated as section 704(c) property under §1.704-3(a)(8). See §1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

(iii) *Contributed contracts.* Property acquired by a partnership pursuant to a contract that is section 704(c) property is treated as the contributed property with regard to the contributing partner for purposes of section 737 to the extent that the acquired property is treated as section 704(c) property under §1.704-3(a)(8). See §1.704-4(d)(1) for a similar rule in the context of section 704(c)(1)(B).

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Par. 5. Section 1.737-5 is revised to read as follows:

§1.737-5 Effective dates.

Sections 1.737-1, 1.737-2, 1.737-3, and 1.737-4 apply to distributions by a partnership to a partner on or after January 9, 1995, except that §1.737-2(d)(3)(ii) and (iii) apply to distributions by a partnership to a partner on or after November 24, 2003.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

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