

Section 705.—Determination of Basis of Partner's Interest

26 CFR 1.705-1: Determination of basis of partner's interest.

T.D. 9049

**DEPARTMENT OF THE
TREASURY**

**Internal Revenue Service
26 CFR Part 1**

Amendments to Rules for Determination of Basis of Partner's Interest; Special Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to special rules on determination of basis of a partner's interest under section 705. The final regulations are necessary to coordinate sections 705 and 1032.

DATES: *Effective Date:* These regulations are effective March 18, 2003.

Applicability Date: For dates of applicability, see §1.705-2(e).

FOR FURTHER INFORMATION CONTACT: Barbara (MacMillan) Campbell or Rebekah A. Myers (202) 622-3050 (not a toll-free number).

Background

On March 29, 2002, the Treasury Department and the IRS published final regulations (T.D. 8986, 2002–1 C.B. 780 [67 FR 15112]) under section 705 of the Internal Revenue Code (Code) in the **Federal Register**. Those final regulations provide guidance on the coordination of sections 705 and 1032 in situations where a corporation acquires an interest in a partnership that holds stock in that corporation, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. During the development of those final regulations, the Treasury Department and the IRS considered other issues related to the coordination of sections 705 and 1032. Accordingly, also on March 29, 2002, the Treasury Department and the IRS published proposed regulations (REG–167648–01, 2002–1 C.B. 790 [67 FR 15132]) to revise the final regulations contained in §1.705–2 of 26 CFR part 1 in the **Federal Register**. No written comments were received in response to the notice of proposed rulemaking, and no public hearing was requested or held. The proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

1. Overview of Proposed Regulations

The proposed regulations apply to situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. As stated in the preamble to the proposed regulations, in these situations it may be inconsistent with the intent of sections 705 and 1032 to increase the basis of the corporation’s partnership interest by the full amount of any gain resulting from the partnership’s sale or exchange of the stock which is not recognized by the corporation under section 1032.

Accordingly, the proposed regulations revise the purpose statement of §1.705–2(a)

to take into account situations involving such partnership distributions. The proposed regulations provide a specific rule implementing the revised purpose in single partnership cases. The proposed regulations also revise §1.705–2(c) to clarify that the tiered partnerships rule applies to situations involving such partnership distributions.

In addition, the proposed regulations clarify that references in the regulations to stock of a corporate partner include any position in stock of a corporate partner to which section 1032 applies.

2. Revisions in Final Regulations

These final regulations follow the proposed regulations but extend the rules of the proposed regulations to situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. The revisions provide a more consistent approach, and better conform these final regulations to the final regulations issued on March 29, 2002, under section 705 (T.D. 8986, 2002–1 C.B. 780).

3. Effective Date

The final regulations apply with respect to sales or exchanges of stock occurring on or after March 18, 2003, except that paragraph (d) applies with respect to sales or exchanges of stock occurring on or after March 29, 2002.

Special Analyses

It has been determined that this Treasury decision 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 the 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 Internal Revenue Code, the notice of

proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of these proposed regulations is Barbara (MacMillan) Campbell of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and the Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 1.705–1 is amended by revising paragraph (a)(7) to read as follows:

§1.705–1 Determination of basis of partner’s interest.

(a) * * *

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock or any position in stock to which section 1032 applies of a corporation that holds a direct or indirect interest in the partnership, see §1.705–2.

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Par. 3. Section 1.705–2 is amended as follows:

1. Paragraph (a) is amended by adding a new sentence after the third sentence.

2. Paragraph (b)(2) is added.

3. Paragraph (c)(1) is amended by adding a sentence at the end of the paragraph.

4. Paragraph (d) is added.

5. Paragraph (e) is revised.

The additions and revision read as follows:

§1.705–2 Basis adjustments coordinating sections 705 and 1032.

(a) * * * Similarly, in situations where a section 754 election was not in effect for the year in which a partnership distrib-

utes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted, the remaining partners' inside basis and outside basis may not be equal.

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(b) * * *

(2) *Required adjustments relating to distributions.* (i) This paragraph (b)(2) applies in situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the partnership made the distribution, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(2) are illustrated by the following example:

Example. (i) A, B, and corporation C form partnership PRS. A and B each contribute \$10,000 and C contributes \$20,000 in exchange for a partnership interest. PRS has no liabilities. PRS purchases stock in corporation C for \$10,000, which appreciates in value to \$70,000. PRS distributes \$25,000 to A in complete liquidation of A's interest in PRS in a year for which an election under section 754 is not in effect. PRS later sells the C stock for \$70,000. PRS realizes a gain of \$60,000 on the sale of the C stock. C's share of the gain is \$40,000. Under section 1032, C does not recognize its share of the gain.

(ii) Normally, C would be entitled to a \$40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the C stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which PRS made the distribution to A, PRS would have been entitled to adjust the basis of partnership property under section 734(b)(1)(A) by \$15,000 (the amount of gain recognized by A with respect to the distribution to A under section 731(a)(1)). See § 1.734-1(b). Under § 1.755-1(c)(1)(ii), the basis adjustment under section 734(b) would have been allocated to the C stock, increasing its basis to \$25,000 (where there is a distribution resulting in an adjustment under sec-

tion 734(b)(1)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property).

(iii) If a section 754 election had been in effect for the year in which PRS made the distribution to A, the amount of gain that PRS would have recognized upon PRS's disposition of C stock would be \$45,000 (\$70,000 minus \$25,000 basis in the C stock), and the amount of gain C would have recognized upon PRS's disposition of the C stock (absent the application of section 1032) would be \$30,000 (C's share of PRS's gain of \$45,000 from the stock sale). Accordingly, upon PRS's sale of the C stock, the increase in the basis of C's interest in PRS is \$30,000.

(c) * * * (1) * * * Similarly, if a corporation owns an indirect interest in its own stock through a chain of two or more partnerships, and a partnership in the chain distributes money or other property to another partner and that partner recognizes gain or loss on the distribution or the basis of the property distributed to that partner is adjusted during a year in which the partnership does not have an election under section 754 in effect, then upon any subsequent sale or exchange of the stock, the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

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(d) *Positions in Stock.* For purposes of this section, stock includes any position in stock to which section 1032 applies.

(e) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999, except that paragraph (d) of this section is applicable with respect to sales or exchanges of stock occurring on or after March 29, 2002, and the fourth sentence of paragraph (a), paragraph (b)(2), and the third sentence of paragraph (c)(1) of this section are applicable with respect to sales or exchanges of stock occurring on or after March 18, 2003.

David A. Mader,
Assistant Deputy Commissioner
of Internal Revenue.

Approved March 6, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 17, 2003, 8:45 a.m., and published in the issue of the Federal Register for March 18, 2003, 68 F.R. 12815)