

No. 2015-305
June 11, 2015

Regulations - Partnership transactions involving equity interest of partner (section 337(d) regulations); aggregation basis for equity interest distributions (section 732(f) regulations)

June 11: The Treasury Department and IRS today released the following sets of regulations:

- Temporary regulations (T.D. 9722) and by cross-reference, proposed regulations (REG-149518-03) to prevent a corporate partner from avoiding corporate-level gain through transactions with a partnership involving equity interests of the partner. With these releases, regulations proposed in 1992 are withdrawn.
- Proposed regulations (REG-138759-14) to allow consolidated group members that are partners in the same partnership to aggregate their basis in stock distributed by the partnership for purposes of limiting application of rules that might cause basis reduction or gain recognition. These proposed regulations require certain corporations that engage in gain-elimination transactions to reduce the basis of corporate assets or recognize gain.

Temporary regulations (T.D. 9722), partnership transactions involving equity interests of a partner

According to the preamble, the [temporary regulations](#) [PDF 252 KB] are intended to prevent corporate taxpayers from using a partnership to circumvent gain required to be recognized under section 311(b) or section 336(a), following the repeal of the *General Utilities* doctrine. The temporary regulations follow in many respects proposed regulations issued in 1992, and address partnership acquisitions, ownership, and distributions of stock and other equity interests in a corporate partner.

The regulations apply when a partnership, either directly or indirectly, owns, acquires or distributes stock of the corporate partner. The temporary regulations provide definitions of a “corporate partner” and the “stock of the corporate partner.” Both definitions are consistent with the definitions provided in the 1992 proposed regulations, except for two changes:

- The scope of the definition of “stock of the corporate partner” has been

both broadened and narrowed to include stock or other equity interests of any corporation that controls the corporate partner. “Control” for this purpose reflect a lower threshold of ownership than previously provided in the 1992 regulations, but eliminates certain types of ownership that would have implicated those regulations.

- An exception is added for certain related-party partners, so that “stock of the corporate partner” does not include stock of equity interests held or acquired by a partnership if all interests in the partnership’s capital and profits are held by members of an affiliated group that includes the corporate partners. The IRS and Treasury have requested comments as to whether to extend this exception to partnerships owned by controlled foreign corporations that are owned entirely by a single affiliated group.

The temporary regulations apply to a transaction or a series of transactions that are identified as a “section 337(d) transaction”—i.e., one that has the effect of an exchange by a corporate partner of its interest in appreciated property for an interest in the stock of the corporate partner that is owned, acquired or distributed by a partnership. If a partnership engages in a “section 337(d) transaction,” the corporate partner must recognize gain.

Deemed redemption rule

Today’s temporary regulations “largely retain” the deemed redemption rule from the 1992 proposed regulations, which addresses pre-distribution transactions involving corporate partner stock owned or acquired by the partnership. In the government’s view, certain of these transactions create the economic effect of an exchange of appreciated property for corporate stock, even when no actual exchange occurred.

The temporary regulations set forth general principles that apply in determining the amount of appreciated property that is effectively exchanged for the stock of the corporate partner. Under these rules, the corporate partner’s economic interest must be determined based on all facts and circumstances, including the allocation and distribution rights listed in the partnership agreement.

The temporary regulations contain two rules related to the effect of application of the deemed redemption rule on partner and partnership basis.

- The corporate partner must increase its basis in its partnership interest by an amount equal to the gain that the corporate partner recognizes in a section 337(d) transaction.
- The partnership must increase its adjusted tax basis in the appreciated property that is treated as the subject of a section 337(d) transaction by the

amount of gain that the corporate partner recognized with respect to that property as a result of the section 337(d) transaction.

Partnership distributions of stock of the corporate partner

The 1992 proposed regulations also contained a distribution rule pursuant to which a corporate partner would recognize gain on receipt of a distribution of its stock by the partnership. Commentators criticized the rule for being overly broad.

The temporary regulations do not adopt the distribution rule in the 1992 proposed regulations. Rather, the temporary regulations extend the deemed redemption rule to certain distributions. These rules apply only if the distributed stock has previously been the subject of a section 337(d) transaction or become the subject of a section 337(d) transaction as a result of the distribution. The temporary regulations provide rules under section 337 and 732 to coordinate the effects of the rule requiring gain recognition when the stock of the corporate partner is stepped down on a section 337(d) distribution with existing rules for determining the basis of property under partnership distributions.

The preamble notes that when a corporate partner receives a partnership distribution of its own stock, it is unclear under existing law whether the corporate partner has basis in that stock, but explains that this issue is beyond the scope of these regulations. However, because the distribution to a corporate partner of its own stock affects the corporate partner's basis in other distributed property and any retained partnership interest, the temporary regulations require the partnership and the corporate partner to determine the basis of other distributed property and any retained partnership interest by reference to the partnership's basis in the distributed stock of the corporate partner.

De minimis and inadvertence exceptions

Today's regulations retain de minimis and inadvertence exceptions contained in the 1992 proposed regulations, but make what are described as "small modifications" to the de minimis rule to reduce the burden on taxpayers.

Effective date and comment period

The 1992 proposed regulations were proposed to be effective for transactions or distributions occurring after March 9, 1989. However, the temporary regulations reject the retroactive effective date, and are instead effective for transactions occurring on or after the date of publication in the *Federal Register*—scheduled for publication on Friday, June 12, 2015.

Comments and requests for a public hearing on the related [proposed regulations](#) [PDF 201 KB] are due by a date that is 90 days after that date.

Proposed regulations (REG-138759-14), aggregation of basis for partnership distributions involving equity interest of a partner

These [proposed regulations](#) [PDF 232 KB] include a reference to the temporary regulations (described above) that address partnership acquisitions, ownership, and distributions of stock and other equity interests in a corporate partner.

As noted in the preamble to the proposed regulations, sections 732(f) and 337(d) share a common purpose of preserving corporate-level gains, and these proposed regulations are intended to carry out the purposes of sections 337(d) and 732(f). The IRS and Treasury believe that, as currently applied, section 732(f) may be too broad in some circumstances and too narrow in others.

The preamble notes that specifically, section 732(f) may require basis reduction or gain recognition even though that basis reduction or gain recognition does not further the purposes of section 732(f). In other circumstances, corporate partners may inappropriately avoid the purposes of section 732(f) by engaging in transactions that allow corporate partners to receive property held by a distributed corporation without reducing the basis of that property to account for basis reductions under section 732(b) made when the partnership distributed stock of the distributed corporation to the corporate partner.

The proposed regulations add rules to conform the application of section 732(f) with the legislative intention for enacting sections 337(d) and 732(f) in these situations.

These proposed regulations also include:

- Rules for aggregation of section 732(b) basis adjustments of consolidated group members
- Provisions providing that, in the event of a gain elimination transaction, section 732(f) applies as though the corporate partner acquired control of the distributing corporation immediately before the gain elimination transaction
- Measures to require taxpayers to apply these regulations to tiered partnerships

Effective date and comment period

These proposed regulations are proposed to apply to distributions or transactions

occurring on or after the date these regulations are published as final regulations in the *Federal Register*. The preamble states that “[n]o inference is expressed or implied with respect to distributions or transactions occurring before the date these regulations are published as final regulations in the *Federal Register*.”

Comments and requests for a public hearing on these proposed regulations are due by a date that is 90 days after the date of publication in the *Federal Register*—scheduled for publication on Friday, June 12, 2015.

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