

Proposed Regulations on Partnership Hot Asset Distributions

Tax Alert
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On Friday, October 31, 2014, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations under the so-called "hot asset" shifting rules of section 751(b). The proposed regulations represent a welcome attempt by the government to modernize guidance under one of the most complex provisions in the Internal Revenue Code.

Background

The purpose of section 751(b) is to prevent partnerships from using the general distribution rules of subchapter K to convert ordinary income into capital gain by ensuring that each partner reports its share of the partnership's ordinary income. Section 751(b) achieves this result by overriding the general non-recognition treatment for partnership distributions and requiring partners to recognize gain when their shares of the partnership's unrealized receivables or substantially appreciated inventory items (collectively "hot assets") shift disproportionately following a distribution of partnership property, including money.

The current Treasury regulations under section 751(b) are outdated and fail to provide an accurate determination of each partner's share of ordinary income because they do not take into account modern allocation rules. The proposed regulations update the rules for determining whether section 751(b) applies to a distribution by calculating whether a distribution has caused any partner's allocable share of income from the partnership's hot assets to change, including the application of mandatory and optional allocations.

Current Section 751(b) Regulations

In order to determine whether section 751(b) is triggered by a distribution, the current Treasury regulations compare the distributee partner's share of the partnership's hot assets and all other assets (the "cold assets") before and after the distribution based on such partner's respective share of the gross value of the assets. Section 751(b) is triggered if the distribution results in a disproportionate change in any partner's share of the partnership's hot or cold assets.

If section 751(b) applies to a distribution of property, the current Treasury regulations construct a deemed asset exchange between the distributee partner and the partnership to determine the tax consequences. This approach requires the partnership to simulate a distribution to the distributee partner of its share of relinquished assets (those in which the distributee partner's share decreases) followed by a taxable exchange between the distributee partner and the partnership of the relinquished assets for the acquired assets (those in which the distributee partner's share increases).

Proposed Section 751(b) Regulations

The proposed regulations are based generally on concepts outlined in Notice 2006-14 (Notice), which requested comments on alternative methods for addressing section 751(b) distributions. The new rules, like the Notice, provide a hypothetical sale approach for determining whether section 751(b) applies to a distribution. Rather than requiring a specific methodology to determine the tax results of a section 751(b) distribution, the new rules provide flexibility to taxpayers to adopt a reasonable method so long as it achieves the objective of the statute to prevent the conversion of ordinary income into capital gain.

Triggering Section 751(b): Hypothetical Sale Approach

The proposed regulations use a hypothetical sale approach for determining a partner's interest in the partnership's hot assets thereby implementing the new policy of determining partners' shares of hot assets with reference to their allocations of ordinary income rather than gross asset values. Under this approach, the partnership compares the partners' shares of ordinary income before and after a distribution based on a hypothetical sale of the partnership's property for fair market value in a taxable transaction, including allocations of built-in gain or loss on property. If the partners' shares of ordinary income from hot assets shift following the distribution, section 751(b) applies.

In an attempt to better preserve partners' shares of unrealized appreciation or depreciation in the partnership's hot assets under section 704(c), the hypothetical sale approach requires partnerships to revalue their property under section 704(b) if the distributing partnership owns hot assets immediately after a distribution. Under the proposed regulations, revaluations are also required for a distributing partnership that owns a controlling interest (defined as a greater than 50 percent interest) in a lower-tier partnership that owns section 751 property immediately after the distribution. If the distributing partnership owns a non-controlling interest in a lower-tier partnership, the distributing partnership must make allocations of its distributive share of the lower-tier partnership's assets among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its assets. In the preamble, the IRS and Treasury recognize that upper-tier partnerships may be unable to obtain sufficient information from lower-tier partnerships to comply with this requirement and request comments on reasonable approaches to address this issue.

The proposed regulations recognize that special basis adjustments available to a partnership under sections 732 or 734 following a distribution of partnership property may alter partners' interests in section 751 property. As a result, the proposed regulations provide complex rules to account for the effect of these basis adjustments in the computation of the partners' shares of ordinary income before and after a distribution and require the preservation of ordinary gain following a distribution.

Tax Consequences of Section 751(b): Reasonable Approach

Under the proposed regulations, if section 751(b) applies to a distribution, the tax consequences are determined by applying a "reasonable approach that is consistent with the purpose of section 751(b)." The examples in the proposed regulations outline two acceptable approaches, but presumably, taxpayers are free to use other reasonable approaches. Except in limited circumstances, however, a partnership must continue to use the same approach once chosen, including after a termination of the partnership under section 708(b)(1)(B).

The proposed regulations allow taxpayers to use the "hot asset sale" approach outlined in the Notice. Under this approach, a partner whose share of partnership hot assets is reduced is treated as receiving the relinquished hot assets in a deemed distribution, followed by a sale back to the partnership of such hot assets. The result is that the selling partner recognizes ordinary income from the deemed sale with corresponding adjustments to the partner's basis in its partnership interest and the partnership's assets.

The preamble acknowledges that there are defects in the hot asset sale approach. As a result, the proposed regulations also provide an alternative approach for determining the tax consequences of a section 751(b) distribution, the "deemed gain" approach. Under this approach, the partnership recognizes ordinary income to the extent of the partners' aggregate reduction in their interests in hot assets, allocates such ordinary income to the partners whose interest in hot assets was reduced by the distribution and makes corresponding basis adjustments.

Anti-Abuse Rule

The proposed regulations identify a series of situations presumed to establish that a transaction is inconsistent with the purpose of section 751 and provide the Commissioner with the authority to recast transactions as appropriate to implement the purpose of the statute.

Effective Dates

The proposed regulations generally apply to distributions occurring in taxable periods ending on or after adoption of the proposed rules as final regulations. However, a partnership and its partners may rely on proposed regulation section 1.751-1(b)(2) (regarding the hypothetical sale approach) on or after November 3, 2014, so long as the partnership and its partners also follow other specified rules in the proposed regulations consistently for all partnership distributions and sales or exchanges.

Requests for Comments

Treasury and the IRS are requesting comments on all aspects of the proposed regulations and specifically, regarding revaluations for tiered partnerships.

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