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Origins and Evolution of Section 751(b)

Karen C. Burke

University of Florida Levin College of Law, burkek@law.ufl.edu

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ORIGINS AND EVOLUTION OF SECTION 751(b)

Karen C. Burke*

Section 751(b), reputedly one of the most widely ignored provisions of Subchapter K, reserves its most daunting complexity for non-pro rata current distributions of property other than cash. While partnership tax has been revolutionized by increasingly sophisticated capital accounting rules, the 1956 regulations implementing section 751(b) have never been updated to reflect the modern concept of revaluations and section 704(c) special allocations. Recently, the Treasury Department requested comments concerning alternative approaches that would simplify and rationalize accounting for shifts of ordinary income and capital gain among partners. Although section 751(b) is concerned mainly with the character of income, it also has a significant impact on the timing of recognition. Thus, updating section 751(b) furnishes a starting point for considering broader reform of the partnership distribution rules.

Section 751(b) emerged in substantially its present form as part of the 1954 codification of Subchapter K, which represented the culmination of intensive study by the ABA and American Law Institute (ALI). The provision owes its origin to the ABA-ALI drafters’ proposed solution to the “collapsible partnership” problem, which threatened to “open up the widest loophole in the field of taxation which would exist.” The approach proposed by the ABA-ALI drafters was startlingly different from section 751(b) as enacted. The ABA-ALI drafters sought to address disproportionate distributions in liquidation (or partial liquidation) of a partner’s interest by reallocating inside basis among distributed and retained assets to preserve shares of unrealized appreciation (or depreciation). When Congress rejected key

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1See ALI, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES 293-95 (1999) (arguing that section 751(b) must be simplified if it is to be retained).


7For a conceptually similar approach to hot asset distributions, see Andrews, supra note 4.

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*Warren Distinguished Professor, University of San Diego School of Law; Smith College, B.A., 1972; Harvard University, M.A., 1975; Ph.D., 1979; Stanford University, J.D., 1982; Boston University, LL.M., 1985.
aspects of the ABA-ALI proposal—partial liquidation treatment and mandatory inside basis adjustments—as excessively complex, it turned to the flawed approach of current section 751(b). By comparison to the current section 751(b) or section 704(c) extended special allocations, however, the ABA-ALI approach may now seem appealing.8

Part I of this Article considers proposals to replace the imputed exchange mechanism under the current section 751(b) regulations with a simple hot asset sale approach, coupled with a revaluation of partnership property and reverse section 704(c) allocations. Part II examines the evolution of the collapsible partnership rules as part of the larger process of enacting the 1954 Code, and traces the flaws of the current provision to the Senate drafters’ failure to focus on disproportionate current distributions. Part III assesses the ABA-ALI basis reallocation approach, which drew a fundamental distinction between current distributions (with no change in the partners’ percentage interests in the partnership) and distributions in liquidation (or partial liquidation) of a partner’s interest. Finally, Part IV considers extending the hot asset sale approach to all non-pro rata distributions that reduce a partner’s interest, thereby remedying section 734(b) adjustments which no longer function well.9

Viewed broadly, reform of section 751(b) presents the challenge of integrating a longstanding statutory provision with more recent developments that may call into question its continued viability. Some commentators view section 751(b) as an anachronism that deserves repeal, particularly given its distressing complexity and limited utility.10 If the operation of section 751(b) appears incongruous, however, it may be well to ask how the provision came to be in the first place. Reexamining the origin and statutory evolution of section 751(b) offers fresh insight: namely, that the architects of the original provision envisaged that it would play a fundamental nonrecognition role by preserving unrealized gain whenever a partner’s interest was fully or partially liquidated. Far from being antiquated, the notion of inside basis adjustments to align properly the partners’ post distribution percentage interests may offer a simpler alternative than section 704(c) to prevent shifting of built-in gain in connection with non-pro rata current distributions. Some 50 years later, Subchapter K has yet to achieve coherent treatment of disproportionate distributions as envisaged by the ABA-ALI drafters.

8See Andrews, supra note 4, at 65 (“Fortunately, inside basis adjustment under section 734 offers a much more satisfactory approach.”); see also Karen C. Burke, Partnership Distributions: Options for Reform, 3 FLA. TAX REV. 677 (1998) (comparing the Andrews proposals and the extended section 704(c) approach).

9For proposals to repair section 734 adjustments, see Howard E. Abrams, The Section 734(b) Basis Adjustment Needs Repair, 57 TAX LAW. 343 (2004); see also Karen C. Burke, Repairing Inside Basis Adjustments, 58 TAX LAW. 639 (2005).

I. NEEDED REPAIRS TO SECTION 751(b)

Section 751(b) is triggered whenever a partner surrenders an interest in hot assets in exchange for an increased interest in cold assets. In these situations, section 751(b) gives rise to an imputed exchange between the partnership—as constituted after the exchange—and the distributee. In the imputed exchange, the partnership is treated as transferring the “excess” property—that is, the disproportionate part of the distribution consisting of hot assets or other partnership property—to the distributee. The distributee is then treated as surrendering property of equal value but of a different class from the class of the excess property received. As a result of the imputed exchange, both the partnership and the distributee may recognize gain or loss, and both the excess property and the surrendered property take a cost basis.

A. Flaws in Imputed Exchange

The imputed exchange mechanism reflects the division of partnership assets between the distributee and the continuing partners when a disproportionate distribution reduces a partner’s interest in the partnership. The imputed exchange model is defective for several reasons. First, it focuses on shifts in the gross value, rather than appreciation, of hot assets and it fails to take into account differences in gain among different hot assets. Second, it imposes a tax “whose purpose is totally obscure” on those partners who surrender an interest in cold assets involved in the imputed exchange, notwithstanding the general nonrecognition policy of Subchapter K. Third, it may trigger recognition of ordinary income even if the partnership’s assets are revalued immediately before a non-pro rata current distribution, so that the distributee’s share of hot asset gain remains unchanged.

By modifying the mechanics of the imputed exchange, it is relatively easy to fix these well-known flaws. Section 751(b) should be revised to focus on shifts in hot asset gain rather than hot asset value; ordinary income would be triggered only to the extent that a disproportionate distribution reduces a partner’s share of hot asset gain, taking into account a revaluation of partnership property. When section 751(b) was enacted in 1954, the drafters apparently never considered the possibility of addressing hot asset shifts through a section 704(c) approach.

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11For purposes of section 751(b), hot assets consist essentially of unrealized receivables (including depreciation recapture) and substantially appreciated inventory. See I.R.C. §§ 751(b)(3), (c), and (d). The Andrews proposals would extend similar treatment to “tepid” assets. See infra note 149 and accompanying text.

12Section 751(b) can also apply if one partner receives hot assets and another partner receives cold assets without any change in the partners’ sharing ratios.

13See Andrews, supra note 4, at 48.

14Id. at 46.

15See Burke, supra note 8, at 703-04.

coupled with reverse section 704(c) allocations. Since the section 704(b) regulations virtually require a revaluation whenever partnership property is distributed, tracking shifts in hot asset gain is clearly feasible.\textsuperscript{17} Indeed, reverse section 704(c) allocations already provide a mechanism for tagging booked-up hot asset gain for later recognition by the proper partner.\textsuperscript{18} The imputed exchange model should be replaced by a deemed sale of hot assets.\textsuperscript{19} Under the “hot asset sale” approach, it is necessary only to specify the amount of ordinary income to be recognized and to adjust inside and outside basis accordingly. Other provisions of Subchapter K already provide for deemed sale treatment on certain distributions, coupled with adjustments to inside and outside basis.\textsuperscript{20}

Under section 751(b), the Treasury has regulatory authority to implement the deemed sale of hot assets for cold assets. While the drafters anticipated that section 751(b) could trigger gain recognition to both the distributee and the partnership,\textsuperscript{21} the hot asset sale approach would greatly simplify the operation of section 751(b). It would no longer be necessary to identify specific cold assets to be exchanged or to construct a deemed distribution of such assets. Any partner whose share of hot assets is reduced (“selling partner”) could be treated as receiving the relinquished hot assets as a distribution and then selling them back to the partnership for fair market value.\textsuperscript{22} Indeed, the fiction of a deemed distribution of relinquished hot assets to the selling partner and imputed cash consideration on the sale seems quite unnecessary.\textsuperscript{23} Any selling partner should simply recognize ordinary income equal to the net reduction in her share of hot asset gain, with corresponding adjustments to inside basis and outside basis.

If partnership property is revalued immediately before a non-pro rata current distribution of hot assets, the selling partners would always be the nondistributee partners whose share of hot asset gain in the distributed property is reduced. Prior to the distribution, the partnership agreement could be amended to allocate unrealized gain in distributed hot assets disproportionately to the distributee, thereby minimizing a shift in hot asset gain.\textsuperscript{24} Any distributed hot assets would take a basis equal to the fair market value less any hot asset gain attributable to the dis-

\textsuperscript{17}See Reg. § 1.704-1(b)(2)(iv)(f)(5).
\textsuperscript{18}See Reg. §§ 1.704-1(b)(1)(vi), 1.704-1(b)(2)(iv)(g).
\textsuperscript{19}See Andrews, supra note 4, at 46 (“As a conceptual matter, there is no reason to insist on the exchange model.”); Notice 2006-14, 2006-8 I.R.B. 498.
\textsuperscript{20}See I.R.C. §§ 704(c)(1)(B), 737.
\textsuperscript{21}See infra notes 104-07 and accompanying text.
\textsuperscript{22}See Notice 2006-14, 2006-8 I.R.B. 498.
\textsuperscript{23}See Andrews, supra note 4, at 46 (“The consideration for the sale should be simply a credit to capital account.”).
\textsuperscript{24}Since such an allocation does not shift the partners’ overall shares of hot asset gain, it should presumably be respected under the section 704(b) regulations. C.f. Reg. § 1.704-1(b)(2)(iii) (substantiality requirement).
ORIGINS AND EVOLUTION OF SECTION 751(b)

The basis of the distributed property would be increased, immediately before the distribution, to reflect any hot asset gain recognized by the selling partners. Cf. I.R.C. § 732(c)(1)(A)(i) (limiting basis of distributed hot asset to basis in partnership's hands).

The only example in the section 751 regulations illustrating the tax consequences of a non-pro rata current distribution predates the revaluation concept. See Reg. § 1.751-1(g), Ex. (5). Oblique support for the book-up approach can be found in an example in the section 704(b) regulations involving admission of a new partner. See Reg. 1.704-2(m), Ex. (3(ii)); see also Monte A. Jackel & Avery I. Stok, Blissful Ignorance: Section 751(b) Uncharted Territory, 98 Tax Notes (TA) 1557, 1578 (Mar. 10, 2003) (concluding that section 704(c) approach is "the most reasonable and workable approach"); cf. Rev. Rul. 84-102, 1984-2 C.B. 119.

See Burke, supra note 8, at 701; Jackel & Stok, supra note 26, at 1577.

Tax Lawyer, Vol. 60, No. 2
Since the book-up preserves C’s entire predistribution share of hot asset gain ($30) and value ($30), section 751(b) should be inapplicable. Special allocations will be necessary, however, to ensure proper allocation of the tax gain corresponding to the booked-up gain. Thus, a simple non-pro rata cash distribution would often avoid section 751(b), since a revaluation preserves shares of hot asset gain.

Under the imputed exchange model, a revaluation may fail to prevent a hot asset shift when the partnership holds nonzero basis hot assets and the distributee receives only cold assets. Even though a revaluation freezes the distributee’s share of hot asset gain, the distributee’s share of the gross value of hot assets will nevertheless be reduced. Under the section 704(c) approach, the distributee’s share of the gross value of hot assets depends on her share of common basis plus her share of hot asset gain. If a distribution reduces the distributee’s percentage share of common basis without altering her share of hot asset gain, her share of the gross value of the partnership’s hot assets is necessarily reduced. Thus, under the existing regulations, section 751(b) will be triggered even though the distributee’s share of hot asset gain is unchanged. This treatment reflects the underlying flaw in the measurement of hot asset shifts under existing section 751(b). The anomaly would be eliminated if the provision were revised to focus on shifts in hot asset gain rather than gross value.

In the above example, assume that the unrealized receivables (worth $90) have a basis of $30 and the land (worth $300) has a basis of $180. Following the distribution of $90 cash to C, the ABC partnership has the following post distribution balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$6.67</td>
<td>$0</td>
<td>$6.67</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Land</td>
<td>23.33</td>
<td>30</td>
<td>53.33</td>
</tr>
<tr>
<td>Total</td>
<td>$30</td>
<td>$60</td>
<td>$90</td>
</tr>
</tbody>
</table>

The gross value of C’s predistribution interest in cold assets ($150) is also unchanged ($90 cash outside partnership plus $60 retained interest in cold assets). The nondistributee partners have the following share of inside basis, gain, and value:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$53.33</td>
<td>$0</td>
<td>$53.33</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>Land</td>
<td>186.67</td>
<td>60</td>
<td>246.67</td>
</tr>
<tr>
<td>Total</td>
<td>$240</td>
<td>$120</td>
<td>$360</td>
</tr>
</tbody>
</table>

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29Applying section 704(c) principles, C has a one-ninth share of the basis of each asset ($30/$270). Thus, C has the following share of inside basis, gain, and value:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$6.67</td>
<td>$0</td>
<td>$6.67</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Land</td>
<td>23.33</td>
<td>30</td>
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<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$53.33</td>
<td>$0</td>
<td>$53.33</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
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<td>186.67</td>
<td>60</td>
<td>246.67</td>
</tr>
<tr>
<td>Total</td>
<td>$240</td>
<td>$120</td>
<td>$360</td>
</tr>
</tbody>
</table>

30See Burke, supra note 8, at 703-04; Jackel & Stok, supra note 26, at 1581.
31A disproportionate distribution may be carefully tailored to avoid a shift in the gross value of hot assets. See Jackel & Stok, supra note 26, at 1594-95.
 Section 704(c) principles presumably require that C's share of the common basis of partnership assets be allocated among the assets in proportion to the total inside basis of such assets. Following the distribution, C has a one-fifth share of the total gross value of partnership assets ($90/$450), but only a one-ninth share ($30/$270) of the basis of each asset. While the book-up preserves C's entire predistribution share of hot asset gain ($20), her share of the gross value of the partnership's hot asset is reduced from $30 (one-third of $90) to $23.33. Based on gross value, C would thus be deemed to relinquish $6.67 worth of hot assets in exchange for an increased interest in cold assets worth $6.67.

The section 704(c) approach "appears to conflict with the 'undivided interest' approach which the section 751(b) regulations use to determine the partnership exchange table." Burke, supra note 8, at 702-03; see McKee et al., supra note 32 at 21-28. Under the undivided interest approach, C would be treated as retaining an undivided one-fifth interest in the gross value of each partnership asset. See Reg. § 1.751-1(g), Ex. (5). Thus, C would be treated as relinquishing hot assets worth $12, the excess of her one-third predistribution share of hot asset value ($30) over her retained one-fifth share ($18).

The nondistributee partners have the following share of inside basis, gain, and value:

<table>
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<tr>
<th>Assets</th>
<th>Basis</th>
<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$53.33</td>
<td>$0</td>
<td>$53.33</td>
</tr>
<tr>
<td>Receivables</td>
<td>26.67</td>
<td>40</td>
<td>66.67</td>
</tr>
<tr>
<td>Land</td>
<td>160</td>
<td>80</td>
<td>240</td>
</tr>
<tr>
<td>Total</td>
<td>$240</td>
<td>$120</td>
<td>$360</td>
</tr>
</tbody>
</table>

The increase ($6.67) in the nondistributee partners' share of hot asset basis and value mirrors the decrease ($6.67) in C's share of hot asset basis and value.
Without any shift of hot (or cold) asset gain, reallocation of the partners' shares of inside basis arguably should not implicate section 751(b). Since a partner's share of hot (or cold) asset gain reflects the difference between basis and value, a revaluation serves to identify and isolate the relevant tax attributes. In effect, a revaluation permits tracking of each partner's interest in specific hot and cold assets; without a revaluation, the partners' respective shares of inside basis, gain, and value for particular assets would often be quite difficult to determine. A revaluation thus allows tagging of preserved hot asset gain for later recognition.

C. Proportionate Share Concept

In focusing on shifts in hot asset value, the 1956 regulations sought to implement the "proportionate share" concept derived from the legislative history. Nevertheless, the 1956 regulations provide little guidance concerning how to determine each partner's share of partnership assets. A partner's interest in a partnership is comprised of two elements: a share of partnership capital and a share of partnership profits and losses. In capital accounting terms, a partner's share of specific partnership assets is generally equal to her share of the partnership's common basis plus her share of any gain or loss that would be allocated to her if the partnership were to sell all of its assets for fair market value. A partner's share of common basis equals her share of partnership tax capital plus her share of partnership liabilities. Since a partner's share of liabilities is reflected in both common basis and gross value, partnership liabilities generally cancel out. Hence, the section 704(c) approach looks to the spread between a partner's book capital account and share of tax capital (both net of liabilities) at any particular time.

The principal purpose of section 751(a)—the cognate provision dealing with sales of partnership interests—is to treat a seller of a partnership interest similarly to an owner disposing of a business. Since a non-pro rata distribution in liquidation or partial liquidation of a partner's interest is economically equivalent to a

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36 See Jackel & Stok, supra note 26, at 1584 ("Shifts of common basis in hot assets should not be a concern of section 751(b)").
37 See infra notes 101-02 and accompanying text.
38 The existing section 751(b) regulations expressly sanction an agreement to treat a distribution of one class of partnership property as reducing the distributee's interest only in that class of property. See Reg. § 1.751-1(b)(1)(ii).
40 See Reg. § 1.743-1(d)(1).
41 Id.
42 See Andrews, supra note 4, at 13 n.45.
43 If partnership allocations vary over time, the hypothetical sale approach may fail to reflect accurately the partners' income rights with respect to particular assets over the life of the partnership. See Notice 2006-14, 2006-8 I.R.B. 498.
44 See Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) (requiring fragmentation of sales proceeds among individual assets when an individual proprietor sells an ongoing business). In Williams, the government maintained that the taxpayer had sold a partnership interest and that his entire loss was therefore capital. The court did not reach the issue of the tax treatment on sale of a partnership interest since it concluded that the partnership had already terminated prior to the sale. Id. at 572.
sale of a partnership interest, section 751(b) was considered necessary to backstop section 751(a). Given other provisions of Subchapter K that prevent conversion of ordinary income into capital gain, section 751(b) is now principally concerned with shifting of ordinary income among partners.\(^4\) In contrast to the section 704(c) approach, which focuses on shifts in hot asset gain, the legislative history clearly contemplates that section 751(b) will be triggered by shifts in hot asset value rather than gain.\(^4\) It is unclear, therefore, to what extent changes in the value (or basis) of the partners' interests in specific categories of partnership assets should continue to implicate section 751(b).

The section 704(c) approach cannot prevent a disproportionate distribution from altering the partners' shares of the value and basis of hot and cold assets. Thus, a disproportionate distribution may give rise to situations in which distributees or continuing partners possess assets of insufficient value or basis to preserve their shares of hot or cold asset gain. For example, a disproportionate distribution may eliminate nearly the entire value of a distributee's partnership interest, leaving her with booked-up hot or cold asset gain in excess of the economic value of her retained partnership interest.\(^4\) Alternatively, a partner's outside basis may be insufficient to absorb her share of the partnership's inside basis in distributed hot assets.\(^4\) Although the latter situation is typically addressed by section 734 adjustments to inside basis, such adjustments need to be integrated with the section 704(c) approach.\(^4\) To the extent that a disproportionate distribution gives rise to prevented basis adjustments, deferral may no longer be warranted. Thus, section 751(b) may continue to play an important role in determining the timing (rather than merely the character) of gain recognized.

II. THE 1954 LEGISLATION: FLAWED SECTION 751(b) APPROACH

Prior to 1954, the area of partnership tax was described as "perhaps the most complicated and confused area of the tax law."\(^4\) The proposals leading to codification of Subchapter K in 1954 represented a collaborative effort by the ABA and ALI spanning several years.\(^3\) Among the major problem areas identified by

\(^{4}\) See I.R.C. §§ 732(c), 735.
\(^{4}\) See infra notes 101-07 and accompanying text.
\(^{4}\) See Burke, supra note 8, at 723.
\(^{4}\) By taxing gain inherent in hot and cold assets involved in the imputed exchange, section 751(b) may provide the distributee with sufficient outside basis to absorb the inside basis of distributed hot assets, but "this is not a convincing defense of the exchange rule." Andrews, supra note 4, at 47.
\(^{4}\) See infra note 160 and accompanying text.


\(^{6}\) The ABA's 1949 recommendations served as the starting point for the ALI's subsequent study of partnership taxation, undertaken in connection with a massive ALI project for revising the entire federal tax code. For a description of the ABA's 1949 proposals, see Gergen, supra note 6, at 214-16. See also Christopher H. Hanna, Partnership Distributions: Whatever Happened to Nonrecognition?, 82 Ky. L.J. 465, 470-75 (1993-1994). In 1952, the ABA Tax Section adopted the ALI's recommendations which were approved "in principle" at the ALI's 1952 annual meeting. See 1952 ABA Report, supra note 50, at 55-56.
the ABA-ALI drafters were contributions, distributions, and transfers of partnership interests.\textsuperscript{52} Study of disproportionate distributions was largely deferred until agreement was reached concerning the proper treatment of contributions.\textsuperscript{53} The ABA-ALI drafters viewed disproportionate distributions that altered the partners' interests as one facet of a larger, contentious problem of taxing sales of partnership interests and adjusting inside basis to reflect the purchaser's cost. The ABA-ALI collapsible partnership rule—treating a disproportionate distribution as essentially equivalent to an exchange of undivided interests in partnership property, with gain (or loss) deferred through basis reallocation—was rejected by Congress in favor of section 751(b).

\subsection*{A. 1952 ABA-ALI Proposals}

Under current law, a sale of a partnership interest results in full fragmentation: the selling partner is treated as realizing her distributive share of income or loss (both capital and ordinary) as if the partnership had sold all of its assets immediately prior to transfer of the interest.\textsuperscript{54} Full fragmentation reflects an aggregate view and is intended to reduce opportunities for using partnerships to convert ordinary income into capital gain. By contrast, under an entity view, a sale of a partnership interest would give rise to capital gain or loss, regardless of the character of the partnership's underlying assets. In 1954, the full fragmentation approach was rejected as "too drastic for the evil sought to be remedied."\textsuperscript{55} The compromise adopted in section 751(a) resulted in fragmentation only if the partnership's assets were "substantially appreciated," a requirement that remained intact for nearly half a century.

Indeed, even partial fragmentation proved so contentious that it threatened early on to derail the proposals for codification of Subchapter K. Tax practitioners pointed out that treatment of a partnership interest as a unitary capital asset was supported by both case law and revenue rulings.\textsuperscript{56} Although the ABA-ALI drafters ultimately withstood pressure to eliminate the fragmentation rule, the issue provoked heated debate. The ABA-ALI drafters appealed to the need for consistent treatment of buyers and sellers of partnership interests. In particular, the prevailing entity approach was incompatible with the ABA-ALI proposals for adjusting inside basis to reflect the purchaser's cost or section 1014 basis.\textsuperscript{57} Bifurcating the

\textsuperscript{52}See 1952 ABA Report, supra note 50, at 56.
\textsuperscript{53}See Gergen, supra note 6, at 224 (attributing scant attention towards distributions to lack of "consensus on how to handle contributions of assets bearing gain or loss"). The 1949 ABA proposals, largely the work of Mark H. Johnson, contained the deferred sale concept that laid the groundwork for mandatory section 704(c) allocations. See id. at 214-16.
\textsuperscript{54}See Reg. § 1.743-1(d)(2).
\textsuperscript{55}Jackson et al., supra note 5, at 146.
\textsuperscript{56}See G.C.M. 26,379, 1950-1 C.B. 58; Commissioner v. Lehman, 165 F.2d 383, 386 (2d. Cir. 1948) (refusing to apply fragmentation rule to sale of a partnership interest); Swirren v. Commissioner, 183 F.2d 656, 660 (7th Cir. 1950) (treating amount realized on sale of partnership interest as capital gain even though part of payment represented uncollected fees for personal services).
\textsuperscript{57}See PROCEEDINGS OF THE 29TH ANNUAL MEETING OF THE ALI, May 22, 1952, at 112-13 (statement of Stanley S. Surrey). In arguing for consistent treatment, Surrey appealed to "the philosophy underlying this entire draft as a unitary matter." Id. at 118.
seller's gain into ordinary and capital components was an essential tradeoff for
the purchaser's ability to obtain a cost basis in the acquired partnership's assets. Moreover, fragmentation was necessary to achieve equivalent tax treatment for
sales of partnership interests and sales of partnership assets.

One of the principal drafters of the ABA-ALI proposals, Mark H. Johnson,
presented testimony to Congress in August 1953 concerning proposed codification
of the partnership rules. He emphasized the need to treat a distribution in
liquidation of a partner’s interest in essentially the same manner as a sale of a
partnership interest. In fact, however, the ABA's 1952 proposal on distributions
in retirement of a partner’s interest fell considerably short of full fragmentation.
Because the distributee’s recognized gain was limited to cash received in excess of
outside basis, only an all cash liquidating distribution would trigger full fragmenta-
tion. Any gain recognized would be allocated between the partnership’s capital
and noncapital assets in proportion to the built-in gain inherent in such assets.
Neither the distributee nor the partnership would recognize gain or loss upon a
distribution of property. Hence, ordinary income could be freely shifted among
partners by having the partnership distribute all of its hot assets to one partner. The
remaining partners would then realize entirely capital gain on a subsequent sale of
their partnership interests, even though appreciation in the value of their interests
was partly attributable to previously distributed hot assets.

While the ABA proposal fell short of full fragmentation, it recognized that a
disproportionate distribution should trigger adjustments to the basis of retained
partnership property along the lines of current section 734.6 Inside basis adjust-

6See PROCEEDINGS OF THE 29TH ANNUAL MEETING OF THE ALI, supra note 57, at 118 (statement of J.
Paul Jackson); see also id. at 116-17 (statement of Mark H. Johnson) (referring to “bargaining balance”
between buyer and seller on valuation matters).
6General Revenue Revision: Hearings Before the Comm. on Ways & Means, 83d Cong. 1368-86
(1953) [hereinafter 1953 Revenue Hearings].
6See id. at 1385 (noting that entity treatment would “make possible large scale diversion of ordinary
income into capital gain through the use of collapsible partnerships”).
6See 1952 ABA Report, supra note 50, § X194(a)(1). The comparable ALI provision provided that the
portion of the distributee’s gain treated as ordinary income “shall be an amount which bears the
same proportion to the distributee’s total gain” as the partnership’s hot asset gain bears to total hot and
cold asset gain. ALI, TENTATIVE DRAFT NO. 7, § X758(a)(2) and explanation at 396 (1952) [hereinafter
Tentative Draft No. 7].
6Cf. 1952 ABA Report, supra note 50, § X194(a)(3)(B) (providing that distributee would recognize
distributive share of ordinary income as if the partnership had sold all of its hot assets other than those
distributed).
6Distributed property would generally take a substituted basis in the distributee’s hands; the nondis-
tributee partners would be required to recognize gain only if the basis of retained property could not
be properly adjusted following a distribution. See 1952 ABA Report, supra note 50, §§ X194(b)(1),
(c)(1)(b). By contrast, the ABA's 1949 proposal required immediate recognition of gain or loss by the
nondistributee partners when property was distributed with a value different from its tax basis. See
Hanna, supra note 51, at 472 n.18; Gergen, supra note 6, at 215.
6See 1952 ABA Report, supra note 50, § X194(c)(1); Tentative Draft No. 7, supra note 61, §
X758(d)(1); see also 1953 Revenue Hearings, supra note 59, at 1384 (statement of Mark H. Johnson)
(notting that “the cost of buying out the retired partner should be reflected in the bases of the remaining
partners for their interests in the aggregate partnership property”).

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ments were the default rule for all partnerships in which each partner’s outside basis was treated as a ratable share of the partnership’s aggregate common basis.55 An all cash liquidating distribution should leave the nondistributee partners with the equivalent of a cost basis in the distributee’s relinquished share of partnership assets.66 The transaction is essentially equivalent to a pro rata purchase of the retiring partner’s interest by the continuing partners. Inside basis adjustments following a distribution of property serve a similar function, namely, ensuring that the remaining partners’ former shares of unrealized gain (or loss) inherent in the partnership’s assets remain unchanged.

The ABA-ALI proposals were prescient in recognizing the need for partial liquidation treatment following a non-pro rata current distribution that alters the partners’ interests in partnership profits and losses.67 Partial liquidation treatment was viewed as essential to preserve parity of treatment between sales of partnership interests and disproportionate distributions. “In order to reflect the cost to the other partners of acquiring the distributee’s interest in the partnership properties retained by the partnership,” the continuing partners (including potentially the distributee) were permitted an adjustment to the common basis of property retained by the partnership under the forerunner of current section 734.68 Gain or loss was triggered to the continuing partners only in the case of prevented basis adjustments.69 This proposal later served as the foundation for the ALI’s proposed solution to the collapsible partnership problem, which looked to reallocation of inside basis to preserve hot (and cold) asset gain in distributed and retained assets.70 Although Congress rejected the basis reallocation approach, the substitute approach of section 751(b) has proved deeply flawed and needlessly complex.

B. Abortive House Proposal

While the House almost certainly relied on the ABA-ALI proposals in drafting Subchapter K, it rejected key elements of those proposals.71 Indeed, the House bill “contained provisions that suggest that the draftsmen did not understand what they

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55See 1952 ABA Report, supra note 50, § X194(c)(2); Tentative Draft No. 7, supra note 61, § X758(d)(2). Under the “standard rule,” the partners “relinquish[ed] their tax positions represented by the basis of their contributions to the partnership” and acquired an undivided interest in each partnership asset. 1952 ABA Report, supra note 50, at 56. Under an elective rule, the partners were permitted to retain the “tax benefit of [their] investment” in the partnership, and adjustments to reflect sales and redemptions were made only to the partners’ outside bases, rather than the bases of partnership assets. See 1952 ABA Report, supra note 50, at 56; see also infra notes 140-41 and accompanying text (describing basis shifting proposal).

56Indeed, the transaction could be structured as a distribution of cash to the continuing partners immediately following a purchase of the retiring partner’s interest. See Andrews, supra note 4, at 11.

57See 1952 ABA Report, supra note 50, § X194(d); Tentative Draft No. 7, supra note 61, § X758(e).

58See 1952 ABA Report, supra note 50, § X194(c)(1).

59See Tentative Draft No. 7, supra note 61, § X758(d). The character of any recognized gain or loss was determined by reference to the distributed property.

60See infra notes 115-32 and accompanying text.

61See Gergen, supra note 6, at 233-34 (noting House drafters’ rejection of basis shifting approach).
were doing.\textsuperscript{72} The House bill provided that distributed property, whether received in a current or liquidating distribution, would generally take the same basis in the distributee’s hands as its basis in the partnership’s hands.\textsuperscript{73} If the partnership’s basis in the distributed property exceeded outside basis, the distributee would recognize gain immediately. Similarly, the distributee would recognize loss on a liquidating distribution if outside basis exceeded the distributed property’s basis in the partnership’s hands. Determining the distributee’s gain or loss by reference to the basis (rather than the value) of distributed property clearly suggests that the House drafters failed to appreciate the relationship between inside basis and outside basis.\textsuperscript{74} In another odd twist, the House version of section 751 provided collapsible treatment for sales of partnership interests and liquidating distributions unless the distributed property consisted of hot assets.\textsuperscript{75}

The House bill encountered strong opposition among the tax bar, which mounted an effective campaign to steer reform back toward the ABA-ALI proposals. In April 1954, barely a month after passage of the House bill, the partnership committee of the ABA’s Tax Section submitted a scathing 21-page critique.\textsuperscript{76} The House bill violated the “fundamental premise” of the ABA-ALI drafters that a distribution should be treated as a nonrecognition event to the maximum extent possible.\textsuperscript{77} The House proposal measuring gain by reference to the basis (rather than the value) of distributed property was described as “new and startling.”\textsuperscript{78} The ABA report offered several examples illustrating the “ridiculous results” that could flow from this noneconomic approach.\textsuperscript{79} Moreover, the House version of section 734 was considered “completely inadequate to bring into balance the partnership’s tax basis for its undistributed properties and the remaining partners’ bases for their partnership basis.”

\textsuperscript{72}Id. at 208-09.
\textsuperscript{73}See H.R. Rep. No. 83-1337, at 68-69 (1954) (noting that carryover basis rule avoids the complexities of present law requiring proportional allocation of basis). The House bill limited the distributee’s basis in distributed property to its fair market value; any “unused basis” was added to the basis of the partnership’s retained property. Id. at 69.
\textsuperscript{74}See Gergen, supra note 6, at 235. Under current law, the basis of distributed property can never exceed the distributee’s outside basis; loss is recognized only on a liquidating distribution in which the distributee receives solely hot assets and cash. See I.R.C. §§ 732(a)(2), 731(a)(2).
\textsuperscript{75}H.R. 8300, 83d Cong. § 751(a)(3) (1954). Of course, section 751(a)(3) makes no sense if the collapsible partnership provisions are intended to prevent shifting of ordinary income among partners.
\textsuperscript{76}The ABA report was submitted by Thomas N. Tarleau, who appeared before the Senate Finance Committee on April 8, 1954. See An Act to Revise the Revenue Laws of the United States: Hearings on H.R. 8300 Before the S. Comm. on Finance, 83d Cong. 343 (1954) (statement of Thomas N. Tarleau). The ABA report can be found in Report Hearings Before the Committee on Finance, United States Senate on H.R. 8300, 83d Cong. (Part I), at 459-80 [hereinafter 1954 ABA Report]. Arthur B. Willis was chair of the Partnership Section, which prepared the report. Mark Johnson may have helped to mobilize opposition by the New York State Bar and the Association of the Bar of the City of New York. See Gergen supra note 6, at 236.
\textsuperscript{77}See 1954 ABA Report, supra note 76, at 469 (describing departure from general nonrecognition policy as “a matter of extreme importance”).
\textsuperscript{78}Id. at 469.
\textsuperscript{79}Id. at 469-71. The House approach produced tax gains and losses that were “startlingly different from economic gains and losses.” Gergen, supra note 6, at 235.

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interests. The report recommended rewriting sections 731 to 734 along the lines of the ALI's revised proposals published in February 1954. The ALI's proposed section X761 dealt specifically with disproportionate distributions that potentially converted ordinary income into capital gain; it overrode the general rule applicable to partnerships whose ordinary income assets were not substantially appreciated. These proposals called for adjusting inside basis to preserve unrealized gain (or loss) on non-pro rata distributions of property "having a tax basis differing from its distribution value" and "recognition of gain or loss to the remaining partners" upon certain disproportionate distributions.

The House's treatment of sales of partnership interests, under section 751(a), was "generally adequate," but the related distribution provisions produced inequitable tax results and "open[ed] opportunities for important tax avoidance." These avoidance opportunities were illustrated by an example involving the three person ABC partnership which held cash ($90), a zero basis hot asset (cattle worth $90), and a full basis cold asset (a ranch worth $90). Each partner's outside basis ($60) represented one-third of the partnership's aggregate inside basis ($180). In the example, A received a liquidating distribution of the partnership's only hot asset. Under the House bill, the distribution would not trigger section 751, since section 751(a) was expressly made inapplicable to in kind distributions of hot assets. Accordingly, under the House bill, A would recognize a capital loss of $60 (the excess of A's outside basis over the zero basis of the distributed property) and take a carryover basis of zero in the cattle, preserving $90 of ordinary income in A's hands. If the partnership later distributed the cash and ranch (with a total fair market value and basis of $180) in complete liquidation, B and C would recognize total capital gain of $60 ($180 basis of distributed property less $120 aggregate outside basis). Capital gain could be diverted to high bracket partners (B and C).

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801954 ABA Report, supra note 76, at 470. The most serious deficiencies stemmed from the House drafters' failure to grasp that "where property of a partnership is distributed to a partner in retirement of his interest, the other partners, in effect, are selling their interests in that property to the retiring partner in consideration of his interest in the remaining partnership properties." Id. at 472. Similarly, the House drafters failed to perceive that, unlike section 734 adjustments to common basis, section 734 adjustments should benefit only the purchasing partner. See id. at 475.

81The publication of the ALI proposals was timed to coincide with the pending revision of the tax code. See ALI, I FEDERAL INCOME TAX STATUTE: FEBRUARY 1954 DRAFT IV (1954) ("If there ever was a time when an objective study would be helpful to a legislative group in considering problems, this seems to be the time."). The ALI's partnership proposals and explanation are contained in the draft's second volume. See ALI, II FEDERAL INCOME TAX STATUTE: FEBRUARY 1954 DRAFT 86, 353 (1954) (hereinafter 1954 ALI DRAFT).

82See 1954 ALI DRAFT, supra note 81, § X761, at 116-19, 409-11 (collapsible partnerships), and § X757, at 101-04, 392-95 (noncollapsible partnerships).

83See 1954 ABA Report, supra note 76, at 472. Like the 1952 ABA-ALI proposals, the noncollapsible partnership rule (section X757) recognized that inside basis adjustments were necessary following a redemption or partial redemption of a partner's interest "in order to reflect the cost to the other partners and in order to postpone recognition of gain or loss resulting from the sale to the distributee of the other partners' interests in the property distributed.") 1954 ALI DRAFT, supra note 81, § X757(c), at 102, 394 (explanation).

841954 ABA Report, supra note 76, at 475.

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while A might have ordinary losses from another transaction to offset the ordinary income on sale of the cattle. "What a splendid opportunity for tax avoidance!"

The ABA report criticized the House bill for failing to recognize that an in kind distribution of hot assets "truly represents an exchange of the interests of the continuing partners in the distributed property for an interest of the distributee in the remaining partnership property." Thus, the distributee A should be treated as exchanging her one-third interest in the retained partnership property for the continuing partners' two-thirds interest in the distributed property. Under the ALI's proposed section X761, all of the partners would realize gain on the deemed exchange of undivided interests. Such gain would, however, be deferred "at least in part, by applying capital gain in reduction of basis of capital assets and ordinary income in reduction of basis of noncapital assets." To eliminate inequitable tax consequences among the partners and curb tax avoidance, the House bill needed to be revised along the lines of the ALI's proposed section X761 "unless a simpler but equally satisfactory statutory formula can be evolved.

These criticisms of the House proposal neglected to mention that the 1952 ABA-ALI proposals also gave short shrift to non-pro rata property distributions that shifted hot and cold asset gain. The ALI drafters did not focus on this problem until 1953, when they proposed a novel solution modeled partly on the like-kind exchange provisions of current section 1031, coupled with "nonboot" treatment of cash. As the ALI drafters perceived, the key to preserving shares of unrealized gain (or loss) was through reallocation of inside basis among distributed and retained assets. The ALI proposal sought to ensure that each partner would ultimately be taxed on her distributive share of the partnership's hot and cold asset gain, while maximizing nonrecognition. Under the ALI approach, shifts in hot (and cold) asset gain were measured by the spread between basis and value following appropriate reallocation of the partnership's inside basis. Unlike section 751(b) as enacted, the ALI approach focused on shifts of gain, not value.

C. Tacking Back to the ABA-ALI Proposals.

In the spring of 1954, the Senate Finance Committee redrafted the House's partnership provisions virtually from scratch. The extraordinary success of the redrafting was possible because representatives of the Treasury, the Service, and

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88Thus, A reported capital loss ($60) immediately, while B and C shifted the partnership's entire ordinary income ($90) to A and deferred capital gain ($60) until liquidation.
891954 ABA Report, supra note 76, at 476.
90Id.
91Id.
92Id. at 476-77. It was unfair to the government to allow "tax minimization . . . through adroit selection of the property . . . distributed." Id. at 476.
93See Surrey & Warren, supra note 5, at 1174 ("But where a partnership's non-capital assets have appreciated significantly in value, special treatment is under consideration to meet the difficult problem of 'collapsible partnerships.'").

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the Joint Committee on Taxation worked in "close consultation" with key proponents of the ABA-ALI proposals. The partnership provisions contained in the Senate Finance Committee bill were mostly enacted in 1954. While they closely resembled the ABA-ALI proposals, they deviated from an aggregate approach in certain key respects.

In response to the ABA's objections, the Senate bill completely reformulated section 732. As under the ABA-ALI proposals, the Senate bill provided generally for carryover basis treatment on nonliquidating distributions and substituted basis treatment on liquidating distributions. The Senate bill added one important caveat to the carryover basis rule on a liquidating or nonliquidating distribution of hot assets. To prevent conversion of ordinary income into capital gain, the basis of distributed hot assets could never be increased in the distributee's hands over their predistribution basis in the partnership's hands. The ABA-ALI proposals contained no such limit. The Senate bill also adopted the concept of section 734 adjustments to the common basis of partnership property that would benefit all continuing partners in proportion to their continuing interests. But the Senate made two important changes: it eliminated partial liquidation treatment and made inside basis adjustments optional. These changes continue to bedevil Subchapter K today; without partial liquidation treatment, section 734 functions poorly as an adjustment to common basis, and an elective basis adjustment seems a strange way to implement a nonrecognition provision intended to preserve shares of inside gain.

With conforming technical amendments, the Senate bill retained the House provision dealing with sales of partnership interests, but added a new subsection, section 751(b), captioned "certain distributions treated as sales or exchanges."

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9See Gergen, supra note 6, at 236. On behalf of the ABA, Mark H. Johnson and Carolyn K. Tenen played pivotal roles. See id.; Arthur B. Willis, Statement, in Comm. on Taxation of Partnerships, ABA Tax Sec., Program and Comm. Rep. 100-01 (1954) ("As of the present moment, it appears that their very effective work will result in elimination from H.R. 8300 of most of the provisions which were found objectionable by this Committee."). Tenen co-authored the definitive survey of the 1954 partnership provisions. See J. Paul Jackson et al., The Internal Revenue Code of 1954: Partnerships, 54 COLUM. L. REV. 1183 (1954).

9See Gergen, supra note 6, at 234-35.

9See S. REP. No. 83-1622, at 4728 (1954), as reprinted in 1954 U.S.C.C.A.N. 4621, 4728 (noting that House bill "would result in the taxation of gains where there were no real gains and the recognition of losses where there were no real losses") [hereinafter S. REP. No. 83-1622].

9See id.

9See id.

9Under the ALI proposal, distributed hot and cold assets would generally take a basis in the distributee's hands equal to their fair market value less any preserved gain. See 1954 ALI DRAFT, supra note 81, § X761(c), at 117.

9See S. REP. No. 83-1622, supra note 94, at 4728; see also I.R.C. §§ 761(d), 734(a), 743(a).

9Mandatory inside basis adjustments were apparently considered too onerous. See S. REP. No. 83-1622, supra note 94, at 5035 (noting that under the substituted basis rule, "there will in virtually every case be a difference" between the basis of the distributed property in the partnership's hands and its basis in the distributee's hands).

9The Senate bill simplified section 751(a) by eliminating the exclusion of previously taxed ordinary income in the hands of the purchaser (or the continuing partnership in the case of a distribution). See id. at 5043.
Under the Senate bill, section 751(b) was triggered whenever a distributee received “more than his proportionate share of the value” of either hot or cold assets.\(^\text{101}\) Thus, the Senate bill introduced the concept of shifts in a partner’s “proportionate share” of hot or cold assets measured by the value of such assets.\(^\text{102}\) According to the Senate report, “[t]he statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.”\(^\text{103}\)

The Senate report contains an example illustrating the operation of section 751(b) when a retiring partner receives a liquidating distribution consisting entirely of cold assets with a basis equal to fair market value.\(^\text{104}\) Since the distributee’s proportionate share of hot asset value is reduced to zero, she realizes ordinary income as a result of the distribution. The amount of ordinary income is equal to the difference between her allocable basis in the hot assets relinquished and the value of the cold assets received in the deemed exchange. The partnership recognizes no gain on the deemed exchange and takes a cost basis in the hot assets relinquished by the distributee. If appreciated cold assets were involved in the section 751(b) exchange, however, the partnership, as constituted after the distribution, would recognize capital gain allocated entirely to the continuing partners.

The Conference Committee generally followed the Senate’s approach but modified the statutory language to make explicit that section 751(b) applied only when the distributee received excess hot or cold assets “in exchange” for her interest in other partnership property.\(^\text{105}\) In addition, the Conference Committee clarified that section 751(b) was generally inapplicable if the distributee received only her proportionate share of hot assets, unless such assets were expressly received in exchange for other partnership property.\(^\text{106}\) Although the revised statutory language omitted any reference to the value of the distributee’s proportionate share, the Conference Committee report reiterated that gain would be determined by reference to the “fair market value of the property” exchanged.\(^\text{107}\) In light of the legislative

\(^{101}\) The Senate version of section 751(b) provided that:

To the extent a partner receives in a distribution . . . more than his proportionate share of the value of [hot or cold assets] such distribution shall, under regulations prescribed by the Secretary . . . , be considered as a sale or exchange of property between the distributee and the partnership (as constituted after the distribution).

H.R. 8300, 83d Cong., § 751(b) (1954) (as amended by the Senate).

\(^{102}\) See H.R. Rep. No. 83-1622, supra note 94, at 5044 (noting that the “partnership will have capital gain on the difference between the basis properly allocable” to excess cold assets distributed and the “value of the [distributee’s] interest” in hot assets surrendered).

\(^{103}\) See id. at 4732 (referring to use of collapsible partnerships as “a device for obtaining capital gain treatment on fees or other rights to income and on appreciated inventory”).

\(^{104}\) See id. at 5037-38.

\(^{105}\) See S. Rep. No. 83-1622, supra note 94, at 5044 (noting that the “partnership will have capital gain on the difference between the basis properly allocable” to excess cold assets distributed and the “value of the [distributee’s] interest” in hot assets surrendered).

\(^{106}\) Id. at 5037-38.

\(^{107}\) See id. at 4732 (referring to use of collapsible partnerships as “a device for obtaining capital gain treatment on fees or other rights to income and on appreciated inventory”.

\(^{108}\) Id. at 65. Under the Senate bill, section 751(b) could be triggered only if the distributee received “more than” her proportionate share of one class. See S. Rep. No. 83-1622, supra note 94, at 5044. Thus, the Conference Committee’s change was evidently intended to broaden the scope of section 751(b).

history, the drafters of the 1956 regulations cannot be faulted for their mechanical implementation of the imputed exchange approach to hot asset distributions. Nevertheless, the focus on shifts in hot asset value may defeat the goal of taxing each partner on her distributive share of the partnership's ordinary income and capital gain.

In retrospect, it seems strange that Congress ever conceived that section 751(b) was likely to accomplish a sensible result. Most likely, the drafters of the Senate provision focused almost exclusively on liquidating distributions. The worst deficiencies of section 751(b) only become apparent on non-pro rata current distributions that reduce, but do not eliminate, the distributee's interest. A partner whose interest is reduced in a non-pro rata current distribution does not expressly relinquish an interest in specific assets retained by the partnership. By contrast, relinquished assets are easily identified when a partner's entire interest is liquidated, leaving behind the distributee's interest in any undistributed assets. In view of the administrative complexity, contemporaries promptly questioned whether Congress, in fact, intended section 751(b) to apply to nonliquidating distributions. Despite "vague inferences" to the contrary in the legislative history, however, section 751(b) has been interpreted as applying to both liquidating and nonliquidating distributions. Indeed, any other interpretation would leave a wide gap in the collapsible partnership provisions.

III. PREVENTING HOT ASSET SHIFTS: ALI APPROACH

In its current form, section 751(b) is essentially a recognition provision: its primary (if perhaps unintended) effect is to eliminate further deferral of hot asset gain upon a disproportionate distribution. Accelerating recognition of gain, however, seems wholly inconsistent with the underlying conceptual framework of Subchapter K as enacted in 1954. Rather than approaching the collapsible
partnership problem "through the complex and unsatisfactory mechanics of what came to be known as section 751(b)."113 the ALI drafters fashioned a radically different solution. The ALI approach—premised on deferral of gain recognition through basis adjustments to retained and distributed assets—bore little relationship to section 751(b) as ultimately enacted. Following a liquidation or partial liquidation of a partner's interest, inside basis reallocation was viewed as the key to preserving unrealized hot and cold asset gain. In comparison to extended section 704(c) special allocations, the ALI approach offered a relatively simple mechanism for preserving shares of unrealized appreciation in hot and cold assets.114

A. Collapsible Partnership Rule

In the spring of 1953, Stanley S. Surrey and William C. Warren, the reporters for the ALI's massive federal income tax project, published an interim report. In discussing the partnership proposals, they identified two policy objectives animating the ALI's treatment of disproportionate distributions: "gain should not be recognized to the extent that it inheres in the value of non-money property distributed," and "potential ordinary gain should not be easily convertible into potential capital gain."115 While "none of [the] solutions [considered by the ALI drafters] produces a perfect answer," a substituted basis approach was chosen as the "ordinary rule" for distributions in liquidation (or partial liquidation) of a partner's interest, coupled with inside basis adjustments.116 In partnerships with appreciated hot assets, however, the fundamental weakness of this approach was that "it enable[d] potential ordinary income to be converted into capital gain by the simple device of a disproportionate distribution."117 To avoid such conversion and to "protect the revenues," a special collapsible partnership rule was necessary.118

Under the ALI approach, a disproportionate distribution would be treated as a "sale between the partners of their undivided interests in the partnership property," but any hot or cold asset gain realized by the partners would be "postponed by respectively subtracting or adding the amount of the gain or loss from or to the respective bases of any non-capital or capital assets remaining in their possession."119 Gain or loss would be recognized only to the extent that either the distributee or continuing partners no longer possessed "assets of the requisite character whose

113Gergen, supra note 6, at 224; see Hanna, supra note 51, at 472, n.18 (suggesting that the ABA's section 194(c) and (d) "appears to be the forerunner of section 751(b)").
114But cf. Gergen, supra note 6, at 224 (comparing ALI approach to the "conceptually simpler [section 704(c)] solution ... implicit in [Mark] Johnson's original recommendations ... . . . . We are still working our way through to this conceptually simple solution.").
115Surrey & Warren, supra note 5, at 1172.
116Id. at 1174 ("This approach is in accord with the present regulations and will be most easily understood by laymen and accountants who do not specialize in the subtleties of the tax law.").
117Id. at 1172.
118Id. at 1174.
119Id. at 1173. The aggregate approach would treat the "distributee partner [as] having sold to the other partners his undivided interest in the properties not distributed to him in return for the other partners' undivided interests in the properties distributed to him." Id.

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bases can be adjusted."\textsuperscript{120} By 1954 standards, the ALI's collapsible partnership rule was "exceedingly complex." It injected "valuation issues into every case of a disproportionate distribution," and could require gain recognition "even though only non-money property is received."\textsuperscript{121} For this reason, the collapsible partnership rule applied only when the partnership's hot assets were substantially appreciated.

\textbf{B. Eliminating Conversion}

The collapsible partnership rule was intended to prevent a disproportionate distribution from shifting basis from assets of one character to assets of another character. Without a special rule, basis reallocation could shift basis from high basis cold assets to low basis hot assets, thereby converting ordinary income into capital gain.\textsuperscript{122} In an example strikingly similar to the one contained in the ABA's critique of the House bill, the ALI drafters succinctly illustrated the conversion problem.\textsuperscript{123} The ABC partnership with three assets—$60 cash, a ranch worth $60 (with a basis of $60), and cattle worth $60 (with a basis of zero)—distributes the ranch to A in liquidation of her partnership interest. Each partner has a basis of $40 in her partnership interest (one-third of the partnership's aggregate common basis of $120). Under the general rule for noncollapsible partnerships, A would take a substituted basis of $40 in the ranch equal to her outside basis, triggering an inside basis adjustment of $20 to reflect the decrease in the basis of the ranch in A's hands. This inside basis adjustment would potentially eliminate $20 of ordinary income inherent in the retained cattle, thereby reducing the partnership's overall ordinary income from $60 to $40. The distribution was "disproportionate" because it converted $20 of capital gain into $20 of ordinary income.\textsuperscript{124}

Under the collapsible partnership rule, the partnership would be deemed to sell all of its assets for fair market value immediately before the distribution.\textsuperscript{125} Thus, A would realize $20 of ordinary income and no capital gain on the hypothetical sale of the partnership's assets, her one-third share of hot (and cold) asset gain. Since A received only cold assets, A's realized ordinary income of $20 would be recognized immediately, and A would take a fair market value basis of $60 in the distributed ranch.\textsuperscript{126} If the partnership's cold assets were appreciated, A would also

\begin{verbatim}
\textsuperscript{120}Id.
\textsuperscript{121}Id.
\textsuperscript{122}Id. at 1172.
\textsuperscript{123}See 1954 ALI DRAFT, supra note 81, at 409.
\textsuperscript{124}Proposed section X761 defined a distribution as "disproportionate" if (applying the general rule of section 757 for noncollapsible partnerships) "a sale, immediately following the distribution, of both the assets received by the distributees, and the assets remaining in the partnership, would not result in the recognition of an amount of ordinary gain or loss substantially similar to the amount of ordinary gain or loss the partnership would have recognized if the partnership had sold for value all of its non-capital assets immediately before the distribution." 1954 ALI DRAFT, supra note 81, § X761(a)(2), at 117. In addition, the provision applied only if the distributee owned at least a ten percent interest in the partnership. See id., § X761(a)(3).
\textsuperscript{125}See id., § X761(b), at 117, 410 (explanation).
\textsuperscript{126}Id., § X761(c), at 117.
\end{verbatim}
realize her proportionate share of cold asset gain, but such gain would be deferred to the extent that it did not exceed the fair market value of cold assets received by A.\(^{127}\)

Following the distribution, the basis of retained partnership property would be adjusted, to the extent possible, to preserve the continuing partners’ respective shares of hot and cold asset gain.\(^{128}\) Such inside basis adjustments would be segregated under rules similar to current section 755. To reflect A’s recognized hot asset gain, the partnership’s basis in the cattle would be increased from zero to $20. Inside basis adjustments would also be required to reflect any increase or decrease in the basis of distributed property in the distributee’s hands. Since the $60 basis of the ranch would be unchanged in A’s hands, no adjustment to the basis of cold assets would be triggered. Following these adjustments, the continuing partners’ aggregate outside basis ($80) would continue to reflect their share of the partnership’s aggregate inside basis ($60 cash and $20 basis of cattle). The continuing partners’ predistribution share of hot asset gain ($40) would be preserved.\(^{129}\)

Under the ALI proposal, a disproportionate distribution that reduced the distributee’s interest in the partnership would be treated as a complete liquidation of the redeemed portion of the interest.\(^{130}\) In effect, the distributee’s interest would be bifurcated into a redeemed and a continuing interest. For example, if the redeemed partner were treated as relinquishing half of her former interest (by value), she would realize half of the hot and cold asset gain attributable to her entire partnership interest.\(^{131}\) Such realized gain would be deferred, however, to the extent that the distributee received hot or cold assets of sufficient value to absorb any required basis adjustments. Increases and decreases to the partnership’s retained property would affect both the distributee and nondistributee partners in proportion to their continuing interests in the partnership.\(^{132}\)

C. Current Versus Liquidating Distributions

Following a disproportionate distribution in liquidation or partial liquidation of a partner’s interest, the collapsible partnership rule forestalled conversion of ordinary income into capital gain. Under current law, the basis segregation rules of section

\(^{127}\)See id., § X761(d)(1), at 118 (adjusting upward and downward the basis of retained assets), and § X761(d)(2), at 118 (segregating basis adjustments to retained capital and non-capital assets). Any prevented basis adjustments would trigger recognition of ordinary income or capital gain. See also id., § X761(d)(3), at 118-19.

\(^{128}\)The ALI drafters were concerned that disproportionate distributions might often leave the distributee with all of the partnership’s hot assets. Since the other partners’ hot asset gain could not be deferred, it might be preferable to require the distributee to recognize her hot asset gain immediately. See id., § X761(b), at 117, 410 (explanation).

\(^{129}\)See id., § X761(e), at 119 (providing that “only the basis of the [redeemed] portion [of the distributee’s interest] shall be used in the computations rather than the basis of [the distributee’s] entire interest”).

\(^{130}\)For example, a reduction in the distributee’s interest from one-third to one-fifth would constitute a complete liquidation of half of the distributee’s interest by value.

\(^{131}\)Following these adjustments, the distributee and nondistributee partners respectively would have a one-fifth and a four-fifths share of inside basis, gain, and value.
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755 prohibit allocation of section 734 adjustments to property of a different class from the distributed property. Moreover, under current law—ignoring section 751(b)—section 732(c) prevents distributed hot assets from taking a basis in the distributee's hands in excess of their basis in the partnership's hands. Thus, these provisions generally prevent conversion of ordinary income into capital gain. Under the ALI proposals, the basis of any property received in a current distribution was the same in the distributee's hands as in the partnership's hands; neither the distributee nor the partnership recognized any gain or loss. Therefore, if one partner received cash and another partner received a low basis asset in a current distribution, the distribution would result in a permanent shift of basis among the partners. The treatment of current distributions seemingly left significant opportunities for income shifting.

The puzzle, then, is why the ALI proposals drew such a sharp distinction between liquidating and current distributions, that is, between those distributions that altered the partners' shares of profits and losses and those that did not. On a current distribution, the ALI drafters adopted a relatively lenient attitude toward shifting of basis and thus gain. Such shifts were not considered problematic since the partners could eliminate any inequities among themselves and the government was considered not to have a stake in the partners' economic arrangements among themselves. Current distributions were narrowly limited, however, to those that did not alter the partners' interests in profits and losses. A distribution that reduced the distributee's partnership interest was treated as a complete liquidation of a portion of the distributee's partnership interest, triggering collapsible treatment if the partnership's assets were substantially appreciated.

A basis shift upon a current distribution, as defined by the ABA-ALI proposals, mirrored the basis shift that occurred upon contribution to a partnership of property

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133See Reg. § 1.755-1(c)(1).
134On a distribution in liquidation or partial liquidation of a partner’s interest, the ALI considered but rejected a carryover basis approach. See Surrey & Warren, supra note 5, at 1174 (noting that carryover basis treatment would enable a partner receiving solely cash in liquidation of her interest to “escape taxation completely” on her share of unrealized appreciation in the partnership’s assets). Equally importantly, a carryover basis approach was also inconsistent with the ALI’s treatment of liquidating distributions as a sale of a ratable portion of the distributee’s interest to the other partners.
135See 1954 ALI DRAFT, supra note 81, §§ X754(a)-(b), at 97.
136A current distribution of property (or cash) reduces the partnership’s common basis by the basis of the distributed property (or the amount of cash). Since a partner’s basis in her partnership interest was always a ratable share of the partnership’s common basis, no separate adjustment to outside basis was needed to reflect the distribution. See Jackson et al., supra note 5, at 136.
137The ALI proposals defined a current distribution as one other than upon winding up of the partnership or “as the result of a sale by the distributee of part or all of his interest in partnership property to the other partners.” See 1954 ALI DRAFT, supra note 81, § X754, at 97; cf. Reg. § 1.761-1(d) (defining a current distribution as any distribution that does not completely terminate a partner’s interest).
138See Jackson et al., supra note 5, at 136 (noting that the partners could agree to eliminate any inequities by “equaliz[ing] the bases to each partner of distributed property” or by “compensat[ing] a partner taking disproportionately low-basis property at a potential tax disadvantage”).
139See 1954 ALI DRAFT, supra note 81, § X757(e), at 103-04 (partial liquidation), and § X761(e), at 119 (partial liquidation).
with a basis different from its value. Under the ABA-ALI “basis shift” approach, the partners were viewed as exchanging tax free undivided interests in contributed property. Each partner’s “permanent basis” in her investment was set equal to her ratable share of the partnership’s aggregate basis in the contributed property. No separate basis was necessary for tracking a partner’s interest in the partnership, unless the partners elected to preserve the bases of their respective contributions as the bases of their partnership interests. Each partner’s “outside basis” was equal to her aggregate share of the partnership’s inside basis. Following a current distribution, each partner’s share of inside basis was automatically reduced, without any need for separate adjustments to outside basis. Perhaps not surprisingly, the basis shift notion was never adopted, although the alternative rule of section 705 reflects vestiges of the concept.

The concept of a basis shift upon contribution of property may help to explain the willingness of the ABA-ALI drafters to tolerate permanent basis shifts upon a current distribution that did not alter the partners’ percentage interests. With respect to contributed property, the basis shift notion now seems peculiar, since differences between the tax and book values of contributed property are properly handled under section 704(c) principles. In 1954, however, Congress adopted an extraordinarily broad definition of a current distribution as one leaving the distributee partner with any interest in the partnership (no matter how small) and allowed elective inside basis adjustments. What is strange, therefore, is that section 704(c) principles have not been extended in a coherent fashion to current distributions that alter the partners’ interests in the partnership.

IV. EXPANDED HOT ASSET SALE APPROACH

While a revaluation may often eliminate hot asset shifts, it cannot prevent a non-pro rata current distribution from altering the continuing partners’ shares of inside basis and value. These distortions may be aggravated by the common basis approach of section 734(b) adjustments, which does not reflect the revaluation concept. Following a disproportionate distribution, section 734 adjustments would generally be unnecessary if the hot asset sale approach were extended to tax shifts.

140See Jackson et al., supra note 5, at 127-30. Under the basis shift approach, there was no attempt to preserve the original basis of contributed property as the contributing partner’s basis in her investment. See id. at 128. The partners could elect, however, to preserve the bases of their respective contributions as the bases of their partnership interests. See id. at 131-33. The basis shift approach, which seems quite strange from the perspective of modern Subchapter K, was intended to preserve an aggregate approach without the full complexity of the credited-value or deferred-sale approach of section 704(c). See Gergen, supra note 6, at 208 (describing basis shift approach as “bizarre”).

141See I.R.C. § 705(b) (determining a partner’s outside basis as her aggregate share of the partnership’s common basis with appropriate adjustments to reconcile any differences between the two accounts).

142Under current law, section 734 is irrelevant to the extent that section 751 applies; assets involved in the imputed exchange obtain a cost basis, whether or not the partnership has a section 754 election in effect. If section 751(b) triggers hot asset gain to the distributee (and the partnership’s assets are not revalued), the corresponding increase in the basis of the partnership’s retained hot assets must be specially allocated to the nondistributee partners. See Burke, supra note 8, at 699-700.
in both hot and cold asset gain that cannot be preserved through a revaluation. Taxing shifts in both hot and cold asset gain is arguably consistent with both the statutory language and purpose of section 751(b).

A. Needed Reforms

In recent years Congress has undertaken piecemeal reform of the distribution rules. Thus, section 734(b) adjustments are now mandatory where a distribution in partial liquidation of a partner’s interest would give rise to a “substantial basis reduction” if a section 754 election were in effect. This provision is intended to prevent a liquidating distribution of low basis property to a departing partner with a high outside basis from leaving the continuing partners with lower net built-in gain or higher net built-in loss than before the distribution. To prevent basis shifting, Congress revised the rules of section 732(c) to take into account the spread between the value and basis of distributed property. Treasury has also exercised its regulatory authority to rationalize the section 755 rules allocating section 734(b) adjustments within different classes of retained property. Consistent with the underlying purpose of section 734(b), the revised rules recognize the need for “wrong way” adjustments to preserve the continuing partners’ shares of unrealized appreciation or depreciation following a distribution.

In an influential 1991 article, Professor William D. Andrews recommended changes to the distribution rules that would treat hot asset shifts as a simple sale and further refine the categories of assets for which basis segregation rules are needed. Under the Andrews proposals, inside basis would be reallocated among distributed and retained property in a manner that preserves, to the extent possible, both the distributee’s and the continuing partners’ shares of unrealized appreciation or depreciation. Shifts in hot or cold asset gain would trigger recognition only to the extent of any prevented basis adjustments. To address potential shifting of basis from nondepreciable to depreciable capital assets, the Andrews proposals would add a third category consisting of “tepid” assets, which are located on the continuum between hot and cold assets.

143 See I.R.C. § 732(c), as amended by the Taxpayer Relief Act of 1997, supra note 16.
144 See Reg. § 1.755-1(c)(2) (allowing adjustments that increase the disparity between basis and fair market value of particular properties).
145 See Andrews, supra note 4, at 52-54.
146 Following a disproportionate distribution, each distributee and the continuing partnership would be required to make basis adjustments as needed to preserve their respective predistribution shares of unrealized gain (or loss) in the partnership’s hot assets and other property. See id. at 55. Each partner’s basis in hot assets would be set equal to the fair market value of her share of the distributed or retained hot assets less her predistribution share of hot asset gain, but not less than zero. See id. at 55, n.178.
147 Gain would be recognized to the extent that the fair market value of each partner’s post-distribution share of hot assets is insufficient to absorb the required basis adjustments. See id. at 53. An election would be allowed, however, to reduce the basis of “hotter” property instead of recognizing gain immediately. See id. at 37, 39.
148 See id. at 53-54. Under current law, a separate class of tepid assets would prevent conversion of “unrecaptured section 1250 gain” into more lightly taxed capital gain. See Reg. § 1.1(h)-1(b) (applying look-through rule to section 1250 capital gain and collectibles gain upon sale of a partnership interest).
Conceptually, the Andrews proposals could be conceived as refining the ABA-ALI drafters’ solution to the collapsible partnership problem. The continuing partners (including the distributee) would share inside basis, gain, and value in proportion to their continuing interests. A non-pro rata distribution that reduces a partner’s interest would be treated as a complete liquidation of the redeemed interest, eliminating the need for complex reverse section 704(c) allocations. Reallocation of inside basis among retained and distributed assets could lead to potential abuses, however. For example, a distribution might have the effect of shifting basis to an asset that the distributee plans to sell shortly. The partial liquidation approach may also require identification of the partners’ overall sharing ratios rather than simply their sharing of gain or loss with respect to specific assets.

A non-pro rata distribution of cash would often trigger gain recognition when a partner’s interest is reduced. For example, assume again that the ABC partnership purchases land for $210 which appreciates in value to $300. When the partnership also has $90 of zero basis receivables and cash of $150, C receives a $90 cash distribution which reduces her interest from one-third to one-fifth. Prior to the distribution, each partner has a basis of $120 in her partnership interest (worth $180). Since C has disposed of one-half of her partnership interest (with a basis of $60 and a value of $90) by value, C would recognize one-sixth of the partnership’s ordinary income ($15) and one-sixth of the partnership’s capital gain ($15). The unrealized gain attributable to C’s redeemed one-sixth interest cannot be preserved through basis adjustments. The partnership would be entitled to an upward adjustment to hot assets ($15) and to cold assets ($15) that would benefit the continuing partners (including C) in proportion to their continuing partnership interests. Following the distribution, the distributee and nondistributee partners respectively would have a one-fifth and a four-fifths share of inside basis, gain, and value. Because the partners’ interests are properly aligned in proportion to their

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150 The partial liquidation approach can also be applied to more “irregular distributions” in which the reduction in the distributee’s interest is not strictly proportional. See Andrews, supra note 4, at 73-75.
151 See id. at 66 (noting that only a single adjustment to common basis would be needed to apportion subsequent partnership income correctly); id. at 65 (rejecting the use of so-called “spectral” section 704(c) allocations to deal with this problem); Burke, supra note 8, at 710-13.
152 See Andrews, supra note 4, at 66; Burke, supra note 8, at 724-25.
153 These objections to partial liquidation treatment may be overstated. Compare Karen C. Burke, Reassessing the Administration’s Proposals for Reform of Subchapter K, TAX NOTES (TA) 1423 (Mar. 6, 2000) with Ernst & Young LLP, Analysis of the Administration’s Partnership Proposals, TAX NOTES (TA) 103 (July 5, 1999).
154 See Andrews, supra note 4, at 67-68.
155 The ABC partnership would have the following post-distribution balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>Value</th>
<th>Capital</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$60</td>
<td>$60</td>
<td>A</td>
<td>$120</td>
<td>$180</td>
</tr>
<tr>
<td>Receivables</td>
<td>15</td>
<td>90</td>
<td>B</td>
<td>120</td>
<td>180</td>
</tr>
<tr>
<td>Land</td>
<td>225</td>
<td>300</td>
<td>C</td>
<td>60</td>
<td>90</td>
</tr>
<tr>
<td>Total</td>
<td>$300</td>
<td>$450</td>
<td>Total</td>
<td>$300</td>
<td>$450</td>
</tr>
</tbody>
</table>

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continuing interests, no section 704(c) special allocations would be required.

B. Revaluations and Section 734 Adjustments

In 1954, the drafters of Subchapter K could not have anticipated the central role that section 704(c) and revaluations have assumed. Indeed, one of the major reasons for extending the section 704(c) approach to hot asset distributions is that the current section 704(b) regulations virtually require a revaluation, coupled with reverse section 704(c) allocations, whenever property is distributed with a tax basis different from its book value. Given the artificial construct of the section 704(b) capital account rules, the section 704(c) approach to hot asset shifts may impose only relatively minor administrative burdens. Unlike the partial liquidation approach, the section 704(c) approach would continue to treat a distribution that reduces, but does not eliminate, a partner’s interest as a current distribution. Thus, the section 704(c) approach may permit excessive deferral of gain when a partner retains only a relatively insignificant partnership interest whose value is less than the corresponding share of booked-up hot or cold asset gain.

The section 704(c) approach cannot prevent distortions in the continuing partners’ shares of inside basis, gain, and value. To remedy these distortions, the hot asset sale approach should be extended to require immediate recognition whenever either hot or cold asset gain cannot be preserved through a revaluation. In addition, the distributee should be required, or permitted, to recognize capital gain when the distributee’s outside basis is insufficient to absorb the partnership’s basis in distributed hot assets. Following a revaluation, shares of inside basis, gain, and value would be determined separately for hot and cold assets. Although it may seem strange to tax shifts in cold asset gain, section 751(b) literally treats shifts in a partner’s share of hot or cold assets identically. Indeed, there seems to be no policy reason why the hot asset sale approach should not also apply to shifts in tepid asset gain.

Following a revaluation of partnership property, an expanded hot asset sale approach could provide welcome relief from existing defects in the operation of section 734(b) adjustments. A revaluation has the unanticipated effect of fundamentally altering the operation of the section 734(b) adjustment. The 1954 Code drafters assumed that a non-pro rata distribution would generally be accompanied by a shift in the partners’ sharing ratios with respect to all unrealized gains and

Upon a sale of the partnership’s hot assets, C would be allocated ordinary income of $15 (one-fifth) and A and B would each be allocated ordinary income of $30 (two-fifths). See Burke, supra note 8, at 720. By bifurcating the distributee’s redeemed and continuing interests based on value, partial liquidation treatment would eliminate such deferral. See Burke, supra note 8, at 720 (“A more far-reaching proposal would be to extend hot asset treatment to exchanges involving [non-hot] assets: hot or cold asset gain would be recognized whenever a non-pro rata distribution leaves the partners with altered shares of such gain.”). Cf. Reg. § 1.751-1(a)(2) (hypothetical sale approach).

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losses, including those arising prior to the distribution. Accordingly, all of the continuing partners—including the distributee whose interest was reduced—would share any section 734(b) adjustment in proportion to their post distribution sharing ratios. By contrast, a revaluation distorts the allocation of the section 734(b) adjustments, since an adjustment to the common basis of partnership property reduces built-in gain that has been frozen in proportion to the partners’ predistribution interests.\textsuperscript{160} The revaluation concept arbitrarily bifurcates predistribution and post distribution sharing of gains and losses, while ignoring shifts in the partners’ relative shares of inside basis and value. Without needed repairs, the section 734 adjustment would often defeat the purpose of the hot asset sale approach.

C. Curbing Deferral

To illustrate the expanded hot asset sale approach, assume that the equal ABC partnership holds one hot asset and one cold asset, each with a basis of zero and value of $150, when the partnership has a section 754 election in effect. Each partner has a zero basis in her partnership interest and a $50 share of both hot and cold asset gain. A receives a liquidating distribution of two-thirds of the cold asset with a value of $100. Prior to the distribution, the partnership’s assets are revalued and each partner’s restated book capital account is increased to $100. Since A’s share of hot asset gain is reduced to zero, A would recognize $50 of ordinary income, increasing A’s outside basis and the basis of the retained hot asset to $50. The distributed cold asset would take a basis of $50 in A’s hands, triggering a downward section 734(b) basis adjustment of $50 to the retained cold asset. Because the basis of the retained cold asset cannot be reduced below zero, however, the section 755 regulations would defer the adjustment until the partnership acquires capital assets with sufficient basis.\textsuperscript{161} If only A is required to recognize gain, B and C would continue to have an outside basis of zero, or $50 less than their share of inside basis attributable to the retained hot asset.\textsuperscript{162}

The partnership’s balance sheet “balances” only if B and C are treated as having a negative $50 share of inside basis in the cold asset, the amount of the prevented section 734(b) adjustment.\textsuperscript{163} The “negative basis asset” of $50 has the character necessary to preserve the continuing partners’ booked-up cold asset gain ($50 value less $100 built-in gain).\textsuperscript{164} To remedy this distortion, the expanded hot asset sale

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|}
\hline
 & Basis & Gain & Value \\
\hline
Hot Asset & 50 & 100 & 150 \\
\hline
Cold Asset & (50) & 100 & 50 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{160}See Burke, supra note 9, at 650.
\textsuperscript{161}See Reg. § 1.755-1(c)(4).
\textsuperscript{162}An imputed section 751(b) exchange would trigger $50 of cold asset gain to B and C, restoring parity between their aggregate outside basis ($50) and their share of common basis attributable to the retained hot asset ($50).
\textsuperscript{163}The continuing partners would have the following shares of inside basis, gain, and value:
\textsuperscript{164}See Jackel & Stok, supra note 26, at 1579.
approach would tax B and C immediately on $50 of cold asset gain, increasing their outside basis to $50 and eliminating their negative share of inside basis in the retained cold asset. Following these adjustments, the continuing partners' shares of preserved hot and cold asset gain would equal the economic value of their retained interest in assets of the proper class less their allocable share of inside basis.\(^6\)

A distributee may have insufficient outside basis to absorb the partnership’s basis in distributed hot assets, potentially triggering a section 734(b) adjustment that eliminates booked-up hot asset gain. In the example above, assume that the ABC partnership instead distributes two-thirds of the hot asset (worth $100) to A. Since their share of hot asset gain is reduced from $100 to $50, B and C recognize total ordinary income of $50, increasing their outside basis and the basis of the distributed portion of the hot asset to $50. Under section 732(c), A’s basis in the distributed hot asset is limited to A’s outside basis (zero), or $50 less than the partnership’s predistribution basis. An upward section 734(b) adjustment to the retained hot asset (worth $50) would potentially allow the continuing partners to escape $50 of booked-up hot asset gain.

Under the statutory ordering rule, the section 734(b) adjustment arises only after the tax consequences of the deemed section 751(b) exchange are determined.\(^6\) B and C would apparently be treated as having a $50 booked-up share of hot asset gain, even though the subsequent section 734 adjustment eliminates the corresponding tax gain. To prevent this unintended result, it would seem necessary to disallow the section 734 adjustment entirely or change the statutory ordering rule. Without a section 734 adjustment to cold assets, however, the continuing partners would be improperly taxed on A’s share of cold asset gain remaining in the partnership. Thus, the amount of the section 734 adjustment ($50) is correct, but what is needed is an upward basis adjustment to cold rather than hot assets to reflect the reduction in A’s share of cold asset gain. A should be required to recognize cold asset gain of $50 immediately, increasing A’s outside basis to $50 and the basis of the retained cold asset to $50.\(^6\) As a result, A’s outside basis would be sufficient to absorb the stepped-up basis of the distributed portion of the hot asset ($50), eliminating any section 734(b) adjustment. The increase in the basis of the retained...
cold asset ($50) is exactly the amount needed to avoid overtaxing the continuing partners on a subsequent sale.\textsuperscript{168}

A non-pro rata current distribution may often leave the distributee or nondistributee partners with a share of built-in hot or cold asset gain in excess of the economic value of their remaining partnership interest.\textsuperscript{169} Taxing the excess booked-up hot or cold asset gain immediately would eliminate this distortion. In the example above, assume that A instead receives $99 worth of the cold asset in a current distribution and retains a partnership interest worth $1. A would take a zero basis in the distributed cold asset, leaving A with a potential capital gain of $99 outside the partnership, or $49 more than her predistribution share. A retains a continuing interest in the partnership's hot asset worth $1 (with built-in gain of $50).\textsuperscript{170} Thus, the partnership's balance sheet balances only if A is treated as having a negative $49 share of inside basis in the partnership's hot asset. Even if the partnership has a section 754 election in effect, however, no inside basis adjustment would be triggered. Similarly, the continuing partners have an interest in the partnership's retained cold asset worth $51 (with a built-in gain of $100), leaving them with a negative $49 share of inside basis in the partnership's cold asset.

Deferral should cease when the continuing partners (including the distributee) retain assets of insufficient value to absorb previously booked-up hot or cold asset gain without giving rise to a negative share of inside basis. Accordingly, A should be required to recognize $49 of ordinary income ($1 hot asset value less $50 built-in gain), increasing A's outside basis and the basis of the retained hot asset to $49. B and C should also be required to recognize $49 of capital gain ($51 cold asset value less $100 built-in gain), increasing their outside basis and the basis of the distributed portion of the cold asset to $49. A would take a substituted basis in the distributed cold asset, leaving A with potential capital gain of $50 ($99 fair market

\textsuperscript{168} See Burke, \textit{supra} note 8, at 723-24; Jackel & Stok, \textit{supra} note 26, at 1579.

\textsuperscript{169} A would have the following share of inside basis, gain, and value attributable to the retained hot asset:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hot Asset</td>
<td>0</td>
<td>50</td>
</tr>
<tr>
<td>Cold Asset</td>
<td>50</td>
<td>100</td>
</tr>
</tbody>
</table>

\textsuperscript{170} Tax Lawyer, Vol. 60, No. 2

\textsuperscript{159} The continuing partners would have the following shares of inside basis, gain, and value:

If A sold her retained partnership interest, she would recognize ordinary income of $50, the amount that would be allocated to A if the partnership sold all of its property for fair market value, and a capital loss of $49, the excess of A's outside basis (zero increased by $50 hot asset gain) over the economic value of her remaining partnership interest ($1). See Reg. \textsection 1.751-1(a). Thus, A has preserved net capital gain of $50 ($99 capital gain in distributed property less $49 capital loss on sale of her partnership interest).
value less $49 basis). Following these adjustments, the continuing partners' (in- 
cluding the distributee's) shares of preserved hot and cold asset gain would equal 
the economic value of their retained interest in assets of the proper class less their 
allocable share of inside basis.  

V. CONCLUSION  

Because section 751(b) is deeply flawed and extraordinarily complex, com-
mentators have repeatedly urged outright repeal. Unless section 751(b) can be 
radically simplified, it may be difficult to justify retaining the provision simply as a 
device to prevent shifting of ordinary income and capital gain on a disproportionate 
distribution. In simplifying and rationalizing the operation of the section 751(b) 
regulations, the Treasury should take into account the modern concept of revalu-
ations and reverse section 704(c) allocations. Indeed, an expanded hot asset sale 
approach would cure defects in existing section 734(b) adjustments to inside basis. 
The most sophisticated defense of section 751(b) is that it has come to represent 
mainly a timing provision. If timing is indeed the main concern, one solution 
is to require gain recognition whenever a partner's share of hot or cold asset gain 
can no longer be preserved, taking into account the effect of a revaluation. An 
even more radical approach would be to reinstate the ABA-ALI solution—partial 
liquidation treatment and mandatory inside basis adjustments—that Congress 
rejected in 1954.  

\[\text{\textsuperscript{171}}\]

\[\text{\textsuperscript{172}}\]  

B and C would have the following shares of inside basis, gain, and value:  

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Gain</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hot Asset</td>
<td>49</td>
<td>100</td>
<td>149</td>
</tr>
<tr>
<td>Cold Asset</td>
<td>0</td>
<td>51</td>
<td>51</td>
</tr>
</tbody>
</table>

A's preserved share of hot asset gain (one dollar) equals the difference between A's share of inside basis (zero) and value (one dollar).  

\[\text{\textsuperscript{173}}\]See, e.g., ALI, FEDERAL INCOME TAX PROJECT: SUBCHAPTER K, PROPOSALS ON THE TAXATION OF PART-
nERS 51-52 (1984) (urging repeal of section 751(b) on the ground that it "is extraordinarily complex" and "produces too harsh a result for the policy it is intended to enforce").  

\[\text{\textsuperscript{174}}\]By extension, a current distribution that does not alter the partners' percentage interests in the 
partnership should also trigger immediate gain recognition to the extent that the nondistributee partners' 
share of gain inherent in the distributed property cannot be preserved. See Gergen, supra note 6, at 
215 (describing the 1949 ABA proposals); see generally Mark P. Gergen, Reforming Subchapter K: 

\[\text{\textsuperscript{175}}\]Indeed, for many (if not most) partnerships, partial liquidation treatment may offer a simpler 
alternative than reverse section 704(c) allocations. See generally Andrews, supra note 4; Burke, supra 
note 153. 

\[\text{Tax Lawyer, Vol. 60, No. 2}\]