



October 1, 2013

Mr. Daniel Werfel
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, Room 3000
Washington, DC 20024

Re: Revenue Ruling 99-6 Related to the Conversion of Partnerships to Disregarded Entities

Dear Mr. Werfel:

The American Institute of Certified Public Accountants (AICPA) is pleased to provide you with comments on Revenue Ruling 99-6 related to the conversion of partnerships to disregarded entities.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Our comments address several issues related to the transactions described in the ruling that are not addressed in the ruling or other guidance. We discuss the construct under which a partnership converts to a disregarded entity (i.e., the possibility of treating a buyer as purchasing a partnership interest rather than assets). Our primary recommendation is to revoke Revenue Ruling 99-6 and treat the buyer as purchasing a partnership interest. However, if the ruling is not revoked, we request that the Department of Treasury ("Treasury") and the Internal Revenue Service (the "IRS" or "Service") address the issues discussed in this letter. A few of the items on which we comment are the treatment of nonrecognition transactions that result in the conversion of a partnership to a disregarded entity and the application of sections 704(c)(1)(B), 737 and 751(b) to the deemed partnership liquidation described in Revenue Ruling 99-6. We respectfully request that you issue additional guidance on these issues.

If you have any questions about these comments, please contact me, at (304) 522-2553, or jporter@portercpa.com; William O'Shea, AICPA Chair of the Partnership Taxation Technical Resource Panel, at (202) 758-1780, or woshea@deloitte.com; or Eileen Sherr, Senior Technical Manager, at (202) 434-9256 or esherr@aicpa.org.

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Sincerely,

A handwritten signature in black ink, appearing to read "Jeffrey A. Porter". The signature is fluid and cursive, with the first name "Jeffrey" being the most prominent.

Jeffrey A. Porter, CPA

Chair, Tax Executive Committee

cc: Craig Gerson, Attorney-Advisor, Department of Treasury
Curt Wilson, Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
Charlotte Chyr, Senior Technical Reviewer (Passthroughs and Special Industries), Internal Revenue Service

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
COMMENTS ON REVENUE RULING 99-6
RELATED TO
THE CONVERSION OF PARTNERSHIPS TO DISREGARDED ENTITIES

OVERVIEW – Revoke Ruling or Provide Additional Guidance

Revenue Ruling (Rev. Rul.) 99-6 addresses the federal income tax treatment of the sale of all of the interests in a limited liability company (LLC) to one person, causing the LLC to have a single owner and to convert from a partnership to a disregarded entity.¹

In Situation 1 of the ruling, all of the interests are sold to an existing partner. In Situation 2 of the ruling, all of the interests are sold to a non-partner. The ruling treats the selling partner as selling its partnership interest and treats the purchaser as acquiring partnership assets. The ruling states that for purposes of determining the tax consequences to the purchaser, (i) the partnership is deemed to make a liquidating distribution of all of its assets to its partners and (ii) immediately thereafter, the purchaser is viewed as purchasing the seller's interest in the partnership's assets.

The AICPA believes that additional guidance is needed on the tax consequences related to the conversion of a partnership to a disregarded entity in transactions described in Rev. Rul. 99-6.² The AICPA believes that the IRS should revoke Rev. Rul. 99-6 because the IRS should view the buyer as purchasing a partnership interest rather than partnership assets. However, if the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") choose not to revoke the ruling, we respectfully request that Treasury and the IRS issue guidance addressing the following issues:

- The amount of the LLC's liabilities that are considered assumed by the buyer (a) as part of the purchase of the selling partner's interest in the LLC and (b) as part of the purchasing partner's liquidating distribution from the LLC.
- The amount and identity of the LLC's assets that are considered (a) purchased from the selling partner and (b) distributed to the purchasing partner in the deemed liquidation of the LLC.
- The tax consequences of the deemed extinguishment of any liabilities of the LLC to the purchasing partner in Situation 1 that results from the merger of the debtor-creditor relationship which occurs upon the termination of the partnership.
- Application of the sections 704(c)(1)(B) and 737 "mixing bowl" rules to the purchasing partner in Situation 1 with respect to the deemed liquidating distributions that occur as part of the Rev. Rul. 99-6 construct.

¹ Sometimes, we will refer to the LLC as "partnership" and the LLC members as "partners."

² 1999-1 C.B. 434 (Feb. 8, 1999).

- Application of the section 751(b) “disproportionate distribution” provisions to the purchasing partner in Situation 1 with respect to the deemed liquidating distributions that occur as part of the Rev. Rul. 99-6 construct.
- The treatment of transfers that are not described in Situation 1 or Situation 2, but which result in the conversion of the partnership to a disregarded entity.
- Application of Rev. Rul. 99-6 to interests-over partnership merger transactions.

SUMMARY – AICPA Recommendations

The AICPA believes that Treasury and the IRS should revoke Rev. Rul. 99-6, and instead provide guidance adopting a single approach to the following issues that arise in the context of a transaction subject to Rev. Rul. 99-6 in order to promote uniform tax results and reporting by similarly situated taxpayers.

The AICPA believes that asset purchase treatment is not appropriate, particularly where a portion of the purchasing partner’s basis in the acquired assets is determined by reference to its basis in the partnership, such as in Situation 1 and in nontaxable transfers. The AICPA believes the IRS should modify the ruling to provide that the purchasing partner is treated as acquiring the seller’s partnership interest, then receiving a liquidating distribution of all of the assets of the partnership. This treatment should resolve many technical issues that arise in connection with the bifurcated treatment of the transaction that is currently prescribed by the ruling, such as the application of sections 704(c)(1)(B), 737 and 751(b). Under this construct, the purchaser should obtain a basis in the assets distributed equal to its unitary basis in the partnership following the purchase of the seller’s interest.

If Rev. Rul. 99-6 is not revoked, the AICPA recommends that the IRS and Treasury publish detailed guidance addressing the following issues (listed in order of priority):

1. The IRS should limit the amount of liabilities assumed by the buyer from the seller to the seller’s share of the liabilities, as determined under section 752 principles immediately before the transaction. This approach should prevent the buyer from recognizing any section 731 gain as a result of the transaction in Situation 1 and from overstating tax basis in the assets deemed purchased from the seller in Situations 1 and 2.
2. The IRS should determine the partnership’s distribution of gross assets to the seller and buyer by adding each partner’s share of liabilities under section 752, immediately before the transaction, to the value of their equity. Such treatment ensures the buyer’s tax basis in the purchased assets is equal to the seller’s amount realized from the sale of his partnership interest, and mitigates the possibility of the buyer suffering a deemed distribution in excess of basis under section 731.

3. Guidance should provide that neither the purchasing partner nor the partnership should recognize gain or loss in a Rev. Rul. 99-6 transaction as a result of the extinguishment of the partnership's indebtedness to the purchasing partner resulting from the deemed liquidation of the partnership in Situation 1.
4. Guidance should clarify that sections 704(c)(1)(B) and 737 do not apply to the purchasing partner in the constructive distribution of partnership assets in Situation 1.
5. Guidance should clarify that section 751(b) does not apply to the purchasing partner in Situation 1. The purchasing partner should take a substituted basis in the partnership's section 751 assets, increased for the gain recognized by the seller under section 751(a).
6. The tax consequences of nontaxable and partially taxable transfers not described in Rev. Rul. 99-6 that result in a partnership having a single owner and, therefore, becoming a disregarded entity for tax purposes (e.g., transfers to corporations, gifts, and bequests) should provide the same construct for basis and holding period as is adopted for Situation 1, except for those transfers resulting in a partnership merger. Thus, the IRS should also apply any new guidance discussed above to these transfers.
7. The IRS should determine the tax consequences of the conversion of two or more partnerships into one partnership under the partnership merger rules of Treas. Reg. § 1.708-1(c) rather than Rev. Rul. 99-6.

SPECIFIC COMMENTS – Rev. Rul. 99-6

A. Revocation of Rev. Rul. 99-6

These comments describe a wide range of unanswered questions regarding the application of Rev. Rul. 99-6.³ Some of these issues are caused by the disparate treatment to the buyer and seller imposed on each transaction addressed by the ruling.⁴ In general, the AICPA believes that it is in the interest of sound tax policy to treat all parties in the same manner for federal income tax purposes. We therefore recommend that in lieu of addressing the myriad of issues raised by Situation 1, that the IRS revoke the ruling or replace it with guidance that provides that the acquiring partner is treated as acquiring the seller's interest, rather than partnership assets. We believe it is most appropriate to treat the transactions described in the ruling as a transfer of one

³ There are a number of additional issues not addressed in this letter. For example, there are issues concerning determining what happens to intangible assets such as unamortized organization and start-up costs that are unclear but are beyond the scope of this letter. This letter is intended to cover the most common technical issues addressed by practitioners.

⁴ The treatment of the extinguishment for federal tax purposes of a liability of the partnership to the acquiring partner is an issue that arises in both the bifurcated treatment prescribed by Rev. Rul. 99-6, and in the alternative construct that respects the purchase of a partnership interest by the acquiring partner followed by a liquidating distribution against that interest.

or more partnership interests followed by the liquidation of the partnership in the hands of the transferee.

Rev. Rul. 99-6 followed the Tax Court's decision in *McCauslen v. Commissioner*.⁵ Therein, a partner in a two person partnership died and his interest was purchased from his estate by the only other partner, Edwin McCauslen, terminating the partnership under section 708(b)(1)(A). Within six months, Mr. McCauslen recognized a gain on the sale of some of the former partnership's assets. The sole issue was whether Mr. McCauslen was entitled to tack the partnership's holding period in the assets under section 735(b)⁶ and thereby claim long-term capital gain. The court concluded that section 735(b) does not apply to the transaction because Mr. McCauslen was properly viewed as having purchased partnership assets rather than a partnership interest:

“Since petitioner's purchase of the decedent's partnership interest resulted in a termination of the partnership under section 708(b), it is our view that petitioner acquired the partnership assets relating to such interest by purchase, rather than by any distribution from the partnership, and that petitioner's holding period for such assets begins from the date of such purchase.”⁷

The Court believed it inappropriate that a taxpayer acquire the benefit of another's holding period simply by purchasing a partnership interest rather than the partnership's assets:

“The provision for tacking on the partnership's holding period is entirely consistent with the general statutory scheme of postponing recognition of gain or loss until the distributee partner finally disposes of the distributed partnership property. But where, as here, a partner acquires another partner's share by purchase and, as a consequence of the termination of the partnership resulting from such purchase, acquires the partnership assets relating to such purchased interest, the statute has no application. The statute cannot be construed as permitting the purchaser to tack on the partnership's holding period of such assets. In effect, petitioner is contending that he purchased assets belonging to another with a built-in holding period. Neither logic nor necessity supports such an argument nor do we believe that section 735(b) calls for such a result.”⁸

Where the purchase of an interest by an existing partner does not cause the termination of the partnership under section 708(b)(1)(A), it is clear that the transfer does not alter the partnership's holding period in its assets, and that, unlike the taxpayer in *McCauslen*, the purchasing partner acquires the benefit of the partnership's holding period in its assets. This treatment would apply

⁵ *McCauslen v. Commissioner*, [45 T.C. 588 \(1966\)](#).

⁶ Section 735(b) provides that “in determining the period for which a partner has held property received in a distribution from a partnership..., there shall be included the holding period of the partnership as determined under section 1223, with respect to such property.”

⁷ *McCauslen v. Commissioner*, 45 T.C. 588 (1966), page 4.

⁸ *Id.*

even if the transfer causes a technical termination of the partnership under section 708(b)(1)(B).⁹ Additionally, if the partnership subsequently distributes property to the purchasing partner, section 735(b) not only permits, but requires, the partner to tack the partnership's holding period to the distributed property, to the extent that the purchasing partner's post-distribution basis in the property does not exceed the partnership's basis. Thus, the *McCauslen* analysis has no application to anything less than the purchase of 100 percent of the partnership interests by the existing partner. The purchase of even slightly less than 100 percent produces drastically different tax results.¹⁰ We see no reason why the results to the purchasing partner should differ if the purchase of the interest results in a section 708(b)(1)(A) termination of the partnership, rather than a section 708(b)(1)(B) termination.

In our view, the *McCauslen* court's distinction between a transfer that causes the partnership to terminate under section 708(b)(1)(A) and one that does not is arbitrary. Furthermore, we believe the court's decision inappropriately overrides the apparent legislative intent of section 735. We acknowledge that taxpayers can easily avoid the result in *McCauslen* with planning,¹¹ but we believe it represents an unnecessary trap for the unwary and a planning opportunity for the well advised. We believe that the purchase of interests provides results that are consistent with section 735. To the extent that the purchasing partner's unitary basis exceeds the partnership's basis in its assets, the purchasing partner should not tack the holding period of the partnership. The excess is treated as a newly acquired asset. Furthermore, the purchase of interests avoids the need for an administratively burdensome bifurcation of the partnership's assets into the purchased and distributed assets, as currently required by the ruling.

Recommendations

In conclusion, we believe that extending the court's analysis in *McCauslen*, which was focused on the acquiring partner's holding period, to recast the form of the transaction and thereby create other tax issues,¹² is not appropriate. We believe that the IRS should subject to section 735(b) a partner who purchases a partnership interest resulting in a section 708(b)(1)(A) termination. We believe that the IRS should view the transaction as a purchase of partnership interests, followed by a distribution of 100 percent of the partnership's assets (and the assumption of the partnership's liabilities) to the acquiring partner, with the tax consequences of the distribution governed by the general rules of Subchapter K (e.g., basis determined under section 732, holding

⁹ All of the transactions deemed to occur in a 708(b)(1)(B) termination under Treas. Reg. § 1.708-1(b)(2) result in a carryover basis and holding period to the new partnership.

¹⁰ As discussed below, technically, the ruling does not apply to the nonrecognition transfer of 100 percent of partnership interests.

¹¹ For example, if the buyer purchases only 99 percent of the partnership's interests, or buys the remaining 1 percent through a separate entity, *McCauslen* and Rev. Rul. 99-6 are inapplicable since the partnership would not become a disregarded entity.

¹² In addition to the issues described in this letter, it appears that the section 197(f)(9) anti-churning rules could apply to a purchasing partner in Situation 1, who owned an interest in the partnership when the partnership owned nonamortizable intangibles. However, if the partner were viewed as purchasing a partnership interest instead, the anti-churning rules should not apply, as long as the purchasing partner is not related to the selling partner.

period determined under section 735(b), etc.) Thus, we recommend that the IRS revoke Rev. Rul. 99-6.¹³ If the ruling is revoked, we request that the IRS and Treasury consider whether to revoke or modify other rulings providing asset purchase treatment, such as Rev. Rul. 72-172.¹⁴

In the event that the ruling is not revoked,¹⁵ we respectfully request that the IRS and Treasury consider the following comments in the process of issuing any future guidance on the issues created from the asset purchase treatment described in Rev. Rul. 99-6.

B. Treatment of Liabilities in a Rev. Rul. 99-6 Transaction

In Situation 1 of Rev. Rul. 99-6, A and B are equal partners in AB, an LLC that is treated as a partnership for federal income tax purposes. A sells its entire interest in AB to B. After the sale, the business is continued by AB, which is owned solely by B. Thus, the partnership terminates for federal income tax purposes and AB is a disregarded entity owned solely by B. The ruling holds that the selling partner, A, must treat the transaction as the sale of a partnership interest. However, for purposes of determining the tax treatment of the acquiring partner, B, AB is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed distributed to A. The facts of the ruling assume that AB has no liabilities and that the assets of AB are not subject to any indebtedness. As such, Rev. Rul. 99-6 provides no guidance on the treatment of liabilities of partnerships in the transactions it describes.

The termination of an LLC treated as a partnership pursuant to a transaction described in Rev. Rul. 99-6 is substantively different from the termination of a partnership through an actual liquidation of the entity. When a partnership actually liquidates, it is common for the partnership agreement to provide that the partnership must first repay its liabilities. If all partnership liabilities are not repaid, the liquidating distributions made to each partner will include assumption of specific partnership liabilities by each of the partners. In contrast, in the case of the sale of an LLC interest that results in a section 708(b)(1)(A) termination, the LLC does not actually liquidate and the LLC liabilities generally remain unpaid. In order to apply the deemed liquidation construct in Rev. Rul. 99-6, the IRS must treat the members as assuming all of the liabilities of the LLC. However, there is no guidance in Rev. Rul. 99-6 prescribing the amount of liabilities deemed assumed by the acquiring partner as part of the purchase from the selling partner and as part of its own liquidating distribution. The AICPA believes that guidance is

¹³ If concerns remain regarding the ability of the buyer of a partnership interest to benefit from the partnership's holding period in its assets, we believe those concerns are more appropriately addressed through legislative action.

¹⁴ Rev. Rul 72-172, 1972-1 C.B. 265, treats the transfer of a partnership interest resulting in a section 708(b)(1)(A) termination of the partnership as a sale of assets for section 1239 purposes.

¹⁵ We acknowledge that there is a benefit to the buyer from applying asset purchase treatment in Situation 2. Under the construct of Rev. Rul. 99-6, it appears that the buyer's aggregate basis in the partnership assets is equal to cost basis and is allocated among the assets in accordance with section 1060. Since the buyer's basis is determined without regard to the partnership's historic basis, the application of the anti-churning rules, depreciation deferral elections, partnership basis allocation rules and any other provisions that would limit the buyer's ability to claim tax deductions with respect to certain acquired partnership assets should not concern the buyer.

needed on the manner in which the LLC's liabilities are assumed by the acquiring partner in transactions described in Rev. Rul. 99-6, regardless of whether our recommendations are adopted. This guidance is particularly important where the partner's share of partnership liabilities differ from their interests in partnership capital. The manner in which liabilities are treated can have a significant impact on the tax consequences to the buyer, including the amount of partnership assets deemed purchased from the other partners, the amount of partnership assets deemed distributed to the acquiring partner, and the acquiring partner's tax basis in the assets following the transaction.

To illustrate the need for additional guidance, assume the following example (Example 1): AB LLC, a partnership for federal income tax purposes, holds assets worth \$100 subject to a liability of \$80. Assume further that B has guaranteed the liability such that all of the liability is allocated to B under Treas. Reg. § 1.752-2. Assume also that A and B shared equally in the profits and losses and had equal equity capital in AB LLC. None of the assets held by AB LLC are unrealized receivables or inventory within the meaning of section 751. B buys A's entire interest in the partnership for \$10. At the time of the sale, B's tax basis in his AB interest is \$10, which includes his share of the \$80 AB LLC liabilities. Rev. Rul. 99-6 does not address the treatment of liabilities and therefore provides no guidance on how much of the \$80 note payable B is deemed to assume on the purchase of A's interest in AB LLC versus with respect to B's liquidating distribution from AB LLC.

Two approaches are commonly applied by practitioners to determine the amount of liabilities that are assumed by each partner for purposes of the deemed liquidation that occurs in the Rev. Rul. 99-6 transaction. The first approach is the "Pro Rata Method" where the acquiring partner is deemed to assume a share of partnership liabilities proportionate to the acquiring partner's share of partnership capital. The second approach is the "Section 752(d) Method" where the acquiring partner is deemed to assume a share of partnership liabilities equal to its share of partnership liabilities immediately prior to the sale, as determined under the section 752 regulations. The tax results of each approach as they apply to Example 1 are illustrated below.

1. The Pro Rata Method

Under the Pro Rata Method, on the purchase of A's interest in Example 1 above, the IRS would treat A and B as each having received a liquidating distribution consisting of \$50 worth of assets subject to \$40 of liabilities.¹⁶ The IRS would deem B to have received a distribution of money equal to the difference between his \$80 share of AB liabilities before the transaction and the \$40 in AB liabilities he assumes in the transaction.¹⁷ B would thus recognize \$30 of section 731(a) gain on this deemed distribution of money in excess of B's basis in AB LLC.

¹⁶ 50 percent of the \$80 of liabilities.

¹⁷ See sections 752(a) and (b) and Treas. Reg. section 1.752-1(f).

The Pro Rata Method assumes that assets are also distributed proportionately to the partners.¹⁸ As such, B would have been distributed \$50 worth of assets subject to the \$40 of debt. Under section 732, the assets distributed to B would take a zero basis in B's hands. Conversely, B is considered to purchase the remaining \$50 worth of assets from A (following a deemed distribution of such assets to A) for the \$10 cash consideration paid by B plus the assumption of the remaining \$40 of partnership debt. These assets would take a \$50 cost basis in B's hands. As a result, under the Pro Rata Method, B would have recognized \$30 of section 731(a) gain and have \$100 worth of assets with a \$50 basis, subject to an \$80 liability.

2. The Section 752(d) Method

In contrast, under the Section 752(d) Method, B is treated as having assumed \$80 of the AB LLC liability in its liquidating distribution and will not suffer a deemed distribution in excess of basis. B is deemed to have received \$90 worth of the AB LLC assets¹⁹ in the liquidating distribution which would take a \$10 carryover basis in B's hands. Further, B is treated as having purchased \$10 worth of AB LLC's assets from A free and clear of liabilities and will take a \$10 cost basis in those assets. Thus, under the Section 752(d) Method, B would have recognized \$0 section 731(a) gain and would have \$100 worth of assets with a \$20 basis, subject to an \$80 liability.

Recommendations

The AICPA believes that the tax result to the partners in Example 1 under the Pro Rata Method is inappropriate. In connection with the partnership termination, B has assumed all \$80 of the liabilities of the partnership. B has not been relieved of liabilities in excess of its basis. In light of the fact that the buyer in this fact pattern is not relieved of any of the partnership's liabilities in a Rev. Rul. 99-6 transaction, we believe the recognition of section 731(a) gain is an inappropriate result.

Further, the results to the buyer under the Pro Rata Method are incongruent with the treatment of the selling partner. Rev. Rul. 99-6 provides that the selling partner is treated as selling a partnership interest and its tax results are determined accordingly. Treas. Reg. § 1.752-1(h) provides that "if a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder." Treas. Reg. § 1.1001-2(a)(4)(v) provides that "the liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership." Accordingly, the selling partner's tax consequences in this Example 1 would include in its amount realized its \$0 share of the AB, LLC's liabilities, as determined under the section 752 regulations. For federal tax purposes, it is clear that A is treated as having sold his interest in AB, LLC to B for \$10 with no associated liabilities. The Section 752(d) Method provides B with a basis in the purchased assets

¹⁸ The distribution of assets is discussed further in depth below.

¹⁹ As discussed below, we believe the value of the gross assets distributed to the purchasing partner should equal the sum of the value of its equity and its share of liabilities under section 752.

equal to A's amount realized, and should avoid unexpected consequences to the buyer, such as gain recognition under section 731(a), and as discussed further below, the inappropriate determination of basis.²⁰

C. Deemed Distribution of Assets in Liquidation of Partnership

As discussed, Rev. Rul. 99-6 does not provide any guidance on the impact of partnership liabilities on the treatment of the sale of an LLC interest, the termination and deemed liquidation of the partnership. The ruling provides that based on the analysis of *McCauslen* and Rev. Rul. 67-65, for purposes of determining the tax consequences to the acquiring partner, the partnership is deemed to make a liquidating distribution of all of its assets to each of the partners. The ruling states “upon the termination of AB, B is considered to receive a distribution of those assets *attributable to* B's former interest in AB.” Based on the facts of the ruling, it appears that the IRS may base the amount of assets deemed distributed to each partner on the equity interests in the partnership (*e.g.*, the Pro Rata Method described above). The ruling states for the sake of simplicity, it is assumed that the partnership has no liabilities. Thus, the ruling does not address the impact of the disproportionate sharing of liabilities on the amount of assets deemed distributed to the partners. The determination of how much of the partnership assets are distributed to each partner is particularly important when liabilities are allocated disproportionately. The following examples illustrate the need for guidance.

The facts from the previous examples have been modified.

Assume the following facts (Example 2): AB, LLC has assets worth \$500 and liabilities of \$350. The partnership obligations are guaranteed by A and allocated to A under section 752. The partnership liquidates based on the section 704(b) capital accounts. Partners A and B each have a section 704(b) capital account of \$75. B has a tax basis in its AB interest of \$25 and A has a tax basis in its interest of \$375. B purchases A's entire LLC interest for \$75.

Under the facts of this Example 2, Rev. Rul. 99-6 treats A as selling its partnership interest to B. Under Treas. Reg. § 1.1001-2(a) and section 752(d), A's amount realized is \$425.²¹ Note that for purposes of determining A's amount realized, A is considered relieved of the liability on the AB partnership debt that it guaranteed because A is no longer a partner in the partnership.

It appears that for purposes of determining the tax consequences to B, Rev. Rul. 99-6 treats each partner as receiving a share of assets and liabilities “attributable to their interests” as the partnership liquidates. However, it is not clear how to determine the value of each of the assets distributed to A and B.

²⁰ As discussed below, the disproportionate sharing of liabilities due to A's guarantee in Example 2 necessitates a corresponding disproportionate distribution of assets.

²¹ The \$425 amount realized is the \$350 debt relief plus \$75 cash consideration from B.

The section 752 regulations provide the framework for determining each partner's share of the terminated partnership's liabilities. In the example above, A guaranteed the entire \$350 of debt, resulting in the entire \$350 liability allocated to A under the section 752 regulations (none of this debt is allocated to B).²²

Under the Pro Rata Method, each partner would receive a share of the assets and liabilities based on their equity interests per the partnership agreement. A and B would each receive \$250 of assets subject to \$175 of liabilities, for a net fair market value amount of \$75. However, this method does not reflect the manner in which the partners share liabilities under the section 752 regulations. One hundred percent of the liabilities are allocated to A. Although A's and B's share of equity is the same, is their share of gross asset value the same? Would IRS consider a more appropriate construct a distribution of \$425 of assets to A and \$75 of assets to B? IRS could base A's share of assets on its share of gross asset value, rather than equity value. The IRS could determine A's share of gross asset value by adding to the equity value of A's interest (\$75), the liabilities allocated to A under section 752 principles (\$350, the "Section 752(d) Method").

Example 3: A and B form AB, LLC by each contributing property with an equity value of \$130. A contributes property with a fair market value of \$130. B contributes property with a fair market value of \$170 subject to nonrecourse debt of \$40. The tax basis of A's property is \$25 and B's property is \$20. Pursuant to Treas. Reg. § 1.752-3, B receives an allocation of \$30 of the liability encumbering the property contributed by B, and A is allocated the remaining \$10.

A sells his partnership interest to B for his equity value of \$130. Pursuant to section 752(d), A's amount realized is increased to \$140 by his share of partnership liabilities (\$10), from which he is relieved as a result of the sale of his interest. At the time of the sale, A's basis in the partnership is \$35 (\$25 basis in property contributed plus \$10 share of partnership liabilities) and B's basis in the partnership is \$10 (\$20 basis in property contributed, less \$40 liability assumed by partnership, plus \$30 share of liabilities).

Rev. Rul. 99-6 treats the partnership as distributing the assets and liabilities to A and B and then B is deemed to acquire A's share of partnership's assets and liabilities. If the equity interests were used to determine each partner's share of assets distributed (the Pro Rata Method, as described above), it appears that the IRS would treat \$150 of assets and \$20 of liabilities as distributed to each of A and B (equal to 50 percent of the value of assets and liabilities). On the other hand, the Section 752(d) Method would deem the partnership to distribute to B assets with a value of \$160 and would treat B as assuming partnership liabilities of \$30. The Section 752(d) Method would treat A as receiving \$140 of partnership assets subject to a \$10 liability, and B as acquiring these assets from A for \$130 cash. B's combined basis in purchased and distributed assets under the Section 752(d) Method is \$150 (\$140 basis in assets acquired from A plus \$10 of substituted basis in the assets deemed distributed to B in liquidation of B's former interest).

²² Treas. Reg. § 1.752-2(b).

Under the Pro Rata Method, A is deemed to assume 50 percent of the partnership liabilities (\$20) as compared to A's assumption of only \$10 of partnership liabilities under the Section 752(d) Method. Likewise, the amount of liabilities B is deemed to assume from the partnership is reduced from \$30 under the Pro Rata Method to \$20 under the Section 752(d) Method. Thus, the Pro Rata Method shifts \$10 of nonrecourse debt from B to A. The Pro Rata Method would treat B as receiving a \$10 deemed distribution, which would reduce B's basis to zero.²³

The Pro Rata Method results in an overstatement of B's purchased basis. Under the Pro Rata Method, each partner is deemed to receive its share of the partnership balance sheet based on its relative capital accounts per the partnership agreement. Since each partner has a 50 percent capital interest, the assets are deemed distributed 50/50 to each partner. Allocating \$150 of fair market value assets and \$20 of nonrecourse debt to each partner would mean B is deemed to acquire partnership assets from A subject to a \$20 liability. Since A is deemed to receive a 50 percent share of the partnership liabilities, the Pro Rata Method shifts an additional \$10 of nonrecourse debt to A for a total of \$20 compared to only a \$10 debt allocation under the Section 752(d) Method. B's basis in the purchased assets would equal \$150 (\$130 cash paid plus \$20 liabilities assumed from A). B's basis in the purchased assets (\$150) is higher than under the Section 752(d) Method (\$140). The result achieved by the Pro Rata Method seems inappropriate when A has recognized gain on the sale of A's interest based on the \$140 amount realized. It appears IRS should limit B's basis in the purchased assets to \$140.²⁴

Recommendations

Any guidance on the treatment of partnership liabilities in transactions addressed by Rev. Rul. 99-6 should also clarify the effect of liabilities on the computation of the buyer's basis in each of the partnership assets acquired. Specifically, guidance is requested on the manner in which the partnership's liabilities are assumed by the acquiring member, for purposes of determining the acquiring member's basis in the purchased assets. The AICPA recommends that the IRS determine the partnership's distribution of assets and liabilities to the seller and buyer under the Section 752(d) Method rather than the Pro Rata Method. The Section 752(d) Method will provide that in determining the tax consequences to the acquiring partner, each partner is treated as receiving a distribution of assets upon the deemed liquidation of the partnership based on each such partner's interest in partnership capital plus each such partner's share of partnership liabilities (as determined under section 752) immediately before the transaction. Such guidance should also provide that the buyer acquires the assets deemed distributed to the selling partner(s) subject to the seller's share of partnership liabilities, as determined under the section 752 regulations immediately before the transaction.

²³ As discussed above, under different facts, the Pro Rata Method could cause B to recognize gain on the termination. B could recognize gain under section 731(a) to the extent the deemed liability distribution exceeds B's tax basis.

²⁴ We recognize that in the aggregate, the basis of the assets is the same. However, the basis in the purchased assets will not reflect what was paid for the interest.

The Section 752(d) Method provides the buyer with a tax basis in the purchased assets equal to the seller's amount realized from the sale of the seller's interest. In certain circumstances, the Pro Rata Method may cause the buyer to recognize gain under section 731 and may provide the buyer with excess basis in the acquired assets. Additionally, as discussed in more detail in this letter, the Pro Rata Method may raise concerns under sections 707(a)(2)(B), 751, 704(c)(1)(B) and 737.²⁵

D. Deemed Payment of Partner-to-Partnership Loans

The AICPA believes that any additional guidance on the treatment of transactions addressed in Rev. Rul. 99-6 should also provide generally that no gain or loss is recognized to either the buyer or the partnership as a result of the extinguishment of the partnership's indebtedness to the buyer, which is deemed to occur during the constructive liquidation of the partnership in Situation 1.

Assume, as in prior examples, that A and B each own 50 percent interests in the profits and capital of partnership AB LLC. Assume that in addition to capital contributions, B has made a loan to the LLC. B purchases A's entire interest in AB, LLC, terminating the partnership.

Under Rev. Rul. 99-6, A is treated as having sold his interest in the LLC to B. A's proceeds include any amount of the LLC's liabilities that were allocated to A immediately before the sale. B is treated as having purchased A's share of the LLC's assets subject to the amount of the LLC's liabilities (including the LLC's liability to B) that A is deemed to have assumed in the liquidating distribution from the LLC.²⁶ Further, B is treated as having received a distribution of his share of the LLC's assets and as having assumed his share of the LLC's liabilities, including his share of the liability owed to himself, in liquidation of his LLC interest. As a result of the transaction, LLC's liability to B is extinguished for federal income tax purposes, as B becomes both the borrower and the lender.²⁷ There is no clear guidance as to how to treat an extinguishment of the partnership's liability by B for federal income tax purposes.²⁸

²⁵ These issues are addressed separately in this letter.

²⁶ The treatment of liabilities in connection with a transaction described in Rev. Rul. 99-6 is discussed elsewhere in this letter.

²⁷ The extinguishment of the liability may not actually occur because the LLC may continue its legal existence. However, if the LLC is a disregarded entity, the loan is extinguished for federal tax purposes.

²⁸ Treas. Reg. § 1.731-1(c)(2) generally treats the partnership's distribution of a note receivable from a partner to that partner as a distribution of money. Rev. Rul. 93-7 alters that result if the partnership acquired the receivable from a third party. Section 108(e)(8) provides that one may trigger COD income if partnership debt is exchanged for partnership equity. These authorities and other authorities may have some bearing on how to treat the extinguishment of debt in this case, but none are directly applicable.

1. *Taxable Transfer of Assets to Creditor Partner*

It is possible to view the transaction as if the LLC satisfied part of its liability to B with some or all of the property otherwise deemed distributed to B under Rev. Rul. 99-6.²⁹ A number of questions arise if this treatment is the proper characterization.

- The use of property to satisfy indebtedness is generally an occasion for gain or loss recognition by the transferor. The LLC may, therefore, recognize gain or loss on the assets it is deemed to have transferred to B in satisfaction of the debt. It is unclear to what extent such gain or loss is subject to sections 1239, 267, or 707.
- If debt is satisfied for an amount less than its face, it may result in cancellation of indebtedness (COD) income to the borrower. If the LLC's property is worth less than the B debt, the LLC may have COD income on the transaction. Alternatively, if the debt is nonrecourse, the IRS could treat the full amount of the debt as proceeds on the sale of partnership property under Treas. Reg. § 1.1001-2(a).
- It is unclear whether the loss on the extinguishment of the debt is treated by B as a bad debt deduction or a capital loss on the retirement of the debt instrument under section 1271. If the LLC allocates COD income to B from the transaction, B may have a corresponding bad debt deduction under section 166. Nevertheless, it is unclear whether B should treat that deduction as a business bad debt (deductible as an ordinary loss) or a nonbusiness bad debt (deductible as a short-term capital loss). There is no direct authority for attributing the business of the partnership to B for this purpose.
- If the LLC recognizes COD income, it is necessary to determine the allocation of that COD income to A and B. It is unclear whether the partnership may allocate the COD income to B first as necessary to chargeback B's partner nonrecourse minimum gain, if any, under Treas. Reg. § 1.704-2(j)(2).

[PLR 200222026](#) provides support for the characterization of the transaction as a deemed payment of partnership assets to B.³⁰ In PLR 200222026, an LLC owned by a foreign bank (X) and its U.S. subsidiary (Y) terminated when Y's interest in the LLC was redeemed for cash. At the time of the redemption, the LLC held a payable to X. The LLC was solvent and the fair market value of its assets was equal to its tax basis because the LLC previously marked its assets to market under section 475. The ruling provides that X's loan to the LLC was cancelled as a result of the deemed distribution of the liability to X because the same taxpayer cannot act as both the debtor and creditor. The ruling provides further that no COD income is realized by the LLC or X because LLC is treated as paying full issue price on the indebtedness.

²⁹ This characterization would only apply to B, as A does not view himself as having assumed any B debt in the transaction.

³⁰ Private Letter Ruling [200222026](#) (May 31, 2002).

However, the ruling does not specify how the issue price is paid by the LLC. The ruling does not indicate whether the debt is satisfied by payment of partnership assets or whether it is assumed by X. The ruling states that the assets and liabilities are distributed to X, and that a distribution will result in an extinguishment of the debt, but it did not indicate the level at which the extinguishment would occur (i.e., at the creditor partner or partnership level). Under the facts in this ruling, the assets had a fair market value in excess of the loan. Thus, no COD income would have been realized regardless of where the extinguishment occurred. Additionally, since the ruling does not specifically state that the LLC's assets are transferred to X in satisfaction of the debt, it does not address whether the LLC recognizes gain or loss in its assets in connection with the satisfaction of the debt. Under the facts of the ruling, no gain or loss would have been recognized since the fair market value of the assets was equal to the tax basis.

2. *Assumption of Partnership's Liability by Creditor Partner*

The IRS could alternatively characterize the transaction as an assumption of the partnership liability by the creditor partner. The IRS could treat B as assuming the liability immediately prior to the deemed liquidation of the partnership that occurs under the principles of Rev. Rul. 99-6. In that case, since B would hold both the receivable and payable, the merger of the debtor-creditor relationship and the extinguishment of the debt would occur at the partner level. Support for this treatment is found in *Arthur L. Kniffen v. Commissioner*,³¹ *Edwards Motor Trust Company v. Commissioner*,³² and PLR 8931006.³³

In *Kniffen*, the petitioner was a shareholder of a corporation who borrowed money from the corporation to acquire assets for his sole proprietorship. At a later date, the shareholder transferred all of the sole proprietorship's assets and liabilities to the corporation in exchange for stock. The transfer of the liability to the creditor corporation resulted in an extinguishment of the debt. The IRS determined that the assumption of the liability by the corporation should be treated as a payment of "other property" to the shareholder under section 351(a). The issue addressed by the court is whether the shareholder received solely stock, or stock plus "other property" in the form of discharge of indebtedness. The court held that the petitioner received only stock in the exchange. The court determined that the debtor-creditor relationship was merged as a result of the transfer of the shareholder's obligation to the creditor, and that the debt was immediately extinguished. The court indicated that the transfer of assets was taxable under section 357(c) only to the extent the liabilities exceeded the tax basis of the assets. Thus, the court determined that the extinguishment of the debt took place at the transferee level.

In *Edwards Motor Trust Company*, the petitioner was a subsidiary of a parent corporation, The Susquehanna Company ("Susquehanna"). Susquehanna merged downstream into Edwards Motor Trust Company. Prior to the merger, the petitioner made advances to its parent. The issue

³¹ 39 T.C. 553, 561 (1962), acq., 1965-2 C.B. 3.

³² T.C. Memo 1964-317 (1964).

³³ Private Letter Ruling 8931006 (Apr. 27, 1989).

addressed by the court was assuming the advances were treated as loans, whether the downstream merger resulted in cancellation of indebtedness income. Under the merger contract, Susquehanna transferred all of its assets to Edwards Motor Trust Company and Edwards Motor Trust Company assumed all of Susquehanna's liabilities (including the liability to Edwards Motor Trust Company). In exchange, the stock of Edwards Motor Trust Company was distributed to Susquehanna's shareholders. The court determined that Edwards Motor Trust Company assumed Susquehanna's liability and it was that assumption which resulted in the merger of the debtor-creditor relationship, and consequent extinguishment of the debt. The court held that the debt was satisfied as a result of the merger, and that no discharge or cancellation of indebtedness had occurred. Again, the court determined that the extinguishment of the debt occurred at the transferee level.

In PLR 8931006, an upper tier partnership (UTP) received a loan from a lower tier partnership (LTP). The partners of UTP dissolved UTP by contributing all of their interests in UTP to LTP and liquidating UTP. In connection with the plan, LTP assumed all of the liabilities of UTP (including the loan from LTP). UTP ceased to exist for U.S. federal tax purposes, and because UTP's payable was held by the lender (LTP) after the transfer, the debt was deemed extinguished. The letter ruling holds that neither the UTP nor LTP realized COD income. The PLR states "after LTP assumes UTP's debt to LTP (the LTP loan) in exchange for UTP's assets, LTP will be both the debtor and creditor."³⁴ The IRS cited *Kniffen* and stated "where, as here, a debtor transfers his debt obligation to his creditor for a valid consideration, the interests of the two parties are merged, and the indebtedness immediately is extinguished."³⁵

All of these authorities indicate that the extinguishment of the debt occurred at the transferee level. If these principles were applied in the context of a Rev. Rul. 99-6 transaction, the extinguishment would occur at the creditor partner level. The creditor partner would assume the liability first, and then the IRS would treat the debt as extinguished in the partner's hands. The assumption is treated as a contribution of cash by the creditor partner. Immediately thereafter, the partnership is treated as distributing its assets to A and B. None of the authorities discussed above, including PLR 200222026, specifically state that the debtor satisfies the liability with its own assets. The authorities merely provide that the transfer of the obligation to the creditor results in a merger of the debtor-creditor relationship, causing the extinguishment of the debt. The authorities do not foreclose the possibility that the liability is treated as assumed by the creditor first.

Further, it appears that a taxable transfer of assets by the debtor partnership in satisfaction of the debt would not appropriately reflect the economic consequences to B. B should not recognize COD income as a result of the termination of a partnership under Rev. Rul. 99-6. COD income is taxable under section 61(a)(12) because it generally represents an accession to the taxpayer's wealth.³⁶ In the case of a Rev. Rul. 99-6 transaction, B should not have any accession to his

³⁴ Private Letter Ruling 8931006 (Apr. 27, 1989), page 6.

³⁵ Private Letter Ruling 8931006 (Apr. 27, 1989), page 6.

³⁶ See *US v. Kirby Lumber Co.*, 284 US 1 (1931).

wealth as a result of relief from his own liability. B merely acquires A's partnership interest. A should not have any COD income either. A's computation of gain under section 741 includes in his amount realized, his share of any partnership indebtedness from which he is relieved. Furthermore, B should have no gain or loss on the disposal of assets. B has merely changed the form of his investment from an interest in a legal entity to a direct interest in partnership property. The treatment of the transaction as an assumption of the liability is more consistent with economic reality.

If the cancellation of indebtedness were treated as occurring at the partnership level, B would be taxed on COD income that is not offset by a bad debt deduction. It appears that it is possible to view the extinguishment of B's loan to the partnership either as a retirement of the debt instrument in exchange for property, that would result in a capital loss under section 1271, or as a nonbusiness bad debt deduction, that would be treated as a capital loss under section 166(d), if B were an individual. The result seems inappropriate in this case, where B's economic position with respect to his interest in the partnership assets has not changed.

The treatment of the transaction as an assumption and extinguishment of the liability by the creditor, the transferee, is also consistent with the newly finalized section 108(e)(8) regulations that describe the consequences of the conversion of partnership loans to partnership equity, where the partnership remains in existence.³⁷ Under the regulations, the extinguishment occurs because the creditor transfers his receivable to the partnership for equity in the partnership. The debt is extinguished as the partnership takes ownership of the receivable. The creditor is viewed as making a section 721 contribution of the receivable to the partnership in exchange for a partnership interest, which increases the creditor's interest in partnership assets. The partnership is viewed as transferring money, rather than assets, to the creditor in satisfaction of the extinguished liability, to the extent of the value of the interest transferred to the creditor. Presumably, in the case of a solvent partnership, the creditor receives an interest with a value equal to the face amount of the debt. Thus, no COD income is recognized.

We have not indicated whether it is correct to view the extinguishment of a partner loan in a Rev. Rul. 99-6 transaction as an assumption of the entire liability by the creditor in the case of an insolvent partnership. The AICPA believes that taxpayers should determine the general construct for solvent partnerships first. If the transaction were viewed as an assumption of the liability by the creditor partner from a partnership that is insolvent *following* the extinguishment of the debt, taxpayers should address certain issues, such as whether to bifurcate the transaction into two pieces (part capital contribution, part discharge of indebtedness) or whether to treat the assumption of liability entirely as a section 721 contribution of cash when the additional interest received by the creditor is less than the face amount of the debt, whether the creditor partner has some accession to wealth as a result of the cancellation of indebtedness and whether he has an offsetting loss, and whether there are any other tax results to the creditor upon the extinguishment of a loan with value less than its face amount. It appears that Treasury has not

³⁷ See TD 9557, Application of Section 108(e)(8) to Indebtedness Satisfied by a Partnership Interest (Nov. 17, 2011).

addressed these issues in any formal guidance, and should consider these issues in conjunction with the review of these comments.

Recommendations

The AICPA believes that guidance is needed on the treatment of the cancellation of partner loans that is deemed to occur in connection with the constructive liquidation of the partnership in Situation 1. We have discussed two views of the transaction – the taxable transfer of assets to the creditor partner in satisfaction of the debt and the assumption of the partnership’s liability by the creditor partner. Guidance should provide generally that no gain or loss is recognized by either the buyer or the partnership in a Rev. Rul. 99-6 transaction as a result of the extinguishment of the partnership’s indebtedness to the buyer resulting from the termination of the partnership under section 708(b)(1)(A). Additionally, the AICPA believes that any guidance in this area should provide generally that the buyer or the partnership recognize no COD income as a result of the extinguishment of a solvent partnership’s indebtedness to the buyer.³⁸

Accordingly, if Rev. Rul. 99-6 is modified to provide guidance on the treatment of partner loans, we recommend that the IRS treat the creditor partner in a solvent partnership as assuming the loan prior to the termination. This approach would prevent the partnership and the buyer from recognizing COD income or gain or loss in its assets since the extinguishment would occur at the partner level. This treatment is consistent with the economic consequences of the transaction to the buyer.

E. Application of the “Mixing Bowl Rules” to Rev. Rul. 99-6 Transactions

Rev. Rul. 99-6 guidance should clarify that sections 704(c)(1)(B) and 737 should not apply when determining the tax consequences of the deemed distribution of assets to the acquiring partner in Situation 1.

Section 704(c)(1)(A) requires a partnership to allocate the tax gain and loss in contributed property to the contributing partner when the partnership disposes of the property in a manner that eliminates the disparity between the property’s fair market value and tax basis as of the date of contribution (“precontribution gain or loss”). If the partnership distributes contributed property to a partner other than to the contributor of the property within seven years of the contribution, section 704(c)(1)(B) requires the partnership to allocate any remaining precontribution gain or loss to the contributing partner. Section 737 requires the contributing partner to recognize the precontribution gain (but not precontribution loss) if he receives a distribution of “other property” from the partnership within seven years of the contribution.

Rev. Rul. 99-6 is silent as to whether or not the purchasing partner should report gain under section 704(c)(1)(B) or section 737 upon the deemed distribution of partnership assets that

³⁸ Notwithstanding this general rule, if B acquired the partnership’s debt from a third party at a discount, IRS should treat B’s purchase of A’s interest as an indirect acquisition of the debt for purposes of Treas. Reg. § 1.108-2(c).

occurs in a transaction described in Situation 1 of the ruling. Regardless of the method used to determine the amount of assets that are deemed distributed to the partners in the deemed liquidation of the partnership, it appears the purchasing and selling partners are treated as receiving a distribution of some portion of each asset, including those assets with precontribution gains or losses. If section 704(c)(1)(B) applied to the deemed distribution of property to the selling partners, a portion of the remaining precontribution gain or loss in any property contributed by the purchasing partner is recognized under section 704(c)(1)(B). Likewise, if section 737 applied to the deemed distribution of other property to the purchasing partner, that partner also is required to recognize any remaining precontribution gain under section 737.

If the partnership agreement requires that each partner receive (if possible) their own contributed property, then the purchasing partner may not have to report gain under either section 704(c)(1)(B) or section 737. We believe that the IRS should not subject a purchasing partner to section 704(c)(1)(B) and section 737 as the purchasing partner has not disposed of any contributed property or exchanged its partnership interest for other property. In fact, the purchasing partner is increasing its ownership of the partnership assets.³⁹ However, no guidance exists permitting a selection of assets to avoid the application of these sections.

Additionally, it appears that if the purchasing partner is a corporation, it can rely upon the partnership incorporation exception in Treas. Reg. § 1.737-2(c) to assert that section 704(c)(1)(B) and 737 should not apply to the deemed distribution since the liquidation of the partnership is viewed as an incorporation of the partnership that occurs by operation of Rev. Rul. 99-6. However, the partnership incorporation exception was not addressed in the ruling or in any other guidance, including the preamble to the final corporate reorganization regulations, and it is not available to acquiring partners that are not corporations for federal income tax purposes.⁴⁰ Further, the regulation does not describe the manner of incorporation to which the exception applies. Thus, it is not clear that a deemed incorporation of every partnership via Rev. Rul. 99-6 is eligible for the incorporation exceptions within sections 704(c)(1)(B) and 737.

Recommendations

The AICPA believes that neither sections 704(c)(1)(B) nor 737 should apply to the transfer of interests in a partnership resulting in the termination of the partnership under section 708(b)(1)(A). The legal form of the transaction is not a distribution of partnership assets. Further, there is no policy reason for the application of sections 707(c)(1)(B) or 737 to a transaction governed by Rev. Rul. 99-6, Situation 1, as the purchasing partner is not liquidating his investment in property it originally contributed in exchange for other property; rather, following the transaction, the purchasing partner owns 100 percent of the assets it originally contributed to the partnership. This issue has been raised by practitioners only because the deemed liquidation construct in Rev. Rul. 99-6 suggests that contributed property is deemed

³⁹ Daniel S. Kleinberger, *Now You See It, Now You Don't: Navigating In and Out of Disregarded Entity Status*, William Mitchell College of Law (2010).

⁴⁰ T.D. 9242, Statutory Mergers and Consolidations, 70 Fed. Reg. 746 (Jan. 26, 2006).

distributed to the seller and that the purchasing partner is deemed to receive property other than the assets he contributed. Thus, the AICPA recommends that any future guidance clarify that sections 704(c)(1)(B) and 737 do not apply to transfers of partnership interests, such as those transfers described in Rev. Rul. 99-6.

F. Application of Sections 751(a) and 751(b)

If Rev. Rul. 99-6 is not revoked, we believe that the IRS should issue guidance to provide that section 751(b) does not apply to any distribution deemed made to the acquiring partner in Situation 1. The revenue ruling assumes that the partnership has no section 751 property; therefore, it fails to address the application of section 751(b) to the termination of the partnership.

To illustrate the need for guidance, assume the following facts: A and B each own a 50 percent interest in the profits and capital of AB, LLC. The LLC owns both capital assets and appreciated inventory items within the meaning of section 751(d). B buys A's entire interest in the LLC.⁴¹

Under these facts, Rev. Rul. 99-6 treats A as having sold his interest to B. Under section 741, A's gain or loss is characterized as capital gain or loss except to the extent provided in section 751(a). Under section 751(a) and Treas. Reg. § 1.751-1(a)(2), A's gain or loss is characterized as ordinary in an amount equal to the income or loss from section 751 property⁴² that would have been allocated to A if AB LLC had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately prior to the sale of A's LLC interest. Any remaining gain or loss on the sale of A's interest is capital under section 741.

In this same transaction, under Rev. Rul. 99-6 Situation 1, B's tax consequences are determined by treating the LLC as liquidating, distributing assets subject to the LLC's liabilities to A and B in liquidation of their interests in the LLC followed by B purchasing from A the assets deemed distributed to A. Section 751(b) provides that to the extent a partner receives a distribution of section 751 assets⁴³ in exchange for all or part of his interest in other partnership property, or receives a distribution of other partnership property in exchange for all or part of his interest in the partnership's section 751 assets, the distribution is considered as a sale or exchange of such property between the distributee and the partnership. In the example, if B is treated as having received a distribution of his pro rata share of section 751 assets and other partnership property, then section 751(b) should generally not apply.

⁴¹ These facts are consistent with Rev. Rul. 99-6, Situation 1. The section 751(b) issue discussed in this section does not arise in Situation 2.

⁴² For this purpose, meaning partnership property consisting of (i) unrealized receivables within the meaning of section 751(c), or (ii) inventory items within the meaning of section 751(d).

⁴³ For this purpose, meaning partnership property consisting of (i) unrealized receivables within the meaning of section 751(c), or (ii) inventory items within the meaning of section 751(d) which have appreciated substantially in value.

However, when B's share of section 751 assets⁴⁴ is not in proportion to the amount of assets deemed distributed to B upon the deemed liquidation of AB LLC, section 751(b) arguably applies to recharacterize the disproportionate distribution of section 751 property as a section 751(b) exchange with AB LLC. Of course, it appears A and B may have some flexibility to designate the property deemed distributed to each of them (e.g., in the manner similar to that used to manage gain recognition under section 704(c)(1)(B)). In the absence of authority permitting the selection of assets, however, section 751(b) may apply. Additionally, it appears the IRS needs to address the treatment of liabilities addressed in any future guidance addressing the application of section 751(b).⁴⁵

If a partner receives a disproportionate distribution of section 751 assets and other assets in a liquidating distribution, then Treas. Reg. § 1.751-1(b) treats the partner as having initially received a proportionate mix of assets and as selling the excess assets of one class back to the partnership in exchange for more of the assets of the other class. This deemed exchange may cause the recognition of gain by the partner, the partnership or both. In the case of a Rev. Rul. 99-6, Situation 1 transaction, if section 751(b) applied, the deemed exchange may trigger the recognition of gain not only to the acquiring partner, but also to the partnership, which would allocate the gain to the selling member under the section 751(b) regulations.⁴⁶ This treatment seems inappropriate since Rev. Rul. 99-6 treats the selling member as having sold its partnership interest and the selling partner already recognizes its share of section 751 gain under section 751(a).

Additionally, this treatment appears inappropriate from the acquiring partner's perspective since that partner has not exchanged an interest in *any* asset. As a result of the purchase of A's interest, partner B holds 100 percent of the assets of the LLC. Section 751(b) by its terms applies only where a partner exchanges his share of his partnership's section 751 assets for other partnership assets, or the reverse.⁴⁷ In a transaction described in Rev. Rul. 99-6, Situation 1, the buyer acquires *all* of the partnership's assets, and as such, is not properly viewed as having exchanged any portion of his interest in the partnership's assets for any other portion of the partnership's assets. Rather, he exchanges the consideration (if any) paid for the other partner's interest for whatever interest in partnership assets he did not already own. We believe it is inappropriate to treat the buyer as having momentarily exchanged his partnership interest for only a portion of the partnership's assets, when in the next moment he is treated as having reacquired any partnership assets he is deemed to have relinquished. Accordingly, we believe

⁴⁴ For example, B's share of section 1245 recapture, as determined under Treas. Reg. § 1.751-1(c)(4)(i), may not agree with the amount of section 1245 recapture deemed distributed to B in the constructive distribution of section 1245 property in Situation 1.

⁴⁵ In Notice 2006-14, the IRS and Treasury have requested guidance on the treatment of liabilities for section 751(b) purposes.

⁴⁶ Treas. Reg. § 1.751-1(b)(2)(i), Treas. Reg. § 1.751-1(b)(2)(ii).

⁴⁷ Section 751(b) provides that to the extent a partner receives in a distribution partnership property which is unrealized receivables or inventory items that have appreciated substantially in value, *in exchange for* all or a part of his interest in other partnership property...such transactions shall...be considered as a sale or exchange of such property between the distributee and the partnership...[emphasis added].

section 751(b) should not apply to the acquiring partner in a Rev. Rul. 99-6, Situation 1 transaction.

Furthermore, we believe that the application of section 751(a) to the seller will adequately address the statute's purpose in most circumstances. Nevertheless, we recognize that where a disproportionate distribution is deemed to have occurred in a Rev. Rul. 99-6 transaction for purposes of determining the buyer's tax results, the mix of assets deemed to have been purchased by the buyer is not consistent with the computation of ordinary income recognized by the seller. Absent a specific rule, this treatment could result in an inappropriate basis being assigned to the section 751 assets deemed purchased from the seller:

Assume that in the deemed liquidation of the LLC, B properly treats A as having received only section 751 assets and himself as receiving only other assets. Without a special rule, B would take a cost basis in the 751 assets. But if A computes his ordinary income under section 751(a) based on his 50 percent interest in the partnership's section 751 assets, then only half of the unrealized gain in AB, LLC's assets will have been recognized. It is inappropriate to allow B a cost basis in those assets as that would eliminate his share of the unrealized ordinary income.

We believe this issue is best resolved by specifying that the buyer's tax basis in the section 751 assets of the partnership following a transaction described in Rev. Rul. 99-6, Situation 1, should equal the basis of such assets in the hands of the partnership immediately before the transaction plus any ordinary gain or minus any ordinary loss recognized by the selling partner(s) under section 751(a).

This treatment is the same as the result if B were deemed to purchase partnership interests instead of partnership assets. If B's purchase of A's interest were viewed by B as a purchase of a partnership interest, followed by a liquidating distribution of 100 percent of the assets to B, the IRS would limit B's increase in basis to the section 751 property to A's section 751(a) gain, if a section 754 election were in effect and the partnership made an adjustment to the section 751 property pursuant to section 743(b) and Treas. Reg. § 1.755-1(b)(2)(i).⁴⁸

Recommendations

The AICPA believes that section 751(b) should not apply to a taxpayer who acquires a partnership interest from another partner in a transaction that terminates the partnership pursuant to Rev. Rul. 99-6. Accordingly, we recommend that any guidance clarifying the tax consequences of the transactions addressed in Rev. Rul. 99-6 provide that section 751(b) is not applicable to the acquiring partner, and that the seller's share of gain in the partnership's section 751 assets is recognized by the seller under section 751(a). Furthermore, the AICPA

⁴⁸ Application of section 732(d) should provide similar results for the acquisition of an interest where a section 754 election was not in effect, given that the interest is acquired and then receives a distribution immediately thereafter.

recommends that guidance clarifying the basis consequences to the purchasing partner provide that the purchasing partner takes a substituted basis in the partnership's section 751 assets, increased only for the gain or loss recognized by the seller under section 751(a).

The IRS has acknowledged that the current regulations under section 751(b) are viewed as overly complex and inadequate to meet the statute's objectives, and has asked for comments on how to modify those regulations.⁴⁹ If the IRS ultimately determines that section 751(b) does or should apply to the deemed distribution that occurs under Rev. Rul. 99-6, then any coordinating guidance should await modification of the section 751(b) regulations. Accordingly, we urge the IRS to give its section 751(b) regulatory project high priority.

G. Transfers Not Described in Rev. Rul. 99-6

Rev. Rul. 99-6 sets forth two types of transfers of interests in an LLC – a taxable sale by one partner of its entire interest in the LLC to the sole remaining member (Situation 1) and a sale of 100 percent of the interests in the LLC to a single purchaser (Situation 2). There are, however, many other transfers whereby an LLC can convert from a partnership to a disregarded entity. The AICPA recommends that the Treasury extend the guidance to include other types of nontaxable and partially taxable transfers resulting in a partnership having one owner (and, thus, is properly classified as an entity disregarded from its owner under the entity classification regulations).

Other transfers could include, for example, transfers of all of the interests in the LLC to a corporation in a transaction governed by section 351 or the corporate reorganization rules, gifts of all interests in the LLC to a single person, bequests of all interests in the LLC to a single person, and transfers of interests as a part-sale, part-gift to a single person. A detailed analysis of each such transfer is beyond the scope of this comment letter. However, as discussed earlier in the letter, the AICPA believes that general tax principles applicable to the specific transaction (e.g., Subchapter C, Subchapter K, or other applicable provisions), should determine the tax treatment to the transferor and the transferee. For example, if all of the partnership interests are transferred to a new corporation in a transaction described in Rev. Rul. 84-111, Situation 3,⁵⁰ the rules in sections 351 and 358 should determine the tax consequences to the transferor and transferee, as well as the aggregate tax basis the transferee obtains in the partnership's assets. Likewise, if a partnership interest is transferred by the merger of two corporations, the corporate reorganization rules under section 368 should dictate the tax treatment of the transfer of the partnership interest by the transferor, and the basis of the acquired property to the transferee.

We believe that the IRS should modify Rev. Rul. 99-6 to provide that any nontaxable transfer of an interest in an LLC to the other member is viewed, from both the transferor and transferee's perspective, as a transfer of interests. Accordingly, the IRS should view the transferee as first receiving a partnership interest. Then, the IRS should view the transferee as receiving a liquidating distribution of 100 percent of the partnership assets. The transferee should take a

⁴⁹ See Notice 2006-14, 2006-1 CB 498.

⁵⁰ 1984-2 C.B. 88.

substituted basis in the distributed assets equal to the outside basis of its entire interest pursuant to section 732(b). The IRS should allocate the outside basis among the distributed assets in accordance with section 732(c).

Recommendations

The AICPA recommends that the IRS issue guidance on the treatment of transfers not described in Rev. Rul. 99-6, but which result in the conversion of a partnership into a disregarded entity. The AICPA believes that Treasury should adopt the same construct for basis and holding period purposes as it adopts for the two types of transfers addressed in Rev. Rul. 99-6, except for those transfers resulting in a partnership merger.

H. Certain Partnership Mergers not Governed by Rev. Rul. 99-6

Two or more existing LLCs or partnerships could merge through an interests-over transfer, resulting in the termination of at least one of the partnerships under the partnership merger rules in Treas. Reg. § 1.708-1(c). In these transactions, the principles of Rev. Rul. 99-6 could apply because the transfer of all of the interests in the LLC to another LLC or partnership results in the conversion of that LLC from a partnership to a disregarded entity.

Recommendations

We recommend that the Treasury clarify the treatment of partnership interest transfers which result in a merger of one or more partnerships into another partnership.⁵¹ The AICPA believes that most of these transactions are partnership mergers.⁵² As such, the IRS should determine the tax consequences of these types of transfers under the partnership merger rules in Treas. Reg. § 1.708-1(c), rather than Rev. Rul. 99-6.

⁵¹ Rev. Rul. 90-17, 1990-1 C.B. 119, does not address the treatment of interests-over transfers that could result in both a Rev. Rul. 99-6 transaction and a partnership merger. In the ruling, which predates Rev. Rul. 99-6, three partnerships contributed their *assets* to a resulting partnership in a section 708(b)(2)(A) merger transaction.

⁵² We note that there is one interests-over fact pattern where the IRS should issue guidance determining whether the transaction is governed by the merger regulations or the principles of Rev. Rul. 99-6. This issue involves a situation where an upper-tier partnership holds an interest in a lower-tier partnership which terminates when all of the other partners contribute their interests in the lower-tier partnership to the upper-tier partnership.