

Dated: June 4, 2018.

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*Associate Commissioner for Policy.*

[FR Doc. 2018-12339 Filed 6-7-18; 8:45 am]

BILLING CODE 4164-01-P

## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 9833]

RIN 1545-BO43

#### Partnership Transactions Involving Equity Interests of a Partner

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final rule.

**SUMMARY:** This document contains final regulations that prevent a corporate partner from avoiding corporate-level gain through transactions with a partnership involving equity interests of the partner or certain related entities.

This document also contains final regulations that allow consolidated group members that are partners in the same partnership to aggregate their bases in stock distributed by the partnership for the purpose of limiting the application of rules that might otherwise cause basis reduction or gain recognition. This document also contains final regulations that may also require certain corporations that engage in gain elimination transactions to reduce the basis of corporate assets or to recognize gain. These final regulations affect partnerships and their partners.

**DATES:**

*Effective Date:* These final regulations are effective on June 8, 2018.

*Applicability Date:* These final regulations are applicable on or after June 12, 2015.

**FOR FURTHER INFORMATION CONTACT:**

Concerning the final regulations, Kevin I. Babitz, (202) 317-6852.

**SUPPLEMENTARY INFORMATION:**

#### Background

##### 1. Overview

On June 12, 2015, the Department of the Treasury (and the IRS published final and temporary regulations (TD 9722) under section 337(d) of the Internal Revenue Code (Code) in the **Federal Register** (80 FR 33402). On July 8, 2015, corrections to TD 9722 were published in the **Federal Register** (80 FR 38940-38941) (together with TD 9722, the temporary regulations). The temporary regulations expire on June 11, 2018.

A notice of proposed rulemaking (REG-149518-03) withdrawing proposed regulations under section 337(d) published in 1992, and proposing new proposed regulations by cross-reference to the temporary regulations, was published in the **Federal Register** (80 FR 33451) on the same date as TD 9722. Additionally, on June 12, 2015, the Treasury Department and the IRS published proposed regulations (REG-138759-14) under section 732(f) in the **Federal Register** (80 FR 33452) (together with the 2015 proposed regulations under section 337(d), the 2015 regulations).

The Treasury Department and the IRS received one comment letter in response to the 2015 regulations. Except as described below, the commenter largely supported the 2015 regulations while recommending some minor modifications and clarifications to the 2015 regulations under both section 337(d) and section 732(f). The comment letter is discussed in detail in the Explanation of Provisions section of this preamble.

After considering this comment letter, this Treasury decision adopts as final regulations the rules set forth in the 2015 regulations under section 337(d) (with only minor, nonsubstantive clarifications in response to the commenter's request for additional certainty regarding certain collateral effects) and section 732(f) (without any change). However, the Treasury Department and the IRS are considering publishing a new notice of proposed rulemaking to propose more substantive amendments to the final regulations under section 337(d) and to allow for additional public comment with respect to these more substantive proposals in response to the comment letter, further reflection by the Treasury Department and the IRS, and concerns raised by practitioners.

#### 2. Regulations Under Section 337(d)

##### A. Background

In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), the Supreme Court held that corporations generally could distribute appreciated property to their shareholders without the recognition of any corporate level gain (the *General Utilities* doctrine). Beginning with legislation in 1969 and culminating in the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) (the Act), Congress repealed the *General Utilities* doctrine by enacting section 336(a) to apply gain and loss recognition to liquidating distributions.

Under current law, sections 311(b) and 336(a) require a corporation that

distributes appreciated property to its shareholders to recognize gain determined as if the property were sold to the shareholders for its fair market value. Additionally, section 631 of the Act added section 337(d) to permit the Secretary to prescribe regulations that are necessary or appropriate to carry out the purposes of the *General Utilities* repeal, "including regulations to ensure that [the repeal of the *General Utilities* doctrine] may not be circumvented through the use of any provision of law or regulations."

After the enactment of sections 311(b) and 337(d), the Treasury Department and the IRS became aware of transactions in which taxpayers used a partnership to postpone or avoid completely gain generally required to be recognized under section 311(b). In one example of this transaction, a corporation entered into a partnership and contributed appreciated property. The partnership then acquired stock of that corporate partner, and later made a liquidating distribution of this stock to the corporate partner. Under section 731(a), the corporate partner did not recognize gain on the partnership's distribution of its stock. By means of this transaction, the corporation had disposed of the appreciated property it formerly held and had acquired its own stock, permanently avoiding its gain in the appreciated property. If the corporation had directly exchanged the appreciated property for its own stock, section 311(b) would have required the corporation to recognize gain upon the exchange.

In response to these types of abusive transactions, the Treasury Department and the IRS issued Notice 89-37, 1989-1 CB 679, on March 9, 1989. Notice 89-37 announced that future regulations under section 337(d) would address the use of partnerships to avoid the repeal of the *General Utilities* doctrine.

On December 15, 1992, the Treasury Department and the IRS published a notice of proposed rulemaking under section 337(d) (PS-91-90, REG-208989-90, 1993-1 CB 919) in the **Federal Register** (57 FR 59324) addressing abusive partnership transactions involving stock of a corporate partner (the 1992 proposed regulations). The 1992 proposed regulations set forth a deemed redemption rule and a separate distribution rule to prevent a corporate partner from avoiding corporate-level gain through transactions with a partnership involving stock of the corporate partner, stock of the partner's affiliate, and other equity interests in the corporate partner or affiliate. The 1992 proposed regulations treated a corporation as an affiliate of a partner at

the time of a deemed redemption or distribution by the partnership if, immediately thereafter, the partner and corporation were members of an affiliated group as defined in section 1504(a) without regard to section 1504(b) (section 337(d) affiliation). On January 19, 1993, the Treasury Department and the IRS issued Notice 93-2, 1993-1 CB 292, which stated that the 1992 proposed regulations would be amended to limit the application of the regulations to transactions in which section 337(d) affiliation existed immediately before the deemed redemption or distribution. The Treasury Department and the IRS received comments on the 1992 proposed regulations, and adopted a number of these comments in the 2015 regulations.

#### B. The 2015 Regulations

The 2015 regulations under section 337(d) set forth a rule (the deemed redemption rule) that was aimed at protecting the repeal of the *General Utilities* doctrine. The 2015 regulations provided that certain transactions create the economic effect of an exchange of appreciated property for Stock of the Corporate Partner and, to tax such exchange appropriately, the deemed redemption rule provided that a Corporate Partner recognizes gain at the time of, and to the extent that, any transaction (or series of transactions) has the economic effect of an exchange by the partner of its interest in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by the partnership. (The terms *Corporate Partner* and *Stock of the Corporate Partner* are defined in section 1.B.i. of the Explanation of Provisions.)

The 2015 regulations did not adopt the separate distribution rule set forth in the 1992 proposed regulations. Instead, the 2015 regulations applied the deemed redemption rule to partnership distributions of Stock of the Corporate Partner to the Corporate Partner as though the partnership amended its agreement, immediately before the distribution, to allocate 100 percent of the distributed stock to the Corporate Partner. The 2015 regulations also set forth de minimis and inadvertence exceptions to the deemed redemption rule.

### 3. Regulations Under Section 732(f)

#### A. Section 732(f)

Section 538 of the Ticket to Work and Work Incentives Improvement Act of 1999, Public Law 106-170 (113 Stat. 1860) (December 17, 1999), added

section 732(f) generally effective for distributions of made after July 14, 1999. Section 732(f) provides that if (1) a corporate partner receives a distribution from a partnership of stock in another corporation (distributed corporation); (2) the corporate partner has control of the distributed corporation, defined as ownership of stock meeting the requirements of section 1504(a)(2), immediately after the distribution or at any time thereafter (control requirement); and (3) the partnership's basis in the stock immediately before the distribution exceeded the corporate partner's basis in the stock immediately after the distribution, then the basis of the distributed corporation's property must be reduced by this excess. The amount of this reduction is limited to the amount by which the sum of the aggregate adjusted basis of property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation. The corporate partner must recognize gain to the extent that the basis of the distributed corporation's property cannot be reduced.

Congress enacted section 732(f) due to concerns that a corporate partner could otherwise negate the effects of a basis step-down to distributed property required under section 732(b) by applying the step-down against the basis of the stock of the distributed corporation.

For example, assume a corporate partner has a partnership interest with zero basis and receives a partnership distribution of high-basis stock in a corporation. The corporate partner's basis in the distributed corporation's stock is reduced to zero under section 732(a) or section 732(b). If the partnership has elected under section 754, then the basis of other partnership property is increased by an equal amount under section 734(b). The section 732 basis decrease and the section 734(b) basis increase generally offset each other. However, if the corporate partner owned stock in the distributed corporation that satisfied the control requirement, the corporate partner could liquidate the distributed corporation under section 332, and section 334(b) would generally provide for a carryover basis in the distributed corporation's property received by the corporate partner in the liquidation. Taken together, these rules could permit the partnership to increase the basis of its retained property without an equivalent basis reduction following the liquidation of the distributed corporation. Section 732(f) generally

precludes this result by requiring that either the distributed corporation must reduce the basis of its property or the corporate partner must recognize gain (to the extent the distributed corporation is unable to reduce the basis of its property). Thus, section 732(f) generally ensures that any basis increase under section 734(b) is offset.

Section 732(f)(8) grants the Secretary authority to prescribe regulations that may be necessary to carry out the purposes of this subsection, including regulations to avoid double counting and to prevent the abuse of such purposes.

#### B. The 2015 Regulations

In the preamble to the 2015 regulations under section 732(f), the Treasury Department and the IRS stated that the application of section 732(f) was too broad in some circumstances and too narrow in others. Specifically, the application was overbroad because section 732(f) could require basis reduction or gain recognition even though that basis reduction or gain recognition did not further the purposes of section 732(f). Alternatively, the application was too narrow because corporate partners could inappropriately avoid the purposes of section 732(f) by engaging in transactions that allow corporate partners to receive property held by a distributed corporation without reducing the basis of that property to account for basis reductions under section 732(b) made when the partnership distributed stock of the distributed corporation to the corporate partner.

To address these concerns, the 2015 regulations set forth specific rules governing the application of section 732(f) in two specific sets of circumstances. The first rule would permit consolidated group members to aggregate the bases of their respective interests in the same partnership, in certain circumstances, for section 732(f) purposes. The second rule would restrict corporate partners from entering into certain transactions or a series of transactions (gain elimination transactions), such as a distribution followed by a reorganization under section 368(a), that might eliminate gain in the stock of a distributed corporation while avoiding the effects of a basis step-down under section 732(f) because the control requirement would not be immediately satisfied.

In addition, the 2015 regulations under section 732(f) required taxpayers to apply those rules to tiered partnerships in a manner consistent with the purpose of section 732(f).

## Explanation of Provisions

### 1. Final Regulations Under Section 337(d)

#### A. Generally

The final regulations under section 337(d) provide that the purpose of the regulations is to prevent corporate taxpayers from using a partnership to circumvent gain required to be recognized under section 311(b) or section 336(a). These final regulations, including the rules governing the amount, timing, and character of recognized gain, must be applied in a manner consistent with, and which reasonably carries out, this purpose.

These final regulations apply when a partnership, either directly or indirectly, owns, acquires, or distributes Stock of the Corporate Partner (as defined in § 1.337(d)-3(c)(2) of these final regulations). Under these final regulations, a Corporate Partner (as defined at § 1.337(d)-3(c)(1) of these final regulations) may recognize gain when it is treated as acquiring or increasing its interest in Stock of the Corporate Partner held by a partnership in exchange for appreciated property in a manner that avoids gain recognition under section 311(b) or section 336(a). These final regulations also provide exceptions under which a Corporate Partner is not required to recognize gain.

#### B. Scope and Definitions

##### i. Corporate Partner and Stock of the Corporate Partner

The 2015 regulations defined a *Corporate Partner* as a person that holds or acquires an interest in a partnership and that is classified as a corporation for federal income tax purposes. The 2015 regulations defined *Stock of the Corporate Partner* expansively to include the Corporate Partner's stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner, or in a corporation that controls the Corporate Partner within the meaning of section 304(c), except that section 318(a)(1) and (3) shall not apply (referred to in this Explanation of Provisions as a Controlling Corporation). Stock of the Corporate Partner also included interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner.

The commenter asked whether an equity interest issued by a third party on a Corporate Partner's stock, such as an option issued by a bank on the Corporate Partner's stock, was considered Stock of the Corporate Partner. The Treasury Department and the IRS confirm that all options,

warrants, and other similar interests issued by third parties on a Corporate Partner's stock, a Controlling Corporation's stock, or any interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner, are Stock of the Corporate Partner under both the temporary regulations and these final regulations. No inference is intended regarding whether options, warrants, and other similar interests are subject to section 1032 where they create an equity interest in the Stock of the Corporate Partner.

##### ii. Stock of the Corporate Partner: Controlling Corporations

The 2015 regulations provided that Stock of the Corporate Partner includes the stock (or other equity interests) in a Controlling Corporation. The commenter asked whether stock in a Controlling Corporation wholly constitutes Stock of the Corporate Partner or only constitutes Stock of the Corporate Partner to the extent the value of the Controlling Corporation's stock is attributable to that corporation's interest in the Corporate Partner. These final regulations clarify that it is intended that stock (or any other equity interest) in a Controlling Corporation will wholly constitute Stock of the Corporate Partner irrespective of the ratio of the Controlling Corporation's interest in the Corporate Partner to the Controlling Corporation's total assets. In response to this comment, the final regulations also include a new example to clearly illustrate this point. See *Example 2* of § 1.337(d)-3(h) in these final regulations.

With respect to the rule that Stock of the Corporate Partner includes an interest in an entity to the extent that the value of the interest is attributable to the Stock of the Corporate Partner (Value Rule), the commenter asked that, in cases in which the entity is not controlled by the Corporate Partner and which is not a Controlling Corporation, that a limitation be added that the interest in the entity would not be treated as Stock of the Corporate Partner if less than 20 percent of the assets of the entity consisted of Stock of the Corporate Partner. The Treasury Department and the IRS agree with the commenter that the Value Rule in the 2015 regulations could be overbroad in certain situations but decline to adopt the commenter's specific suggestion in these final regulations because such a rule would be too generous and could permit taxpayers to structure transactions that would contravene the purpose of section 337(d) and these regulations. However, the Treasury

Department and the IRS are considering publishing new proposed regulations to limit the application of the Value Rule to entities that are not Controlling Corporations but which own, directly or indirectly, 5 percent or more of the stock, by vote or value, of the Corporate Partner and clarifying how taxpayers would determine what portion of the value of the interest in the entity is attributable to Stock of the Corporate Partner.

##### iii. Stock of the Corporate Partner: Attribution

The 2015 regulations defined Stock of the Corporate Partner to include stock in a Controlling Corporation. The 2015 regulations employed the section 304(c) definition of control, which generally requires the ownership of stock with either 50 percent of the voting power in the corporation or 50 percent of the value of the corporation. While section 304(c) incorporates the constructive ownership rules of section 318(a) with some modifications, the 2015 regulations excluded the application of sections 318(a)(1) and (3) from its definition of control.

The commenter agreed with excluding section 318(a)(3) attribution from the application of section 304(c) under the 2015 regulations, but noted that it may be inappropriate to exclude section 318(a)(1) family attribution. The commenter suggested that families could invoke this exclusion to structure partnerships in such a way to avoid these regulations but which would be subject to these final regulations. The Treasury Department and the IRS agree that excluding family attribution under section 318(a)(1) could produce inappropriate results. Additionally, the Treasury Department and the IRS have also determined that taxpayers could structure transactions designed to take advantage of the lack of section 318(a)(3) attribution. Therefore, the Treasury Department and the IRS are considering publishing new proposed regulations to further modify the definition of Stock of the Corporate Partner so that it would no longer exclude attribution under sections 318(a)(1) and (3) when determining whether an interest in an entity is Stock of the Corporate Partners under section 304(c), but which would limit the proposed expanded scope of section 304(c) control to entities that own, directly or indirectly, an interest in the Corporate Partner.

iv. Stock of the Corporate Partner: Related-Party Partnerships

The 2015 regulations provided an exception from the definition of Stock of the Corporate Partner in the case of certain related-party partnerships. Under this exception, Stock of the Corporate Partner did not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group defined in section 1504(a) that includes the Corporate Partner (Affiliated Group Exception).

The commenter suggested that the final regulations extend the Affiliated Group Exception to partnerships in which a high percentage, but not all, of its interests are owned by affiliated group members. The commenter asserted that, under these facts, there would be no reason to require gain recognition. The commenter also recommended that the final regulations extend the affiliated group exception to lower-tier partnerships owned by one or more upper-tier partnerships, if the upper-tier partnerships are entirely owned by members of an affiliated group that includes the Corporate Partner.

After further study of this issue, and in light of the other exceptions to the deemed redemption rule, the Treasury Department and the IRS decline to adopt these comments because even without such extensions the Affiliated Group Exception could permit inappropriate elimination of corporate level built-in gain. For example—

Assume that P, a corporation, owns all of the stock of S1, and S1 owns all of the stock of CP. P, S1, and CP are members of an affiliated group. P and CP form a 50–50 partnership, where CP contributes an appreciated asset to the partnership, and P contributes S1 stock with a basis equal to fair market value. After seven years, the partnership liquidates and distributes the S1 stock to CP and the appreciated asset to P. At that time, the asset may be sold outside of the group with an artificially increased basis. While the built-in gain that was in the asset now is preserved in the S1 stock held by CP, the group may permanently eliminate the gain without tax by causing CP to liquidate. CP would receive nonrecognition treatment on distribution of the S1 stock to S1 under section 332, and S1 would receive nonrecognition treatment on the receipt of its own stock under section 1032. Thus, the liquidation of CP permanently eliminates the built-in gain on the appreciated asset that attached to the stock CP held in S1 after the liquidation of the partnership.

Although these final regulations retain the Affiliated Group Exception, the Treasury Department and the IRS are considering publishing new

proposed regulations to remove the Affiliated Group Exception because this exception can permit corporations to engage in transactions with partnerships to eliminate permanently the built-in gain on appreciated assets or otherwise to avoid the purposes of *General Utilities* repeal and these regulations.

v. Section 337(d) Transactions

The 2015 regulations provided that, for partnerships that hold Stock of the Corporate Partner, the 2015 regulations apply to a transaction (or a series of transactions) that is a “Section 337(d) Transaction.” The 2015 regulations defined a *Section 337(d) Transaction* as a transaction (or series of transactions) that has the effect of an exchange by a Corporate Partner of its interest in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by a partnership. For example, a Section 337(d) Transaction may occur if: (i) A Corporate Partner contributes appreciated property to a partnership that owns Stock of the Corporate Partner; (ii) a partnership acquires Stock of the Corporate Partner; (iii) a partnership that owns Stock of the Corporate Partner distributes appreciated property to a partner other than the Corporate Partner; (iv) a partnership distributes Stock of the Corporate Partner to the Corporate Partner; or (v) a partnership agreement is amended in a manner that increases a Corporate Partner's interest in the Stock of the Corporate Partner (including in connection with a contribution to, or distribution from, a partnership).

In certain circumstances, a partnership's acquisition of Stock of the Corporate Partner does not have the effect of an exchange of appreciated property for that stock. For example, if a partnership with an operating business uses the cash generated in that business to purchase Stock of the Corporate Partner, the deemed redemption rule does not apply to the stock purchase because the Corporate Partner's share in appreciated property has not been reduced, and thus no exchange has occurred. The Treasury Department and the IRS acknowledge that such stock acquisitions would not trigger the deemed redemption rule. The Treasury Department and the IRS note, however, that because of the administrative difficulties in tracing the source of cash used to acquire Corporate Partner stock, taxpayers wishing to invoke this exception must maintain appropriate records or other documentation to affirmatively demonstrate that the consideration used

in the exchange to acquire the Stock of the Corporate Partner at issue came from operating cashflow.

The commenter asked whether the 2015 regulations encompassed other types of acquisitions of Stock of the Corporate Partner for cash, and requested that the final regulations include examples of transactions that do not have the effect of an exchange of appreciated property for Stock of the Corporate Partner. The Treasury Department and the IRS considered this comment, but decline to add additional examples because those examples would go beyond the scope of these final regulations which is to prevent the exchange of appreciated property for Stock of the Corporate Partner.

C. Deemed Redemption Rule

i. Generally

The 2015 regulations provided that if a transaction is a Section 337(d) Transaction, a Corporate Partner must recognize gain under the deemed redemption rule. To determine the amount of gain, the Corporate Partner must first determine the amount of appreciated property (other than Stock of the Corporate Partner) effectively exchanged for Stock of the Corporate Partner (by value) and then calculate the amount of taxable gain recognized.

The deemed redemption rule applies only to the extent that the transaction has the effect of an exchange by the Corporate Partner of its interest in appreciated property for Stock of the Corporate Partner. Thus, this rule does not apply to the extent a transaction has the effect of an exchange by a Corporate Partner of non-appreciated property for Stock of the Corporate Partner or has the effect of an exchange by a Corporate Partner of appreciated property for property other than Stock of the Corporate Partner.

The 2015 regulations set forth general principles that apply in determining the amount of appreciated property effectively exchanged for Stock of the Corporate Partner. These general principles require that the Corporate Partner's economic interest with respect to both Stock of the Corporate Partner and all other appreciated property of the partnership be determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement.

A Corporate Partner must recognize gain under the 2015 regulations even if the Section 337(d) Transaction would not otherwise change the Corporate Partner's allocable share of gain under section 704(c). For example, if a Corporate Partner contributes

appreciated property to a newly-formed partnership and an individual contributes cash that the partnership subsequently uses to purchase Stock of the Corporate Partner, then the purchase of the stock is a Section 337(d) Transaction even though the Corporate Partner's allocable share of gain in the appreciated property under section 704(c) is the same before and after the purchase. See *Example 4* of § 1.337(d)-3(h) in these final regulations.

The Treasury Department and the IRS did not receive comments on this general deemed redemption rule. Therefore, these final regulations adopt the rule set forth in the 2015 regulations.

#### ii. Subsequent Transactions

Under the 2015 regulations, the deemed redemption rule did not apply to transactions involving stock that does not meet the definition of Stock of the Corporate Partner. The commenter asked whether, in cases in which the deemed redemption rule does not apply to an initial transaction because the definition of Stock of the Corporate Partner is not satisfied, if certain subsequent transactions would trigger gain recognition by treating those transactions as Section 337(d) Transactions. The Treasury Department and the IRS intend for certain subsequent transactions to trigger gain recognition as Section 337(d) Transactions. Therefore, in response to this comment, the Treasury Department and the IRS clarify that these final regulations apply to certain transactions involving related parties in which a first transaction does not constitute a Section 337(d) Transaction because the partnership does not own stock in either a Corporate Partner or in a Controlling Corporation, but the Corporate Partner in a later, separate transaction transfers its partnership interest to a related corporation whose stock the partnership owns. In these transactions, the deemed redemption rule will trigger gain as if the first transaction was a Section 337(d) Transaction with the result that the transferee corporation who is now itself a Corporate Partner will "step into the shoes" of the first Corporate Partner and will be subject to the deemed redemption rule to the extent of the first Corporate Partner's remaining built-in gain in the appreciated asset immediately prior to the transfer.

#### iii. Prior Transactions

The 2015 regulations provided that, if the Corporate Partner has an existing interest in the partnership's Stock of the Corporate Partner prior to the Section 337(d) Transaction, the deemed

redemption rule applies only with respect to the Corporate Partner's incremental increase in the Stock of the Corporate Partner. For example, changing allocations to increase a Corporate Partner's interest in the Stock of the Corporate Partner from 50 percent to 80 percent and to decrease the Corporate Partner's interest in other appreciated property from 80 percent to 50 percent would have the effect of an exchange by the Corporate Partner of the 30-percent incremental decrease in its interest in the appreciated property for the 30-percent incremental increase in the Stock of the Corporate Partner. The Treasury Department and the IRS did not receive comments on this rule, and therefore, these final regulations adopt the rule set forth in the 2015 regulations.

#### iv. Special Rule for Determination of Corporate Partner's Interest

For purposes of recognizing gain under the deemed redemption rule, the 2015 regulations provided that a Corporate Partner's interest in an identified share of Stock of the Corporate Partner will never be less than the Corporate Partner's largest interest (by value) in that share of Stock of the Corporate Partner that was taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction (regardless of whether the Corporate Partner recognized gain in the earlier transaction). See *Example 7* of § 1.337(d)-3(h) in these final regulations. This rule ensures that alternating increases and decreases in a Corporate Partner's interest in Stock of the Corporate Partner do not cause duplicate gain recognition.

This limitation does not apply if any reduction in the Corporate Partner's interest in the identified share of Stock of the Corporate Partner occurred as part of a plan or arrangement to circumvent the purpose of these final regulations. See *Example 8* of § 1.337(d)-3(h) in these final regulations.

The commenter raised a question regarding the numbers used in this *Example 8* (which was numbered as *Example 7* in the 2015 regulations under section 337(d)). The commenter pointed out that under the example's facts, the two partners make initial contributions to the partnership in a 99 to 1 ratio, and make subsequent contributions in a 50 to 50 ratio. The commenter questioned why the example stated that the two partners are "equal partners" in all respects after the subsequent contributions. In response to this comment, the Treasury Department and the IRS clarify the example to

provide that the subsequent contributions resulted in the partners' total contributions as being in a 50 to 50 ratio, so that, after the partners make these subsequent contributions, the partners have equal interests in the partnership in all respects. The aim of the example is to illustrate the rule that partners cannot utilize this special rule for determining a Corporate Partner's interest to circumvent the purpose of these final regulations. The Treasury Department and the IRS did not receive any other comments on this rule, and therefore, these final regulations adopt the rule set forth in the 2015 regulations.

#### v. Amount and Character of Gain

The 2015 regulations provided that, if a transaction is a Section 337(d) Transaction, the deemed redemption rule requires the Corporate Partner to recognize a percentage of the total gain in partnership appreciated property that is subject to the exchange equal to a fraction, the numerator of which is the Corporate Partner's interest (by value) in appreciated property effectively exchanged for Stock of the Corporate Partner under the deemed redemption rule, and the denominator of which is the Corporate Partner's interest (by value) in appreciated property immediately before the Section 337(d) Transaction. The 2015 regulations define this fraction as the *Gain Percentage*. The Corporate Partner's gain under the deemed redemption rule equals the product of (i) the Corporate Partner's Gain Percentage and (ii) the gain from the appreciated property that is the subject of the exchange that the Corporate Partner would recognize if, immediately before the Section 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the Section 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)), reduced, but not below zero, by any gain the Corporate Partner is required to recognize with respect to the appreciated property in the Section 337(d) Transaction under any other section of the Code.

The gain from the hypothetical sale used to compute gain under the deemed redemption rule is determined by applying the principles of section 704(c), which generally requires the partnership to take into account variations between the adjusted tax basis and fair market value of partnership property at the time it is contributed to the partnership and upon certain other events that allow or

require the value of partnership property to be redetermined under § 1.704-1(b)(2)(iv)(f). See *Examples 4 and 6* of § 1.337(d)-3(h) in these final regulations. A partner's share of gain under section 704(c) for this purpose includes any remedial allocations under § 1.704-3(d) for a partnership that has elected under section 704(c) to report notional items of offsetting tax gain and loss to its partners to eliminate distortions that may arise when the partnership's total tax gain or loss on the sale of partnership property is less than all partners' aggregate share of gain or loss from the property. The Treasury Department and the IRS did not receive comments on this general rule governing the amount of gain from a Section 337(d) Transaction. These final regulations therefore adopt the rule set forth in the 2015 regulations. However, the commenter asked whether section 743(b) basis adjustments are taken into account when determining a Corporate Partner's gain in a Section 337(d) Transaction. The Treasury Department and the IRS confirm that basis adjustments, including adjustments made pursuant to section 743(b), are taken into account when calculating this gain, so that the Corporate Partner would not be subject to a duplication of tax liability.

The commenter also noted that the 2015 regulations do not specify the character of the gain that a Corporate Partner recognizes in a Section 337(d) Transaction. In response to this comment, the final regulations clarify that the character of the gain that the Corporate Partner recognizes in a Section 337(d) Transaction is the same character of the gain that the Corporate Partner would have recognized if, immediately before the Section 337(d) Transaction, the Corporate Partner had disposed of the appreciated property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)).

#### vi. Basis Rules

The 2015 regulations contained two rules related to the effect of the deemed redemption rule on partner and partnership basis. First, the 2015 regulations require the Corporate Partner to increase its basis in its partnership interest by an amount equal to the gain that the Corporate Partner recognizes in a Section 337(d) Transaction. This basis increase is necessary to prevent the Corporate Partner from recognizing gain a second time when the partnership liquidates (or, if property is distributed to the Corporate Partner, when that property is

sold). Under the 2015 regulations, this basis increase applies regardless of whether the partnership has a Section 754 election in effect. The commenter suggested that the final regulations clarify how a basis increase is treated for basis-recovery purposes. The final regulations provide this clarification by specifying that this increase is treated as property that is placed in service by the partnership in the taxable year of the Section 337(d) Transaction.

Second, the 2015 regulations require the partnership to increase its adjusted tax basis in the appreciated property that is treated as the subject of a Section 337(d) Transaction by the amount of gain that the Corporate Partner recognized with respect to that property as a result of the Section 337(d) Transaction. The Treasury Department and the IRS did not receive comments on this basis increase rule and, accordingly, these final regulations adopt the rule set forth in the 2015 regulations.

#### D. Partnership Distributions of Stock of the Corporate Partner

##### i. General Rule Governing Distributions

The 2015 regulations extended the deemed redemption rule to certain distributions to the Corporate Partner of Stock of the Corporate Partner. These rules governing distributions applied only if the distributed stock had previously been the subject of a Section 337(d) Transaction or became the subject of a Section 337(d) Transaction as a result of the distribution (a section 337(d) distribution). The 2015 regulations did not apply to a distribution to the Corporate Partner of the Stock of the Corporate Partner to which section 732(f) applied at the time of the distribution.

If the deemed redemption rule applied to a distribution, the 2015 regulations deem the partnership to amend its agreement immediately before the distribution to allocate a 100 percent interest in that portion of the stock to the Corporate Partner that is distributed and to allocate an appropriately reduced interest in other partnership property away from the Corporate Partner. The 2015 regulations employ this deemed allocation solely for purposes of recognizing gain, and no inference is intended with regard to the treatment of such allocations generally.

The Treasury Department and the IRS did not receive comments on this general rule governing partnership distributions and, accordingly, these final regulations adopt the rule set forth in the 2015 regulations.

##### ii. Gain Recognition Rule

The 2015 regulations provided that if a distribution is a section 337(d) distribution, then in addition to any gain recognized under the deemed redemption rule upon the distribution of Stock of the Corporate Partner to the Corporate Partner, the 2015 regulations also would require the Corporate Partner to recognize gain to the extent that the partnership's basis in the distributed Stock of the Corporate Partner exceeds the Corporate Partner's basis in its partnership interest (as reduced by any cash distributed in the transaction) immediately before the distribution.

The commenter noted that the language used in this provision differs from the gain recognition provision of section 732(f)(1)(C), which evaluates whether the partnership's adjusted basis in the distributed stock immediately before the distribution exceeded the Corporate Partner's adjusted basis in that stock immediately after the distribution. The commenter asked whether these differences were intentional and, if so, for the explanation of the differences. The differences were not intentional and the Treasury Department and the IRS have determined that the provisions should be the same. Accordingly, the language of the gain recognition rule in these final regulations is modified to conform to the language used in the section 732(f) gain recognition provision.

##### iii. Basis Rules

The 2015 regulations set forth two rules under sections 337(d) and 732 to coordinate the effects of the rule requiring gain recognition when the basis of the Stock of the Corporate Partner is stepped down on a section 337(d) distribution with existing rules for determining the basis of property upon partnership distributions.

The first rule applied for purposes of: (1) Determining the basis of property distributed to the Corporate Partner (other than the basis of the Corporate Partner in its own stock); (2) determining the basis of the Corporate Partner's remaining partnership interest; (3) determining the partnership's basis in undistributed Stock of the Corporate Partner; and (4) computing gain on the distribution. For these purposes, the basis of Stock of the Corporate Partner distributed to the Corporate Partner equals the greater of (i) the partnership's basis of that distributed Stock of the Corporate Partner immediately before the distribution, or (ii) the fair market value of that distributed Stock of the Corporate Partner immediately before

the distribution, less the Corporate Partner's allocable share of gain from all of the Stock of the Corporate Partner, if the partnership sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately before the distribution. See *Examples 3* and *4* of § 1.337(d)-3(h) in these final regulations. This special rule is necessary to prevent basis from shifting away from distributed Stock of the Corporate Partner to other property. This basis shift could occur, for example, upon a distribution of less than all of the partnership's Stock of the Corporate Partner to the Corporate Partner.

The commenter asked whether this basis rule applies solely to the Corporate Partner or whether it applies for all purposes and recommended expanding *Example 4* of § 1.337(d)-3(h) in these final regulations (which was numbered as *Example 3* in the 2015 regulations under section 337(d)) to address the basis consequences to the partnership and to the non-corporate partner. The Treasury Department and the IRS confirm that this basis rule applies for all purposes, and these final regulations expand *Example 4* of § 1.337(d)-3(h) to discuss the basis that AX partnership and partner A have in the X stock that is distributed to A.

The second rule applied when a Corporate Partner receives both Stock of the Corporate Partner and other property in a section 337(d) distribution. Under this rule, the basis to be allocated to the properties distributed under section 732(a) or (b) is allocated first to the Stock of the Corporate Partner before taking into account the distribution of any other property (other than cash). Therefore, before taking into account the distribution of other property, the Corporate Partner will reduce its basis in its partnership interest by the Corporate Partner's basis in the distributed Stock of the Corporate Partner (but not below zero). The Corporate Partner will determine its basis in other distributed partnership property and in its remaining partnership interest after giving effect to this reduction. The 2015 regulations set forth this rule to ensure that the purposes of the repeal of the *General Utilities* doctrine are not circumvented through the use of any provision of law or regulations.

When a Corporate Partner receives a partnership distribution of its own stock, it is unclear under existing law whether the Corporate Partner has basis in that stock. (See, for example, Rev.

Rul. 2006-2, 2006-1 CB 261.) The resolution of this question is beyond the scope of these final regulations. However, because the distribution to a Corporate Partner of its own stock affects the Corporate Partner's basis in other distributed property and any retained partnership interest, these final regulations make clear that the partnership and the Corporate Partner must determine the basis of other distributed property and any retained partnership interest by reference to the partnership's basis in the distributed Stock of the Corporate Partner. That is, the Corporate Partner determines its basis in other distributed property and in any retained partnership interest as though the distributed stock was stock other than Stock of the Corporate Partner. Similarly, the 2015 regulations computed any gain recognition on the distribution by comparing the Corporate Partner's basis in its partnership interest to the basis of that Stock of the Corporate Partner in the hands of the partnership (without regard to whether the Corporate Partner can have basis in the distributed stock). No inference is intended with respect to the question of whether a corporation does or does not have basis in its own stock.

The commenter noted that duplication of gain under sections 337(d) and 732(f) may occur under the 2015 regulations. The commenter provided an example in which a Corporate Partner could potentially recognize gain first under section 337(d) from a partnership distribution to which section 732(f) does not apply, because its control requirement is not satisfied at the time of the distribution, but then later be subject to the 732(f) basis reduction if the control requirement is subsequently satisfied. The Treasury Department and the IRS agree with the commenter and therefore, these final regulations set forth a basis rule providing that, for purposes of determining the amount of the decrease to the basis of property held by a distributed corporation pursuant to section 732(f), the amount of this decrease is reduced by the amount of gain that a Corporate Partner has recognized under this section in a Section 337(d) Transaction, both in cases where section 732(f) applies at the time of the Section 337(d) Transaction and in cases where section 732(f) is subsequently triggered. This rule prevents the Corporate Partner from recognizing the same gain twice.

## E. Exceptions

### i. De Minimis Exception

The 2015 regulations set forth a de minimis rule providing that the 2015 regulations do not apply to a Corporate Partner if three conditions are satisfied. These conditions are tested upon the occurrence of a Section 337(d) Transaction and upon any subsequent revaluation event described in § 1.704-1(b)(2)(iv)(f).

The first condition requires that both the Corporate Partner and any persons related to the Corporate Partner under section 267(b) or section 707(b) own, in the aggregate, less than 5 percent of the partnership. The second condition requires that the partnership hold Stock of the Corporate Partner worth less than 2 percent of the value of the partnership's gross assets, including Stock of the Corporate Partner. The third condition requires that the partnership has never, at any point in time, held more than \$1,000,000 in Stock of the Corporate Partner or more than 2 percent of any particular class of Stock of the Corporate Partner.

The 2015 regulations provided a special rule that applies if the conditions of the de minimis rule are satisfied at the time of a Section 337(d) Transaction, but are not satisfied at the time of a subsequent Section 337(d) Transaction or revaluation event described in § 1.704-1(b)(2)(iv)(f). This rule provided that, solely for purposes of the deemed redemption rule, a Corporate Partner may determine its gain on the subsequent acquisition or revaluation event as if it had already recognized gain at the previous event. Accordingly, the Corporate Partner would only recognize gain with respect to appreciation arising between the earlier acquisition or revaluation event and the subsequent event. Neither the Corporate Partner nor the partnership increases its basis by the gain the Corporate Partner would have recognized if the de minimis rule did not apply to the prior acquisition or revaluation event.

The Treasury Department and the IRS are concerned that taxpayers could intentionally plan to combine entities, each meeting the de minimis limits, to avoid the purposes of these final regulations. To address this concern, in these final regulations, the Treasury Department and the IRS add a clarifying provision to the de minimis exception stating that the exception does not apply to Stock of the Corporate Partner that is acquired as part of a plan to circumvent the purpose of these final regulations.



ii. Exception for Certain Dispositions of Stock

The 2015 regulations set forth another exception titled the “inadvertence rule.” This exception provided that the 2015 regulations do not apply to Section 337(d) Transactions in which the partnership satisfies two requirements. First, the partnership must dispose of, by sale or distribution, the Stock of the Corporate Partner before the due date (including extensions) of its federal income tax return for the taxable year in which the partnership acquired the stock (or in which the Corporate Partner joined the partnership, if applicable). Second, the partnership must not have distributed the Stock of the Corporate Partner to the Corporate Partner or a person possessing section 304(c) control of the Corporate Partner.

The commenter asked, whether, notwithstanding the exception’s title, the dispositions needed to be inadvertent to qualify for the exception. In order to avoid any ambiguity or any assumption that these dispositions must be inadvertent, these final regulations rename the exception to state that the exception simply applies to “certain dispositions of stock” that qualify for the exception and that inadvertence is not a requirement.

The Treasury Department and the IRS also note that this exception requires that the stock at issue is not distributed to the Corporate Partner or a Controlling Corporation. As discussed in (1)(B) of this Explanation of Provisions with respect to the general definition of Stock of the Corporate Partner, the Treasury Department and the IRS are considering publishing new proposed regulations to modify the definition of Stock of the Corporate Partner to remove the exception for attribution under section 318(a)(1) and (3) from the scope of section 304(c) control.

F. Other Comments

The commenter requested that these final regulations provide examples on how to measure a Corporate Partner’s partnership interest in more complex partnership agreements, such as situations in which the agreement contains a distribution waterfall. Similarly, the commenter requested that these final regulations provide more detailed examples relating to tiered partnership structures. The Treasury Department and the IRS believe that the purpose of these final regulations is to set forth rules of general applicability to prevent a corporate partner from avoiding corporate level gain through transactions with a partnership. The Treasury Department and the IRS

therefore believe that providing such detailed examples is beyond the scope of these final regulations.

2. Final Regulations Under Section 732(f)

These final regulations adopt the rules set forth in the 2015 regulations under section 732(f) without any change to conform the application of section 732(f) with Congress’ identified purposes for enacting sections 337(d), 732(f), and 1502 in certain situations.

A. Aggregation of Section 732(b) Basis Adjustments

As discussed in the Background, section 732(f) generally applies on a partner-by-partner basis. However, the Treasury Department and the IRS determined that, in certain circumstances, it is appropriate to aggregate the bases of consolidated group members in a partnership for purposes of applying section 732(f).

The 2015 regulations provided that corporate partners that are members of the same consolidated group (as defined in § 1.1502-1(h)) could aggregate their bases in interests in the same partnership for purposes of section 732(f) when two conditions are met. First, two or more of the corporate partners receive a distribution of stock in a distributed corporation from the partnership. Second, the distributed corporation is or becomes a member of the distributee partners’ consolidated group following the distribution.

Under this rule, section 732(f) only applies to the extent that the partnership’s adjusted basis in the distributed stock immediately before the distribution exceeds the aggregate basis of the distributed stock in the hands of all members of the distributee corporate partners’ consolidated group immediately after the distribution. The 2015 regulations included the requirement that the distributed corporation be a member of the consolidated group in order to avoid unintended consequences that could result if that corporation were a controlled foreign corporation.

The commenter recommended that the final regulations extend this basis-aggregation rule to include a distributed corporation (including a controlled foreign corporation) that is owned by members of the distributee partners’ consolidated group following the distribution. The commenter stated that the distributed corporation need not be a member of the distributee partners’ consolidated group, and that the rule should apply to corporations like a controlled foreign corporation that cannot be a member of a consolidated

group. The Treasury Department and the IRS decline to adopt the comment because there could be unanticipated consequences if the distributed corporation were a controlled foreign corporation.

B. Gain Elimination Transactions

The 2015 regulations also provided rules that restrict corporate partners from entering into transactions or a series of transactions (gain elimination transactions), such as a distribution followed by a reorganization under section 368(a), that might eliminate gain in the stock of a distributed corporation while avoiding the effects of a basis step-down in transactions, because the section 732(f) control requirement is not immediately satisfied.

Accordingly, the 2015 regulations provided that, in the event of a gain elimination transaction, section 732(f) shall apply as though the corporate partner acquired control (as defined in section 732(f)(5)) of the distributed corporation immediately before the gain elimination transaction.

The Treasury Department and the IRS did not receive comments on the proposed rule governing gain elimination transactions. These final regulations adopt the rules set forth in the 2015 regulations.

C. Tiered Partnerships

The 2015 regulations required taxpayers to apply its rules to tiered partnerships in a manner consistent with the purpose of section 732(f). These final regulations maintain this requirement. The commenter requested that these final regulations provide examples illustrating their application to tiered partnerships. The Treasury Department and the IRS decline to adopt this comment, because such examples are beyond the scope of these final regulations, which is to set forth rules of general applicability governing the application of section 732(f) to two specific sets of circumstances.

Applicability Date

These final regulations apply to transactions occurring on or after June 12, 2015.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

Further, pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is



hereby certified that these final regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these final regulations would primarily affect sophisticated ownership structures involving corporations that own partnerships owning stock or other equity interests in corporate partners. Additionally, these final regulations contain a number of de minimis and other exceptions that render the final regulations inapplicable to most small businesses, and do not impose a collection of information on small entities.

Pursuant to section 7805(f), these final regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

#### Statement of Availability of IRS Documents

Notice 89–37 cited in this document is published in the Internal Revenue Bulletin (or Cumulative Bulletin) and is available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

#### Drafting Information

The principal author of these final regulations is Kevin I. Babitz, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART I—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by removing the sectional authority for § 1.337(d)–3T, adding a sectional authority for § 1.337(d)(3) in numerical order, and revising the sectional authority for § 1.732–3 to read as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

\* \* \* \* \*

Section 1.337(d)–3 also issued under 26 U.S.C. 337(d).

\* \* \* \* \*

Section 1.732–3 also issued under 26 U.S.C. 337(d), 732(f)(8), and 1502.

\* \* \* \* \*

■ **Par. 2.** Section 1.337(d)–3 is added to read as follows:

#### § 1.337(d)–3 Gain recognition upon certain partnership transactions involving a partner's stock.

(a) *Purpose.* The purpose of this section is to prevent corporate taxpayers from using a partnership to circumvent gain required to be recognized under section 311(b) or section 336(a). The rules of this section, including the determination of the amount of gain, must be applied in a manner that is consistent with and reasonably carries out this purpose.

(b) *In general.* This section applies when a partnership, either directly or indirectly, owns, acquires, or distributes Stock of the Corporate Partner (within the meaning of paragraph (c)(2) of this section). Under paragraphs (d) or (e) of this section, a Corporate Partner (within the meaning of paragraph (c)(1) of this section) is required to recognize gain when a transaction has the effect of the Corporate Partner acquiring or increasing an interest in its own stock in exchange for appreciated property in a manner that contravenes the purpose of this section as set forth in paragraph (a) of this section. Paragraph (f) of this section sets forth exceptions under which a Corporate Partner does not recognize gain.

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Corporate Partner.* A *Corporate Partner* is a person that is classified as a corporation for federal income tax purposes and holds or acquires an interest in a partnership.

(2) *Stock of the Corporate Partner*—(i) *In general.* With respect to a Corporate Partner, *Stock of the Corporate Partner* includes the Corporate Partner's stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of section 304(c) (except that section 318(a)(1) and (3) shall not apply). *Stock of the Corporate Partner* also includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner.

(ii) *Affiliated partner exception.* Stock of the Corporate Partner does not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner.

(3) *Section 337(d) Transaction.* A *Section 337(d) Transaction* is a

transaction (or series of transactions) that has the effect of an exchange by a Corporate Partner of its interest in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by a partnership. For example, a Section 337(d) Transaction may occur when —

(i) A Corporate Partner contributes appreciated property to a partnership that owns Stock of the Corporate Partner;

(ii) A partnership acquires Stock of the Corporate Partner;

(iii) A partnership that owns Stock of the Corporate Partner distributes appreciated property to a partner other than a Corporate Partner;

(iv) A partnership distributes Stock of the Corporate Partner to the Corporate Partner; or

(v) A partnership agreement is amended in a manner that increases a Corporate Partner's interest in Stock of the Corporate Partner (including in connection with a contribution to, or distribution from, a partnership).

(4) *Gain Percentage.* A Corporate Partner's *Gain Percentage* equals a fraction, the numerator of which is the Corporate Partner's interest (by value) in appreciated property effectively exchanged for Stock of the Corporate Partner under the test described in paragraphs (d)(1) and (2) of this section, and the denominator of which is the Corporate Partner's interest (by value) in that appreciated property immediately before the Section 337(d) Transaction. Paragraph (d) of this section requires a partnership to multiply the Gain Percentage by the Corporate Partner's aggregate gain in appreciated property to determine gain recognized under this section.

(d) *Deemed redemption rule*—(1) *In general.* A Corporate Partner in a partnership that engages in a Section 337(d) Transaction recognizes gain at the time, and to the extent, that the Corporate Partner's interest in appreciated property (other than Stock of the Corporate Partner) is reduced in exchange for an increased interest in Stock of the Corporate Partner, as determined under paragraph (d)(2) of this section. This section does not apply to the extent a transaction has the effect of an exchange by a Corporate Partner of non-appreciated property for Stock of the Corporate Partner, or has the effect of an exchange by a Corporate Partner for property other than Stock of the Corporate Partner.

(2) *Corporate Partner's interest in partnership property.* The Corporate Partner's interest with respect to both Stock of the Corporate Partner and the appreciated property that is the subject

of the exchange is determined based on all facts and circumstances, including the allocation and distribution rights set forth in the partnership agreement. The Corporate Partner's interest in an identified share of Stock of the Corporate Partner will never be less than the Corporate Partner's largest interest (by value) in that share of Stock of the Corporate Partner that was taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction with respect to such share (regardless of whether the Corporate Partner recognized gain in the earlier transaction). See *Example 7* of paragraph (h) of this section. However, this limitation will not apply if any reduction in the Corporate Partner's interest in the identified share of Stock of the Corporate Partner occurred as part of a plan or arrangement to circumvent the purpose of this section. See *Example 8* of paragraph (h) of this section.

(3) *Amount and character of gain recognized on the exchange*—(i) *Amount of gain.* The amount of gain the Corporate Partner recognizes under paragraph (d)(1) of this section equals the product of the Corporate Partner's Gain Percentage and the gain from the appreciated property that is the subject of the exchange that the Corporate Partner would recognize if, immediately before the Section 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the Section 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)), reduced, but not below zero, by any gain the Corporate Partner is required to recognize with respect to the appreciated property in the Section 337(d) Transaction under any other provision of this chapter. This gain is computed taking into account allocations of tax items applying the principles of section 704(c), including any remedial allocations under § 1.704-3(d), and also taking into account any basis adjustments including adjustments made pursuant to section 743(b).

(ii) *Character of gain.* The character of the gain that the Corporate Partner recognizes under paragraph (d)(1) of this section from the appreciated property that is the subject of the exchange shall be the character of the gain that the Corporate Partner would recognize if, immediately before the Section 337(d) Transaction, the Corporate Partner had disposed of the appreciated property that is the subject of the exchange in a fully taxable transaction for cash in an amount equal to the fair market value of

such property (taking into account section 7701(g)).

(4) *Basis adjustments*—(i) *Corporate Partner's basis in the partnership interest.* The basis of the Corporate Partner's interest in the partnership is increased by the amount of gain that the Corporate Partner recognizes under this paragraph (d).

(ii) *Partnership's basis in partnership property.* The partnership's adjusted tax basis in the appreciated property that is treated as the subject of the exchange under this paragraph (d) is increased by the amount of gain recognized with respect to that property by the Corporate Partner as a result of that exchange, regardless of whether the partnership has an election in effect under section 754. For basis recovery purposes, this basis increase is treated as property that is placed in service by the partnership in the taxable year of the Section 337(d) Transaction.

(e) *Distribution of Stock of the Corporate Partner*—(1) *In general.* This paragraph (e) applies to distributions to the Corporate Partner of Stock of the Corporate Partner to which section 732(f) does not apply and that have previously been the subject of a Section 337(d) Transaction or become the subject of a Section 337(d) Transaction as a result of the distribution. Upon the distribution of Stock of the Corporate Partner to the Corporate Partner, paragraph (d) of this section will apply as though immediately before the distribution the partners amended the partnership agreement to allocate to the Corporate Partner a 100 percent interest in that portion of the Stock of the Corporate Partner that is distributed, and to allocate an appropriately reduced interest in other partnership property away from the Corporate Partner.

(2) *Basis rules*—(i) *Basis allocation on distributions of stock and other property.* If, as part of the same transaction, a partnership distributes Stock of the Corporate Partner and other property (other than cash) to the Corporate Partner, see § 1.732-1(c)(1)(iii) for a rule allocating basis first to the Stock of the Corporate Partner before the distribution of the other property.

(ii) *Computation of basis.* For purposes of determining the basis of property distributed to a partner in a transaction that includes the distribution of Stock of the Corporate Partner (other than the basis of the Corporate Partner in its own stock), the basis of the partner's remaining partnership interest, and the partnership's basis in undistributed Stock of the Corporate Partner, and for purposes of computing gain under

paragraph (e)(3) of this section, the partnership's basis of Stock of the Corporate Partner distributed to the partner equals the greater of—

(A) The partnership's basis of that distributed Stock of the Corporate Partner immediately before the distribution; or

(B) The fair market value of that distributed Stock of the Corporate Partner immediately before the distribution less the partner's allocable share of gain from all of the Stock of the Corporate Partner if the partnership sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately before the distribution.

(iii) *Section 732(f) basis reduction.* For purposes of determining the amount of the decrease to the basis of property held by a distributed corporation pursuant to section 732(f), the amount of this decrease shall be reduced by the amount of gain that a Corporate Partner has recognized under this section in the same Section 337(d) Transaction or in a prior Section 337(d) Transaction involving the property.

(3) *Gain recognition.* The Corporate Partner will recognize gain on a distribution of Stock of the Corporate Partner to the Corporate Partner to the extent that the partnership's adjusted basis in the distributed Stock of the Corporate Partner (as determined under paragraph (e)(2)(ii) of this section) immediately before the distribution exceeds the Corporate Partner's adjusted basis in its partnership interest immediately after the distribution.

(f) *Exceptions*—(1) *De minimis rule*—(i) *In general.* Unless Stock of the Corporate Partner is acquired as part of a plan to circumvent the purpose of this section, this section does not apply to a Corporate Partner if at the time that the partnership acquires Stock of the Corporate Partner or at the time of a revaluation event as described in § 1.704-1(b)(2)(iv)(f) (without regard to whether or not the partnership revalues its assets)—

(A) The Corporate Partner and any persons related to the Corporate Partner under section 267(b) or section 707(b) own in the aggregate less than 5 percent of the partnership;

(B) The partnership holds Stock of the Corporate Partner with a value of less than 2 percent of the partnership's gross assets (including the Stock of the Corporate Partner); and

(C) The partnership has never, at any point in time, held in the aggregate—

(1) Stock of the Corporate Partner with a fair market value greater than \$1,000,000; or

(2) More than 2 percent of any particular class of Stock of the Corporate Partner.

(ii) *De minimis rule ceases to apply.* If a partnership satisfies the conditions of the de minimis rule of paragraph (f)(1) of this section upon an acquisition of Stock of the Corporate Partner or revaluation event as described in § 1.704-1(b)(2)(iv)(f), but later fails to satisfy the conditions of the de minimis rule upon a subsequent acquisition or revaluation event, then solely for purposes of paragraph (d) of this section, the Corporate Partner may compute its gain on the subsequent acquisition or revaluation event as if it had already recognized gain at the previous event. Neither the Corporate Partner nor the partnership increases its basis by the gain the Corporate Partner would have recognized if the de minimis rule of paragraph (f)(1) of this section did not apply to the prior acquisition or revaluation event.

(2) *Certain dispositions of stock.* Unless acquired as part of a plan to circumvent the purpose of this section, this section does not apply to Stock of the Corporate Partner that—

(i) Is disposed of (by sale or distribution) by the partnership before the due date (including extensions) of its federal income tax return for the taxable year during which the Stock of the Corporate Partner is acquired (or for the taxable year in which the Corporate Partner becomes a partner, whichever is applicable); and

(ii) Is not distributed to the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of section 304(c), except that section 318(a)(1) and (3) shall not apply.

(g) *Tiered partnerships.* The rules of this section shall apply to tiered partnerships in a manner that is consistent with the purpose set forth in paragraph (a) of this section.

(h) *Examples.* The following examples illustrate the principles of this section. All amounts in the following examples are reported in millions of dollars:

*Example 1. Deemed redemption rule—contribution of Stock of the Corporate Partner.* (i) In Year 1, X, a corporation, and A, an individual, form partnership AX as equal partners in all respects. X contributes Asset 1 with a fair market value of \$100 and a basis of \$20. A contributes X stock, which is Stock of the Corporate Partner, with a basis and fair market value of \$100.

(ii) Because A and X are equal partners in AX in all respects, the partnership formation causes X's interest in X stock to increase from \$0 to \$50 and its interest in Asset 1 to decrease from \$100 to \$50. Thus, the partnership formation is a Section 337(d) Transaction because the formation has the effect of an exchange by X of \$50 of Asset 1 for \$50 of X stock.

(iii) X must recognize gain under paragraph (d) of this section with respect to Asset 1 to prevent the circumvention of section 311(b) principles. X's gain equals the product of X's Gain Percentage and the gain from Asset 1 that X would recognize (decreased, but not below zero, by any gain that X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, all assets were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If Asset 1 had been sold in a fully taxable transaction immediately before the formation of partnership AX, X's allocable share of gain would have been \$80. X's Gain Percentage is 50 percent (equal to a fraction, the numerator of which is X's \$50 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$40 of gain (\$80 multiplied by 50 percent) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$20 to \$60. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$20 to \$60 because Asset 1 is the appreciated property treated as the subject of the exchange.

*Example 2. Deemed redemption rule—contribution of stock in a corporation that controls the Corporate Partner.* (i) In Year 1, X, a corporation, and A, an individual, form partnership AX as equal partners in all respects. X contributes Asset 1 with a fair market value of \$100 and a basis of \$20. A contributes stock in P, with a basis and fair market value of \$100. P is the sole owner of X. P's interest in X constitutes 10 percent of P's total assets.

(ii) Because P controls X within the meaning of section 304(c), stock in P is Stock of the Corporate Partner under paragraph (c)(2)(i) of this section.

(iii) Because A and X are equal partners in AX in all respects, the partnership formation causes X's interest in Stock of the Corporate Partner stock to increase from \$0 to \$50 and its interest in Asset 1 to decrease from \$100 to \$50. Thus, the partnership formation is a Section 337(d) Transaction because the formation has the effect of an exchange by X of \$50 of Asset 1 for \$50 of Stock of the Corporate Partner.

(iv) X must recognize gain under paragraph (d) of this section with respect to Asset 1 to prevent the circumvention of section 311(b) principles. X's gain equals the product of X's Gain Percentage and the gain from Asset 1 that X would recognize (decreased, but not below zero, by any gain that X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, all assets were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If Asset 1 had been sold in a fully taxable transaction immediately before the formation of partnership AX, X's allocable share of gain would have been \$80. X's Gain Percentage is 50 percent (equal to a fraction,

the numerator of which is X's \$50 interest in Asset 1 effectively exchanged for Stock of the Corporate Partner, and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$40 of gain (\$80 multiplied by 50 percent) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$20 to \$60. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$20 to \$60 because Asset 1 is the appreciated property treated as the subject of the exchange.

*Example 3. Distribution of Stock of the Corporate Partner—pro rata distribution.* (i) The facts are the same as in *Example 1*(i) of this paragraph (h). AX liquidates in Year 9, when Asset 1 and the X stock each have a fair market value of \$200. X and A each receive 50 percent of Asset 1 and 50 percent of the X stock in the liquidation. At the time AX liquidates, X's basis in its AX partnership interest is \$60 and A's basis in its AX partnership interest is \$100.

(ii) When AX liquidates, X's interests in its stock and in Asset 1 do not change. Thus, the liquidation is not a Section 337(d) Transaction because it does not have the effect of an exchange by X of appreciated property for Stock of the Corporate Partner.

(iii) Paragraph (e) of this section applies because the distributed X stock was the subject of a previous Section 337(d) Transaction and because section 732(f) does not apply. Under § 1.732-1(c)(1)(iii), the distribution to X of X stock is deemed to immediately precede the distribution of 50 percent of Asset 1 to X for purposes of determining X's basis in the distributed property. For purposes of determining X's basis in Asset 1 and X's gain on distribution, the basis of the distributed X stock is treated as \$50, the greater of \$50 (50 percent of the stock's \$100 basis in the hands of the partnership), or \$50, the fair market value of that distributed X stock (\$100) less X's allocable share of gain from the distributed X stock if AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately before the distribution (\$50). Thus, X reduces its basis in its partnership interest by \$50 prior to the distribution of Asset 1. Accordingly, X's basis in the distributed portion of Asset 1 is \$10. Because AX's basis in the distributed X stock immediately before the distribution (\$50) does not exceed X's basis in its AX partnership interest immediately before the distribution (\$60), X recognizes no gain under paragraph (e)(3) of this section.

*Example 4. Distribution of Stock of the Corporate Partner—non pro rata distribution.* (i) The facts are the same as *Example 3*(i) of this paragraph (h), except that when AX liquidates, X receives 75 percent of the X stock and 25 percent of Asset 1 and A receives 25 percent of the X stock and 75 percent of Asset 1.

(ii) The liquidation of AX causes X's interest in X stock to increase from \$100 to \$150 and its interest in Asset 1 to decrease from \$100 to \$50. Thus, AX's liquidating distributions of X stock and Asset 1 to X are

a Section 337(d) Transaction because the distributions have the effect of an exchange by X of \$50 of Asset 1 for \$50 of X stock.

(iii)(A) X must recognize gain with respect to Asset 1 to prevent the circumvention of section 311(b) principles. Under paragraph (e)(1) of this section, paragraph (d) of this section is applied as if X and A amended the AX partnership agreement to allocate to X a 100 percent interest in the distributed portion of the X stock. X must recognize gain equal to the product of X's Gain Percentage and the gain from Asset 1 that X would have recognized (decreased, but not below zero, by any gain X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property.

(B) If Asset 1 had been sold in a fully taxable transaction immediately before the amendment of the AX partnership agreement, X's allocable share of gain would have been \$90, or the sum of X's \$40 remaining gain under section 704(c) and \$50 of the \$100 post-contribution appreciation. X's Gain Percentage is 50 percent (equal to a fraction, the numerator of which is X's \$50 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$45 of gain (\$90 multiplied by 50 percent) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$60 to \$105. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$60 to \$105 because Asset 1 is the appreciated property treated as the subject of the exchange.

(iv)(A) Paragraph (e) of this section applies because the distributed X stock was the subject of a previous Section 337(d) Transaction and because section 732(f) does not apply. Under § 1.732-1(c)(1)(iii), AX is treated as first distributing the X stock to X before the distribution of 25 percent of Asset 1. For purposes of determining X's basis in Asset 1 and X's gain on distribution, the basis of the distributed X stock is treated as \$100, the greater of \$75 (75 percent of the stock's \$100 basis in the hands of the partnership) or \$100, the fair market value of the distributed X stock (\$150) less X's allocable share of gain if the partnership had sold all of the X stock immediately before the distribution for cash in an amount equal to its fair market value (\$50). Thus, X will reduce its basis in its partnership interest by \$100 prior to the distribution of Asset 1. Accordingly, X's basis in the distributed portion of Asset 1 is \$5. Because AX's basis in the distributed X stock immediately before the distribution as computed for purposes of this section (\$100) does not exceed X's basis in its AX partnership interest immediately before the distribution (\$105), X recognizes no additional gain under paragraph (e)(3) of this section.

(B) For purposes of determining A's basis in Asset 1 and A's gain on distribution, the

basis of the distributed X stock is treated as \$25, the greater of \$25 (25 percent of the stock's \$100 basis in the hands of the partnership) or \$0, the fair market value of the distributed X stock (\$50) less A's allocable share of gain if the partnership had sold all of the X stock immediately before the distribution for cash in an amount equal to its fair market value (\$50). Thus, A will reduce its basis in its partnership interest by \$25 prior to the distribution of Asset 1. Accordingly, A's basis in the distributed portion of Asset 1 is \$75. Because AX's basis in the distributed X stock immediately before the distribution as computed for purposes of this section (\$100) does not exceed A's basis in its AX partnership interest immediately before the distribution (\$100), A recognizes no additional gain under paragraph (e)(3) of this section.

*Example 5. Deemed redemption rule—subsequent purchase of Stock of the Corporate Partner.* The facts are the same as *Example 1(i)* of this paragraph (h), except that A contributes cash of \$100 instead of X stock. In a later year, when the value of Asset 1 has not changed, AX uses the contributed cash to purchase X stock for \$100. AX's purchase of X stock has the effect of an exchange by X of appreciated property for X stock, and thus, is a Section 337(d) Transaction. X must recognize gain at the time, and to the extent, that X's share of appreciated property (other than X stock) is reduced in exchange for X stock. Thus, the consequences of the partnership's purchase of X stock are the same as those described in *Example 1(ii)* and *(iii)* of this paragraph (h), resulting in X recognizing \$40 of gain.

*Example 6. Change in allocation ratios—amendment of partnership agreement.* (i) The facts are the same as *Example 3(i)* of this paragraph (h), except that in Year 9, AX does not liquidate, and the AX partnership agreement is amended to allocate to X 80 percent of the income, gain, loss, and deduction from the X stock and to allocate to A 80 percent of the income, gain, loss, and deduction from Asset 1. If AX had sold the partnership assets immediately before the change to the partnership agreement, X would have been allocated \$90 of gain from Asset 1 and \$50 of gain from the X stock.

(ii) The amendment to the AX partnership agreement causes X's interest in its stock to increase from \$100 (50 percent of the stock value immediately before the amendment of the agreement) to \$160 (80 percent of stock value immediately following amendment of agreement) and its interest in Asset 1 to decrease from \$100 to \$40. Thus, the amendment of the partnership agreement is a Section 337(d) Transaction because the amendment has the effect of an exchange by X of \$60 of Asset 1 for \$60 of its stock.

(iii) X must recognize gain equal to the product of X's Gain Percentage and the gain from Asset 1 that X would have recognized (decreased, but not below zero, by any gain X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) if, immediately before the Section 337(d) Transaction, AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If

Asset 1 had been sold in a fully taxable transaction immediately before the amendment of the AX partnership agreement, X's allocable share of gain would have been \$90, or the sum of X's \$40 remaining gain under section 704(c) and 50 percent of the \$100 post-contribution appreciation. X's Gain Percentage is 60 percent (equal to a fraction, the numerator of which is X's \$60 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$100 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$54 of gain (\$90 multiplied by 60 percent) under the deemed redemption rule in paragraph (d) of this section. Under paragraph (d)(4)(i) of this section, X's basis in its AX partnership interest increases from \$60 to \$114. Under paragraph (d)(4)(ii) of this section, AX's basis in Asset 1 increases from \$60 to \$114 because Asset 1 is the appreciated property treated as the subject of the exchange.

*Example 7. Change in allocation ratios—admission and exit of a partner.* (i) The facts are the same as *Example 1(i)* of this paragraph (h). In addition, in Year 2, when the values of Asset 1 and the X stock have not changed, B contributes \$100 of cash to AX in exchange for a one-third interest in the partnership. Upon the admission of B as a partner, X's interest in Asset 1 decreases from \$50 to \$33.33, and its interest in B's contributed cash increases. B's admission is not a Section 337(d) Transaction because it does not have the effect of an exchange by X of its interest in Asset 1 for X stock. Accordingly, X does not recognize gain under paragraph (d) of this section.

(ii) In Year 9, when the values of Asset 1 and the X stock have not changed, the partnership distributes \$50 of cash and 50 percent of Asset 1 (valued at \$50) to B in liquidation of B's interest. X and A are equal partners in all respects after the distribution. Upon the liquidation of B's interest, X's interest in Asset 1 decreases from \$33.33 to \$25, and its interest in X stock increases from \$33.33 to \$50. AX's liquidation of B's interest has the effect of an exchange by X of appreciated property for X stock, and thus, is a Section 337(d) Transaction.

(iii) Pursuant to paragraph (d)(2) of this section, X's interest in X stock and other appreciated property held by the partnership is determined based on all facts and circumstances, including allocation and distribution rights in the partnership agreement. However, paragraph (d)(2) of this section also requires that X's interest in its stock for purposes of paragraph (d) will never be less than the Corporate Partner's largest interest (by value) in those shares of Stock of the Corporate Partner taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction (regardless of whether the Corporate Partner recognized gain in the earlier transaction). Although X's interest in X stock increases to \$50 upon AX's liquidation of B's interest, X's largest interest previously taken into account under paragraph (d)(1) of this section was \$50. Thus, X's interest in its stock is not considered to be increased, and X therefore recognizes no gain under paragraph (d) of

this section, provided that the transactions did not occur as part of a plan or arrangement to circumvent the purpose of this section.

**Example 8. Change in allocation ratios—plan to circumvent purpose of this section.** (i) In Year 1, X, a corporation, and A, an individual, contribute \$99 and \$1, respectively, to newly-formed partnership AX, with X receiving a 99 percent interest in AX and A receiving a 1 percent interest in AX. AX borrows \$100,000 from a third-party lender and uses the proceeds to purchase X stock, which is Stock of the Corporate Partner. Later, as part of a plan or arrangement to circumvent the purposes of this section, A contributes \$99,999 of cash, which AX uses to repay the loan, and X contributes Asset 1 with a fair market value of \$99,901 and basis of \$20,000. After these contributions, A and X are equal partners in AX in all respects.

(ii) Pursuant to paragraph (d)(2) of this section, X's interest in X stock and other appreciated property held by the partnership is determined based on all facts and circumstances, including allocation and distribution rights in the partnership agreement. Generally, pursuant to paragraph (d)(2) of this section, X's interest in X stock for purposes of paragraph (d) of this section will never be less than the Corporate Partner's largest interest (by value) in those shares of Stock of the Corporate Partner taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction (regardless of whether the Corporate Partner recognized gain in the earlier transaction). This limitation does not apply, however, if the reduction in X's interest in X's stock occurred as part of a plan or arrangement to circumvent the purpose of this section. Because the transactions described in this example are part of a plan or arrangement to circumvent the purpose of this section, the limitation in paragraph (d)(2) of this section does not apply. Accordingly, the deemed redemption rule under paragraph (d) of this section applies to the transactions with the consequences described in *Example 1(iii)* of this paragraph (h), resulting in X recognizing \$39,950.50 of gain.

**Example 9. Tiered partnership.** (i) In Year 1, X, a corporation, and A, an individual, form partnership UTP. X contributes Asset 1 with a fair market value of \$80 and a basis of \$0 in exchange for an 80 percent interest in UTP. A contributes \$20 of cash in exchange for a 20 percent interest in UTP. UTP and B, an individual, form partnership LTP as equal partners. UTP contributes Asset 1 and \$20 of cash. B contributes X stock, which is Stock of the Corporate Partner, with a basis and fair market value of \$100.

(ii) Pursuant to paragraph (g) of this section, the rules of this section shall apply to tiered partnerships in a manner that is consistent with the purpose set forth in paragraph (a) of this section. Pursuant to paragraph (d)(1) of this section, if X is in a partnership that engages in a Section 337(d) Transaction, X must recognize gain at the time, and to the extent, that X's share of appreciated property is reduced in exchange for X stock. The formation of LTP causes X's interest in X stock to increase from \$0 to \$40

and its interest in Asset 1 to decrease from \$64 to \$32. Thus, LTP's formation is a Section 337(d) Transaction because the formation has the effect of an exchange by X of \$32 of Asset 1 for \$32 of X stock.

(iii) X must recognize gain with respect to Asset 1 to prevent the circumvention of section 311(b) principles. X must recognize gain equal to the product of X's Gain Percentage and the gain from Asset 1 (decreased, but not below zero, by any gain X recognized with respect to Asset 1 in the Section 337(d) Transaction under any other provision of this chapter) that X would recognize if, immediately before the Section 337(d) Transaction, all assets were sold in a fully taxable transaction for cash in an amount equal to the fair market value of such property. If Asset 1 had been sold in a fully taxable transaction immediately before LTP's formation, X's allocable share of gain would have been \$80 pursuant to section 704(c). X's Gain Percentage is 50 percent (equal to a fraction, the numerator of which is X's \$32 interest in Asset 1 effectively exchanged for X stock, and the denominator of which is X's \$64 interest in Asset 1 immediately before the Section 337(d) Transaction). Thus, X recognizes \$40 of gain (\$80 multiplied by 50 percent) under the deemed redemption rule in paragraph (d) of this section. Under paragraphs (d)(4)(i) and (ii) of this section, X's basis in its UTP partnership interest increases from \$0 to \$40, UTP's basis in its LTP partnership interest increases from \$20 to \$60, and LTP's basis in Asset 1 increases from \$0 to \$40 pursuant to paragraph (g) of this section.

(i) **Applicability date.** This section applies to transactions occurring on or after June 12, 2015.

#### § 1.337(d)–3T [Removed]

■ **Par. 3.** Remove § 1.337(d)–3T.

■ **Par. 4.** Section 1.732–1 is amended by revising paragraphs (c)(1) and (c)(5)(ii) to read as follows:

#### § 1.732–1 Basis of distributed property other than money.

\* \* \* \* \*

(c) \* \* \*  
(1) **General rule**—(i) **Unrealized receivables and inventory items.** Except as provided in paragraph (c)(1)(iii) of this section, the basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in § 1.732–1(c)(2)(i). See § 1.460–4(k)(2)(iv)(D) for a

rule determining the partnership's basis in long-term contract accounted for under a long-term contract method of accounting.

(ii) **Other distributed property.** Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section or to stock of persons that control the corporate partner or to the corporate partner's stock under paragraph (c)(1)(iii) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in § 1.732–1(c)(2).

(iii) **Stock distributed to the corporate partner.** If a partnership makes a distribution described in § 1.337(d)–3(e)(1), then for purposes of this section, the basis to be allocated to properties distributed under section 732(a)(2) or (b) is allocated first to the Stock of the Corporate Partner, as defined in § 1.337(d)–3(c)(2), before the distribution of any other property (other than cash). The amount allocated to the Stock of the Corporate Partner is as provided in § 1.337(d)–3(e)(2).

\* \* \* \* \*

(5) \* \* \*

(ii) **Exception.** Notwithstanding paragraph (c)(5)(i) of this section, the first sentence of each of paragraphs (c)(1)(i) and (ii) of this section, and paragraph (c)(1)(iii) of this section in its entirety, apply to distributions of Stock of the Corporate Partner, as defined in § 1.337(d)–3(c)(2), that occur on or after June 12, 2015.

\* \* \* \* \*

#### § 1.732–1T [Removed]

■ **Par. 5.** Remove § 1.732–1T.

■ **Par. 6.** Section 1.732–3 is revised to read as follows:

#### § 1.732–3 Corresponding adjustment to basis of assets of a distributed corporation controlled by a corporate partner.

(a) **Determination of control.** The determination of whether a corporate partner that is a member of a consolidated group has control of a distributed corporation for purposes of section 732(f) shall be made by applying the special aggregate stock ownership rules of § 1.1502–34.

(b) *Aggregation of basis within consolidated group.* With respect to distributed stock of a corporation, if the following two conditions are met, then section 732(f) shall apply only to the extent that the partnership's adjusted basis in the distributed stock immediately before the distribution exceeds the aggregate basis of the distributed stock of the corporation in the hands of corporate partners that are members of the same consolidated group (as defined in § 1.1502-1(h)) immediately after the distribution:

(1) Two or more of the corporate partners receive a distribution of stock in another corporation; and

(2) The corporation, the stock of which was distributed by the partnership, is or becomes a member of the distributee partners' consolidated group following the distribution.

(c) *Application of section 732(f) to Gain Elimination Transactions—(1) General rule.* In the event of a Gain Elimination Transaction, section 732(f) shall apply as though the Corporate Partner acquired control (as defined in section 732(f)(5)) of the Distributed Corporation immediately before the Gain Elimination Transaction.

(2) *Definitions.* The following definitions apply for purposes of this paragraph (c):

(i) *Corporate Partner.* The term *Corporate Partner* means a person that is classified as a corporation for federal income tax purposes and that holds or acquires an interest in a partnership.

(ii) *Stock.* The term *Stock* includes other equity interests, including options, warrants, and similar interests.

(iii) *Distributed Stock.* The term *Distributed Stock* means Stock distributed by a partnership to a Corporate Partner, or Stock the basis of which is determined by reference to the basis of such Stock. *Distributed Stock* also includes Stock owned directly or indirectly by a Distributed Corporation if the basis of such Stock has been reduced pursuant to section 732(f).

(iv) *Distributed Corporation.* The term *Distributed Corporation* means the issuer of Distributed Stock (or, in the case of an option, the issuer of the Stock into which the option is exercisable).

(v) *Gain Elimination Transaction.* The term *Gain Elimination Transaction* means a transaction in which Distributed Stock is disposed of and less than all of the gain is recognized unless—

(A) The transferor of the Distributed Stock receives in exchange Stock or a

partnership interest that is exchanged basis property (as defined in section 7701(a)(44)) with respect to the Distributed Stock; or

(B) A transferee corporation holds the Distributed Stock as transferred basis property (as defined in section 7701(a)(43)) with respect to the transferor corporation's gain. A Gain Elimination Transaction includes (without limitation) a reorganization under section 368(a) in which the Corporate Partner and the Distributed Corporation combine, and a distribution of the Distributed Stock by the Corporate Partner to which section 355(c)(1) or 361(c)(1) applies.

(d) *Tiered partnerships.* The rules of this section shall apply to tiered partnerships in a manner that is consistent with the purposes of section 732(f).

(e) *Applicability date.* This section applies to transactions occurring on or after June 8, 2018.

**Kirsten Wielobob,**

*Deputy Commissioner for Services and Enforcement.*

Approved: May 25, 2018.

**David J. Kautter,**

*Assistant Secretary of the Treasury (Tax Policy).*

[FR Doc. 2018-12407 Filed 6-7-18; 8:45 am]

**BILLING CODE 4830-01-P**

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## DEPARTMENT OF HOMELAND SECURITY

### Coast Guard

#### 33 CFR Part 117

[Docket No. USCG-2018-0516]

#### Drawbridge Operation Regulation; Charles River, Boston, MA

**AGENCY:** Coast Guard, DHS.

**ACTION:** Notice of deviation from drawbridge regulation.

**SUMMARY:** The Coast Guard has issued a temporary deviation from the operating schedule that governs the Massachusetts Department of Transportation (Craigie) Bridge across Charles River, mile 1.0, at Boston, Massachusetts. This deviation is necessary to facilitate the Boston Pops Fireworks Spectacular on July 4, 2018, and allows the bridge to remain in the closed position for two hours.

**DATES:** This deviation is effective from 11 p.m. on July 4, 2018 through 1 a.m. on July 5, 2018.

**ADDRESSES:** The docket for this deviation, USCG-2018-0516 is available at <http://www.regulations.gov>. Type the docket number in the "SEARCH" box and click "SEARCH". Click on Open Docket Folder on the line associated with this deviation.

**FOR FURTHER INFORMATION CONTACT:** If you have questions on this temporary deviation, call or email Jeffrey Stieb, Bridge Management Specialist, First District Bridge Branch, U.S. Coast Guard; telephone 617-223-8364, email [Jeffrey.D.Stieb@uscg.mil](mailto:Jeffrey.D.Stieb@uscg.mil).

**SUPPLEMENTARY INFORMATION:** The Massachusetts Department of Transportation (Craigie) Bridge across Charles River, mile 1.0, at Boston, Massachusetts, has a vertical clearance of 12 feet at normal pool in the closed position. The existing drawbridge operating regulations are listed at 33 CFR 117.591(e).

The Massachusetts Department of Transportation requested a temporary deviation from the normal operating schedule. This temporary deviation will allow the bridge to remain closed from 11 p.m. on July 4, 2018 through 1 a.m. on July 5, 2018 to allow pedestrian traffic to exit the Boston Pops Fireworks Spectacular. The waterway is used extensively by recreational traffic during the fireworks display. A State Police Unit will be on-scene to direct vessel traffic. Vessels that can pass under the bridge in the closed position may do so at any time. The bridge will be able to open for emergencies. There is no alternate route for vessels to pass. The Coast Guard will inform users of the waterway of the change in operating schedule through our Local and Broadcast Notices to Mariners so that vessel operators can arrange their transits to minimize any impact caused by the temporary deviation.

In accordance with 33 CFR 117.35(e), the drawbridge must return to its regular operating schedule immediately at the end of the effective period of this temporary deviation. This deviation from the operating regulations is authorized under 33 CFR 117.35.

Dated: June 4, 2018.

**C.J. Bisignano,**

*Supervisory Bridge Management Specialist, First Coast Guard District.*

[FR Doc. 2018-12310 Filed 6-7-18; 8:45 am]

**BILLING CODE 9110-04-P**