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subject:

This Chief Counsel Advice responds to your memorandum dated December 7, 2015. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Parent1 =
Parent2 =
Partnership1 =
Partnership2 =
Corporation1 =
Corporation2 =
Corporation3 =
SubsidiaryA =

SubsidiaryB =
SubsidiaryC =

SubsidiaryD =

SubsidiaryE =
SubsidiaryF =
SubsidiaryG =
SubsidiaryH =
Business =
Brand =
Year1 =
Year2 =
Year3 =
Year4 =
Year5 =
Year6 =
Year7 =
Year8 =
Year9 =
n1 =
n2 =
n3 =
n4 =
n5 =
n6 =
n7 =
n8 =
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n10 =
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n28 =

ISSUES

1. Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a reorganization to which § 368(a)(1)(A) and/or (D) applies is considered a transfer by sale or exchange for purposes of § 743(b).
2. Whether § 743(b) adjustments are subject to reallocation under § 704(b).
3. Under the circumstances described below, whether §1.1502-13 permits the Taxpayer's consolidated group (the "Taxpayer Group") to claim increased deductions for depreciation and amortization that are attributable to § 743(b) adjustments arising from the transfer of a partnership interest in an intercompany reorganization to which § 368 applies and from the distribution of a partnership interest in an intercompany liquidation to which § 332(a) applies.[1]

4. Under the circumstances described below, whether the basis adjustment provisions of § 743(b) conflict with the basis provisions of § 362(a) when a partnership interest is transferred in an intercompany reorganization to which § 368 applies or with the basis provisions of § 334(b)(1) when a partnership interest is distributed in an intercompany liquidation to which § 332(a) applies.

CONCLUSIONS

1. The transfer of a partnership interest in a complete liquidation to which § 332(a) applies or in a reorganization to which § 368(a)(1)(A) and/or (D) applies is considered a transfer by sale or exchange for purposes of § 743(b).

2. Section 743(b) adjustments are not subject to reallocation under § 704(b) because they are personal to the transferee and do not affect common basis.

3. Under the circumstances described below, §1.1502-13 does not permit the Taxpayer Group to claim increased deductions for depreciation and amortization that are attributable to § 743(b) adjustments arising from the transfer of a partnership interest in an intercompany reorganization to which § 368 applies and from the distribution of a partnership interest in an intercompany liquidation to which § 332(a) applies.

4. Under the circumstances described below, the basis adjustment provisions of § 743(b) do not conflict with the basis provisions of § 362(a) when a partnership interest is transferred in an intercompany reorganization to which § 368 applies or with the basis provisions of § 334(b)(1) when a partnership interest is distributed in an intercompany liquidation to which § 332(a) applies.

FACTS

[1] [redacted]

In Year1, Parent1 and Parent2 formed a joint venture to combine the operations of each of their Business under the Brand name. At the time, Parent1 and Parent2 were unrelated corporations and each was the common parent of its respective consolidated group. All subsidiaries mentioned below are domestic. As part of the transaction, Partnership1 was formed in Year1. SubsidiaryA (which was owned n1% by Parent1 and n1% by Parent2) owned n2% of the membership interests in Partnership1 and served as the managing member. SubsidiaryB, an indirect subsidiary of Parent2, and SubsidiaryC, an indirect subsidiary of Parent1, each contributed substantially all of their Business assets to Partnership1 in exchange for the remaining membership interests in Partnership1, approximately n3% and n4%, respectively.

In Year2, Parent1 and Parent2, indirectly through Partnership1, acquired the outstanding stock of unrelated Corporation1 for cash of $n5. The acquisition was structured as follows. Partnership1 formed Corporation2 as an acquisition vehicle. SubsidiaryD, an indirect subsidiary of Parent2, and SubsidiaryE, an indirect subsidiary of Parent1, made cash contributions of $n6 and $n7, respectively, to Partnership1 in exchange for membership interests in Partnership1. Partnership1 then contributed this cash to Corporation2 which was used to acquire the outstanding stock of Corporation1, via a merger of Corporation1 into Corporation2.

Later in Year2, Partnership1 formed a lower-tier partnership, Partnership2, to hold the combined Business assets of Partnership1 and Corporation2. Partnership1 contributed substantially all of its operating assets to Partnership2 in exchange for a n8% membership interest in Partnership2, and Corporation2 contributed substantially all of its assets (which consisted primarily of stock of subsidiaries) to Partnership2 in exchange for a n9% membership interest in Partnership2. As a result of the contributions, Partnership1 and Corporation2 essentially became holding companies.

In Year3, Parent2 acquired Corporation3 for $n10, and Parent2's name was changed to Taxpayer. Partnership1, Partnership2, and SubsidiaryA were all renamed at this time. In Year4, Taxpayer (formerly Parent2) acquired all of the stock of Parent1 in an all-stock acquisition valued at $n11. Taxpayer continued to be the common parent of the Taxpayer Group, which now includes Parent 1 and the former members of Parent 1's consolidated group. (The Taxpayer Group includes, at all relevant times, all of the corporations referenced below.)

SubsidiaryD and SubsidiaryE each had a relatively high basis in its membership interest in Partnership1 as a result of the Year2 cash contributions to Partnership1 that Partnership1 used to acquire Corporation1 stock for $n5. SubsidiaryB and SubsidiaryC each had a relatively low basis in its membership interest in Partnership1 as a result of their contribution of historic Business assets to Partnership1 when the original joint venture was formed in Year1.

In Year6, Partnership1 partially redeemed the membership interests held by SubsidiaryB and SubsidiaryC. Partnership1 distributed n12% of its Corporation2 stock to these distributee partners (n13% to SubsidiaryB and n14% to SubsidiaryC). After the partial redemption, Corporation2 became a member of the Taxpayer Group. At the time of the partial redemption, both Partnership1 and Partnership2 had § 754 elections in place. SubsidiaryB and SubsidiaryC had a combined outside basis in Partnership1 of approximately $n15 prior to the partial redemption. Following the distribution, the Taxpayer Group claimed a § 734(b) basis adjustment of approximately $n16 derived from the difference between the excess partnership inside basis in Corporation2 stock of approximately $n5 and SubsidiaryB's and SubsidiaryC's combined outside basis of approximately $n15. SubsidiaryB and SubsidiaryC took a combined carryover basis of approximately $n15 in the Corporation2 stock and their outside basis in Partnership1 was reduced to $n17.

Starting in Year2, pursuant to the Partnership1 and Partnership2 partnership agreements, gains attributable to pre-formation contributions were tracked and allocated to the contributing partners as required by § 704(c). Additional layers of reverse § 704(c) gain were created from revaluations in Year2, Year6, Year7, and Year8. The § 704(c) allocations to SubsidiaryB and SubsidiaryC remained unchanged after the Year6 distribution of Corporation2 stock despite the significant reductions in their interests in Partnership1's capital.

In Year9, the Taxpayer Group engaged in another restructuring of its corporate subsidiaries engaged in Business. At that time, interests in Partnerhip1 were held by SubsidiaryA, SubsidiaryB, SubsidiaryC, SubsidiaryE, and SubsidiaryF.[2] SubsidiaryB and SubsidiaryC, the two partners that received distributions of Corporation2 stock in Year6, were merged or liquidated (as described more fully below) into other members of the Taxpayer Group. As a result of these transactions, SubsidiaryE and SubsidiaryF, each a direct partner in Partnership1, acquired additional interests in Partnership1.

At the time of the Year9 restructuring, SubsidiaryB was owned n18% by SubsidiaryG and n19% by SubsidiaryH. SubsidiaryB distributed cash to SubsidiaryG in redemption of its stock, and then merged upstream into SubsidiaryH in a transaction purported to qualify as a complete liquidation under § 332. Immediately thereafter, SubsidiaryH merged sideways into SubsidiaryF in a transaction purported to qualify as a reorganization under § 368(a)(1)(A) and (D) (the "Reorganization"). Neither SubsidiaryB nor SubsidiaryH recognized an amount of gain or loss with respect to their transfers of the interest in Partnership1, and SubsidiaryH and SubsidiaryF took a basis in the interest equal to that of the respective transferor.

SubsidiaryC, which was wholly owned by SubsidiaryE, merged upstream into SubsidiaryE in a transaction purported to qualify as a complete liquidation under § 332

[2] Ownership of Partnership1 interests changed during the period spanning Year2 to Year9; however, such changes are not relevant to the issues at hand.

(the "Liquidation"). SubsidiaryC recognized no amount of gain or loss with respect to its transfer of its interest in Partnership1, and SubsidiaryE took a basis in the interest equal to that of the transferor, SubsidiaryC.

Finally, SubsidiaryA distributed its interest in Partnership1 to SubsidiaryE, in a distribution to which §§ 301 and 311(b) applied (the "Distribution").

Partnership1 and Partnership2 each had § 754 election in place at the time of the Year9 transactions. Accordingly, the Taxpayer Group took the position that the Reorganization, the Liquidation, and the Distribution resulted in transfers of partnership interests that are considered transfers by sale or exchange under § 743(b). The transfers, including those pursuant to the purported nonrecognition transactions, therefore, triggered a step-up in basis of partnership assets owned by Partnership1 and its lower-tier partnership, Partnership2. The Taxpayer Group calculated a net § 743(b) adjustment of $n20 for the transfers of Partnership1 interests pursuant to the Reorganization[3] and the Liquidation; of this amount, $n21 arose from the transfer in the Reorganization and was allocated solely to SubsidiaryF, and $n22 arose from the transfer in the Liquidation and was allocated solely to SubsidiaryE. The Taxpayer Group calculated a net § 743(b) adjustment of $n23 for the indirect transfers of Partnership2 pursuant to such transactions; of this amount, $n24 arose from the transfer in the Reorganization and was allocated solely to SubsidiaryF and $n25 arose from the transfer in the Liquidation and was allocated solely to SubsidiaryE.

For Year9, the § 743(b) basis adjustments associated with the transfers of Partnership1 pursuant to the Reorganization and the Liquidation, and the indirect transfers of Partnership2 pursuant to such transactions, resulted in additional depreciation and amortization deductions in the amount of $n26, of which $n27 was allocated solely to SubsidiaryF and $n28 was allocated solely to SubsidiaryE.

Thus, as a result of the Reorganization and Liquidation, the Taxpayer Group claimed additional depreciation and amortizations deductions of $n26 on its consolidated federal income tax return for Year9.

LAW AND ANALYSIS

Issue 1: Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a reorganization to which § 368(a)(1)(A) and/or (D) applies is a transfer by sale or exchange for purposes of § 743(b).

[3] The § 743(b) basis adjustment for a subsequent transferee of a partnership interest is separately determined by reference to the common basis of partnership assets without regard to the prior transferee's § 743(b) basis adjustment. §1.743-1(f). However, while the § 743(b) basis adjustment for each of SubsidiaryH and SubsidiaryF was separately determined, the amount of each successive § 743(b) basis adjustment was identical because the interest in Partnership1 was immediately transferred from SubsidiaryB to SubsidiaryH to SubsidiaryF.

Section 743(b) provides that in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in § 754 is in effect or which has a substantial built-in loss immediately after such transfer shall (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his adjusted share of the adjusted basis of the partnership property, or (2) decrease the adjusted basis of the partnership property by the excess of the transferee's proportionate share of the adjusted basis of the partnership property over the basis of its interest in the partnership.

Sale or exchange is not defined in § 743, the regulations thereunder, or the legislative history of the provision. Section 743 was enacted to ameliorate the tax consequences to a transferee partner by giving a partnership the option to eliminate discrepancies between a transferee partner's inside and outside basis when the partnership's inside basis in its property is not equal to the fair market value of the property. Jt. Comm. On Taxation, Summary of the New Provisions of the Internal Revenue Code of 1954, at 92 (1955).

General Counsel Memorandum 35921 (July 29, 1974) held that for purposes of § 743(b), a transfer of a partnership in a liquidation under former § 333 was not a transfer of an interest by sale or exchange. As demonstrated by the GCM, whether the distribution of a partnership interest by a liquidating corporation was a sale or exchange was considered an open question prior to the Deficit Reduction Act of 1984 (1984 Act). See, e.g., John S. Pennell and Terence F. Cuff, "Tax Results of Liquidation of Corporate Partner Still Unclear Despite DRA 1984," Journal of Taxation, Vol. 62, No. 2 (February 1985).

Section 761(e), enacted as part of the 1984 Act, provides that except as otherwise provided in regulations, for purposes of (1) § 708 (relating to continuation of partnership), (2) § 743 (relating to optional adjustment to basis of partnership property), and (3) any other provision of this subchapter specified in regulations prescribed by the Secretary, any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

The regulations under § 761 do not limit the definition of exchange to taxable exchanges for purposes of § 743. In particular, no provisions limit the definition of an exchange between related parties or members of a consolidated group. The transactions at issue here involved the distribution of a partnership interest as part of the complete liquidation of a corporate partner, and the transfer of a partnership interest as part of the reorganization of a corporate partner. Consequently, these transactions constitute an exchange for purposes of § 743 under the provisions of § 761(e).

Issue 2: Whether § 743(b) adjustments are subject to reallocation under § 704(b).

Section 703(a) provides that the taxable income of a partnership shall be computed in the same manner as in the case of an individual except for certain enumerated exceptions, including the requirement that items described in § 702(a) shall be separately stated.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 743(b) provides, in relevant part, that in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in § 754 is in effect or which has a substantial built-in loss immediately after such transfer shall (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or (2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership. Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with its interest in partnership capital and, in the case of property contributed to the partnership by a partner, § 704(c) (relating to contributed property) shall apply in determining such share.

Section 1.704-1(b)(iii) provides, in relevant part, that the determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under § 704(b) is not conclusive as to the tax treatment of a partner with respect to such distributive share. If a partnership has a § 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in §1.743-1.

Section 1.704-1(b)(2)(iv)(m)(1) provides that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of paragraph (b)(2)(iv) unless, upon adjustment to the adjusted tax basis of partnership property under § 732, 734, or 743, the capital accounts of the partners are adjusted as provided in paragraph (b)(2)(iv)(m).

Section 1.704-1(b)(2)(iv)(m)(2) provides, in relevant part, that in the case of a transfer of all or a part of an interest in a partnership that has a § 754 election in effect for the partnership taxable year in which the transfer occurs, adjustments to the adjusted tax

basis of partnership property under § 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment.

Section 1.743-1(j)(1) provides that the basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee only. No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under § 743(b) and the regulations. The adjustment to the basis of partnership property under § 743(b) has no effect on the partnership's computation of any item under § 703.

Partnership1 and Partnership2 each had a § 754 election in effect for Year9. As described above, the Year9 transactions are sales or exchanges for purposes of § 743(b). Consequently, Partnership1 and Partnership2 are required to adjust the basis of the partnership property with respect to transferees as required by § 743(b) and the underlying regulations. Adjustments to the adjusted tax basis of partnership property under § 743 are not reflected in the capital account of the transferee partner or on the books of the partnership. §1.704-1(b)(2)(iv)(m)(2). No adjustment is made to the common basis of partnership property, and the § 743(b) adjustment has no effect on the partnership's computation of any item under § 703. §1.743-1(j)(1). Section 743(b) adjustments are personal to the transferee partners and are not subject to reallocation under § 704(b).

Issue 3: Whether §1.1502-13 permits the Taxpayer Group to claim increased deductions for depreciation and amortization that are attributable to § 743(b) adjustments arising from the transfer of a partnership interest in an intercompany reorganization to which § 368 applies and from the distribution of a partnership interest in an intercompany liquidation to which § 332(a) applies.[4]

Section 1.1502-13 provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions ("the intercompany transaction regulations"). The purpose of these regulations is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). §1.1502-13(a)(1).

The amount and location of the item (or items) of each member to an intercompany transaction (intercompany items and corresponding items) are determined on a

[4] We do not address the application of §1.1502-13 to the Distribution (SubsidiaryA's taxable distribution of its interest in Partnership1 to SubsidiaryE). We understand that this interest in Partnership1 was negligible, and that the amount recognized with respect to the Distribution and the amount of any associated §743(b) adjustments, were not significant.

separate entity basis (separate entity treatment), but the timing, character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined to produce the effect of transactions between divisions of a single corporation (single entity treatment). §1.1502-13(a)(2).

An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. §1.1502-13(b)(1)(i). The parties to an intercompany transaction are identified as S, the member transferring property or providing services, and B, the member receiving the property or services. §1.1502-13(b)(1)(i). Intercompany transactions include, for example, S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized; and S's distribution to B with respect to S stock. §1.1502-13(b)(1)(i).

S's income, gain, deduction, and loss from an intercompany transaction, whether directly or indirectly, are its intercompany items. §1.1502-13(b)(2)(i). S's intercompany items include amounts from an intercompany transaction that are not yet taken into account under its separate entity method of accounting, and amounts reflected in basis (or amounts equivalent to basis) under S's separate entity method of accounting that is a substitute for income, gain, deduction, or loss from an intercompany transaction. §1.1502-13(b)(2)(iii).

B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. §1.1502-13(b)(3)(i). An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction). §1.1502-13(b)(3)(i). B's corresponding items include amounts that are permanently disallowed or permanently eliminated, whether directly or indirectly; thus, for example, corresponding items include an amount not recognized under § 332 (nonrecognition on liquidating distributions). §1.1502-13(b)(3)(ii).

The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. §1.1502-13(b)(4). For example, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B's corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the property would have if S and B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account. §1.1502-13(b)(4).

The attributes of an intercompany item or corresponding item are all of the item's characteristics (except amount, location, and timing) necessary to determine the item's effect on taxable income (and tax liability). §1.1502-13(b)(6). For example, attributes of

an item include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under § 382(h) or § 384. §1.1502-13(b)(6).

In general, for each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the rules of §1.1502-13(c). The separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. §1.1502-13(c)(1)(i). Thus, the activities of both S and B might affect the attributes of both intercompany items and corresponding items. §1.1502-13(c)(1)(i).

B takes its corresponding item into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing. §1.1502-13(c)(2)(i). For example, if B's sale of property acquired from S is treated as a dealer disposition because of S's activities, § 453(b) prevents any corresponding income of B from being taken into account under the installment method. §1.1502-13(c)(2)(i).

S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item. §1.1502-13(c)(2)(ii). That is, the amount of S's intercompany item taken into account in any year equals the hypothetical amount that the single entity would take into account for that year (the recomputed corresponding item) minus the amount of B's corresponding item.

As divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring). §1.1502-13(c)(3). For example, S's sale of land to B for cash is not disregarded, but is treated as an exchange of land for cash between divisions (and B therefore succeeds to S's basis in the property). §1.1502-13(c)(3).

Special rules for redetermining and allocating attributes are found in §1.1502-13(c)(4). Under §1.1502-13(c)(4)(ii), to the extent S's intercompany item and B's corresponding item do not offset in amount, the attributes redetermined under §1.1502-13(c)(1)(i) must be allocated to S's intercompany item and B's corresponding item by using a method that is reasonable in light of all the facts and circumstances, including the purposes of this section and any other rule affected by the attributes of S's intercompany item and B's corresponding item.

Section 1.1502-13(c)(6) provides special rules for the treatment of S's intercompany items if B's corresponding items are excluded or nondeductible. Section 1.1502-13(c)(6)(i) begins with the general statement that, *under §1.1502-13(c)(1)(i), S's*

intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount (emphasis added). This general statement is illustrated by an example in which S's intercompany loss from the sale of property to B is treated as a noncapital, nondeductible amount if B distributes the property to a nonmember shareholder at no further gain or loss (because, if S and B were divisions of a single corporation, the loss would not have been recognized under § 311(a)).

Section 1.1502-13(c)(7)(ii), Example (9) illustrates application of the matching rule to an intercompany sale of a partnership interest. In the example, S owns a 20% interest in the capital and profits of a general partnership which has an election under § 754 in effect. The partnership holds land for investment with a basis equal to its value, and depreciable assets which have value in excess of basis. S's basis in its partnership interest equals its share of the adjusted basis of the partnership's land and depreciable assets. On January 1 of Year 1, S sells its partnership interest to B at a gain. During Years 1 through 10, the partnership depreciates the operating assets, and B's depreciation deductions from the partnership reflect the increase in the basis of the depreciable assets under § 743(b).[5] §1.1502-13(c)(7)(ii), Example (9)(a).

In the example, S's gain is taken into account during Years 1 through 10 to reflect the difference in each year between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions from the partnership. Under §1.1502-13(c)(1)(i) and §1.1502-13(c)(4)(i), S's gain taken into account is ordinary income. §1.1502-13(c)(7)(ii), Example (9)(b).

The example also posits an alternative set of facts in which the partnership sells a portion of its depreciable assets to a third party at a gain on December 31 of Year 4. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, S takes intercompany gain into account in Year 4 to reflect the difference between B's partnership items taken into account from the sale (which reflect the basis increase under § 743(b)) and the recomputed partnership items. The attributes of S's additional gain are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation (recapture income or § 1231). §1.1502-13(c)(7)(ii), Example (9)(c),

The Taxpayer Group has taken the position that the transfers of Partnership1 interests in the Year9 Reorganization and Liquidation resulted in a step-up in basis of the assets owned by Partnership1 and Partnership2, pursuant to § 743(b) and the regulations thereunder. The net § 743(b) basis adjustment for the transfers of interests in Partnership1 pursuant to the Reorganization and Liquidation was $n20, and the net § 743(b) basis adjustment for the indirect transfers of interests in Partnership2 pursuant to such transactions was $n23. As a result of these adjustments, the transferees,

[5] The depreciation and amortization deductions are corresponding items even though they arise indirectly from the intercompany sale. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction). §1.1502-13(b)(3)(i).

SubsidiaryF and Subsidiary E, claimed increased depreciation and amortization deductions in the amount of $n26 for the Taxpayer Group's taxable year ending in Year9. However, because the transfers occurred pursuant to nonrecognition transactions, the transferors, SubsidiaryH and SubsidiaryC, recognized no corresponding amount of income or gain.

At issue here is the appropriate treatment, under the intercompany transaction regulations, of these additional items of depreciation and amortization that are indirectly attributable to the Reorganization and Liquidation.

The merger of SubsidiaryH into SubsidiaryF (the Reorganization), as well as the liquidation of SubsidiaryC into SubsidiaryE (the Liquidation), are both intercompany transactions; each is a transaction between corporations that are members of the Taxpayer Group immediately after the transaction.[6] In the Reorganization, SubsidiaryH is the 'selling member' and SubsidiaryF is the 'buying member.' In the Liquidation, SubsidiaryC is the selling member and SubsidiaryE is the buying member.

S's gain from an intercompany transaction is an intercompany item. §1.1502-13(b)(2)(i). The selling members (SubsidiaryH and SubsidiaryC) each realized an amount of gain with respect to their interest in Partnership1, however, such amounts were not recognized (either under § 337 or § 361). Thus, SubsidiaryH and SubsidiaryC each have an intercompany item of $0.

B's deductions, whether directly or indirectly, from an intercompany transaction or from property acquired in an intercompany transaction are corresponding items. §1.1502-13(b)(3)(i). Thus, SubsidiaryF's and SubsidiaryE's increased depreciation and amortization deductions that flow through from Partnership1 (and Partnership2) as a result of their acquisitions of the Partnership1 interests in the Reorganization and Liquidation, respectively, constitute corresponding items.

An item's attributes are all of its characteristics (except amount, location, and timing) necessary to determine the item's effect on taxable income (and tax liability); such attributes include treatment as a noncapital, nondeductible amount. §1.1502-13(b)(6). Under the matching rule, the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction

[6] Section 1.1502-13(j)(2)(i) provides that a reference to a person includes, as the context requires, a reference to a predecessor or successor. For this purpose, a predecessor includes a transferor of assets to a transferee (the "successor") in a transaction to which § 381(a) applies. §1.1502-13(j)(2)(i). Thus, although SubsidiaryH and SubsidiaryC each ceased to exist as a result of the Reorganization and Liquidation, respectively, SubsidiaryF and SubsidiaryE are 'successors' for purposes of applying the rules of §1.1502-13.

between divisions. §1.1502-13(c)(1)(i).[7] Although the intercompany transaction regulations most often redetermine the attributes of the seller's intercompany item, the regulations specifically provide for redetermination of the buyer's corresponding item (or items) in order to achieve the appropriate single-entity result. §1.1502-13(c)(1)(i); *see e.g.*, §1.1502-13(c)(7)(ii), Example 5(e).

Basis adjustments required by § 743(b) constitute an adjustment to the basis of partnership property with respect to the transferee only; importantly, such adjustments are segregated and allocated solely to the transferee partner for whom the adjustment is made. § 743(b) and §1.743-1(j). Thus, for purposes of calculating income, deduction, gain, and loss, *the transferee has a special basis* for those partnership properties that are adjusted under § 743(b). §1.743-1(j).

SubsidiaryF's and SubsidiaryE's corresponding items, consisting of increased depreciation and amortization deductions that flow through from Partnership1 and Partnership2, arise solely from the creation of this special basis under § 743(b). This special basis and its tax treatment is a characteristic of SubsidiaryF's and SubsidiaryE's corresponding items, necessary to determine the items' effects on taxable income (and tax liability). Thus, SubsidiaryF's and SubsidiaryE's entitlement to the depreciation and amortization deductions that stem from this special basis, is an attribute to be considered separate and apart from the items generated in the Reorganization and Liquidation (but only to the extent necessary to achieve the effect as if the transferors and transferees were divisions of a single corporation). *See* §1.1502-13(b)(6) and §1.1502-13(c)(1)(i).

Under §1.1502-13(c)(1)(i), the attributes of SubsidiaryF's and SubsidiaryE's depreciation and amortization deductions must be redetermined to the extent necessary to produce the same effect on consolidated taxable income as if the Reorganization and Liquidation were between divisions of a single corporation. If the respective transferor members, SubsidiaryH and SubsidiaryC, and the respective transferee members, SubsidiaryF and SubsidiaryE, were divisions of a single corporation, the transferee members would succeed to the transferor members' basis in the Partnership1 interest, precisely the result accomplished here (pursuant to §§ 334(b) and 362(b)).

However, if SubsidiaryH and SubsidiaryF, and SubsidiaryC and SubsidiaryE, respectively, were divisions of a single corporation, the transfers of the Partnership1 interests would not result in, and the single corporation would not be entitled to claim, a net deduction for the increased depreciation and amortization arising from the special basis adjustments under § 743(b). Thus, to achieve the effect of single entity treatment, SubsidiaryF's depreciation and amortization deductions of $n27 and SubsidiaryE's depreciation and amortization deductions of $n28 must be redetermined to be treated as noncapital, nondeductible items (because, as divisions of a single corporation,

[7] As divisions of a single corporation, the intercompany transactions are not ignored; thus, SubsidiaryH and SubsidiaryC are treated as engaging in an actual transfer of the interests in Partnership1, and SubsidiaryF and SubsidiaryE are treated as owning the interests in Partnership1. §1.1502-13(c)(3).

§ 743(b) would not give rise to a net deduction for depreciation and amortization for the Taxpayer Group). *See* §1.1502-13(c)(1)(i); *see also* §1.1502-13(c)(4)(ii) (when the amounts of S's intercompany item and B's corresponding item do not offset, the redetermined attributes of those items will be allocated to the intercompany item and corresponding item using a method that is reasonable in light of all of the facts and circumstances). Effectively, SubsidiaryF and SubsidiaryE are not permitted the special basis adjustments under §743(b) to the extent their corresponding items produce a result that is inconsistent with treating the transactions as between divisions of a single corporation.

Treatment of SubsidiaryF's and SubsidiaryE's corresponding items as noncapital, nondeductible items is consistent with the special rules of §1.1502-13(c)(6) which address attribute redetermination in the context of intercompany items. Section §1.1502-13(c)(6)(i) explicitly acknowledges that an intercompany item may be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount *under §1.1502-13(c)(1)(i)* in order to achieve single entity treatment. This is illustrated by an example provided therein, in which S's intercompany loss from the sale of property to B is treated as a noncapital, nondeductible amount when B distributes the property to a nonmember shareholder at no further gain or loss. Redetermination is appropriate because if S and B were divisions of a single corporation, no loss would have been recognized under § 311(a).

Notably, the example applies the attribute redetermination rule to eliminate S's intercompany item entirely. Thus, while the amount of an item is not an attribute, it is clear that redetermination of an item's attributes can affect whether the item is taken into account at all. Moreover, while the example addresses the redetermination of S's intercompany items, its conclusion is based upon the application of §1.1502-13(c)(1)(i) which, by its terms, applies attribute redetermination not only to S's intercompany items but also to B's corresponding items.

Applying a similar analysis to the Reorganization and Liquidation here, SubsidiaryF's and SubsidiaryE's increased depreciation and amortization deductions must be redetermined to be treated as noncapital, nondeductible items because if each of the members to the Reorganization and to the Liquidation were divisions of a single corporation, no net deduction for the increased depreciation and amortization would have arisen from the application of § 743(b).

This treatment is not inconsistent with the analysis and conclusions of §1.1502-13(c)(7)(i), Example (9), which illustrates application of the matching rule to a taxable sale of a partnership interest between members. In the example, the sale of the interest results in a gain to S (S's intercompany item). Through the operation of § 743(b), the sale also results in a corresponding increase to the basis of the partnership's assets, which is allocated wholly to B, and an increase to the partnership's depreciation deductions, which flow through solely to B (B's corresponding items). §1.1502-13(c)(7)(i), Example (9)(a).

The example states that S's basis in its partnership interest equals its share of the adjusted basis of the partnership's land and depreciable assets; that is, there is parity between S's share of the inside basis of the partnership's assets and S's outside basis in its partnership interest. As a result of this parity, the amount of gain recognized by S from its sale of the partnership interest corresponds precisely with the increased partnership asset basis allocated to B under § 743(b) and, over time, S's gain can be matched precisely with B's increased depreciation deductions. Similar results are obtained if the partnership sells an asset which reflects the § 743(b) basis increase; a proportionate amount of S's gain from its sale of the partnership interest can be matched precisely with B's reduced share of the gain or increased share of the loss from the partnership's sale of the asset. *See* §1.1502-13(c)(7)(i), Example (9)(b) and (c). Because the amount of S's and B's items offset (with the result that consolidated taxable income (and consolidated tax liability) is unaffected), attribute redetermination is necessary only to the extent of the character of those matching items. The intercompany sale, in addition to the § 743(b) basis adjustments resulting from that sale, will have no effect on consolidated taxable income (and consolidated tax liability).

The facts underlying the Reorganization and Liquidation, and the consequences of these transactions, are distinguishable from those in Example (9). Here, there is no correspondence between the amount of the items of the transferors (SubsidiaryH and SubsidiaryC) and those of the respective transferees (SubsidiaryF and SubsidiaryE). As a result, there is no ability to match the members' respective intercompany and corresponding items to achieve the appropriate single entity result. Under these facts, application of the attribute redetermination rule to treat the increased depreciation and amortization deductions as noncapital, nondeductible items is not only warranted, but is compelled, by the fundamental purpose of the intercompany transaction regulations, as clearly stated therein -- to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). *See* §1.1502-13(a)(1) and (c)(1)(i).[8]

Thus, we conclude that §1.1502-13 does not permit the Taxpayer Group to claim increased deductions for depreciation and amortization that are attributable to § 743(b) adjustments arising from the Reorganization and Liquidation. Such amounts must be redetermined to be treated as noncapital, nondeductible items.

Issue 4: Whether the basis adjustment provisions of § 743(b) conflict with the basis provisions of § 362(a) when a partnership interest is transferred in an intercompany reorganization to which § 368 applies or with the basis provisions of § 334(b)(1) when a

[8] We note that application of the attribute redetermination rule is not a one-way street. Attribute redetermination would be equally appropriate had the intercompany transactions resulted in decreased depreciation and amortization deductions flowing through from Partnership1 and Partnership2 as a result of the application of § 743(b).

partnership interest is distributed in an intercompany liquidation to which § 332(a) applies.

In the case of property transferred in a reorganization to which § 368 applies, in which no gain or loss is recognized, the basis of such property in the hands of the transferee generally is the same as it would be in the hands of the transferor under § 362(a). Similarly, in the case of property distributed to a corporate parent from a subsidiary in a complete liquidation to which § 332(a) applies, in which no gain or loss is recognized, the basis of such property in the hands of the distributee generally is the same as it would be in the hands of the distributor under § 334(b)(1).

Thus, with respect to the transfer of the Partnership1 interest from SubsidiaryH to SubsidiaryF in the Reorganization (to which § 368 applies), and the distribution of the Partnership1 interest from SubsidiaryC to SubsidiaryE in the Liquidation (to which § 332 applies), the transferee's and distributee's basis in their Partnership1 interest is the same as it would be in the hands of the respective transferor and distributor.

Application of § 743(b), by contrast, has no effect on the basis of a *partnership interest* transferred in a reorganization or distributed in a complete liquidation. Rather, in such cases, if the partnership has a § 754 election in effect, § 743(b) provides for an increase or decrease in the adjusted basis of *partnership property*.

Thus, with respect to the transfers of Partnership1 interests, there is no conflict between the basis adjustment provisions of § 743(b) and the applicable carryover basis provisions of § 362(a) and § 334(b)(1).

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

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