

Partnership Distributions of Marketable Securities

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Section 731(c) treats marketable securities as money for purposes of certain provisions of the Internal Revenue Code relating to partnership distributions. This report provides an in-depth analysis of section 731(c). The authors begin by briefly reviewing the general tax treatment of partnership distributions under the code. The authors then provide an overview of the purpose and basic mechanics of section 731(c). That is followed by a detailed analysis of the meaning of the term “marketable securities.” After that, the authors review the exceptions to section 731(c) and the section 731(c) antiabuse rule. Throughout the article, the authors point out the many uncertain aspects of section 731(c), as well as traps for the unwary and planning opportunities. The authors also compare the asserted purpose of section 731(c) with the provision’s actual operation, ultimately concluding that section 731(c) is less about taxing like transactions similarly than about targeting a specific perceived abuse.

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Introduction

At first blush, section 731(c) seems perfectly reasonable: Treat marketable securities like money for purposes of determining whether gain is recognized in a partnership distribution.¹ (Securities that are readily marketable sure seem a lot like money — they should be treated like money!) And the absence of a single case interpreting any of the substantive aspects of section 731(c)² might even create the impression that it is an unusually well-drafted provision. But a closer look reveals that section 731(c) is less about treating marketable securities like money as a matter of principle and more about targeting a perceived abuse. Also, section 731(c) often produces unexpected, unintended, and unclear results.

Section 731(c) should be seen as part of a larger erosion of the principal nonrecognition provisions of subchapter K. From section 751(b), to section 707(a)(2)(B), to the anti-mixing-bowl provisions in sections 704(c)(1)(B) and 737, to the proposed regulations dealing with disguised sales of partnership interests (prop. reg. section 1.707-7), the nonrecognition rules in sections 721 and 731 — which are the touchstones of the touted flexibility of subchapter K³ — are becoming the exceptions. While each provision was born out of a desire to combat a perceived abuse, their number and imprecision are undermining the original objectives of subchapter K.

Treating marketable securities like money for purposes of determining whether gain is recognized in a partnership distribution sounds simple. However, having only a passing familiarity with section 731(c) and the regulations thereunder can prove quite dangerous. Many

¹Except as otherwise indicated, all section references are to the Internal Revenue Code of 1986 or the regulations thereunder, as amended.

²But see *United States v. G-I Holdings Inc.*, No. 02-3082 (SRC), Doc 2007-14101, 2007 TNT 115-20 (D.N.J. June 8, 2007) (interpreting effective date provision of section 731(c)).

³See reg. section 1.701-2(a) (“Subchapter K is intended to permit taxpayers to conduct joint business . . . activities through a flexible economic arrangement without incurring an entity-level tax”); H.R. Rep. No. 83-1337, at 65 (1954), *reprinted in* 1954 U.S.C.A.N. 4017, 4091 (“[T]he principal objectives [of subchapter K are] simplicity, flexibility, and equity as between the partners”).

distributions expected to result in gain recognition do not. Conversely, many distributions not expected to result in gain recognition do. Closer attention must be paid.

This report looks beneath the surface of section 731(c) and challenges the notion that it is simply about treating like transactions similarly. Also, the report discusses and analyzes the myriad issues raised by section 731(c). Part I discusses partnership distributions in general. Part II analyzes the purpose of section 731(c) and describes the basic mechanics of its operation. Part III dissects the definition of marketable securities. Part IV discusses the many exceptions to section 731(c). Part V addresses the antiabuse rule in the section 731(c) regulations.

I. Partnership Distributions in General

The primary function of the distribution provisions of subchapter K is to provide for nonrecognition of gain (and loss). The enactment of the general nonrecognition rule for partnership distributions was motivated by two considerations. First, Congress was concerned that treating distributions as recognition events “would result in the taxation of gains where there were no real gains and the recognition of losses where there were no real losses.” S. Rep. No. 83-1622, at 95 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4728. Second, Congress wanted to “remove deterrents to property being moved in and out of partnerships as business reasons dictate.” *Id.* at 96, reprinted in 1954 U.S.C.C.A.N. 4729. As discussed below, exceptions to nonrecognition exist to prevent partners from shifting or eliminating ordinary income and to otherwise prevent abuse.

A. Basic Mechanics

1. Gain recognition. Under section 731(a)(1), a partner does not recognize gain in connection with a partnership distribution to the partner except to the extent the amount of money⁴ distributed exceeds the partner’s basis

⁴“Money” includes deemed distributions of money under section 752(b) resulting from a decrease in a partner’s share of partnership liabilities or a decrease in a partner’s individual liabilities by reason of the partnership’s assumption of (or taking property subject to) such liabilities. Of course, as discussed in detail below, money also includes “marketable securities” within the meaning of section 731(c). Otherwise, there is no authority as to what constitutes money for purposes of section 731(a)(1). Presumably, it includes more than U.S. currency. For example, for purposes of reg. section 1.60501-1, relating to returns for cash receipts in excess of \$10,000, “cash” can include a cashier’s check (including a treasurer’s check or a bank check), a bank draft, a traveler’s check, or a money order. See reg. section 1.60501-1(c)(1)(ii)(B). In *Boise Cascade Corp. v. United States*, 288 F. Supp. 770, 773 (D. Idaho 1968), *aff’d per curiam*, 429 F.2d 426 (9th Cir. 1970), the district court, begging the question, interpreted the word “money” for purposes of former section 334(b)(2) as limited to “items which could not logically be given a basis, such as currency, coin, bank accounts, checks, drafts, money orders, etc.” However, a note issued by the partnership (even a secured, negotiable note) should not be treated as money (or as property) for purposes of section 731.

(Footnote continued in next column.)

in its partnership interest (outside basis).⁵ Therefore, a partner recognizes no gain on a distribution of property and is permitted to recover its basis before recognizing gain on a distribution of money. As a result, section 731(a)(1) is one of the most taxpayer-favorable provisions of the code.

Example 1. A transfers property with a tax basis of 40 and a fair market value of 100 to newly formed ABC in exchange for 40 of cash and a 60 interest in ABC. B and C each contribute property and cash. If ABC is a partnership, under section 731(a)(1) (ignoring the disguised-sale provisions), A does not recognize any gain (basis recovery first). If ABC is a corporation, under section 351(b), A recognizes 40 of gain (gain recognition first). If, instead, A simply transferred 40 of the property to ABC for 40 of cash, under section 1001 and reg. section 1.61-6(a) A would recognize 24 of gain (proportionate basis recovery).

The benefits of section 731(a)(1) tempt many taxpayers to aggressively force transactions into its boundaries. That, of course, is one of the reasons Congress and Treasury have been using antiabuse provisions to steadily limit its application.

2. Loss recognition. In general, a partner does not recognize a loss in connection with a partnership distribution to the partner unless the distribution is in liquidation of the partner’s interest in the partnership⁶ and no property other than money, “unrealized receivables” (within the meaning of section 751(c)), and “inventory [items]” (within the meaning of section 751(d)) is distributed to the partner. Section 731(a)(2). If a loss is allowed under section 731(a)(2), the amount of the loss is equal to the excess of the partner’s outside basis over the sum of the amount of any money distributed and the basis the partner takes in any distributed unrealized receivables and inventory items.⁷

Example 2. A partnership distributes 20 of cash and inventory with a tax basis of 40 and an FMV of 80 to partner P in liquidation of P’s interest in the

See McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners* para. 19.05 n.114 (3d ed. 1997).

⁵Any gain recognized is considered gain from the sale or exchange of the distributee’s partnership interest, that is, capital gain. Section 731(a).

⁶A distribution is in liquidation of a partner’s interest in a partnership if it results in the termination of the partner’s interest in the partnership by means of a distribution or series of distributions by the partnership to the partner. Section 761(d).

⁷Any loss recognized is considered loss from the sale or exchange of the distributee’s partnership interest, that is, capital loss. Section 731(a). By its terms, the section 707(b)(1) loss-disallowance rule, which disallows losses on sales or exchanges of property between a partnership and some partners and between some commonly controlled partnerships, does not apply to losses recognized on an exchange of an interest in the partnership.

partnership. P has an outside basis of 100. Assuming section 751(b) is inapplicable, P recognizes a capital loss of 40.⁸

3. Effect on outside basis and basis in distributed property. A partner's basis in its partnership interest is reduced (but not below zero) by the amount of money distributed to the partner. Section 733(1). A partner's outside basis is also reduced by the basis the partner takes under section 732 in distributed property. Section 733(2). In the case of a distribution of property in liquidation of a partner's interest, the partner generally takes a basis in the distributed property equal to its outside basis, as reduced by any money distributed in the same transaction. Section 732(b). In the case of a nonliquidating distribution of property, the partner takes a basis in the distributed property equal to the partnership's basis in the property immediately before the distribution. Section 732(a)(1). However, if the partner's outside basis, as reduced by any money distributed in the same transaction, is lower than the partnership's basis in the distributed property, the partner takes a basis in the distributed property equal to its outside basis. Section 732(a)(2).⁹

Example 3. A partnership distributes 20 of cash and a capital asset with a tax basis of 40 and an FMV of 80 to P in liquidation of P's interest in the partnership. P has an outside basis of 100. Assuming section 751(b) is inapplicable, P takes an 80 basis in the capital asset. If the distribution was not in liquidation of P's interest in the partnership, P would take a 40 basis in the capital asset.

4. Partnership treatment. Partnerships generally do not recognize gain or loss in connection with a distribution of money or property to a partner. Section 731(b). Under section 734(a), no adjustments are made to the basis of a partnership's assets (inside basis) on a distribution of money or property to a partner. However, if the partnership has a section 754 election in effect, the partnership increases the basis of its assets by the amount of gain recognized by the distributee-partner under section 731(a)(1) and the amount of any decrease in the basis of distributed property in the distributee-partner's hands (as compared with the basis in the partnership's hands). Section 734(b)(1). If the partnership has a section 754 election in effect or if there is a "substantial basis reduc-

tion"¹⁰ with respect to the distribution, the partnership decreases the basis of its assets by the amount of any loss recognized by the distributee-partner under section 731(a)(2) and the amount of any increase in the basis of distributed property in the distributee-partner's hands (as compared with the basis in the partnership's hands). Section 734(b)(2). Those adjustments, which are allocated among the partnership's assets under the section 755 regulations, are designed to preserve the equality between inside basis and outside basis.

B. Exceptions Other Than Section 731(c)

1. Section 751(b). Section 751(b) is designed to prevent partners from using the distribution provisions to avoid their share of the partnership's ordinary income. Under section 751(b), a partner that receives a distribution of money or other property in exchange for all or part of its interest in the partnership's unrealized receivables or inventory items that have substantially appreciated in value (or vice versa) is treated as engaging in a sale or exchange of that property. Thus, the general nonrecognition rule is suspended to the extent the distribution effects an exchange of ordinary-income assets for money and other assets (or vice versa). As a result, section 751(b) can produce income or gain recognition by the distributee-partner, the remaining partners, or both.

2. Section 736. Section 736 characterizes payments made to a retiring partner or to the successor-in-interest of a deceased partner. To the extent a payment is made in exchange for the partner's interest in partnership property, the payment is treated as a distribution for purposes of section 731. Section 736(b)(1); reg. section 1.736-1(a)(2). However, when capital is not a material income-producing factor in the partnership (for example, when the partnership is a service partnership) and the retiring or deceased partner was a general partner,¹¹ a payment made to the partner in exchange for goodwill (to the extent the partnership agreement does not provide for a payment for goodwill) or unrealized receivables is not treated as a distribution governed by section 731. Section 736(b)(2). Any payment not treated as a distribution, whether under section 736(b)(2) or otherwise, is considered to be a distributive share of partnership income, if the amount is determined with regard to partnership income, or a guaranteed payment (within the meaning of

⁸Example 2 illustrates one of the most pervasive themes of subchapter K: the preservation of ordinary income. There are many provisions of subchapter K that are designed to ensure that partners cannot use partnerships to avoid or shift ordinary income. Even though P's 100 outside basis is exactly equal to the FMV of the distributed assets (20 of cash and 80 of inventory), P is required to take a 40 basis in the inventory under section 732(c)(1)(A), preserving 40 of ordinary income, and is given a current 40 capital loss. As shown in Example 3, if the partnership had distributed a capital asset instead of inventory, P would not have recognized a loss and would have taken an 80 basis in the capital asset. See section 732(b).

⁹When multiple properties are distributed, section 732(c) provides rules for allocating basis determined under section 732(a)(2) or section 732(b) among the properties.

¹⁰There is a "substantial basis reduction" for a distribution if the sum of the amount of loss recognized and any increase in the basis of distributed property exceeds \$250,000. Section 734(d)(1). A substantial basis reduction can exist only in the case of a distribution in liquidation of a partner's interest. It is not clear whether distributions to more than one partner are aggregated for purposes of determining whether there is a substantial basis reduction. The language of section 734 could support either approach. On one hand, section 734(b) appears to be focused on a distribution to "a partner." On the other hand, the calculation under section 734(d)(1) is based on the "sum of" the amount of loss recognized and any increase in basis in distributed property; a single distributee-partner cannot have a loss recognized and an increased basis in distributed property.

¹¹It is unclear whether an active member of a limited liability company qualifies as a general partner for purposes of section 736.

section 707(c)), if the amount is determined without regard to partnership income. Section 736(a). The net effect is that, in limited circumstances, section 736 enables partners to choose whether a payment made for goodwill produces capital gain to the distributee-partner and a positive basis adjustment under section 734(b) (which may be amortizable) for the continuing partners or ordinary income to the distributee-partner and an immediate deduction to the continuing partners.

3. Anti-mixing-bowl provisions. Sections 704(c)(1)(B) and 737 are designed to prevent partners from using partnerships to effect tax-free exchanges of assets. Under section 704(c)(1)(B), if a partner contributes property to a partnership and, less than seven years later, the property is distributed to another partner, the contributing partner generally recognizes an amount of gain or loss equal to the amount that would have been allocated to the partner under section 704(c)(1)(A) if the distributed property had been sold for its FMV at the time of the distribution.

Section 737 is the flip side of section 704(c)(1)(B). If a partner receives a partnership distribution within seven years of having contributed appreciated property to the partnership, the partner may recognize gain under section 737. The gain recognized is equal to the lesser of the excess distribution and the "net precontribution gain" of the partner. Section 737(a). The excess distribution is equal to the excess (if any) of the FMV of the distributed property (other than money) over the distributee-partner's outside basis immediately before the distribution reduced (but not below zero) by any money distributed. Section 737(a)(1). The net precontribution gain is the net gain (if any) that would have been recognized by the partner under section 704(c)(1)(B) if all property that had been contributed to the partnership by the distributee-partner and that was still held by the partnership had been distributed by the partnership to another partner. Section 737(b).

4. Disguised-sale provisions. Section 707(a)(2)(B) and the regulations thereunder are designed to distinguish bona fide partnership contributions and distributions that should be entitled to the benefits of sections 721 and 731 from transactions that are essentially sales. If a transaction that is in form a partnership distribution is treated as part of a disguised sale of property or as part of a disguised sale of a partnership interest, the transaction is treated as a sale of property or as a sale of a partnership interest for all tax purposes.

II. Section 731(c) in General

A. The Purpose of Section 731(c)

Section 731(c) is another exception to the general rules for partnership distributions. Section 731(c)(1)(A) provides that, for purposes of sections 731(a)(1) and 737, the term "money" includes marketable securities.¹² As a result, a partner recognizes gain under section 731(a)(1) to the extent that the FMV of distributed marketable

¹²Section 731(c)(2) and the regulations thereunder identify the assets that are treated as marketable securities for purposes of section 731(c).

securities exceeds the partner's outside basis. Before enactment of section 731(c), a partner could receive a distribution of marketable securities from a partnership and not be subject to current taxation. The partner's gain was deferred and preserved in the distributed securities.¹³ In fact, those transactions were promoted as tax-efficient exits from partnerships. For example, one commentator described a situation in which a partnership borrows money to acquire property to distribute to a partner (referred to as the "selling" partner) in liquidation of its partnership interest:

[I]f the partnership invests the borrowing proceeds in . . . property (i.e., marketable stocks, mutual fund shares or long-term securities) and that property is distributed to the "selling" partner in liquidation of its interest, the "selling" partner would not be taxed currently since it would receive "property" rather than money. § 731(a).

(a) It is irrelevant that the property distributed to the "selling" partner may be completely liquid.

(b) It should also be irrelevant that the property distributed was recently purchased by the partnership to accomplish the buy-out since § 731 does not require that distributed property consist of the partnership's "historic business assets". Contrast with the "historic asset" requirement in Reg. § 1.368-1(d).

Turlington, "Contemporary Tax Strategies and Techniques Using Partnerships," 316 *PLI/Tax* 743, 806-807 (Oct. 1991).¹⁴ In the case of a partner who was an individual, the securities could have been held until death, resulting in the permanent elimination of the gain.

The preamble to the proposed section 731(c) regulations states that "the basic rationale of section 731(c) [is] that marketable securities are the economic equivalent of money." PS-2-95, 1996-1 C.B. 853, 854, *Doc 96-521*, 96 *TNT* 1-8. Treating partnership distributions of cash the same as partnership distributions of assets that are nearly as liquid as cash could be a legitimate objective. Like transactions should be taxed similarly. But that seemingly neutral rationale of section 731(c) is merely an illusion. The legislative history provides a rationale for section 731(c) that is slightly less fair and balanced than the one offered in the preamble to the proposed section 731(c) regulations:

¹³In some nonliquidating distributions, the partner's gain was also deferred and preserved in the partner's partnership interest.

¹⁴The IRS might have taken issue with the transaction even before the enactment of section 731(c). In *CCA 200650014*, *Doc 2006-25084*, 2006 *TNT* 242-17, a partnership, instead of distributing money in liquidation of a partner's interest, purchased a house selected by the partner and then distributed it to the partner. The house bore no relationship to the partnership's business and apparently was intended for use as a personal residence by the distributee-partner. The IRS concluded that the transaction should be treated as a distribution of money to the partner (as opposed to a distribution of the house) and that gain should thus be recognized.

[T]axpayers can exchange interests in appreciated assets for marketable securities while deferring or avoiding tax on the appreciation, by using the present-law rules relating to partnership distributions. . . . If the taxpayer were to exchange an interest in an appreciated asset for cash, he generally would recognize gain on the appreciated asset; yet if the taxpayer receives a partnership distribution of marketable securities, which are nearly as easily valued and as liquid as cash, he can avoid gain recognition.

This distinction in tax treatment between cash and marketable securities elevates form over substance, causes taxpayers to choose the form of transactions for tax reasons rather than economic reasons, and may not promote accurate income measurement. Rather, the present-law rule merely permits taxpayers to defer or avoid tax.

H.R. Rep. No. 103-826(I) at 187-88 (1994), reprinted in 1994 U.S.C.A.N. 3773, 3959-3960. Also, section 731(c) contains many exceptions that — although welcome — are antithetical to treating like transactions similarly. The actual operation of section 731(c) makes it clear that the purpose of section 731(c) is to prevent a perceived abuse by taxing the distribution of nonhistoric marketable securities in exchange for the distributee-partner's interest in other partnership assets. See reg. section 1.731-2(j), Example 1 (applying section 731(c) when a partnership purchases a marketable security and immediately distributes it to a partner).

Although those transactions may sound abusive, the ability to exchange assets for marketable securities on a tax-free basis is not uniformly regarded as an abuse in the tax law. In fact, in many cases, the “abuse” is embraced. It would likely be viewed as heretical to suggest that the corporate reorganization provisions should be amended to prevent taxpayers from exchanging illiquid stock or corporate assets for publicly traded stock in a tax-free manner. The partnership antiabuse regulations themselves bless a taxpayer's ability to exchange, on a tax-free basis, an interest in real estate for an interest in an umbrella partnership real estate investment trust (UPREIT) that is exchangeable for publicly traded REIT stock. See reg. section 1.701-2(d), Example 4. Furthermore, while there has been some concern about the ability of taxpayers to monetize highly liquid assets in a tax-free manner, the response has not been to tax the receipt of the monetizable asset but to tax the monetization. See section 1259.¹⁵

¹⁵It might initially be thought that section 351(g) was motivated by the same policy goals as section 731(c), but that is not the case. Section 351(g) treats “nonqualified preferred stock” as boot for purposes of section 351. (Related provisions, including section 354(a)(2)(C), do the same for some other nonrecognition provisions of the code.) Subject to exceptions, nonqualified preferred stock means preferred stock if the holder of the stock has the right to require the issuer or a related person to redeem or purchase the stock, the issuer or a related person is required to redeem or purchase the stock, the issuer or a related person has the right to redeem or purchase the stock and, as of the issue

(Footnote continued in next column.)

Regardless of whether section 731(c) is viewed as a failed attempt to treat like transactions similarly or as a misguided antiabuse provision, there can be no dispute that it should apply only to securities that are highly liquid and easy to value. However, as discussed in detail in Part III below, section 731(c) applies to many assets that are illiquid and difficult to value. The application of section 731(c) to those assets undermines any possible rationale for the provision and infringes, for no apparent reason, on the general policy of nonrecognition underlying section 731.

B. The Basic Mechanics of Section 731(c)

1. Gain recognition. Section 731(c)(1) provides that, for purposes of sections 731(a)(1) and 737, the term “money” includes marketable securities and that those securities are taken into account at their FMV as of the date of the distribution. Thus, if a partner receives a distribution of marketable securities with a value exceeding the partner's outside basis, the partner recognizes gain as if an amount of money were distributed in excess of the partner's outside basis. However, because section 731(c)(1) does not apply for purposes of section 731(a)(2), a partner cannot recognize a loss on a distribution of marketable securities in liquidation of the partner's interest in the partnership, even though the partner would be entitled to a loss if money were distributed. This one-sided treatment of marketable securities significantly undercuts a view that section 731(c) was enacted to treat like transactions similarly. If a distribution of marketable securities should be treated similarly to a distribution of money because the two transactions are similar, there would be no reason to deny a partner a loss when marketable securities, rather than money, are distributed. The fact that a loss is denied in those circumstances supports the view that the true purpose of section 731(c) is to prevent a perceived abuse.

date, it is more likely than not that such right will be exercised, or the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. Section 351(g)(2)(A). Congress enacted section 351(g) because it objected to the tax-free receipt of stock that is economically as secure as debt (*not* stock that is marketable or easily valued). See H.R. Rep. No. 105-148, at 866 (1997) (stating that “it is appropriate to view [nonqualified preferred stock] as taxable consideration since the investor has often obtained a *more secure form of investment*” (emphasis added)). Thus, section 351(g) functions as a backstop to the 1989 amendment to section 351, which eliminated nonrecognition treatment for the exchange of property for securities. It does not prevent a taxpayer from exchanging under section 351 or section 354 nonmarketable property for stock that is both highly marketable and easily valued (such as publicly traded common stock of a large corporation).

However, new section 355(g), which disallows section 355 treatment in some cases when either the distributing corporation or the controlled corporation is a “disqualified investment corporation” immediately after the distribution, is reasonably consistent with the spirit of section 731(c).

Section 731(c)(1) also treats marketable securities as money for purposes of section 737.¹⁶ Because section 737 does not apply to distributions of money, only to distributions of property, section 731(c)(1) effectively renders section 737 inapplicable to distributions that are subject to section 731(c). That avoids the duplication of gain that would otherwise arise if both provisions applied to the same distribution of property.¹⁷ However, the results to taxpayers under section 731(c) will be at least as unfavorable as the results under section 737. As discussed above, under section 737, a distributee-partner recognizes gain to the extent of the lesser of the excess (if any) of the value of property distributed over the partner's outside basis and the partner's net precontribution gain. By contrast, under section 731(c), a distributee-partner generally recognizes gain to the extent the value of the distributed marketable security exceeds the partner's outside basis. Therefore, a distributee-partner should generally recognize at least as much gain under section 731(c) as the partner would have recognized under section 737.

2. Fair market value. For purposes of section 731(c), marketable securities are taken into account at their FMV as of the distribution date. Section 731(c)(1)(B). For federal tax purposes, the FMV of an asset is generally defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. Bogdanski, *Federal Tax Valuation* para. 2.01[1] (1996). The willing buyer and willing seller are hypothetical, not actual, persons. *Id.* at para. 2.01[2][c].

The FMV of a marketable security that is actively traded should be easily determinable by reference to the market price on the distribution date. However, as discussed below in Part III, marketable securities include not only assets that are themselves actively traded, but also other assets, such as interests in entities holding (directly or indirectly) a specified amount of marketable securities. No guidance is provided under section 731(c) on how to determine the FMV of marketable securities that are not actively traded. In those cases, the various discounts and premiums that are often taken into account in determining FMV in other contexts would likely apply. For example, it is common to apply a discount for lack of marketability when the assets being valued are subject to restrictions limiting their transferability or are not themselves publicly traded but are being valued by reference to publicly traded assets. *Id.* at para. 4.04[1][a].

Other discounts could also be applicable. For example, it is often appropriate to apply a minority discount to a noncontrolling interest in an entity to reflect the fact that

¹⁶Marketable securities contributed to a partnership are not, however, treated as money for purposes of determining a partner's net precontribution gain under section 737(b). Reg. section 1.731-2(g)(1)(iii).

¹⁷As discussed below, to the extent a distribution of a marketable security is *not* subject to section 731(c) because an exception applies, the distribution is treated as a distribution of property for purposes of section 737.

the interest is worth less than an otherwise identical, but controlling, interest. *Id.* at para. 4.03[1][a]. Because the definition of marketable securities is broad enough to include a non-actively-traded minority interest in an entity, a minority discount could be proper.¹⁸ Of course, the converse could also be true. When a partnership distributes a non-actively-traded controlling interest in an entity, it could be proper to apply a control premium.

Despite the irony (and absurdity) of applying a marketability or minority discount (or control premium) to determine the FMV of marketable securities under section 731(c), it seems clearly appropriate to do so, regardless of the uncertainty and difficulty that may cause. Of course, in enacting a provision aimed at assets that "are nearly as easily valued and as liquid as cash," Congress could not possibly have intended to impose such a burden on taxpayers.

3. Basis in distributed securities. The basis of distributed marketable securities with respect to which gain is recognized is the basis determined under section 732, increased by the amount of gain recognized in the distribution.¹⁹ Section 731(c)(4)(A); reg. section 1.731-2(f)(1)(i). The basis of distributed marketable securities with respect to which no gain is recognized would presumably be the basis determined under section 732.

Example 4. Partner P has an outside basis of 100 in its interest in a partnership. The partnership distributes marketable securities with a basis of 10 and a value of 40 to P in a nonliquidating distribution. Assume no exception to section 731(c) is applicable. No gain is recognized because the value of the securities does not exceed P's outside basis. P takes a 10 basis in the securities, not a 40 basis.

Had money been distributed to P, P would have taken a 40 basis in any asset acquired with the money (and retained a 60 outside basis). Instead, P takes a 10 basis in the securities under section 732 (and retains a 90 outside basis). This represents yet another departure from treating distributions of marketable securities in the same manner as distributions of money.²⁰

4. Inside and outside basis effects. For purposes of section 733, the distributee-partner's outside basis is determined as if no gain were recognized and no adjustment were made to the basis of the distributed property. Section 731(c)(5); reg. section 1.731-2(f)(1)(ii). Thus, the distributee-partner's outside basis is reduced by the basis

¹⁸When minority interests in an entity are actively traded, no minority discount would be applied in valuing the interests, because the market price will already incorporate the discount.

¹⁹When multiple marketable securities are distributed in a single transaction, any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) is allocated to the securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before the increase. Section 731(c)(4)(B); reg. section 1.731-2(f)(1)(i).

²⁰If P had been permitted to take a 40 basis in the marketable securities, P's outside basis would have had to be reduced by 40, and the 30 increase in the basis of the marketable securities would have had to be taken into account for purposes of section 734 (potentially resulting in an inside basis reduction).

of the distributed securities determined under section 732 without regard to any basis increase under section 731(c)(4). Similarly, section 734 is applied as if no gain were recognized and no basis increase was made to the distributed security under section 731(c)(4). Section 731(c)(5); reg. section 1.731-2(f)(2). Thus, for purposes of sections 733 and 734, a distribution of marketable securities is treated as a property distribution. These provisions can produce results that are far from intuitive.

Example 5. A partnership distributes marketable securities with a basis of \$1 million and a value of \$10 million to partner P, which has a \$6 million outside basis. Assume the distribution is not a liquidating distribution and no exception to section 731(c) is applicable. P will recognize \$4 million of gain under section 731(a)(1) and will take a basis in the securities of \$5 million (\$1 million basis under section 732(a)(1) increased by \$4 million of gain). P's outside basis will be reduced by \$1 million, the basis under section 732(a)(1). Even if the partnership has a section 754 election in effect, there will be no section 734(b) adjustment, because, for purposes of section 734, neither the gain nor the increase in the basis of the securities is taken into account.

Example 6. Assume the same facts as above except that the distribution is a liquidating distribution. P still recognizes \$4 million of gain but takes a \$10 million basis in the marketable securities (\$6 million basis under section 732(b) increased by \$4 million of gain recognized). For purposes of section 734, P is treated as if it took a \$6 million basis in the marketable securities. Thus, whether or not the partnership has a section 754 election in effect,²¹ the partnership is required to reduce the basis of its assets by \$5 million. Although the result is proper, it is quite anomalous to have gain recognized under section 731(a)(1) but an inside basis *reduction*.

Gain recognition under section 731(c) and the resulting basis increase in the distributed securities are based on the value of the distributed assets. By contrast, the basis rules under sections 733 and 734, which are designed to preserve the equality between inside and outside basis, operate by reference to the basis of the distributed assets. Consequently, to avoid creating inside/outside basis disparities, any gain recognized as a result of section 731(c) and any resulting increase in the basis of the distributed securities have no effect on the partnership's basis in its assets or on the distributee-partner's outside basis.

5. Miscellaneous rules. In the case of a distribution of a marketable security that is an unrealized receivable or an inventory item, any gain recognized by reason of section 731(c) is treated as ordinary income to the extent of any increase in the basis of the marketable security attributable to the gain recognition. Section 731(c)(6).

²¹There is a substantial basis reduction because the basis of the marketable securities is treated as increasing from \$1 million to \$6 million for purposes of section 734.

If a distribution results in the application of section 731(c) and one or both of sections 704(c)(1)(B) and 737, the tax consequences of the distribution are determined by applying section 704(c)(1)(B), then section 731(c), and finally section 737. *See* reg. section 1.731-2(j), Example 7 (illustrating the interaction of section 731(c) and section 737). It is not clear whether this ordering rule applies solely for purposes of gain recognition or also for purposes of basis determination. If the ordering rule applies for both purposes, it is unclear how basis determinations are to be made, because marketable securities are treated as property for purposes of sections 732, 733, and 734.

In response to comments on the proposed regulations, the final regulations provide that if a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c). Reg. section 1.731-2(g)(2). Also, the deemed distribution of the interests in the new partnership that occurs as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c). *Id.*²²

III. The Meaning of 'Marketable Securities'²³

A. In General

For purposes of section 731(c), the term "marketable securities" means financial instruments and foreign currencies that are, as of the date of the distribution, actively traded within the meaning of section 1092(d)(1).²⁴ Section

²²Section 731(c) is silent on the holding period of distributed marketable securities in the distributee partner's hands. Because section 731(c) applies only for purposes of explicitly enumerated provisions, which do not include section 735(b), a distribution of marketable securities should be treated as a distribution of property for purposes of section 735(b), and therefore the ordinary rule (tacked holding period) should apply.

²³Other provisions of the IRC contain definitions of marketable securities that are far less complicated than the definition in section 731(c). *See* section 453(f)(2) ("any security for which . . . there was a market on an established securities market or otherwise"); section 1259(c)(2) (applying section 453(f)(2) definition of marketable security); reg. section 1.884-2T(b)(2) ("a security (including stock) that is part of an issue any portion of which is regularly traded on an established securities market . . . and a deposit described in section 871(i)(3)(A) or (B)" relating to deposits at banks or savings and loans). *Cf.* section 368(a)(2)(F)(vii) (defining "securities" as "obligations of State and local governments, commodity futures contracts, shares of [regulated investment companies] and [REITs], and other investments constituting a security within the meaning of the Investment Company Act of 1940"). Other provisions contain no definition. *See, e.g.,* reg. section 1.355-6(a)(4).

²⁴The section 731(c) regulations state that a financial instrument is actively traded (and thus a marketable security) if it is "of a type" that is actively traded on the distribution date. Reg. section 1.731-2(c)(2). The following example is given: "[I]f XYZ common stock is listed on a national securities exchange, particular shares of XYZ common stock that are distributed by a partnership are marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time." *Id.* The preamble to the proposed regulations states that "[t]his provision is intended to prevent a

(Footnote continued on next page.)

731(c)(2)(A). For this purpose, financial instruments include stocks and other equity interests, evidences of indebtedness,²⁵ options, forward or futures contracts, notional principal contracts, and derivatives. Section 731(c)(2)(C). An asset is actively traded within the meaning of section 1092(d)(1) if there is an established financial market for the asset. Reg. section 1.1092(d)-1(a).

Reg. section 1.1092(d)-1(b)(1) provides that an established financial market includes:

- (i) A national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);
- (ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934;
- (iii) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;
- (iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marché à Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);
- (v) An interbank market;
- (vi) An interdealer market (as defined in Treas. Reg. § 1.1092(d)-1(b)(2)(i)),²⁶ and

partnership from avoiding section 731(c) by temporarily restricting the transferability of the distributed security." PS-2-95, 1996-1 C.B. 853, 854.

²⁵"Evidence of indebtedness" is not necessarily as broad a term as "indebtedness." The distinction between the two terms was important for purposes of former section 1232, which granted capital gain treatment on the retirement of some "evidences of indebtedness." In Rev. Rul. 68-537, 1968-2 C.B. 372, the IRS ruled that the retirement of an open account indebtedness, which was not evidenced by a note or any other evidence of indebtedness, did not qualify for capital gain treatment under former section 1232. *Accord*, *Cornelius v. Commissioner*, 58 T.C. 417 (1972), *aff'd*, 494 F.2d 465 (5th Cir. 1974); *Smith v. Commissioner*, 48 T.C. 872 (1967), *aff'd on this issue, rev'd in part*, 424 F.2d 219 (9th Cir. 1970); *Brown v. Commissioner*, T.C. Memo. 1981-608; *Barr v. Commissioner*, T.C. Memo. 1980-3.

²⁶An interdealer market is characterized by a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine FMV by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent transactions. An interdealer market does not include a directory or listing of brokers, dealers, or traders for specific contracts (such as yellow sheets) that provides neither price quotations nor actual prices of recent transactions. Reg. section 1.1092(d)-1(b)(2)(i).

(vii) Solely with respect to a debt instrument, a debt market (as defined in Treas. Reg. § 1.1092(d)-1(b)(2)(ii)).²⁷

Section 731(c)(2)(B) provides that the term "marketable securities" also includes the following assets that are not actively traded:²⁸

- (i) any interest in (I) a common trust fund, or (II) a regulated investment company which is offering for sale or has outstanding any redeemable security (as defined in section 2(a)(32) of the Investment Company Act of 1940) of which it is the issuer;²⁹
- (ii) any financial instrument which, under its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities;
- (iii) any financial instrument the value of which is determined substantially by reference to marketable securities;
- (v) except as otherwise provided in regulations prescribed by the secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both; and

²⁷A debt market exists for a debt instrument if price quotations for the instrument are readily available from brokers, dealers, or traders. Reg. section 1.1092(d)-1(b)(2)(ii). However, a debt market does not exist for a debt instrument if:

- no other outstanding debt instrument of the issuer (or of any guarantor) is traded on an established financial market other than a debt market;
- the original stated principal amount of the issue that includes the debt instrument does not exceed \$25 million;
- the conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (for example, the debt instrument is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or
- the maturity date of the debt instrument is more than three years after the latest maturity date of the issuer's other traded debt.

Id.

²⁸A marketable security also includes, except to the extent provided in regulations, any interest in a precious metal that, as of the date of the distribution, is actively traded (within the meaning of section 1092(d)(1)), unless the metal was produced, used, or held in the active conduct of a trade or business by the partnership. Section 731(c)(2)(B)(iv). The legislative history states, by way of example, that "monetized or unmonetized gold coins, and gold or silver ingots or bullion, are marketable securities, if they are not produced, used or held in the active conduct of a trade or business by the partnership." H.R. Rep. No. 103-826(I) at 190, *reprinted in* 1994 U.S.C.C.A.N. 3962.

²⁹By way of illustration, the legislative history states that "an interest in an open-ended mutual fund is treated as a marketable security even though, for example, trading in fund shares takes place exclusively through purchase and redemption transactions with the issuer of the fund shares." H.R. Rep. No. 103-826(I) at 189, *reprinted in* 1994 U.S.C.C.A.N. at 3961.

(vi) to the extent provided in regulations prescribed by the secretary, any interest in an entity not described in clause (v) but only to the extent of the value of such interest which is attributable to marketable securities, money, or both.

Section 731(c)(2)(B)(i)-(iii), (v)-(vi). It is the inclusion of some of those assets as marketable securities that significantly expands the scope of section 731(c) and requires closer examination.

B. Convertible or Exchangeable Instruments

Section 731(c)(2)(B)(ii) provides that a marketable security includes "any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities." It is not entirely clear what constitutes an "other arrangement" or when a financial instrument is "readily convertible" into money or marketable securities. Consequently, there are serious questions regarding the scope of this provision.

The legislative history of section 731(c)(2)(B)(ii) sheds some light with the following example: "[A]n in-the-money option to buy marketable securities is treated as a marketable security because the holder can readily convert it to marketable securities by exercising the option." H.R. Rep. No. 103-826(I) at 189, reprinted in 1994 U.S.C.C.A.N. at 3961. Thus, it appears that, at the time of the distribution, an instrument must be convertible into money or marketable securities at the holder's election for it to be considered readily convertible within the meaning of section 731(c)(2)(B)(ii). If only the issuer has the right to convert an instrument into money or marketable securities or if the instrument is convertible into money or marketable securities only by the agreement of the holder and the issuer or some other third party, the instrument should not be treated as a marketable security. That conclusion is consistent with applying section 731(c) only to those assets that are in fact liquid.

1. Ease of resale. An issue that arises is whether a financial instrument is readily convertible into money or marketable securities under an other arrangement merely because it is easy to resell. That issue was addressed in CCA 200250013, *Doc 2002-27223, 2002 TNT 241-51*, which involved the tax consequences of a partnership distribution of a promissory note. The note was issued by a newly formed limited liability company, which owned units of participation in a trust securitizing bank credit card receivables. Neither the note, the units, nor the receivables were actively traded within the meaning of section 1092(d)(1). CCA 200250013 states that, although the units could not, by their terms, be sold without registration under federal securities laws, those units were "frequently the subject of private placements, representing a safe, conservative investment that is in frequent demand by financial institutions." Also, the investment banker who had arranged for the creation of the note also arranged for its sale by the partnership less than two years later. Even though "the investment banker was apparently not bound to arrange for the resale" of the note, CCA 200250013 determined that there was "a market for the interests" in question and that the distributee-partner knew, at the time of the distribution, that it would be "easy to later resell" the note. Conse-

quently, CCA 200250013 concluded that the note was readily convertible into money under an other arrangement within the meaning of section 731(c)(2)(B)(ii).

CCA 200250013 seems incorrect. Section 731(c)(2)(B)(ii) does not apply whenever a financial instrument is readily convertible into money or marketable securities. Rather, it applies only when a financial instrument is readily convertible "pursuant to its terms or any other arrangement."³⁰ The mere fact that the distributee-partner knew that the note would be easy to resell could hardly constitute an other arrangement under which the partner could convert the note into money. An other arrangement should be found to exist only when the holder of an instrument has an enforceable right (even though not pursuant to the instrument's terms) to convert the instrument into money or marketable securities.

2. Related-party debt instruments. Another issue that can arise is whether debt of a related party should be treated as readily convertible into money or marketable securities for purposes of section 731(c)(2)(B)(ii).³¹

Example 7. Parent, a corporation, owns all of the outstanding stock of Sub1 and Sub2. Sub2 owes money to a partnership in which Sub1 is a partner. The partnership distributes the debt of Sub2 to Sub1.

It might be argued that the Sub2 debt should be treated as readily convertible into money in Sub1's hands, on the grounds that Parent, by virtue of its control over Sub2, could cause Sub2 to repay the debt. Consequently, it might be argued that Parent's control is an "other arrangement" under which the note is readily convertible into money. However, as discussed above, the legislative history and purpose of section 731(c) suggest that a financial instrument should be treated as readily convertible into money or marketable securities only if it is convertible at the sole election of its holder. In the example, Sub1 does not control Sub2, and therefore Sub1 could not at its sole election cause the Sub2 debt to be converted into money or marketable securities. Accordingly, the debt should not be treated as readily convertible into money or marketable securities.³²

³⁰See Blake D. Rubin and Andrea M. Whiteway, "IRS Overreaches in Recent Attacks on Partnership Tax Deferral Structures," *Tax Notes*, Apr. 28, 2003, p. 555, *Doc 2003-10602, 2003 TNT 82-34*.

³¹The distribution of debt of a party related to the distributee-partner is to be distinguished from a distribution of the partner's *own* debt. When a partnership lends money to a partner in exchange for a note and subsequently distributes the note to the partner, the distribution is treated as a distribution of money. See reg. section 1.731-1(c)(2). That was the case even before the enactment of section 731(c). By contrast, the IRS has ruled that when a partnership acquires debt of a partner from a third party and later distributes the debt to the partner, the partner recognizes capital gain or loss to the extent that the FMV of the debt differs from its adjusted basis determined under section 732. Rev. Rul. 93-7, 1993-1 C.B. 8, *Doc 93-216, 93 TNT 1-11*.

³²Of course, if the corporations are members of a consolidated group, the consequences under the deemed satisfaction and reissuance rules of reg. section 1.1502-13(g) would have to

(Footnote continued on next page.)

When the distributee-partner controls the issuer of the distributed security, the answer becomes less clear.

Example 8. The facts are the same as in Example 7 above, except that Parent (not Sub1) is the partner in the partnership and receives the distribution of the Sub2 debt.

Parent controls Sub2, and therefore Parent can readily cause the Sub2 debt to be converted into money or marketable securities, assuming Sub2 has sufficient money or marketable securities (or sufficient assets that are readily convertible into money or marketable securities) to pay off the debt. Under those circumstances, treating the debt as readily convertible into money or marketable securities seems consistent with the purpose of section 731(c). Nevertheless, it is unclear whether the debt falls within the scope of section 731(c)(2)(B)(ii). Nothing in section 731(c) appears to provide for such a result, unless control or related-party status could be treated as an other arrangement. Certainly, Congress knows how to apply related-party rules. If Congress had intended to subject related-party debt to the application of section 731(c), it would have been easy for Congress to do so clearly, rather than through an expansive reading of "other arrangement." Therefore, even when the distributee-partner controls the issuer of a distributed security, it seems unlikely that that control alone constitutes an other arrangement that will cause the security to be subject to section 731(c)(2)(B)(ii).

3. Short-term debt. The IRS has taken the position that short-term debt is readily convertible into money and therefore is treated as a marketable security under section 731(c)(2)(B)(ii). In FSA 200219008, *Doc 2002-11408*, 2002 TNT 92-55, a real estate partnership borrowed money from a bank and purchased debt instruments with a nine-month term. The partnership immediately contributed a portion of the debt instruments to newly formed subsidiary partnerships and distributed the interests in the partnerships. The IRS concluded that because the debt instruments "had a nine-month term and were to be paid off shortly after the distribution," they should be treated as readily convertible into money under section 731(c)(2)(B)(ii). As a result, the interests in the subsidiary partnerships were treated as marketable securities under the "interest in an entity" provisions discussed below.³³

be carefully considered. On Sept. 27, 2007, Treasury issued a notice of proposed rulemaking (REG-107592-00) proposing to modify those rules and other aspects of the regulations under reg. section 1.1502-13(g) and withdrawing the prior proposed regulations issued on Dec. 21, 1998 (REG-105964-98).

³³FSA 200219008 appears to rely both on the original term of the nine-month debt instruments and on the short interval between the distribution and the maturity date for its conclusion that the debt instruments were marketable securities under section 731(c)(2)(B)(ii). It is not clear whether the same conclusion would have been reached if the original term of the debt instruments had been longer than nine months. However, the original term of a debt instrument has nothing to do with whether the instrument is readily convertible into money or marketable securities at the time the instrument is distributed by a partnership.

The conclusion in FSA 200219008 is highly suspect. Nothing in the code, the regulations, or the legislative history suggests that the original or remaining term of a debt instrument is a factor in determining whether the instrument is readily convertible into money or marketable securities for purposes of section 731(c)(2)(B)(ii). Furthermore, the example in the legislative history suggests that, for section 731(c)(2)(B)(ii) to apply, the taxpayer must have the immediate right to acquire money. A taxpayer holding a nine-month debt instrument cannot immediately acquire money at its election. Of course, a demand note would likely be treated as a marketable security under section 731(c)(2)(B)(ii), because the holder would have the immediate right to acquire money. What about a note with a one-week term? A one-month term? A six-month term? It is unclear where the tipping point would be.³⁴

4. Conversion costs. The example in the legislative history (discussed above) deals with an option that is in the money. That suggests that a financial instrument should not be treated as readily convertible into money or marketable securities if converting would be economically detrimental to the taxpayer. For example, cash withdrawals from a certificate of deposit (CD) are usually subject to a substantial penalty, which generally makes it undesirable to redeem the CD before maturity. It is not entirely clear whether such a penalty would prevent the CD from being treated as a marketable security under section 731(c)(2)(B)(ii), because the holder of the CD could, albeit at a substantial penalty, "readily" obtain money. The answer may depend on whether the holder has an economic incentive to redeem the CD. For example, in periods of rising interest rates, the penalty may not be sufficient to discourage a holder from redeeming the CD before maturity. Under those circumstances, perhaps the CD would be treated as a marketable security under section 731(c)(2)(B)(ii).³⁵ In any event, the conversion costs should be taken into account in determining the FMV of the instrument for purposes of section 731(c)(1)(B).

³⁴In a different but arguably analogous context, a one-year period is used. Under section 453(f)(4)(B), "readily tradable" obligations are not eligible for installment sale reporting. Section 453(f)(5) treats an obligation as readily tradable if it is in a "form designed to render it readily tradable in an established securities market." An obligation is treated as in a form designed to render it readily tradable in an established securities market if it contains a right whereby a holder "may convert" it into an instrument that is readily tradable, unless the obligation "is convertible only at a substantial discount." Temp. reg. section 15A.453-1(e)(5)(i). A substantial discount is considered to exist when the conversion privilege may not be exercised within a period of one year from issuance. Temp. reg. section 15A.453-1(e)(5)(ii).

³⁵The regulations under section 453 may provide support for treating a security as readily convertible into cash or marketable securities only when the value of the money or marketable securities into which the security is convertible is at least 80 percent of the FMV of the convertible security. See temp. reg. section 15A.453-1(e)(5).

C. Value Determined 'by Reference to'

The term "marketable securities" includes "any financial instrument the value of which is determined substantially by reference to marketable securities." Section 731(c)(2)(B)(iii). The legislative history provides three examples of instruments that are treated as marketable securities under this provision: a private notional principal contract that is not actively traded, but whose value is determined by reference to a financial instrument that is actively traded; an interest in an index fund that is not actively traded, but whose value is determined by reference to an index of securities that are actively traded; and privately offered stock the value of which is determined by reference to actively traded stock of another class or another issuer. H.R. Rep. No. 103-826(1) at 189, reprinted in 1994 U.S.C.C.A.N. 3961.

Each example in the legislative history involves a financial instrument the value of which is determined, by the very terms of the instrument, by reference to marketable securities. However, the statutory language could be read broadly to also include a financial instrument whose value generally follows the value of marketable securities, although not under the instrument's terms. For example, the value of a debt instrument that is not otherwise treated as a marketable security would likely follow the value of a similar-term debt instrument of a comparable issuer in the same industry. If the other debt is actively traded within the meaning of section 1092(d)(1), the value of the debt could be said to be determined substantially by reference to marketable securities. However, that would seem to go too far. While the value of the debt instrument might be *determinable* by reference to marketable securities, the value is not *determined* by reference to marketable securities.³⁶ Accordingly, an instrument should be subject to section 731(c)(2)(B)(iii) only if its value is tied to marketable securities under the express terms of the instrument.³⁷

³⁶It might initially be thought that a floating-rate debt instrument of a creditworthy issuer should be treated as a marketable security under section 731(c)(2)(B)(iii) if the interest rate floats by reference to the rates on Treasury securities, which are marketable securities. However, section 731(c)(2)(B)(iii) requires the value, not just the rate, to be determined substantially by reference to marketable securities.

³⁷Section 351(g)(2)(A)(iv) defines "nonqualified preferred stock" to include preferred stock the dividend rate on which "varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices." That language is similar to the "determined substantially by reference to" language of section 731(c)(2)(B)(iii). However, section 351(g)(2)(A)(iv) applies even when the rate varies directly or indirectly with reference to interest rates and so on. Furthermore, the legislative history of section 351(g) states that, for purposes of section 351(g)(2)(A)(iv), a dividend rate is to be treated as varying with respect to interest rates and so on "regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock)." H.R. Rep. No. 105-148, at 472-473 (1997), reprinted in 1997 U.S.C.C.A.N. 866-67. Thus, section 351(g) can apply even if the rate varies not by virtue of the express terms of the stock.

A notional principal contract for marketable securities would likely be treated as a marketable security even though its value is affected by the financial condition of the counterparty.

Example 9. A partnership enters into a derivative contract with a bank. The notional principal amount of the contract is determined by reference to publicly traded debt instruments. At a time when the contract is in the money with respect to the partnership (that is, the partnership would be entitled to receive payments from the bank), the bank's financial health significantly deteriorates, making it questionable whether the partnership will ever receive the payments. As a consequence, the FMV of the partnership's interest in the derivative contract declines significantly. At that time, the partnership distributes the contract to partner P.

Notwithstanding that the value of the partnership's interest in the derivative contract is affected by the bank's financial health, because the notional principal amount of the contract is tied to marketable securities, the value of the contract is likely to be treated as "determined substantially by reference to marketable securities" for purposes of section 731(c)(2)(B)(iii). However, the adverse tax consequences to P should be mitigated by the fact that the contract should be taken into account at its FMV, which would presumably be quite low, for purposes of section 731(c)(1)(B).

D. Interests in Entities

Section 731(c)(2)(B)(v) provides that an interest in an entity, substantially all the assets of which consist (directly or indirectly) of money or marketable securities, is itself treated as a marketable security. The regulations provide that substantially all the assets of an entity consist (directly or indirectly) of money or marketable securities if 90 percent or more of the assets of the entity (by value) at the time of the distribution consist (directly or indirectly) of money or marketable securities. Reg. section 1.731-2(c)(3)(i).

Section 731(c)(2)(B)(vi) authorizes the issuance of regulations to treat interests in entities, other than as described above, as marketable securities, but only to the extent the value of the interest is attributable to money or marketable securities. Under that authority, Treasury has issued regulations that provide that, if less than 90 percent but 20 percent or more of the assets of an entity (by value) at the time of a distribution consist (directly or indirectly) of money or marketable securities, an interest in the entity is treated as a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to money or marketable securities. Reg. section 1.731-2(c)(3)(ii).

1. What is an 'interest in an entity'? Neither the code, the regulations, nor the legislative history define the term "interest in an entity" for purposes of section 731(c)(2)(B)(v) and (vi). It is likely that the term was intended to apply to equity interests in entities, such as stock and partnership interests. However, the scope of the term "interest" in ordinary usage and elsewhere in the code raises questions as to how broadly the term is to be interpreted for purposes of section 731(c).

An important question is whether an interest in an entity as a creditor is to be treated as an interest in an entity under section 731(c)(2)(B)(v) and (vi). The word “interest” has been defined as “[t]he most general term that can be employed to denote a right, claim, title, or legal share in something.” *Black’s Law Dictionary* 812 (6th ed. 1990). The usage of the word in the code at times approaches the breadth of that definition. Section 302(c)(2)(A)(i) provides that family attribution will not apply for purposes of section 302 if immediately after the distribution the distributee has “no interest in the corporation (including an interest as an officer, director, or employee), other than an interest as a creditor.” That language suggests that, for tax purposes, an “interest” in an entity can include an interest as a creditor (as well as an interest as an officer, director, or employee).³⁸ Section 385(a) authorizes regulations to determine whether an interest in a corporation is to be treated as “stock or indebtedness.” Section 897(c)(1)(A)(ii) provides that a U.S. real property interest includes “any interest (other than an interest solely as a creditor)” in some corporations. Section 465(b)(3)(B)(i) provides that an “interest in an activity” does not include “an interest as a creditor in the activity.” Although those authorities support the proposition that an interest as a creditor of an entity is generally treated as an interest in an entity, such an interest should not be treated as an interest in an entity for purposes of section 731(c).³⁹

Section 351(e)(1)(B)(vi) and (vii), which was enacted after section 731(c), supports the conclusion that section 731(c)(2)(B)(v) and (vi) does not apply to interests as creditors. For purposes of determining whether a corporation is an investment company under section 351(e)(1), stock and securities include “interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of” stock and securities. Section 351(e)(1)(B)(vi). Stock and securities also include, “to the extent provided in regulations . . . any interest in any entity not described in [section 351(e)(1)(B)](vi), but only to the extent of the value of such interest that is attributable to” stock and securities. Section 351(e)(1)(B)(vii). Therefore, the relevant language of section 351(e)(1)(B)(vi) and (vii) is, in all material respects, identical to that of section 731(c)(2)(B)(v) and (vi). Furthermore, the legislative history of section 351(e) states that, until the promulgation of regulations under section 351(e)(1)(B)(vi) and (vii), “the Treasury regula-

tions promulgated under the similar provisions of section 731(c)(2) generally will apply.” S. Rep. No. 105-33, at 131 n.69 (1997). This strongly suggests that Congress generally intended “interest in an entity” to have the same meaning for purposes of both sections 351(e) and 731(c).

It is clear that an interest in an entity cannot include an interest as a creditor for purposes of section 351(e). All “evidences of indebtedness” are treated as stock and securities for purposes of section 351(e). Section 351(e)(1)(B)(ii). Treating an evidence of indebtedness as an interest in an entity for purposes of section 351(e)(1)(B)(vii) could result in its being treated as stock and securities only in part, which would be inconsistent with section 351(e)(1)(B)(ii). Treating an evidence of indebtedness as an interest in an entity for purposes of section 351(e)(1)(B)(vi) would simply be redundant, because evidences of indebtedness are already treated as stock and securities in full under section 351(e)(1)(B)(ii). Accordingly, it is clear that, for purposes of section 351(e), “interest in an entity” should not be interpreted to include an interest as a creditor.⁴⁰

⁴⁰Stock in a corporation is generally treated as stock and securities for purposes of section 351(e). See section 351(e)(1)(B)(ii). Reg. section 1.351-1(c)(4), which was promulgated before the enactment of section 351(e)(1)(B)(vi) and (vii), contains a look-through rule for stock of subsidiary corporations, and the legislative history states that the enactment of section 351(e)(1) was not intended to override that look-through rule. See S. Rep. No. 105-33 at 131. Therefore, stock cannot logically be treated as an interest in an entity for purposes of section 351(e)(1)(B)(vi) and (vii), because the pre-1997 look-through rule continues to apply to determine the extent to which stock in a subsidiary corporation should be treated as stock and securities. However, it is clear that stock constitutes an interest in an entity for purposes of section 731(c)(2)(B)(v) and (vi). Because stock is not treated as an interest in an entity for purposes of section 351(e)(1)(B)(vi) and (vii) but is treated as an interest in an entity for purposes of section 731(c)(2)(B)(v) and (vi), it might be thought that the fact that a debt instrument is not treated as an interest in an entity for purposes of section 351(e) does not necessarily mean that a debt instrument is not treated as an interest in an entity for purposes of section 731(c).

However, it is understandable that Congress decided not to treat stock as an interest in an entity for purposes of section 351(e). Such a rule would have been inconsistent with the reg. section 1.351-1(c)(4) look-through rule for subsidiary stock that was already in place when section 351(e)(1)(B)(vi) and (vii) was enacted. Congress simply left the preexisting look-through rule in place. By contrast, there is no indication that Congress intended to apply a look-through approach, an “interest in an entity” approach, or any comparable approach to debt instruments. The legislative history of section 351(e)(1)(B)(vi) and (vii) shows that Congress was aware of the distinction between sections 351(e) and 731(c) regarding the treatment of stock. Although the legislative history states that the regulations under section 731(c)(2)(B)(v) and (vi) generally apply for purposes of section 351(e)(1)(B)(vi) and (vii), it goes on to state:

Specifically, . . . with respect to *partnerships and other non-corporate entities*, it is intended that, where 20 percent or more (but less than 90 percent) of the entity’s assets consist of listed assets [i.e., stock and securities], a pro rata portion of the interest in the entity will be treated as a listed asset.

(Footnote continued on next page.)

³⁸The IRS has even taken the position that the provision of services to a corporation on an unpaid basis constitutes an “interest” in the corporation for purposes of section 302(c)(2)(A)(i). See Rev. Rul. 56-556, 1956-2 C.B. 177.

³⁹The IRS has implicitly agreed with that conclusion. In LTR 9620020, *Doc 96-14870*, 96 *TNT* 99-20, the IRS ruled that mortgage notes held by a partnership were not marketable securities based on the taxpayer’s representation that they were not actively traded within the meaning of section 1092(d)(1). If a debt instrument could constitute an interest in an entity under these rules, the IRS would have had to also base its conclusion on the fact that the obligors under the notes were not entities or that less than 20 percent of the obligors’ assets consisted of money and marketable securities.

Further, treating debt instruments as interests in an entity for purposes of section 731(c)(2)(B)(v) and (vi) would make the provisions virtually impossible to administer. When a partnership distributes a debt instrument issued by another entity, the partnership would need information regarding the balance sheet of the other entity as of the date of distribution to determine whether the debt instrument would be treated as a marketable security in whole or in part under section 731(c)(2)(B)(v) or (vi). However, in many, if not most, cases, the partnership will not have access to that information. Furthermore, if a partnership distributes a debt instrument issued by an entity and the issuer holds debt instruments issued by other entities, information regarding the balance sheets of all of those other entities could be relevant in determining whether the debt of the first entity constitutes a marketable security.

Example 10. A partnership distributes to a partner a private placement note issued by JA Co. Assume the note is not otherwise a marketable security. If the note were an interest in an entity for purposes of section 731(c), the determination of whether the note was a marketable security in whole or in part would require an analysis of the balance sheet as of the date of the distribution of JA Co., the balance sheet as of the date of the distribution of every entity that owed money to JA Co., the balance sheet as of the date of the distribution of every entity that owed money to an entity that owed money to JA Co., and so on.

In practice, such a test would be impossible to administer, and it seems unlikely that Congress would have intended such a result.

2. Minority interests. Under section 731(c)(2)(B)(v) and (vi), an interest in an entity can be treated as a marketable security even if the interest is a minority interest.

Example 11. A partnership owns a building worth 900 and C common stock worth 100. The stock represents 1 percent of all the outstanding stock of C, which is a closely held corporation. The remaining 99 percent of the outstanding C stock is held by a single shareholder unrelated to the partnership and its partners. Forty percent of C's assets consist of money and marketable securities. The partnership distributes the C stock to partner P. Assume none of the exceptions to section 731(c) are applicable.

S. Rep. No. 105-33 at 131 n.69 (emphasis added). That Congress provided the foregoing elaboration on the proper application of the section 731(c) regulations in the section 351(e) context shows that Congress was aware that stock was treated as an interest in an entity for purposes of section 731(c) but not for purposes of section 351(e). By contrast, the legislative history provides no indication that Congress intended a debt instrument to be treated as an interest in an entity for purposes of section 731(c) but not for purposes of section 351(e). Accordingly, the differing treatment of stock for purposes of sections 351(e)(1)(B)(vi) and (vii) and 731(c)(2)(B)(v) and (vi) should not lead to the conclusion that those provisions also apply differently to debt.

Because 20 percent or more of C's assets consist of money and marketable securities, the distribution of the C stock is treated as the distribution of 40 of marketable securities and 60 of property other than marketable securities. However, the application of section 731(c) in this context seems absurd. Even though 40 percent of C's assets consist of stock and marketable securities, it is highly unlikely that the distributed C stock is liquid or even easy to value. After the distribution, P will own only a 1 percent minority interest in C. P will not be able to control C. P will be entitled to dividends only if and when dividends are declared by C's board of directors. Accordingly, P will have no ability to gain access to the money and marketable securities held by C. Moreover, as discussed above, valuation of the C stock should take into account discounts for lack of control and marketability. While those discounts might reduce the amount P would otherwise have to take into account under section 731(c), the very applicability of the discounts demonstrates that section 731(c) should not apply. Because the application of the interest in an entity rules is based solely on the entity's assets, without regard to the nature of the interest, those rules broaden the scope of the term "marketable security" to cover instruments that are not necessarily highly liquid and easy to value, which was what Congress claimed to have been concerned with when it enacted section 731(c).⁴¹

3. Structures with multiple tiers of entities. The interest-in-an-entity provisions also produce anomalous results when multiple tiers of entities are involved. The anomalies are a direct function of the use of the 20 percent and 90 percent thresholds for triggering the application of section 731(c)(2)(B)(v) and (vi), rather than a pure look-through approach.⁴²

⁴¹In an analogous context, Congress provided that the element of control (or the absence thereof) should be taken into account. Under section 453(k)(2)(A), dispositions of stock or securities traded on an established securities market are not eligible for installment sale treatment. The flush language at the end of section 453(k) authorizes regulations preventing the avoidance of its provisions through the use of related parties, passthrough entities, or intermediaries. However, the legislative history states that:

The committee intends that any Treasury regulations would not deny use of the installment method if the seller could not have sold, or caused the sale of, the publicly traded stock or securities directly. For example, a retiring partner in a large investment partnership makes an installment sale of his partnership interest, a substantial portion of the value of which is attributable to stocks and securities held by the partnership. Provided that the retiring partner could not have sold or caused the sale of the partnership's assets directly, the gain on the sale of the partnership interest may be reported on the installment method.

S. Rep. No. 99-313, at 131 (May 29, 1986).

⁴²Arguably, a look-through approach may be applicable to interests in lower-tier entities. Section 731(c)(2)(B)(v) applies when a partnership owns an interest in an entity substantially all the assets of which consist "directly or indirectly" of money or marketable securities. Also, reg. section 1.731-2(c)(3)(ii) treats an interest in an entity as a marketable security to the extent that

(Footnote continued on next page.)

Example 12. Assume that a partnership holds all the outstanding stock of corporation C. C has 43 of cash and real estate worth 81. Assume the C stock is not otherwise a marketable security. Under section 731(c)(2)(B)(vi), because approximately 35 percent of C's assets consist of cash, the C stock is treated as a marketable security to the extent of the value of the C stock attributable to money or marketable securities (that is, 43).

Example 13. Assume the same facts as above except that C has a wholly owned subsidiary, D, which holds 19 in cash and the real estate worth 81. C holds 24 in cash. Because only 19 percent of D's assets consist of cash, the D stock is not treated as a marketable security in whole or in part. Because the D stock is not a marketable security, only about 19.4 percent of C's assets are treated as consisting of cash and marketable securities; therefore, the C stock is not treated as a marketable security in whole or in part.

Accordingly, even though the amount of money, as a percentage of the aggregate assets of both entities, is the same in each example (about 35 percent), the manner in which the assets are distributed between the entities determines whether or not section 731(c)(2)(B)(vi) applies. The extent to which money or marketable securities can be "hidden" in a structure increases with the number of tiers in the structure.

Example 14. A partnership owns the stock of C, which owns D stock worth 124 and 30 of cash. D owns E stock worth 100 and 24 of cash. E owns real estate worth 81 and 19 of cash. The C stock will not be treated as a marketable security in whole or in part, even though more than 47 percent of the corporate chain's aggregate assets, by value, consists of cash.

In a structure with six tiers, more than 72 percent of the entities' aggregate assets could consist of money or marketable securities, without the interest in the uppermost entity being treated as a marketable security in whole or in part. As the number of tiers increases, the limit will approach 100 percent.⁴³

the value of the interest is attributable directly or indirectly to money or marketable securities. It could be argued that, while the 20 percent and 90 percent thresholds clearly apply for purposes of determining whether an interest in the entity directly held by the partnership is treated as a marketable security, the language "directly or indirectly" means that the uppermost entity should be treated as owning its proportionate share of the assets of each entity in which it owns, directly or indirectly, an interest. However, there appears to be no support for that approach, and applying the 20 percent and 90 percent thresholds to each interest in each entity in the structure appears to be more consistent with the language of the code and regulations.

⁴³If additional tiers of entities are created solely to avoid the application of section 731(c)(2)(B)(v) and (vi), the section 731(c) antiabuse rule, the more general subchapter K antiabuse rule, or (when corporate entities are involved) section 269 could apply.

The potential for anomalies is also present in the application of section 731(c)(2)(B)(v).

Example 15. Corporation C holds real estate worth 10 and D stock worth 100. D holds 90 of cash and real estate worth 10. Because 90 percent or more of D's assets consist of cash, the D stock is treated as a marketable security in whole under section 731(c)(2)(B)(v). Consequently, C is treated as holding a marketable security worth 100 and real estate worth 10, and therefore the C stock is also treated as a marketable security to the full extent of its 110 value, even though less than 90 percent of the aggregate assets consist of cash.

Example 16. Assume the same facts as above except that D holds 89 in cash and C holds 1 in cash. In this example, because at least 20 percent but less than 90 percent of D's assets consist of cash and marketable securities, the D stock is treated as a marketable security to the extent of the value of the D stock attributable to money or marketable securities (that is, 89). Consequently, C is treated as holding 1 of cash, a marketable security worth 89 (the portion of the D stock that is treated as a marketable security), and a nonmarketable security worth 10 (the portion of the D stock that is not treated as a marketable security). Because at least 20 percent but less than 90 percent of C's assets are treated as consisting of cash and marketable securities, the C stock is treated as a marketable security to the extent of the value of the C stock attributable to money or marketable securities (that is, 90).

Accordingly, even though the amount of money as a percentage of the aggregate assets of both entities is the same in each of the above examples (about 82 percent), the manner in which the assets are distributed between the entities determines whether or not section 731(c)(2)(B)(v) applies.

4. Use gross values rather than net values of assets. For purposes of section 731(c) and the regulations thereunder, the value of an entity's assets is determined on a gross basis, that is, without regard to any debt that may encumber or otherwise be allocable to those assets. Reg. section 1.731-2(c)(4). However, debt that encumbers or is otherwise allocable to an asset is taken into account if the debt was incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c). *Id.*

Example 17. A partnership owns all the stock of corporation C. C's sole assets are marketable securities worth 200 and land worth 800. With a principal purpose of avoiding the effect of section 731(c), C borrows 100 and uses the cash to buy nonmarketable securities. On the following day, the partnership distributes the C stock to one of its partners.

Under the general rules, because less than 20 percent of C's gross assets consist of money or marketable securities, the C stock would not be treated as a marketable security in whole or in part. However, because C borrowed the 100 with a principal purpose of avoiding the effect of section 731(c), the debt is taken into account

in determining the value of C's assets for purposes of the interest in an entity provisions. Accordingly, the value of C's assets is treated as being 1,000. Therefore, 20 percent of the total value of C's assets is treated as consisting of marketable securities, and the distribution of the C stock is treated as a distribution of 200 of marketable securities and 800 of property other than marketable securities.

Although the determination of whether an interest in an entity is a marketable security in whole or in part is made based on the gross value of the entity's assets, the determination of the amount of gain recognized is based on the net value of the interest. In some cases, distributing interests in entities can reduce the amount of gain recognized.

Example 18. Partnership UTP owns a marketable security that has a gross FMV of 20 and is subject to 10 in debt. UTP also owns an interest in partnership LTP worth 10. LTP has no liabilities and its sole asset is land worth 20. UTP contributes the marketable security, subject to the debt, to LTP, causing the FMV of its interest in LTP to increase from 10 to 20. Subsequently, UTP distributes the interest in LTP to P, one of its partners. Assume that no exception to section 731(c) is applicable.

Under the interest-in-an-entity provisions, 50 percent of UTP's interest in LTP is treated as a marketable security. Because the net value of UTP's interest in LTP is 20, P is treated as receiving a distribution of a marketable security in the amount of 10 (50 percent of 20). By contrast, if UTP had instead separately distributed the marketable security and the interest in LTP, P would have been treated as receiving a distribution of a marketable security in the amount of 20 (that is, the FMV of the marketable security). Consequently, the transfer of a marketable security that is subject to debt to a lower-tier entity can decrease the portion of a distribution that is treated as a marketable security.⁴⁴

5. Other valuation issues. These provisions can impose an administrative burden on taxpayers in determining the extent to which an interest in an entity is a marketable security. A partnership distributing an interest in an entity must determine the relative values of the marketable securities and the other assets held by the entity. In many cases, this may not be difficult, such as when all the entity's assets are held directly by the entity, the interests are all proportionate to capital, and the partnership and distributee-partner can agree on the FMV of the interest. However, in some cases it will not be easy. For example, difficulties can arise when the interest is a preferred interest, when the distribution is proportionate to all partners, or when there are multiple tiers of entities.

Example 19. A partnership owns 100 percent of the stock of C. C owns a parcel of real estate and 40 of cash and marketable securities. The partnership distributes the stock to one of its partners, and the parties agree that the stock is worth 100. Implicitly,

the real estate is worth 60, and 40 of the stock is treated as a marketable security under the "interest in an entity" rules.

Example 20. A partnership owns preferred stock in D. D owns 40 of cash and marketable securities and a parcel of real estate. The partnership distributes the stock to one of its partners, and the parties agree that the stock is worth 100. It is not clear what portion, if any, of the preferred stock is a marketable security under the interest in an entity rules. The partnership will have to determine the value of the real estate. If it is worth more than 160, the preferred stock is not a marketable security in whole or in part.

Example 21. A partnership owns 100 percent of the stock of E, which owns 100 percent of the stock of F. In addition to the stock of F, E owns a parcel of real estate and 30 of marketable securities. F owns 10 of marketable securities and a parcel of real estate. The partnership distributes the stock to one of its partners, and the parties agree that the stock is worth 100. It is not clear what portion of the stock is a marketable security under the interest in an entity rules. If E's real estate is worth 55 and F's real estate is worth 5, 40 of the stock is a marketable security. If E's real estate is worth 5 and F's is worth 55, 30 of the stock is a marketable security. If each parcel of real estate is worth 30, 40 of the stock is a marketable security.

IV. Exceptions to Section 731(c)

There are many (and important) exceptions to the general rules of section 731(c). The existence of the exceptions can be explained only when section 731(c) is understood to be an antiabuse provision. The existence of many of those exceptions would be difficult, if not impossible, to defend if section 731(c) were really intended to treat like transactions similarly.

A. Limitation for Share of Gain

One of the most important exceptions to the treatment of marketable securities as money under section 731(c) is the limitation for the distributee-partner's share of gain in the partnership's marketable securities. Under this exception, the amount of marketable securities treated as money is reduced by an amount equal to the excess, if any, of the distributee-partner's distributive share of the net gain⁴⁵ that would be recognized if all of the partnership's marketable securities were sold for FMV immediately before the transaction to which the distribution relates over the partner's distributive share of the net gain that would be recognized by the partnership on a sale of the marketable securities held by the partnership

⁴⁴See Hortenstine and Marich, "Final Regulations Under Sections 704(c)(1)(B), 737, and 731(c)," 701 *PLI/Tax* 231, 342-343 (June 2006).

⁴⁵Some have suggested that the statute is not clear on whether the net gain is the net book gain or the net taxable gain allocable to the distributee-partner. See *id.* at 337. However, the use of the term "distributive share" can mean only net taxable gain, including gain allocable under section 704(c). See sections 704 and 705.

immediately after the transaction to which the distribution relates.⁴⁶ Section 731(c)(3)(B); reg. section 1.731-2(b)(2).⁴⁷ The same FMV used for purposes of determining the partner's share of the gain before the distribution is used for purposes of determining the partner's share of gain after the distribution.⁴⁸ See section 731(c)(3)(B)(ii); reg. section 1.731-2(b)(2)(ii). Under this exception, to the extent the partner's share of gain from marketable securities held by the partnership decreases as a result of the distribution, the amount of marketable securities treated as money decreases.⁴⁹

The legislative history states that Congress did "not intend[] that a partner be taxed under [section 731(c)] on the partnership's gain attributable to his share of the partnership's marketable securities distributed to him, because he has not exchanged his share of any other partnership asset for an increased share of the partnership's marketable securities." H.R. Rep. No. 103-826(I) at 188, reprinted in 1994 U.S.C.A.N. 3960. The preamble to the proposed regulations states that, as a result of this exception, "section 731(c) generally applies only when a partner receives a distribution of marketable securities in exchange for the partner's share of appreciated assets other than marketable securities." PS-2-95, 1996-1 C.B. 853, 854.⁵⁰ However, in operation, the exception does not

⁴⁶In LTR 200223036, *Doc 2002-13646*, 2002 TNT 111-36, the IRS ruled that "held by the partnership immediately after the transaction" refers to only the divided partnership in the case of an assets-over partnership division under section 708(b)(2)(B) even if both resulting partnerships are continuations of the prior partnership.

⁴⁷Section 731(c)(3)(B) applies the limitation solely to securities of the same class and issuer. However, under the delegation of authority in section 731(c)(3), the regulations provide that, for purposes of section 731(c)(3)(B), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed securities. Reg. section 1.731-2(b)(1). The preamble to the proposed regulations stated that "[t]reating all marketable securities as a single asset for this purpose is consistent with the basic rationale of section 731(c) that marketable securities are the economic equivalent of money." PS-2-95, 1996-1 C.B. 853, 854. While the rule is generally helpful to taxpayers, it could be detrimental when a partnership holds some marketable securities that have appreciated in value and other marketable securities of another class or another issuer that have declined in value and the partnership distributes some of the appreciated securities. See Hortenstine and Marich, *supra* note 42, at 337.

⁴⁸The requirement that the same FMV be used prevents distortions due to fluctuations in value when the transaction involves multiple distributions that take place over an extended period.

⁴⁹To the extent that section 731(c)(3)(B) applies to reduce the amount of a marketable security that is treated as money under section 731(c), the distribution of the marketable security is treated as a distribution of property to which section 737 may apply. See reg. section 1.731-2(g)(1)(iii)(A), (j), Example 7(iii).

⁵⁰If the purpose of section 731(c) was to tax a partner when the distribution provisions of subchapter K are used to effect an exchange of the partner's interest in assets other than marketable securities for an interest in marketable securities, the provision should cause gain recognition regardless of which assets are distributed, along the lines of section 751(b). It is true

(Footnote continued in next column.)

necessarily permit a partner to receive a distribution of its share of marketable securities without gain recognition. Rather, the exception can apply only if the partner's share of the partnership's marketable securities is appreciated.

Example 22. P is a 50 percent partner in a partnership that owns marketable securities with a value and basis of 200 and significant other assets. P has a zero basis in its partnership interest. The partnership distributes the marketable securities proportionately to the partners. Assume no other exception to section 731(c) is applicable. Even though P receives only its share of the partnership's marketable securities, P recognizes 100 of gain, because no gain would have been recognized by P if all the partnership's marketable securities had been sold before or after the distribution.

Example 23. Assume the same facts as above, except the partnership's basis in the marketable securities is zero. P recognizes no gain in the distribution. The amount of marketable securities distributed to P that is treated as money under section 731(c) is reduced by P's share of the gain in the partnership's marketable securities before the distribution (100) minus P's share of the gain in the partnership's marketable securities after the distribution (0). Thus, none of the distributed marketable securities is treated as money, and P recognizes no gain.

Also, the exception has different effects depending on whether a distribution is liquidating or nonliquidating and can produce anomalous results where there are inside/outside basis disparities.

1. Liquidating distributions. In liquidating distributions, the exception produces a result that is reasonably consistent with its purpose. Because the distributee-partner's distributive share of the net gain that would be recognized by the partnership on a sale of the partnership's marketable securities immediately after the transaction will always be zero in a liquidating distribution, the amount of the reduction will always equal the partner's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold for FMV immediately before the distribution. Because all of the partnership's marketable securities are aggregated, this is the result regardless of whether the marketable securities that are selected for distribution are themselves appreciated.

that the antiabuse rule in the section 731(c) regulations, discussed below, can result in gain recognition when substantially all of a partnership's assets other than marketable securities and money are distributed to one partner, leaving behind mostly marketable securities and money for the remaining partners. See reg. section 1.731-2(h)(2). However, that rule is limited, and section 731(c) would not apply to the distribution of less than substantially all of a partnership's assets other than marketable securities and money, even though such a distribution could result in some partners' exchanging their interests in the distributed assets for increased interests in the partnership's marketable securities and money.

Example 24. P is a one-third partner in a partnership that owns publicly traded stock with a value of \$4 million and a basis of \$1 million, publicly traded debt with a value and basis of \$4 million, and land with a value of \$4 million and a basis of \$1 million. P has an outside basis of \$2 million. The partnership distributes the stock to P in liquidation of P's interest in the partnership. Assume no other exception to section 731(c) is applicable.

The amount of money that P is treated as receiving under section 731(c) (\$4 million) is reduced by \$1 million. Therefore, under section 731(c), P is treated as receiving a distribution of \$3 million in money, resulting in \$1 million of gain recognition. P takes a basis of \$3 million in the stock. The \$1 million of gain that was embedded in P's partnership interest (and attributable to marketable securities) is thus preserved in the stock. The treatment to P would have been exactly the same if the partnership had distributed the debt (instead of the stock) to P, even though there is no appreciation in the debt.⁵¹

2. Nonliquidating distributions. In nonliquidating distributions, the exception does not necessarily produce a result consistent with its purpose. Also, the presence or absence of a section 754 election can have an effect on the amount of the reduction under section 731(c)(3)(B).

Example 25. Assume the same facts as in Example 24 except that the value of the land is \$10 million and the distribution to P is therefore a nonliquidating distribution.

The amount of money that P is treated as receiving under section 731(c) (\$4 million) is reduced by \$1 million.⁵² Therefore, under section 731(c), P is treated as receiving a distribution of \$3 million of money, resulting in \$1 million of gain recognition. P's outside basis is reduced to \$1 million, preserving \$1 million of gain in P's remaining \$2 million partnership interest. P takes a \$2 million basis in the stock, preserving \$2 million of gain in the stock. Effectively, P was able to exchange in a tax-free manner \$1 million of gain attributable to the land for \$1 million of appreciation in the stock.⁵³

⁵¹The treatment to the partnership would differ depending on which asset was distributed. If the debt were distributed, the partnership would be entitled to a \$2 million positive basis adjustment under section 734(b) (allocated \$1 million to each of the stock and the land) if it had a section 754 election in effect. Section 734(b)(1)(B). If the stock were distributed, there would be a substantial basis reduction under section 734(d), and therefore the partnership would be required to reduce the basis of its assets by \$1 million under section 734(b) whether or not it had a section 754 election in effect. Section 734(b)(2)(B), (d).

⁵²The excess of P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately before the distribution (\$1 million) over P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately after the distribution (0) is equal to \$1 million.

⁵³P had \$4 million of gain embedded in its partnership interest. \$1 million of gain was attributable to marketable securities, and \$3 million of gain was attributable to the land. P clearly should be able to preserve the \$1 million of gain attributable to marketable securities in the stock, but it is not

(Footnote continued in next column.)

If, instead, the debt were distributed to P, the analysis would be far different and the result might depend on whether the partnership had a section 754 election in effect. P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately before the distribution would still be \$1 million; however, the determination of P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately after the distribution is not as straightforward. If, before the distribution, the partnership adjusted the book values of its assets under reg. section 1.704-1(b)(2)(iv)(f), thereby creating reverse section 704(c) gain in its assets, and it had no section 754 election in effect, P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately after the distribution would be \$1 million and there would be no reduction in the amount of marketable securities treated as money. As a result, P would recognize \$2 million of gain. P would take a \$4 million basis in the debt and have \$2 million of gain still embedded in its partnership interest.

If, however, the partnership had a section 754 election in effect, it would be entitled to a \$2 million positive basis adjustment. Sections 731(c)(5) and 734(b)(1)(B). Under section 755 and the regulations thereunder, \$500,000 of the adjustment would be allocated to the stock and \$1.5 million of the adjustment would be allocated to the land. P's share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately after the distribution would be less than \$1 million, assuming that postdistribution net gain is to be determined *after* taking section 734(b) basis adjustments into account.⁵⁴ After the distribution, the partnership would have \$2.5 million of gain on a sale of the stock. While it is not entirely clear how that gain would be allocated under the IRC and regulations, the "correct" approach would be to allocate only \$500,000 to P.⁵⁵ In that case, the amount of the reduction under section 731(c)(3)(B) would be \$500,000.⁵⁶ P would therefore recognize \$1.5 million of gain.

3. Inside/outside basis disparities. As is often the case in applying the rules of subchapter K, distortions may arise

clear why P should be permitted to preserve \$1 million of the appreciation attributable to the land.

⁵⁴Presumably, in the above example, it would be appropriate to take the section 734(b) basis adjustment into account, because the adjustment arose in, and as a consequence of, the distribution.

⁵⁵Under that approach, the other partners' distributive share of the gain from a sale of the partnership's assets would remain the same before and after the distribution.

⁵⁶The excess of P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately before the distribution (\$1 million) over P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately after the distribution (\$0.5 million) would be \$0.5 million.

when a partner's outside basis differs from the partner's share of the partnership's inside basis.

Example 26. In 2001 P purchased from an existing partner a one-third interest in a partnership for \$1 million. The partnership's sole asset was stock in C, a publicly traded corporation. The stock had a value of \$3 million and a basis of \$6 million. The partnership did not have a section 754 election in effect in 2001.⁵⁷ The stock subsequently increased in value to \$6 million. In 2007 the partnership distributes \$2 million of the stock to P in a liquidating distribution. Assume no other exceptions to section 731(c) are available.

There is no reduction under section 731(c)(3)(B) because P's share of the net gain that would be recognized if all of the partnership's marketable securities were sold immediately before the distribution is zero. Thus, P recognizes \$1 million of gain on the distribution even though P is simply receiving its share of the partnership's marketable securities, which have appreciated since P became a partner. In this case, the section 731(c)(3)(B) limitation should apply, since P has not exchanged an interest in an appreciated asset other than a marketable security for a marketable security.⁵⁸ The result would have been avoided if the partnership had made a section 754 election in 2001.⁵⁹ In that case, P's share of the net gain that would have been recognized if all of the partnership's marketable securities had been sold immediately before the distribution would have been \$1 million. Consequently, P would have been treated as receiving a distribution of \$1 million of money, which would not have exceeded P's outside basis, and P would not have recognized gain.

4. Special rules for determining net gain. A partner's distributive share of net gain is determined without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c). Reg. section 1.731-2(b)(3)(ii). Also, a partner's distributive share of net gain is determined without taking into account any gain or loss attributable to a distributed security to which an exception under reg. section 1.731-2(d)(1) applies.⁶⁰ Reg. section 1.731-2(b)(3)(iii). The foregoing rule applies only to *distributed* securities to which an exception applies; securities that

⁵⁷If the transfer had occurred after Oct. 22, 2004, there would have been a mandatory \$1 million negative section 743(b) basis adjustment in the stock because there would have been a substantial built-in loss. See section 743(d)(1).

⁵⁸See Hortenstine and Marich, *supra* note 44, at 335.

⁵⁹For purposes of section 731(c)(3)(B), a partner's distributive share of net gain is determined by taking into account any basis adjustments under section 743(b) with respect to that partner. Reg. section 1.731-2(b)(3)(i). As a result, negative section 743(b) adjustments allocated to the basis of marketable securities will increase the limitation on the amount of marketable securities treated as money, and positive section 743(b) adjustments will reduce the limitation on the amount of marketable securities treated as money.

⁶⁰As discussed in greater detail below, reg. section 1.731-2(d)(1) contains exceptions for distributions of some marketable securities.

are retained by the partnership are apparently taken into account, even if they would have qualified for an exception if they had been distributed.

Example 27. A partnership's assets consist of land with a value and basis of 700 and marketable security MS1 with a value and basis of 200. P contributes marketable securities MS2 and MS3 to the partnership in exchange for a 25 percent interest. MS2 has a value of 200 and a basis of zero. MS3 has a value of 100 and a basis of zero. Over the next eight years, the bases of all the partnership's assets remain unchanged, MS1 increases in value to 300, the land increases in value to 1,000, and the values of MS2 and MS3 remain unchanged. At the end of the eighth year, the partnership distributes MS1 and MS3 to P in liquidation of P's partnership interest.

As discussed in more detail below, under the exception in reg. section 1.731-2(d)(1)(i), section 731(c) generally does not apply to the distribution to a partner of a security that the partner contributed to the partnership. Accordingly, section 731(c) does not apply to the distribution of MS3 to P. Therefore, P is treated under section 731(c) as receiving a distribution of 300 in money (that is, the FMV of MS1) reduced by the amount determined under section 731(c)(3)(B). Under reg. section 1.731-2(b)(3)(ii), P's distributive share of the partnership's net gain is determined without taking into account any gain or loss attributable to MS3. However, because MS2 is not distributed in the transaction, MS2 apparently *is* taken into account for purposes of determining P's distributive share of the partnership's net gain (even though MS2 would have been eligible for the same exception if distributed to P). Accordingly, the amount of the distribution that is subject to section 731(c) is reduced under section 731(c)(3)(B) by the excess of P's distributive share of the net gain that would be recognized if all of the partnership's marketable securities (other than MS3) were sold (immediately before the transaction to which the distribution relates) for FMV (225) over P's distributive share of the net gain that would be recognized by the partnership on a sale of the partnership's marketable securities immediately after the transaction (zero). Accordingly, section 731(c) applies to only 75 of the distribution received by P.

B. The 'Investment Partnership' Exception

Another significant exception to section 731(c) is the exception for "investment partnerships." Section 731(c) does not apply to the distribution of marketable securities by an investment partnership to an "eligible partner." Section 731(c)(3)(A)(iii). A partnership qualifies as an investment partnership if it has *never* been engaged in a trade or business and substantially all⁶¹ of its assets (by

⁶¹Although there is no definition of substantially all for this purpose, it has been defined elsewhere in section 731(c) to mean at least 90 percent. See reg. section 1.731-2(c)(3)(i).

value) have *always* consisted of certain specified assets (eligible assets).⁶² Eligible assets are:

- money;
- stock in a corporation;
- notes, bonds, debentures, or other evidences of indebtedness;
- interest rate, currency, or equity notional principal contracts;
- foreign currencies;
- interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset listed above or in any commodity traded on or subject to the rules of a board of trade or commodity exchange; or
- any combination of the above.

Section 731(c)(3)(C)(i).⁶³

An asset can be an eligible asset whether or not it is actively traded or otherwise treated as a marketable security under section 731(c).⁶⁴ Presumably, all marketable securities are eligible assets.

A partner generally qualifies as an eligible partner if the partner has not contributed any assets other than eligible assets to the partnership.⁶⁵ Section 731(c)(3)(C)(iii)(I). However, a partner that acquires an interest in a partnership in a nonrecognition transaction from a transferor that was not an eligible partner does not qualify as an eligible partner. Section 731(c)(3)(C)(iii)(II). By implication, a partner can qualify as an eligible partner if it acquires its partnership interest in a taxable transaction from a partner that was not an eligible partner.

Neither the code nor the regulations describe what activities cause a partnership to be treated as having

engaged in a trade or business. However, the regulations provide that the following activities do *not* result in the partnership's being treated as having engaged in a trade or business:

- any activity undertaken as an investor, trader, or dealer in any [eligible] asset . . . including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;
- reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership . . . in which the partnership holds a partnership interest; or
- reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

Reg. section 1.731-2(e)(3); H.R. Rep. No. 103-826(I) at 191, reprinted in 1994 U.S.C.C.A.N. 3963. Those permitted activities generally allow venture capital funds to qualify as investment partnerships.⁶⁶

For purposes of determining whether a partnership qualifies as an investment partnership, the partnership is generally treated as engaged in any trade or business engaged in by, and as holding its proportionate share of the assets held by, a lower-tier partnership. Section 731(c)(3)(C)(iv)(I). Similarly, for purposes of determining whether a partner is an eligible partner, a partner that contributes an interest in another partnership to a partnership is treated as contributing a proportionate share of the assets of the other partnership. Section 731(c)(3)(C)(iv)(II). The regulations provide that the look-through rule does not apply when the upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership and the interest held by the upper-tier partnership is less than 20 percent⁶⁷ of the total profits and capital interests in the lower-tier partnership. Reg. section 1.731-2(e)(4).⁶⁸

⁶⁶Hedge funds and private equity funds are also likely to qualify as investment partnerships, but because it would be unusual for those funds to make in-kind distributions, their qualification is not particularly relevant.

⁶⁷The proposed regulations had a 10 percent threshold. However, in response to comments that ownership of more than a 10 percent interest in a lower-tier partnership may still be consistent with passive ownership, the final regulations increased the threshold to 20 percent. T.D. 8707, 1997-1 C.B. 128, 130.

⁶⁸If a partnership interest is contributed to an investment partnership and, after the contribution, the requirements of reg.

(Footnote continued on next page.)

⁶²According to the preamble to the final section 731(c) regulations, the requirement that substantially all a partnership's assets always have consisted of eligible assets applies even to periods before the enactment of section 731(c). T.D. 8707, 1997-1 C.B. 128, 130, *Doc 96-33008*, 96 *TNT* 252-5. The same principle would presumably also apply to the requirement that the partnership never have been engaged in a trade or business. A partnership that fails to satisfy one of those requirements will be unable to qualify as an investment partnership even if it subsequently terminates under section 708(b)(1)(B). *See* reg. section 1.731-2(g)(2).

⁶³Section 731(c)(3)(C)(i)(VII) also includes any assets specified in regulations. No other assets have been specified in regulations.

⁶⁴The IRS has issued several private letter rulings regarding the status of a partnership as an investment partnership. *See* LTRs 200049032, *Doc 2000-31692*, 2000 *TNT* 238-35; 199926032, *Doc 1999-22822*, 1999 *TNT* 128-23; 199917049, *Doc 1999-15639*, 1999 *TNT* 84-72; 199902008, *Doc 1999-2068*, 1999 *TNT* 11-47; and 9821015, *Doc 98-16145*, 98 *TNT* 100-73.

⁶⁵A contribution of services is not a contribution of assets; therefore, a partner that contributes services to a partnership can qualify as an eligible partner. Reg. section 1.731-2(e)(2)(i). Deemed contributions of assets resulting from the creation of a partnership under Rev. Rul. 99-5, 1999-1 C.B. 434, *Doc 1999-2045*, 1999 *TNT* 10-6, are taken into account as contributions of assets and do not create a problem as long as the assets deemed contributed are eligible assets. *See* LTR 200633019, *Doc 2006-15790*, 2006 *TNT* 161-19.

When the look-through rule does not apply, the interest in the lower-tier partnership is treated as an eligible asset. Section 731(c)(3)(C)(iv) (flush language).

While some aspects of the investment-partnership exception seem unreasonably restrictive, it is unclear why eligible partners in investments partnerships should not be subject to section 731(c). Marketable securities are no less moneylike when they are received from an investment partnership. Why should eligible partners of investment partnerships be permitted to exchange interests in eligible assets that are not marketable securities for eligible assets that are marketable securities on a tax-free basis?⁶⁹ Furthermore, the legislative history demonstrates that Congress did not understand the provisions it was enacting:

It is acknowledged that certain partnerships are formed for the purpose of holding *marketable securities* for investment or for sale to customers. Thus, an exception is provided in the case of a distribution of marketable securities by an investment partnership to a partner who did not contribute any property to the partnership other than money or securities or other similar property.

H.R. Rep. No. 103-826(I) at 188, reprinted in 1994 U.S.C.C.A.N. 3960 (emphasis added). However, because nonmarketable securities can be eligible assets, a partnership can qualify as an investment partnership even if it holds no marketable securities.

C. Reg. Section 1.731-2(d) Exceptions

1. Distribution of previously contributed securities. Section 731(c) generally does not apply to the distribution of a marketable security to a partner if the security was contributed to the partnership by the partner.⁷⁰ Section

section 1.731-2(e)(4)(i) (no active and substantial participation in management) are satisfied, the contributed interest is treated as an eligible asset in determining whether the contributor is an eligible partner. Reg. section 1.731-2(e)(2)(ii). According to the preamble to the final regulations, this provision was added in response to a comment and “clarifies] that an interest in a lower-tier partnership that qualifies for the exception to the investment partnership ‘look-through’ rule is treated as eligible property for purposes of determining whether the partner who contributed the lower-tier partnership interest is an eligible partner.” T.D. 8707, 1997-1 C.B. 130. However, the provision cross-references only the requirement that there be no active and substantial participation in management. It is unclear whether the failure to cross-reference the other requirement (that the upper-tier partnership own less than 20 percent of the capital and profits interests in the lower-tier partnership) was intentional.

⁶⁹The opposite policy seems to be at work in section 368(a)(2)(F), which denies tax-free reorganization treatment to transactions involving two or more “investment companies” when at least one is not sufficiently diversified.

⁷⁰This type of exception is common in the distribution provisions of subchapter K. See sections 751(b)(2)(A), 704(c)(1)(B), and 737(d)(1). Although it can be difficult to identify which securities were contributed by the distributee, the IRS has been reasonable in the application of this exception. See LTR 200627013, *Doc 2006-14733*, 2006 *TNT 151-30* (applying the exception when two partners contributed identical assets)

(Footnote continued in next column.)

731(c)(3)(A)(i). It is not clear whether this exception applies when one person contributes property to a partnership and subsequently transfers its partnership interest to another person who later receives a distribution of the contributed property. For many purposes in subchapter K, a transferee of a partnership interest steps into the transferor’s shoes. See, e.g., reg. section 1.704-1(b)(2)(iv)(l) (transferee of partnership interest succeeds to transferor’s capital account); reg. section 1.704-3(a)(7) (transferee of a property-contributor’s interest in a partnership treated as contributor for purposes of section 704(c)). Even for other purposes under section 731(c), the transferee of a partnership interest is treated as the transferor. See section 731(c)(3)(C)(iii)(II) (transferee of partnership interest in a nonrecognition transaction is not an eligible partner for purposes of the investment partnership exception if the transferor was not an eligible partner).⁷¹ However, there is nothing providing for that treatment in this context. The IRC states that, for the exception to apply, the property in question must have been contributed to the partnership “by such partner,” and the regulations use similar language. Reg. section 1.731-2(d)(1)(i). Further, the IRS has apparently declined to rule that the section 731(c)(3)(A)(i) exception is available when a taxpayer acquires a partnership interest by gift. See Hausman, “Mixing Bowls and Marketable Securities in a Family Limited Partnership,” *Tax Notes*, Oct. 20, 2003, p. 375, *Doc 2003-22703*, 2003 *TNT 203-36*; Gergen, “Potential Tax Traps in Liquidating a Family Limited Partnership,” *Tax Notes*, Dec. 22, 2003, p. 1434, *Doc 2003-26869*, 2003 *TNT 246-31*.

2. Distribution of securities that were not marketable securities when acquired. Section 731(c)(3)(A)(ii) provides that, to the extent provided in regulations, section 731(c) does not apply to a partnership distribution of a marketable security if it was not a marketable security when acquired by the partnership. According to the legislative history, Congress intended this exception to apply to transactions such as the “distribution of stock of a corporation acquired by [a] partnership in a private placement, if the corporation subsequently went public and its stock is actively traded at the time the partnership distributes it.” H.R. Rep. No. 103-826(I) at 191, reprinted in 1994 U.S.C.C.A.N. 3963.

The regulations provide that section 731(c) does not apply to the distribution of a marketable security if the security was not a marketable security on the date acquired by the partnership, the entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership, the security was held by the partnership for at least six

and LTR 9801057, *Doc 98-450*, 98 *TNT 2-35* (applying identification under reg. section 1.1012-1(c)(3) to conclude distributee-partners received distributions of previously contributed stock, where each distributee-partner had contributed stock in the same company).

⁷¹The transferee of a partnership interest does not step into the shoes of the transferor for purposes of section 704(c)(1)(C), except when a corporation succeeds to the attributes of a corporate partner under section 381. See H.R. Conf. Rep. No. 108-755, at 610-611, n.546 (2004), reprinted in 2004 U.S.C.C.A.N. 1341, 1675.

months before the date the security became marketable,⁷² and the partnership distributes the security within five years of the date the security became marketable. Reg. section 1.731-2(d)(1)(iii). This exception makes it unnecessary for a partnership to distribute an asset in anticipation of its becoming a marketable security to avoid section 731(c).

Determining whether the issuer had any outstanding marketable securities at the time the partnership acquired the distributed security could be problematic. Given the breadth of what can constitute a marketable security, it may be difficult to satisfy the requirement. For example, as discussed above in FSA 200219008, the IRS concluded that nine-month debt instruments were marketable securities because they were treated as readily convertible into money for purposes of section 731(c)(2)(B)(ii). On the basis of FSA 200219008, if the issuer of a security had any debt outstanding with a term of nine months or less at the time the partnership acquired the security, the security will not qualify for the section 731(c)(3)(A)(ii) exception.⁷³

The requirement in the regulations that the partnership distribute the security within five years of the date the security became marketable does not appear in the code or legislative history. The preamble to the final regulations notes that this requirement was included because of administrative concerns regarding the potential difficulty of determining after many years the circumstances under which a partnership acquired a security. T.D. 8707, 1997-1 C.B. 128, 129. The preamble also states that it is unclear whether the exception should apply to a distribution of securities that were acquired by a partnership many years in the past and are later distributed to a partner that was not a partner when the securities were acquired. *Id.* Whether it should apply or not, as the exception is written, it can apply to a partner that was not a partner at the time the securities were acquired, provided the five-year requirement is satisfied.

Example 28. On January 1, 2006, a partnership owned land with a basis and value of 100 and stock in a private corporation (Oldco) with a basis and value of 300. Oldco, which previously had no outstanding marketable securities, went public on January 15, 2007, turning the partnership's Oldco stock into a marketable security. On January 1, 2009, when the values of the assets are unchanged, P contributes 200 of cash to the partnership for a one-third interest. The partnership uses the 200 of cash to acquire more land. On January 14, 2012, when all the partnership's land is worth 600 and the Oldco stock is worth 300, the partnership distributes the Oldco stock to P in liquidation of its interest in the partnership. All the requirements of reg. section 1.731-2(d)(2)(iii) are satisfied, the Oldco

stock is not treated as a marketable security, and P does not recognize any gain.

The existence of this exception provides further support for the contention that section 731(c) is really an antiabuse provision. An asset is no less similar to cash merely because it became similar to cash only recently. Consequently, there would be no reason to exclude those securities from the application of section 731(c) if section 731(c) had been enacted to conform the treatment of distributions of marketable securities to the treatment of distributions of money. It is only when section 731(c) is viewed as an antiabuse provision that the exception for distributions of marketable securities that were not acquired as such can be justified.

3. Distribution of marketable securities acquired in a nonrecognition transaction. The regulations introduced another exception that applies to a partnership's distribution of a marketable security. This exception applies when the security was acquired by the partnership in a nonrecognition transaction, the value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction was less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction, and the partnership distributes the security within five years of either the date the security was acquired by the partnership or, if later, the date the security becomes marketable.⁷⁴ Reg. section 1.731-2(d)(1)(ii).

Example 29. A partnership contributes real estate to OP, the operating partnership in an UPREIT structure, in exchange for units in OP. The units are exchangeable at the holder's option into cash or stock of a publicly traded REIT, at the REIT's option. The partnership distributes the OP units to one of its partners within five years. Because the units are readily convertible into money or publicly traded stock, they are treated as marketable securities under section 731(c)(2)(B)(ii). However, because the partnership acquired the interests in a nonrecognition transaction, the value of marketable securities and money exchanged by the partnership was less than 20 percent of the value of all the assets exchanged by the partnership in the transaction (in fact, the partnership exchanged no money or marketable securities), and the partnership distributed the interests within five years, section 731(c) does not apply to the distribution.⁷⁵

According to the preamble to the proposed regulations, the rationale for this exception is "that the marketable security in these situations is simply a substitute for the underlying assets exchanged in the nonrecognition transaction." PS-2-95, 1996-1 C.B. 853, 854. Like the

⁷²The regulations presumably added this six-month holding period requirement, which is not in the statute, to prevent partnerships from acquiring securities on the eve of their becoming marketable to qualify for the exception.

⁷³That unreasonable conclusion makes the IRS's position in FSA 200219008 highly questionable.

⁷⁴The five-year requirement was included in this exception for the reasons discussed above that prompted its inclusion in the regulations implementing the exception under section 731(c)(3)(A)(ii).

⁷⁵See LTRs 200011036, Doc 2000-8046, 2000 TNT 54-19; 199915030, Doc 1999-14050, 1999 TNT 74-36; and 9801016, Doc 98-409, 98 TNT 2-36, for rulings applying this exception.

exception for securities that were not marketable securities when acquired by the partnership, the existence of this exception can be explained only by considering section 731(c) an antiabuse provision. Why else should a distribution of marketable securities be treated differently depending on how they were acquired by the partnership? The effect of the distribution on the partners is the same regardless of whether the partnership purchased the securities or acquired them in a nonrecognition transaction. What is perverse, however, is that this exception, which applies when an asset is exchanged for a marketable security in a nonrecognition transaction, applies in connection with a provision purportedly designed to *prevent* taxpayers from exchanging interests in assets for marketable securities in nonrecognition transactions. It is more than a little puzzling how a provision that rejects the distribution of marketable securities in a nonrecognition transaction can contain an exception granting favorable treatment for marketable securities acquired by the partnership in a nonrecognition transaction.

4. Antistuffing rule. The regulations contain an antistuffing rule that limits the application of the three above-mentioned exceptions to the extent that 20 percent or more of the value of a distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership⁷⁶ to the entity to which the distributed security relates after the security was acquired by the partnership.⁷⁷ Reg. section 1.731-2(d)(2).⁷⁸

Example 30. P contributes all of the outstanding stock of corporation C, with a basis and value of 100, to a partnership in exchange for an interest in the partnership. C's sole asset is a marketable security with a basis and value of 100. Eight years later, the value of C's marketable security and the partnership's C stock are still 100, and the value of

P's interest in the partnership has increased to 300. The partnership contributes 200 in cash to C. On the following day, the partnership distributes the C stock to P in liquidation of P's interest.

The C stock is a marketable security because the value of the C stock is entirely attributable to money and marketable securities.⁷⁹ Without the antistuffing rule, the distribution of the C stock would qualify for the exception in reg. section 1.731-2(d)(1)(i) for distributions of previously contributed securities. However, the antistuffing rule applies because two-thirds of the value of the C stock is attributable to the cash contributed by the partnership to C after the partnership acquired the C stock. As a result, under the antistuffing rule, the previously contributed property exception does not apply to the extent of 200 of the C stock. The remaining 100 of C stock should be eligible for the exception. If the partnership had contributed only 20 to C, less than 20 percent of the value of the C stock would have been attributable to money or marketable securities contributed by the partnership to C; thus, the antistuffing rule would not have applied, and the distribution of the C stock in its entirety would have been eligible for the previously contributed property exception.

Example 31. Partnership OP has a REIT as its general partner and owns 1,000 in real estate assets. Assume that OP has no liabilities. Partnership PQR contributes land worth 60 to OP in exchange for an interest in OP that is readily convertible into publicly traded stock of the REIT. Several months later, in an unrelated transaction, PQR contributes 40 of cash to OP. On the following day, PQR distributes the interest in OP to one of its partners.

PQR's interest in OP is a marketable security because it is readily convertible into publicly traded REIT stock. Without the antistuffing rule, the distribution of the OP interest would be eligible for the reg. section 1.731-2(d)(1)(ii) exception for distributions of marketable securities acquired in some nonrecognition transactions. However, the antistuffing rule applies because 40 percent of the value of PQR's interest in OP is attributable to money contributed by PQR to OP after PQR acquired its interest in OP. As a result, under the antistuffing rule, the exception does not apply to the extent of 40 of the OP interests.⁸⁰

The antistuffing rule can apply regardless of whether there is a tax-avoidance motive for the "stuffing" and regardless of the timing of the stuffing in relation to the

⁷⁶Money contributed by the partnership does not include money deemed contributed to a partnership as a result of section 752(a). Reg. section 1.731-2(d)(2).

⁷⁷However, the antistuffing rule does not apply to the extent that marketable securities contributed to the entity in question had originally been contributed to the partnership by the distributee-partner. Reg. section 1.731-2(d)(2) (second sentence).

⁷⁸The code contains an antistuffing rule, but it applies only to the exception for previously contributed securities. See section 731(c)(3)(A)(i). The proposed regulations followed the approach of the IRC by applying the antistuffing rule only to that exception. See prop. reg. section 1.731-2(d)(1), 1996-1 C.B. 853, 856. The drafters of the proposed regulations believed that it was not necessary to apply the antistuffing rule to the other exceptions because, under the proposed regs, the other exceptions applied only if the distributed security was itself actively traded. See prop. reg. section 1.731-2(d)(2)(ii) and -2(d)(3)(ii), 1996-1 C.B. 856. Stuffing was not viewed as a concern when dealing with securities that were actively traded. However, in response to comments, the final regs extended the application of those exceptions to all marketable securities. "To address the concern to which the actively-traded requirement of the proposed regulations [had been] directed," the final regs introduced an antistuffing rule applicable to all three exceptions under reg. section 1.731-2(d)(1). T.D. 8707, 1997-1 C.B. 128, 129.

⁷⁹As discussed above, section 731(c)(2)(B)(v) treats an interest in an entity as a marketable security if 90 percent or more of its assets (by value) consist, directly or indirectly, of money and marketable securities.

⁸⁰If PQR had transferred the 40 of money along with the 60 of land as part of PQR's initial contribution to OP, the *entire* interest in OP would have been ineligible for the exception in reg. section 1.731-2(d)(1)(ii) because 20 percent or more of the property transferred by PQR in exchange for the OP interest would have consisted of money. The 20 percent limitation in reg. section 1.731-2(d)(1)(ii) thus functions as a super-antistuffing rule that applies only for purposes of that exception.

distribution of the security.⁸¹ Curiously, the antistuffing rule applies to all contributions made after the security was acquired by the partnership rather than all contributions made after the security became eligible for an exception under reg. section 1.731-2(d)(1).

Example 32. A partnership purchases the stock of corporation C for 200. C is a private company that operates a business and owns only a de minimis amount of money and marketable securities (and has no marketable securities outstanding). The partnership later contributes 100 of cash to C, which is used in C's business. Ten years later, C goes public and the partnership's C stock, which is worth 300, thus becomes a marketable security. One year later, the partnership distributes the C stock, which is still worth 300, to one of its partners.

The C stock is a marketable security because it is actively traded within the meaning of section 1092(d)(1). Without the antistuffing rule, the distribution of the C stock would qualify for the exception in reg. section 1.731-2(d)(1)(iii) for distributions of securities that were not marketable securities when acquired. However, the antistuffing rule applies because one-third of the value of the C stock is attributable to the cash contributed by the partnership to C. As a result, under the antistuffing rule, the exception does not apply to the extent of 100 of the C stock. This result seems unduly harsh, because the stuffing occurred 10 years before the C stock became a marketable security eligible for the exception and without any tax avoidance motive. Clearly, the antistuffing rule should have been limited to contributions made after the interest in the entity in question becomes eligible for one of the exceptions in reg. section 1.731-2(d)(1) or to contributions made in contemplation of the interest becoming eligible for one of the exceptions.

It is not entirely clear how the antistuffing rule applies when the value of the distributed security changes over time. It appears that the determination of whether 20 percent or more of the value of the distributed security is attributable to contributions of money or marketable securities is made at the time of the distribution of the security. In the previous example, if the C stock was worth 900 immediately before the partnership's 100 cash contribution, the antistuffing rule would nevertheless seem to apply if the stock was worth only 300 at the time of the distribution. However, it appears that the antistuffing would not apply if the stock was worth 1,000 at the time of the distribution even if the C stock was worth 200 immediately before the partnership's 100 cash contribution to C.

⁸¹This antistuffing rule should be contrasted with the antistuffing rule in section 382(l)(1), which requires the stuffing to be done with a principal purpose to avoid or increase a section 382 limitation and presumes contributions within two years to be made with such a purpose. However, the antistuffing rule in reg. section 1.737-2(d)(2), which appears to be the model for the antistuffing rule in reg. section 1.731-2(d)(2), does not have a motive requirement, nor does it focus on the timing of the contribution.

The interaction of the antistuffing rule with the interest in an entity provisions can be enormously complicated, particularly when the exception for securities that were not marketable securities when acquired is involved. The complication arises in part from the fact that the interest in an entity provision employs a 20 percent threshold based on the gross value of all of the entity's assets, whereas the antistuffing rule employs a 20 percent threshold based on the value of the distributed security.

Example 33. Partnership UTP contributes land worth 40 to partnership LTP in exchange for an interest in LTP. LTP's sole assets are the land contributed by UTP and a building with a value of 40. LTP has never had any interests outstanding that have been treated as marketable securities. Seven months later in an unrelated transaction, UTP contributes 20 of cash to LTP and, on the following day, distributes the interest in LTP to one of its partners.

After UTP's contribution of 20 of cash to LTP, 20 percent of LTP's assets consist of cash. Thus, UTP's contribution to LTP causes 20 percent of UTP's interest in LTP to be treated as a marketable security under section 731(c)(2)(B)(vi). Without regard to the antistuffing rule, the distribution of the interest in LTP would appear to qualify for the exception in reg. section 1.731-2(d)(1)(iii) for assets that were not marketable securities when acquired. However, the antistuffing rule applies, because a third of the value of UTP's interest in LTP is attributable to money contributed by UTP to LTP after UTP acquired its interest in LTP. Thus, the exception is not applicable to the extent of one-third of the value of UTP's interest in LTP. But only 20 percent of the interest in LTP is treated as a marketable security under section 731(c)(2)(B)(vi) and, therefore (ignoring the antistuffing rule), apparently eligible for the exception under reg. section 1.731-2(d)(1)(iii). It is not clear whether one-third of 20 percent of the interest in LTP that is treated as a marketable security is subject to the antistuffing rule or whether the entire 20 percent of the interest in LTP that is treated as a marketable security is subject to the antistuffing rule. Even though one-third of the value of the interest in LTP is attributable to money contributed by UTP to LTP, it is clear that the antistuffing rule does not apply to one-third of the value of the distributed interest, because the antistuffing rule is simply a limitation on the exceptions in reg. section 1.731-2(d)(1) and not a blanket prohibition on stuffing.

It is quite surprising that the antistuffing rule applies only as a limitation on the exceptions contained in reg. section 1.731-2(d)(1). Outside of those exceptions, but subject to the antiabuse rule in reg. section 1.731-2(h) (discussed below), stuffing appears to be permissible.

Example 34. Partnership UTP contributes 100 of marketable securities to partnership LTP, which has 900 of real estate, in exchange for a 10 percent interest in LTP. UTP distributes the interest in LTP to P, one of the UTP partners.

UTP's interest in LTP is not a marketable security because less than 10 percent of LTP's assets are money or marketable securities. Even though 100 percent of the

value of UTP's interest in LTP is attributable to a contribution of marketable securities to LTP, the anti-stuffing rule does not apply.

5. Successor securities. Under a successor-security rule in reg. section 1.731-2(d)(3), a distribution of a marketable security acquired in a nonrecognition transaction in exchange for another security is eligible for any of the exceptions in reg. section 1.731-2(d) to the extent a distribution of the exchanged security would have been eligible for the exception immediately before the exchange.

V. The Obligatory Antiabuse Rule

Section 731(c)(7) provides that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations to prevent the avoidance of such purposes." The legislative history contains the following paragraph describing circumstances in which Congress believes it would be appropriate for the section 731(c) antiabuse rule to apply:

It is intended that regulations address avoidance of the provision through, for example, arrangements involving changes in partnership allocations and distribution rights, multiple distributions, related entities, or otherwise. Thus, for example, regulations may provide that exceptions to the provision do not apply if the partnership allocations are changed to increase a partner's share of marketable securities shortly before a distribution, or to achieve the functional equivalent of a distribution (without an actual distribution) by allocating substantially all the items associated with the security to a particular partner or partners. As another example, regulations may address avoidance of this provision in the case in which a partnership distributes substantially all of its assets (other than marketable securities and money) to some partners, with the practical effect of a distribution of the marketable securities to the other partners. As a further example, regulations may address avoidance of the provision through distributions of property in connection with a pre-arranged purchase of the distributed property, or through transactions involving a distribution of property together with the right to dispose of such property at substantially above its FMV.

H.R. Rep. No. 103-826(I) at 195, reprinted in 1994 U.S.C.C.A.N. at 3967. The legislative history also states that "[b]ecause the partnership tax rules provide a great deal of flexibility, and taxpayers can arrange their affairs so as to take advantage of this flexibility, the bill grants to the Treasury Department regulatory authority to prescribe rules that effectively prevent taxpayers from avoiding the intent of this provision (as well as to provide relief from the application of the provision, where appropriate)." H.R. Rep. No. 103-826(I) at 188, reprinted in 1994 U.S.C.C.A.N. at 3960.

The regulation implementing the antiabuse rule provides:

The provisions of section 731(c) and this section must be applied in a manner consistent with the

purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances.

Reg. section 1.731-2(h). The regulations give the following examples of the application of the antiabuse rule:

- a change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;
- a distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and
- the distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

Reg. section 1.731-2(h)(1)-(3).

The examples in the legislative history and the regulations make it clear that the intended purpose of the antiabuse rule is essentially to apply substance-over-form principles to transactions involving marketable securities or money. However, in FSA 200219008, *supra*, as an alternative to the argument that debt instruments with a nine-month term should be treated as readily convertible into money, the IRS concluded that the section 731(c) antiabuse rule could apply to treat the debt instrument as a marketable security even if it did not otherwise fall within the definition of marketable securities in the code. That application of the antiabuse rule seems clearly incorrect. First, all of the examples in the legislative history and the regulations involve the application of substance-over-form principles to transactions involving marketable securities; they do not involve the extension of the rules of section 731(c) to treat an asset that is not a marketable security as a marketable security. Second, the IRC contains a precise definition of marketable securities. That definition authorizes regulations altering its scope only in some limited cases. See section 731(c)(2)(B)(iv) (precious metals) and section 731(c)(2)(B)(v) and (vi) (interests in entities holding marketable securities).⁸²

⁸²The legislative history notes that section 731(c)(2)(B)(vi) provides "limited regulatory authority" for Treasury to treat an interest in an entity as a marketable security when less than substantially all of the entity's assets consist of money and/or marketable securities. H.R. Rep. No. 103-826(I) at 190, reprinted (Footnote continued on next page.)

There is no indication that Congress intended the anti-abuse rule to enable the IRS to expand the definition of marketable securities.

Conclusion

Treating marketable securities like money for purposes of determining whether gain is recognized in a partnership distribution does not sound particularly complicated. However, a closer look at the expansive definitions, the arcane limitations, and the unwarranted exceptions in section 731(c) reveals a purpose that is less than neutral and an often wickedly complex set of rules. The uncertainty in the application of various aspects of section 731(c) and the vastness of its potential scope make it a critical provision to consider when analyzing the tax consequences of any partnership distribution.

in 1994 U.S.C.C.A.N. at 3962. The reference to “limited” regulatory authority would be nugatory if Treasury had unlimited authority to expand the definition of marketable security by means of the antiabuse rule.