



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-135671-17]

RIN 1545-BO44

Partnership Transactions Involving Equity Interests of a Partner

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

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

These regulations affect partnerships and their partners.

DATES: Comments and requests for a public hearing must be received by **INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-135671-17), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-135671-17), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically, via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-135671-17).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kevin I. Babitz, (202) 317-6852, or Mary Brewer, (202) 317-6975; concerning submission of comments or to request a public hearing, Regina L. Johnson at (202) 317-6901.

SUPPLEMENTARY INFORMATION:

### **Background and Explanation of Provisions**

This notice of proposed rulemaking contains amendments to the Income Tax Regulations (26 CFR part 1) under section 337(d) of the Internal Revenue Code (Code) set forth in §1.337(d)-3 (final regulations) that prevent a corporate partner from using a partnership to avoid recognition of corporate-level gain. The final regulations largely adopted proposed regulations (REG-149518-03) published in the **Federal Register** (80 FR 33451) on June 12, 2015 (2015 regulations) with minor, nonsubstantive clarifying changes in response to requests for further certainty in the single comment letter received on the proposed regulations. See the Explanation of Provisions section of the preamble to TD 9833 (83 FR 26580 (June 8, 2018)) for a detailed discussion of each of the specific points raised in the comment letter received on the 2015 regulations.

The rules set forth in this notice of proposed rulemaking contain substantive modifications to the final regulations relating to the definition of Stock of the Corporate Partner. Accordingly, the Treasury Department and the IRS determined it appropriate to publish these modifications in the form of new proposed regulations to afford the public the opportunity to submit additional comments.

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

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

The final regulations adopted a definition of Stock of the Corporate Partner that was modified as compared to the definition in the regulations that the Treasury Department and the IRS proposed on December 15, 1992 (PS-91-90, REG-208989-90, 1993-1 CB 919) (1992 proposed regulations). The final regulations broadened the definition of Stock of the Corporate Partner with respect to the relationship needed for a Controlling Corporation to be treated as controlling the Corporate Partner (using a modified section 304(c) standard instead of section 1504(a)) but also narrowed the definition, generally excluding sister corporations and subsidiary corporations of the Corporate Partner from being treated as Controlling Corporations.

More specifically, the final regulations define Stock of a Corporate Partner by including stock and other equity interests of any corporation that controls the Corporate Partner within the meaning of section 304(c), except that section 318(a)(1) and (3) shall

not apply (section 304(c) control). In contrast, the 1992 proposed regulation's definition was limited to stock or other equity interests issued by the Corporate Partner and its "section 337(d) affiliates" – that is any corporation that is a member of an affiliated group as defined in section 1504(a) of the Code without regard to section 1504(b).

Section 304(c) control generally exists when there is ownership of stock of a corporation possessing at least 50 percent of the total combined voting power of all classes of the corporation's stock entitled to vote or at least 50 percent of the value of the shares of all classes of stock of the corporation, while control of a corporation under section 1504(a)(2) requires ownership of stock of the corporation possessing at least 80 percent of the total voting power of the stock of the corporation and at least 80 percent of the total value of the stock of the corporation. The Treasury Department and the IRS adopted this lower ownership threshold for determining control in the final regulations as a more appropriate standard for this purpose because General Utilities repeal could more easily be avoided by acquiring stock of a corporation that owns less than 80 percent of the vote and value of the Corporate Partner's stock. See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

While section 304(c) incorporates the constructive ownership rules of section 318(a) with some modifications, the 2015 regulations excluded the application of section 318(a)(1) and (3) from their definition of control.

The commenter that submitted the only comment on the 2015 regulations demonstrated that families could use the exclusion of section 318(a)(1) attribution from the determination of section 304(c) control to structure transactions using partnerships

to eliminate gain on appreciated assets or contravene the purposes of section 337(d) in other ways. For example—

Husband owns 90 percent of corporation A, which owns 49 percent of Corporate Partner (CP). Wife owns 90 percent of corporation B, which also owns 49 percent of CP. CP owns an interest in partnership PRS. Under these facts, because the 2015 regulations determined section 304(c) control without applying the section 318(a)(1) family attribution rule, neither A nor B control CP. Accordingly, other partners in Partnership could contribute stock of A and B to PRS in exchange for an interest in PRS without triggering gain to A or B.

The Treasury Department and the IRS agree with the commenter that excluding section 318(a)(1) attribution from the determination of section 304(c) control could produce unintended results. In addition, the Treasury Department and the IRS have determined that taxpayers can structure transactions to take advantage of the exclusion of section 318(a)(3) attribution from the determination of section 304(c) control. For example, in the preceding fact pattern, if the interests held by Husband and Wife were instead held by a single corporation, X, neither A nor B would control CP without the application of section 318(a)(3) attribution.

As a result, the Treasury Department and the IRS propose to modify the definition of Stock of the Corporate Partner to eliminate the exclusion of section 318(a)(1) and (3) attribution from the determination of section 304(c) control. However, as explained below, the Treasury Department and the IRS propose to limit this expanded definition of Stock of the Corporate Partner to entities that own a direct or indirect interest in the Corporate Partner.

The exclusion of attribution under sections 318(a)(1) and 318(a)(3) in the 2015 regulations and the final regulations was intended to limit section 304(c) control to entities that own a direct or indirect interest in the Corporate Partner, while excluding

entities that do not own a direct or indirect interest in the Corporate Partner. To implement this intent more precisely, the Treasury Department and the IRS propose to limit the proposed scope of section 304(c) control to ownership, direct or indirect, of an interest in the Corporate Partner. For the purpose of testing direct or indirect ownership of an interest in the Corporate Partner, ownership of Stock of the Corporate Partner would be attributed to an entity under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) would not apply) and under section 318(a)(4), but otherwise without regard to section 318. Thus, sections 318(a)(1), 318(a)(3), and 318(a)(5) would not apply for determining whether an entity directly or indirectly owns an interest in Stock of the Corporate Partner, but once an entity is found to directly or indirectly own an interest in such stock, then the section 304(c) control definition would apply in its entirety to determine whether the tested entity is a Controlling Corporation. The Treasury Department and the IRS continue to study the appropriate scope of the definition of Stock of the Corporate Partner, and request comments regarding these provisions.

## 2. Definition of Stock of the Corporate Partner: Affiliated Groups

These proposed regulations, if finalized, would make a second change to the definition of Stock of the Corporate Partner. The final regulations provide that the term Stock of the Corporate Partner does not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner (Affiliated Group Exception). The 1992 proposed regulations included affiliate stock within its definition of the Stock of a Corporate Partner, but the

2015 proposed regulations instead set forth this Affiliated Group Exception, which the final regulations adopted. Thus, the final regulations do not apply if a domestic corporation and its wholly owned domestic subsidiaries (each of which is an includible corporation under section 1504(b)) are the only partners in a partnership and any of these corporations contributes stock of another affiliate to a partnership. The preamble to T.D. 9722 (80 FR 33402 (June 12, 2015)), which contained temporary regulations that accompanied the 2015 regulations, stated that the Treasury Department and the IRS had determined that the Affiliated Group Exception is appropriate because “the purpose of these regulations is not implicated if a partnership is owned entirely by affiliated corporations.”

After further study, the Treasury Department and the IRS have determined that the Affiliated Group Exception may result in abuse and therefore is not appropriate. Specifically, the Treasury Department and the IRS believe that a partnership held entirely by members of an affiliated group could enter into transactions that permanently eliminate the built-in gain on an appreciated asset that one partner contributes to the partnership. For example—

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

This ability to increase the basis of an appreciated asset artificially and to eliminate the built-in gain permanently contravenes the purposes of section 337(d) and these regulations. The Treasury Department and the IRS are also aware that practitioners have observed that the Affiliated Group Exception runs counter to the general rule that related-party transactions are subject to greater scrutiny. In light of these concerns, these proposed regulations would remove the Affiliated Group Exception contained in the final regulations.

However, because there may be specific circumstances under which the elimination of the Affiliated Group Exception could adversely impact ordinary business transactions between affiliated group members and group-owned partnerships, the Treasury Department and the IRS request comments describing situations in which a more tailored version of the Affiliated Group Exception would be warranted.

### 3. Definition of Stock of the Corporate Partner: Value of an interest attributable to Stock of the Corporate Partner

These proposed regulations would modify the scope of the rule in the final regulations that Stock of the Corporate Partner includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner (Value Rule). Under the final regulations, the Value Rule applies to all interests in an entity regardless of whether the entity is controlled by the Corporate Partner. The sole commenter responding to the 2015 regulations agreed that the scope of the Value Rule was appropriate if the entity was controlled by the Corporate Partner. However, for entities that are not controlled by the Corporate Partner, the commenter asked that the

scope of the Value Rule be narrowed to apply only if 20 percent or more of the assets of an entity were Stock of the Corporate Partner.

The Treasury Department and the IRS agree that the Value Rule in the 2015 regulations and the final regulations could be overbroad in certain circumstances. For example—

Assume X, a publicly traded corporation, owns a portfolio investment in P, a publicly traded corporation. P controls CP, a Corporate Partner under the final regulations, within the meaning of section 304(c); thus, P's stock is Stock of the Corporate Partner under the final regulations. Under the Value Rule, X's stock would be Stock of the Corporate Partner to the extent that the value of X is attributable to Stock of the Corporate Partner. If CP contributed appreciated property to a partnership, and another party contributed X stock to the partnership, CP would be unable to determine whether it had engaged in a Section 337(d) Transaction (within the meaning of §1.337(d)-3(c)(3)) or otherwise apply the rules of the final regulations because CP (through P) might have no way to determine that the X stock used in the transaction could be Stock of the Corporate Partner. Alternatively, if CP were aware that X owned a portfolio investment in P, it would have no ability to determine the amount of X stock that is Stock of the Corporate Partner under the Value Rule. This is because, absent actual or constructive knowledge (for example through required disclosures such as filings with the Securities and Exchange Commission), a widely held corporation might not know or have the ability to know who owns its stock.

For this reason, the Treasury Department and the IRS have determined that narrowing the scope of the Value Rule is appropriate. However, the Treasury Department and the IRS decline to adopt the commenter's specific suggestion that interests in an entity not be subject to the Value Rule unless 20 percent or more of the assets of the entity consisted of Stock of the Corporate Partner. Such a rule would cause the Value Rule to be overly narrow and could permit taxpayers to structure transactions that would contravene the purpose of section 337(d) and these regulations. Instead, the Treasury Department and the IRS propose to narrow the scope of the Value Rule through an alternate measure. Under the proposed regulations, if an entity is not controlled by the Corporate Partner and is not a Controlling Corporation, the

Value Rule would apply to treat interests in the entity as Stock of the Corporate Partner only if the entity owns, directly or indirectly, 5 percent or more of the stock, by vote or value, of the Corporate Partner. For this purpose, direct or indirect ownership would mean ownership of stock that would be attributed to a person under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) would not apply) and under section 318(a)(4), but otherwise without regard to section 318. The Treasury Department and the IRS believe that using a 5-percent ownership threshold is appropriate because entities have the ability to determine whether they have 5-percent or greater owners, and corporations may track their 5-percent shareholders for other reasons (such as for section 382 purposes). Further, the Treasury Department and the IRS propose to apply this 5-percent threshold to direct or indirect stock ownership, rather than all equity interests, in the Corporate Partner in order to make the Value Rule more readily administrable.

The proposed regulations also would clarify how taxpayers should apply the Value Rule to determine the extent to which the value of an equity interest is attributable to Stock of the Corporate Partner. The proposed regulations would provide that taxpayers would multiply the value of the equity interest in an entity by a ratio, the numerator of which is the fair market value of the Stock of the Corporate Partner owned directly or indirectly by the entity and the denominator of which is the fair market value of all of the equity interests in the entity. For this purpose, direct or indirect ownership would mean ownership of stock that would be attributed to a person under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) would not apply) and under section 318(a)(4), but otherwise without regard to section 318.

The proposed regulations would also provide that the ratio may not exceed one. The Treasury Department and the IRS determined that the fair market value of all of the equity interests in the entity is the most appropriate measure to determine the value of the entity because the Value Rule seeks to determine what portion of the value of an equity interest in an entity reflects the value of Stock of the Corporate Partner owned by that entity.

Additionally, the proposed regulations would clarify that, if an equity interest is Stock of the Corporate Partner because it is an interest in the Corporate Partner or in an entity with a direct or indirect ownership interest that controls the Corporate Partner within the meaning of section 304(c), then the Value Rule will not apply. The Treasury Department and the IRS request comments on all aspects of the proposed changes to the scope of the Value Rule, including the appropriate measure of the value of the entity.

#### 4. Exception for Certain Dispositions of Stock

Finally, these proposed regulations would make a modification to the exception for certain dispositions of stock in §1.337(d)-3(f)(2) to make its language consistent with the modified definition of Stock of the Corporate Partner. Under this exception, the final regulations do not apply to Stock of the Corporate Partner that (i) is disposed of (by sale or distribution) by the partnership before the due date (including extensions) of its federal income tax return for the taxable year of the relevant transaction; and (ii) is not distributed to the Corporate Partner or a corporation that controls the Corporate Partner. With respect to the second requirement, the final regulations refer to a corporation that controls the Corporate Partner within the meaning of section 304(c), except that section

318(a)(1) and (3) shall not apply. For the same reasons that these proposed regulations modify the definition of Stock of the Corporate Partner, these proposed regulations also modify the second requirement of this exception to refer to a corporation that controls the Corporate Partner within the meaning of section 304(c), but only if the controlling corporation owns directly or indirectly stock or another equity interest in the Corporate Partner, in order to conform the second requirement with the modified definition of Stock of the Corporate Partner.

### **Proposed Effective Date**

These regulations are proposed to be effective as of the date of their publication as final regulations in the **Federal Register**. Taxpayers may rely on these proposed regulations for transactions occurring on or after June 12, 2015 and prior to the date that these regulations are published as final regulations in the **Federal Register**, provided that the taxpayer consistently applies all of the proposed regulations to such transactions.

### **Special Analyses**

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

These proposed regulations do not impose a collection of information on small entities. Further, pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact

that these proposed regulations would primarily affect sophisticated ownership structures with interlocking ownership of corporations, partnerships and corporate stock. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at <http://www.regulations.gov> or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### **Drafting Information**

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

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

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

**PART I—INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.337(d)-3 is amended by revising paragraphs (c)(2), (f)(2)(ii) and (i) to read as follows:

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

\* \* \* \* \*

(c) \* \* \*

(2) Stock of the Corporate Partner--(i) In general. With respect to a Corporate Partner, Stock of the Corporate Partner includes stock, warrants and other options to acquire stock, and similar interests (each an equity interest) in the Corporate Partner. Stock of the Corporate Partner also includes equity interests in a corporation that controls the Corporate Partner within the meaning of section 304(c), and which also has a direct or indirect equity interest in the Corporate Partner. Solely for purposes of determining whether a corporation that controls the Corporate Partner also has a direct or indirect equity interest in the Corporate Partner under this paragraph (c)(2), a direct or indirect ownership of an equity interest in the Corporate Partner includes ownership of Stock of the Corporate Partner that would be attributed to a person under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) does not apply) and under section 318(a)(4) (but otherwise without regard to section 318).

(ii) Equity Interests with value attributable to Stock of the Corporate Partner. If an equity interest in an entity is not Stock of the Corporate Partner within the meaning of

paragraph (c)(2)(i) of this section, then the equity interest will be treated as Stock of the Corporate Partner to the extent that the value of that equity interest is attributable to Stock of the Corporate Partner. The preceding sentence will apply only if either—

(A) The Corporate Partner is in control (within the meaning of section 304(c)) of that entity; or

(B) That entity owns directly or indirectly 5 percent or more, by vote or value, of the stock in the Corporate Partner.

(iii) Determination of value attributable to Stock of the Corporate Partner. The value of an equity interest in an entity that is attributable to Stock of the Corporate Partner under paragraph (c)(2)(ii) of this section is equal to the product of—

(A) The fair market value of the equity interest; and

(B) The lesser of—

(1) The ratio of the fair market value of the Stock of the Corporate Partner owned (directly or indirectly (as defined in paragraph (c)(2)(i) of this section), by the entity to the fair market value of all the equity interests in the entity; or

(2) One.

\* \* \* \* \*

(f) \* \* \*

(2) \* \* \*

(ii) Is not distributed to the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of section 304(c) and owns directly or indirectly stock or other equity interests in the Corporate Partner. For purposes of this paragraph (f)(2), a direct or indirect ownership of an equity interest in the Corporate Partner means

ownership of Stock of the Corporate Partner that would be attributed to a person under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) does not apply) and under section 318(a)(4) (but otherwise without regard to section 318).

\* \* \* \* \*

(i) Effective/applicability date. The regulations in this section are effective as of the date of their publication as final regulations in the **Federal Register**.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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