

Partnerships With Multiple Corporate Partners

A commentator expressed concern that the partnership rule does not specify whether the C corporation partner or the partnership is considered the transferor for purposes of making the deemed sale election. Further, the commentator asserted that in the case of a partnership with multiple corporate partners, each corporate partner should be allowed to make (or not make) a deemed sale election.

Treasury and the IRS believe that requiring each corporate partner to make a deemed sale election would be inconsistent with section 703(b) (which generally requires that elections be made at the partnership level) and would create unnecessary administrative complexity. Therefore, the final regulations under § 1.337(d)-7 retain the rule under section 703(b) that the deemed sale election is made at the partnership level.

Contribution of Loss Assets by Partnership

Under the partnership rule, if a partnership were to elect deemed sale treatment under § 1.337(d)-7T, any gain recognized by the partnership on the deemed sale is allocated to the C corporation partner. A commentator expressed concern that if the contribution by the partnership to a RIC or REIT includes multiple assets, the deemed sale may generate losses on certain assets and gain on others even though there is an overall net built-in gain. The commentator suggested that losses recognized by the partnership must also be allocated to the C corporation partner.

Under § 1.337(d)-7T, when a partnership elects deemed sale treatment, only net gains are recognized. If a net gain is recognized, the C corporation partner will receive the benefit of offsetting losses (as a result of the reduction in net gain). The final regulations under § 1.337(d)-7 have been modified to clarify that the gain allocated to the C corporation partner on a deemed sale transaction is the C corporation partner's distributive share of the net gain in the assets transferred to the RIC or REIT by the partnership.

Allocation of Gain or Loss on Subsequent Sale of RIC or REIT Stock

Under section 358, a partnership that elects deemed sale treatment under § 1.337(d)-7T(c) with respect to a conversion transaction increases its basis in the RIC or REIT stock by the net gain recognized on such transaction. A commentator suggested that the C

corporation partner should be allowed to use this basis increase to offset any gain or loss recognized by the partnership on the eventual sale of the RIC or REIT stock.

Treasury and the IRS agree with this comment. Accordingly, the final regulations under § 1.337(d)-7 provide that any adjustment to the basis of the RIC or REIT stock held by the partnership as a result of electing deemed sale treatment will constitute an adjustment to the basis of that stock with respect to the C corporation partner only.

Partnerships With Tax-Exempt Partners

A commentator expressed concern that the partnership rule in § 1.337(d)-7T may have an unintended punitive effect when the C corporation partner is a tax-exempt entity. Tax-exempt entities that are partners in a partnership that holds debt financed property are subject to tax under the unrelated business income tax (UBIT) rules unless certain criteria are satisfied. One of these criteria (the fractions rule) requires that: (1) the tax-exempt partner's share of overall partnership income for any tax year is no greater than its smallest share of partnership loss in any tax year; and (2) each allocation with respect to the partnership has substantial economic effect within the meaning of section 704(b)(2). The commentator expressed concern that the special allocation of gain to the tax-exempt partner that is required by "1.337(d)-7T when the partnership makes a deemed sale election may violate the fractions rule, tainting all income from the partnership for UBIT purposes.

In response to this comment, Treasury and the IRS have amended the regulations under section 514 to provide that allocations that are mandated by statute or regulation (other than subchapter K of chapter 1 of the Internal Revenue Code and the regulations thereunder) are not considered for purposes of determining qualification under the fractions rule. This rule applies to partnership allocations made in taxable years beginning on or after January 1, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the

Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these final regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Jennifer D. Sledge of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "Section 1.337(d)-5T", "Section 1.337(d)-6T", and "Section 1.337(d)-7T" and adding entries in numerical order to read in part as follows:

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

Section 1.337(d)-5 also issued under 26 U.S.C. 337.

Section 1.337(d)-6 also issued under 26 U.S.C. 337.

Section 1.337(d)-7 also issued under 26 U.S.C. 337. * * *

§ 1.337(d)-5T [Redesignated as § 1.337(d)-5]

Par. 2. Section 1.337(d)-5T is redesignated as § 1.337(d)-5 and the language "(temporary)" is removed from the end of the section heading.

Par. 3. Newly designated § 1.337(d)-5 is amended as follows:

1. In paragraph (b)(3), first sentence, the reference to "§ 1.337(d)-5T(b)" is removed and "paragraph (b) of this section" is added in its place.

2. In paragraph (d), third sentence, the references to "§ 1.337(d)-5T(b)(1)" and "§ 1.337(d)-6T" are removed and "paragraph (b)(1) of this section" and "§ 1.337(d)-6" are added in their places, respectively.

3. In paragraph (d), fourth sentence, the reference to "§ 1.337(d)-6T" is