

On December 14, 1999, final regulations (TD 8847; 1999-2 C.B. 701) were published in the **Federal Register** under section 755 (64 FR 69903). Under these regulations, basis adjustments under section 743(b) are allocated among a partnership's assets as follows. First, the adjustment is allocated between the two classes of property described in section 755(b). These classes of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). The amount of a basis adjustment under section 743(b) that is allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss that would be allocated to the transferee from the sale of all ordinary income property. The amount of the basis adjustment under section 743(b) that is allocated to capital gain property is the total amount of the basis adjustment under section 743(b) less the amount of the basis adjustment allocated to ordinary income property. The basis adjustment is then allocated to individual assets within each class.

The final regulations issued on December 14, 1999, worked in conjunction with § 1.755-2T. In the case of a basis adjustment under section 743(b) or section 732(d), the fair market values of all assets other than goodwill or going concern value were determined on the basis of all the facts and circumstances, and the fair market value of goodwill and going concern value was determined using the residual method. As described more fully in the notice of proposed rulemaking, § 1.755-2T was published prior to the enactment of section 1060(d), which (as amended in 1993) requires the residual method to be applied for purposes of determining the values of section 197 intangibles for purposes of applying section 755. These final regulations implement section 1060(d) and replace § 1.755-2T.

These final regulations differ from § 1.755-2T by using the residual method to value all section 197 intangibles (not just goodwill and going concern value). In addition, these final regulations also apply to basis adjustments under section 734(b) and contain special rules for certain substituted basis transactions. Finally, for convenience, the provisions of the regulations have been relocated to the beginning of § 1.755-1.

Under these final regulations, a partnership is required to assign values to its assets as follows. First, the partnership must determine the values of each of its assets other than section 197 intangibles under all the facts and circumstances, taking into account

section 7701(g) (treating the fair market value of a property as not less than the amount of any nonrecourse indebtedness to which the property is subject). The partnership then must determine the gross value of all partnership assets (partnership gross value). Last, the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles. For purposes of these regulations, the term *section 197 intangibles* includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

If the aggregate value of partnership property other than section 197 intangibles is equal to or greater than partnership gross value, then all section 197 intangibles are deemed to have a value of zero. In all other cases, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles. The residual section 197 intangibles value must be allocated, first, among section 197 intangibles other than goodwill and going concern value. Any remaining value is assigned to goodwill and going concern value.

The proposed regulations used the residual method to assign values to all partnership assets, rather than limiting the scope of the residual method to section 197 intangibles. Treasury and the IRS have concluded that these rules were unduly complex, especially when they applied to partnerships whose partnership agreements contained special allocations of partnership income or loss. Accordingly, the final regulations utilize the residual method only to value section 197 intangibles.

2. Transactions Subject to the Regulations

Because the proposed regulations used the residual method to value all partnership assets (and not just section 197 intangibles), it was desirable for all partnerships to value their assets using the same method. Accordingly, under the authority of sections 1060(d) and 755, the proposed regulations applied to all partnerships, whether or not their assets constituted a trade or business. In contrast, the final regulations apply the residual method only for the purpose of valuing section 197 intangibles, which are usually held by partnerships whose assets constitute a trade or business. Thus, the final regulations apply the residual method only to partnerships whose assets constitute a trade or

business (as described in § 1.1060-1(b)(2)).

The proposed regulations specifically applied to basis adjustments under section 732(d). Some references to section 732(d) have been removed in the final regulations to enhance readability. Nevertheless, the final regulations continue to apply to basis adjustments under section 732(d).

3. Methods for Determining Partnership Gross Value

If a partnership interest is transferred in a taxable transaction, the transferee's basis in its partnership interest provides a frame of reference for determining partnership gross value. In these transactions, both the proposed and the final regulations generally provide that partnership gross value is the amount that, if assigned to all partnership property, would result in a liquidating distribution to the transferee partner equal to that partner's basis (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) in the transferred partnership interest immediately following the relevant transfer.

In certain circumstances involving basis adjustments under section 743(b), such as where income or loss with respect to particular section 197 intangibles is allocated differently among partners, partnership gross value may vary depending on the fair market values of particular section 197 intangibles held by the partnership. In these situations, the final regulations require the partnership to use a reasonable method, consistent with the purposes of the final regulations, to determine partnership gross value.

In the preamble to the proposed regulations, the IRS and the Treasury Department requested comments regarding how the residual method applies in the context of a basis adjustment that results from an exchange of a partnership interest in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest (a transferred basis exchange). Determining partnership gross value in such an exchange is problematic, because the transferee's basis in the partnership interest does not necessarily have any connection to the fair market values of partnership assets. No comments were received regarding the specific method to be adopted by the final regulations.

The IRS and the Treasury Department also requested comments regarding how the residual method applies in the context of basis adjustments under section 734(b). One commentator