

to absorb any deduction with respect to the § 1.752-7 liability that passed through the partnership.

For this reason, these proposed regulations do not reduce the outside basis of the § 1.752-7 liability partner upon the partnership's assumption of the § 1.752-7 liability. If the partnership satisfies the § 1.752-7 liability while the § 1.752-7 liability partner is a partner in the partnership, then the deduction with respect to the portion of the § 1.752-7 liability assumed by the partnership from the § 1.752-7 liability partner (the built-in loss associated with the § 1.752-7 liability) is allocated to the § 1.752-7 liability partner, reducing that partner's outside basis. If, instead, one of three events occur that separate the § 1.752-7 liability partner from the § 1.752-7 liability, then the § 1.752-7 liability partner's outside basis is reduced at that time. These events are: (1) A disposition (or partial disposition) of the partnership interest by the § 1.752-7 liability partner, (2) a liquidation of the § 1.752-7 liability partner's partnership interest, and (3) the assumption (or partial assumption) of the § 1.752-7 liability by a partner other than the § 1.752-7 liability partner. Immediately before the occurrence of one of these events, the § 1.752-7 liability partner's basis in the partnership interest generally is reduced by the lesser of: (1) The excess of the § 1.752-7 liability partner's basis in the partnership interest over the adjusted value of that interest, or (2) the remaining built-in loss associated with the § 1.752-7 liability (the § 1.752-7 liability reduction). For this purpose, the adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under §§ 1.752-1 through 1.752-5. In the case of a partial disposition of the § 1.752-7 liability partner's partnership interest or a partial assumption of the § 1.752-7 liability by another partner, the § 1.752-7 liability reduction is pro rated based on the portion of the interest sold or the portion of the § 1.752-7 liability assumed.

After the occurrence of such an event, the partnership (or the assuming partner) is not entitled to any deduction or capital expense on the economic performance of the § 1.752-7 liability to the extent of the remaining built-in loss associated with the § 1.752-7 liability. If, however, the partnership (or the assuming partner) notifies the § 1.752-7 liability partner of the partial or complete economic performance of the § 1.752-7 liability, then the § 1.752-7 liability partner is entitled to a deduction or loss. The amount of that

deduction or loss is, in the case of a partial satisfaction of the § 1.752-7 liability, the amount paid by the partnership in satisfaction of the § 1.752-7 liability (but not more than the § 1.752-7 liability reduction) or, in the case of a complete satisfaction of the § 1.752-7 liability, the remaining § 1.752-7 liability reduction. To the extent of the amount paid in satisfaction of the § 1.752-7 liability, the character of that deduction or loss is determined as if the § 1.752-7 liability partner had satisfied the § 1.752-7 liability. To the extent that the § 1.752-7 liability reduction exceeds the amount paid in satisfaction of the § 1.752-7 liability, the character of the § 1.752-7 liability partner's loss is capital.

The proposed regulations further provide that, solely for purposes of section 705 (adjustments to the basis of a partnership interest) and § 1.704-1(b)(2)(iv)(b) (partnership capital accounting rules), the remaining built-in loss associated with the § 1.752-7 liability is not treated as a nondeductible, noncapital expense to the partnership. Therefore, the remaining partners' bases in their partnership interests and capital accounts are not reduced by the remaining built-in loss associated with the § 1.752-7 liability.

If the § 1.752-7 liability is assumed by a partner other than the § 1.752-7 liability partner, then, on economic performance of the § 1.752-7 liability, the assuming partner is treated as contributing cash to the partnership in the amount of the lesser of: (1) The amount paid to satisfy the § 1.752-7 liability; or (2) the remaining built-in loss associated with the § 1.752-7 liability as of the time of the assumption. Adjustments as a result of this deemed cash contribution may include adjusting the basis of the partnership interest, any assets (other than cash, accounts receivable, or inventory) distributed by the partnership to the partner, or gain or loss on the disposition of the partnership interest or of property distributed by the partnership, as the case may be. However, the assuming partner cannot take into account any adjustments to depreciable basis, reduction in gain, or increase in loss until economic performance of the § 1.752-7 liability. Any adjustment to the basis of an asset under this provision is taken into account over the recovery period of that asset.

3. Exceptions

Certain exceptions apply to these rules. In the corporate context, section 358(h) does not apply in the following

two situations: (1) Where the trade or business with which the liability is associated is transferred to the corporation assuming the liability; and (2) where substantially all of the assets with which the liability is associated are transferred to the corporation assuming the liability. Section 358(h)(2) authorizes the Secretary to limit the application of these exceptions.

The statutory provision relating to partnerships does not specify whether the exceptions in section 358(h)(2) should apply. The only cross-reference to section 358(h) in this statutory provision is to section 358(h)(3), which defines the term *liability*. Treasury and IRS believe it is appropriate to provide for a variation on one of the two exceptions to section 358(h), as well as an additional exception that is not included in section 358(h), in these proposed regulations. Treasury and the IRS request comments on these exceptions and on whether additional exceptions should be included in the final regulations.

The first exception applies where the partnership assumes the § 1.752-7 liability as part of the contribution of the trade or business with which the liability is associated and the partnership continues to conduct that trade or business after the contribution. For this purpose, a trade or business is a specific group of activities carried on by a person for the purpose of earning income or profit if the activities included in that group include every operation that forms a part of, or a step in, the process of earning income or profit.

The proposed regulations provide that the activity of acquiring, holding, or disposing of financial instruments constitutes a trade or business for this purpose if and only if the activity is conducted by an entity registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended. Treasury and the IRS are concerned that certain activities involving acquiring, holding, or disposing of financial instruments could be structured to accomplish the types of transactions that section 309(c) of the Act was designed to prevent. Nonetheless, Treasury and the IRS recognize that many persons contribute such activities to partnerships for substantial business purposes. For example, mutual funds often contribute substantially all of their assets to a master partnership to save administrative costs. Under some circumstances, such a mutual fund may transfer portfolio positions (including hedge positions that could be