

Rev. Rul. 96-10

ISSUE

(1) If a loss on the sale of partnership property is disallowed under § 707(b)(1) of the Internal Revenue Code, are the partners' bases in their partnership interests decreased under § 705(a)(2) to reflect the disallowed loss?

(2) If gain from the sale of partnership property is not recognized due to §§ 707(b)(1) and 267(d), are the partners' bases in their partnership interests increased under § 705(a)(1) to reflect that gain?

FACTS

A and B contribute cash to form *PRS*, a general partnership. Under the partnership agreement, each item of income, gain, loss, and deduction of the partnership is allocated 75 percent to A and 25 percent to B. A is also a partner in *PRS2*, a general partnership. Under the partnership agreement, each item of income, gain, loss, and deduction of the partnership is allocated 60 percent to A and 40 percent to C. A, B, and C are unrelated to each other.

In year 1, *PRS* sells Property to *PRS2* at its fair market value of \$80x. The adjusted basis of Property at the time of the sale is \$100x.

In year 5, *PRS2* sells Property to an unrelated party for its fair market value of \$90x. The adjusted basis of Property at the time of the sale is \$80x.

LAW AND ANALYSIS

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis and the loss shall be the excess of the adjusted basis over the amount realized. Section 1001(c) requires that the entire amount of this gain or loss be recognized, except as otherwise provided in subtitle A of the Code.

Section 707(b)(1) provides that no deduction shall be allowed for losses

from sales or exchanges of property (other than an interest in the partnership) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest or the profits interest in the partnership or between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

Section 707(b)(1) also provides that, in the case of a subsequent sale or exchange by a transferee described in § 707(b)(1), § 267(d) applies as if the loss were disallowed under § 267(a)(1). Section 267(d) provides that, if a taxpayer acquires property by sale or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of § 267(a)(1), then any gain realized by the taxpayer on a sale or other disposition of the property shall be recognized only to the extent that the gain exceeds so much of the loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

Section 705(a)(1) provides that the adjusted basis of a partner's interest in a partnership shall be increased by the sum of the partner's distributive share for the taxable year and prior taxable years of: (1) taxable income of the partnership as determined under § 703(a), (2) income of the partnership exempt from income tax, and (3) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 705(a)(2) provides that the adjusted basis of a partner's interest in a partnership shall be decreased (but not below zero) by distributions by the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of: (1) losses of the partnership, and (2) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

The adjustments to the basis of a partner's interest in a partnership under § 705 are necessary to prevent inappropriate or unintended benefits or detriments to the partners. Generally, the basis of a partner's interest in a partnership is adjusted to reflect the tax allocations of the partnership to that partner. This ensures that the income and loss of the partnership are taken

into account by its partners only once. In addition, as provided in § 705(a)(1)(B) and (a)(2)(B), adjustments must also be made to reflect certain nontaxable events in the partnership. For example, a partner's share of nontaxable income (such as exempt income) is added to the basis of the partner's interest because, without a basis adjustment, the partner could recognize gain with respect to the tax-exempt income, for example, on the sale or redemption of the partner's interest, and the benefit of the tax-exempt income would be lost to the partner. Similarly, a partner's share of nondeductible expenditures must be deducted from the partner's basis in order to prevent that amount from giving rise to a loss to the partner on a sale or a redemption of the partner's interest in the partnership. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954).

In determining whether a transaction results in exempt income within the meaning of § 705(a)(1)(B) or a nondeductible, noncapital expenditure within the meaning of § 705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income. *PRS* realizes a \$20x loss on the sale of Property to *PRS2* (\$100x adjusted basis less \$80x amount realized). Pursuant to § 707(b)(1), this loss is not deductible in computing taxable income because A owns more than 50 percent of the profits interest in both *PRS* and *PRS2*. Consequently, the sale results in a permanent decrease in the aggregate basis for the assets of *PRS* that is not taken into account by *PRS* in determining its taxable income and will not be taken into account for federal income tax purposes in any other manner. Therefore, for purposes of § 705(a)(2)(B), the loss on the sale of Property, and the resulting permanent decrease in partnership basis, is an expenditure of the partnership not deductible in computing its taxable income and not properly chargeable to capital account. Cf. § 1.704-1(b)(2)(iv)(i)(3) (losses disallowed under § 707(b) treated as § 705(a)(2)(B) expenditures for purposes of maintaining partners' capital accounts); § 1.701-2(f), *Example 2* (requiring adjustments under § 705(a)(2)(B) for reductions in the basis of stock held by a partnership following an extraordinary dividend under § 1059).

Reducing the partners' bases in their partnership interests by their respective shares of the partnership's \$20x loss preserves the intended detriment of not allowing losses from sales or exchanges between partnerships and related persons to be deducted. If the partners' bases in their partnership interests were not reduced by the amount of the partnership's disallowed loss, the partners could subsequently recognize this loss (or a reduced gain), for example, upon a disposition of their partnership interests.

Under the *PRS* agreement, A's distributive share of the partnership loss is \$15x and B's distributive share is \$5x. Accordingly, the basis of A's interest in *PRS* is decreased by \$15x and the basis of B's interest in *PRS* is decreased by \$5x.

PRS2 realizes a gain of \$10x on the subsequent sale of Property (\$90x amount realized less \$80x adjusted basis). Pursuant to §§ 707(b)(1) and 267(d), *PRS2* must recognize the gain only to the extent that it exceeds the amount of *PRS*'s disallowed loss. *PRS2*'s gain on the sale (\$10x) does not exceed *PRS*'s disallowed loss (\$20x) and, therefore, *PRS2* does not recognize any gain on the sale of Property. Consequently, the sale of Property results in a permanent increase in the aggregate basis of the assets of *PRS2* that is not taken into account by *PRS2* in determining its taxable income and will not be taken into account for federal income tax purposes in any other manner. Therefore, for purposes of § 705(a)(1)(B), the gain realized but not recognized by *PRS2* on the sale of Property, and the resulting permanent increase in basis, is income of the partnership exempt from tax.

Increasing the partner's bases in their partnership interests by their respective shares of the unrecognized gain on the sale of Property preserves the intended benefit of §§ 707(b)(1) and 267(d). If the partners' bases in their partnership interests were not increased by the amount of the partnership's unrecognized gain, the partners could subsequently recognize this gain (or a reduced loss), for example, upon a disposition of their partnership interests.

Under the *PRS2* agreement, A's distributive share of the partnership gain is \$6x and C's distributive share is \$4x. Accordingly, the basis of A's

interest in *PRS2* is increased by \$6x and the basis of C's interest in *PRS2* is increased by \$4x.

HOLDINGS

(1) If a loss on the sale of partnership property is disallowed under § 707(b)(1), the basis of each partner's interest in the partnership is decreased (but not below zero) under § 705(a)(2) by the partner's share of that loss.

(2) If gain from the sale of partnership property is not recognized under §§ 707(b)(1) and 267(d), the basis of each partner's interest in the partnership is increased under § 705(a)(1) by the partner's share of that gain.

DRAFTING INFORMATION

For further information regarding this revenue ruling contact Deborah Harrington at (202) 622-3050 (not a toll-free call).
