Navigating the Split-Holding-Period Rules for Partnership Interests

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Abstract

When a partner contributes a capital asset or a section 1231 asset to her partnership in exchange for her interest in the partnership, section 1223(1) provides that her holding period for the contributed asset tacks—*i.e.*, is added to—her holding period for the partnership interest. This ensures that, if the partner sells her partnership interest within one year, any deferred long-term capital gain on the contributed asset retains its long-term character when the partner recognizes it at the time of the sale. When a partner contributes more than one asset to her partnership and receives only a portion of her partnership interest in exchange for a contributed capital asset or section 1231 asset, there needs to be a mechanism for determining the portion of the partner's holding period for her interest to which the partner's holding period for the contributed capital or section 1231 asset tacks. The split-holding-period rules in Regulation section 1.1223-3 provide that mechanism.

Unfortunately, although the split-holding-rules serve a necessary purpose, the current formulation of Regulation section 1.1223-3 is both needlessly complex and substantially flawed. Much of the complexity comes from "special" rules in paragraphs (b)(4) and (e) of the Regulation to disregard a partner's contribution of section 751 assets and to bifurcate contributed section 1231 assets with built-in section 1245 recapture income, respectively. The rules concerning treatment of section 1245 recapture income have been a particular source of confusion for some commentators.

The most troubling flaw relates to the formula in Regulation section 1.1223-3(b)(1) for dividing a partner's holding period for her partnership interest. Under that formula, when a partner sells her partnership interest within one year, a portion of her capital gain attributable to partnership assets other than the capital or section 1231 asset she contributed, is often treated as long-term. Because that portion of the partner's gain does not derive from the partner's continued investment in the contributed asset, it should instead be treated as short-term capital gain and taxed at the partner's marginal rate for ordinary income. Given the preferential long-term capital gain rates for

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individual taxpayers, this flaw in the Regulation often provides an unwarranted tax break for short-term sellers of partnership interests.

This Article provides a detailed review of the split-holding-period rules in Regulation section 1.1223-3, to make sense out of the confusion they often cause. Then, the Article explains precisely how the rules create an unjustified tax windfall for a partner who sells her partnership interest within one year after acquiring the interest from the partnership.

Finally, this Article proposes specific textual revisions to Regulation section 1.1223-3, which would eliminate the regulation's flaws and reduce its complexity. If the Article's recommended changes to Regulation section 1.1223-3 were made, the split-holding-period rules would continue to serve their intended purpose of preserving the character of deferred long-term capital gain on an asset that a partner contributes to her partnership. At the same time, however, the rules would no longer be susceptible to misuse, to convert other gain on a short-term sale of a partnership interest to long-term capital gain.

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I. Introduction

When a taxpayer contributes property to a partnership[1] in exchange for an interest in the partnership,[2] the partnership interest that she receives is a capital asset.[3] If the taxpayer subsequently disposes of her partnership interest in a taxable sale or exchange and recognizes any capital gain, whether that gain is short-term[4] or long-term[5] depends on how long the taxpayer held—or is deemed to have held—the partnership interest prior to selling or exchanging it. The determination matters greatly, because long-term capital

[1] Section 761 of the Internal Revenue Code of 1986, as amended (the "Code"), defines a "partnership" as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [the Code], a corporation or a trust or estate." I.R.C. § 761(a).

[2] Typically, a partner's interest in a partnership is a "capital" interest entitling the holder to claims on both the current assets and future profits (as well as any losses) of the partnership. In some circumstances, however, a partnership will grant a partner only a profits interest—*e.g.*, in exchange for the partner's performance of services for the partnership. *See* LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 195 (6th ed. 2020). As used herein, "partnership interest" refers to a capital interest in a partnership.

[3] A "capital asset" includes any asset held by a taxpayer that does not come within one of the categories set forth in paragraphs (1) through (8) of section 1221(a). I.R.C. § 1221(a). Partnership interests do not come within any of those eight categories. *See* I.R.C. § 1221(a)(1)-(8).

[4] A "short-term capital gain" is a "gain from the sale of a capital asset held for not more than 1 year." I.R.C. § 1222(1).

[5] A "long-term capital gain" is a "gain from the sale of a capital asset held for more than 1 year." I.R.C. § 1222(3).

gains are taxed to individual taxpayers at preferential rates[6] that are significantly lower than the ordinary marginal rates at which short-term capital gains (or ordinary gains) are taxed.

This Article explains and critiques the rules for determining a partner's holding period(s) for her partnership interest when the partner contributes multiple assets of different tax characters to the partnership in exchange for her interest. As the Article demonstrates, the holding-period rules for partnership interests in such a case are both complex and flawed.

In general, when a taxpayer receives an interest in a partnership in exchange for noncash property that she contributes to the partnership, the taxpayer takes an initial carryover basis in her partnership interest equal to her adjusted basis in the contributed property immediately before the contribution.[7] When a taxpayer's basis in property that she transfers in a taxable exchange carries over as her initial basis in the property that she receives in the exchange, section 1223(1) provides that the taxpayer's holding period for the transferred property tacks to—*i.e.*, is added to—her holding period for the received property, if the transferred property is either a capital asset or a section 1231 asset.[8] Therefore, if a taxpayer contributes a capital asset or a section 1231[9] asset to a partnership in exchange for an interest in

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[6] *See* I.R.C. § 1(h)(1).

[7] I.R.C. § 722. In the case of a contribution of property to an "investment partnership," the contributing partner's initial basis in her partnership interest is her carryover basis in the contributed property increased by the amount of gain that she recognized on the contribution under section 721(b). *See* I.R.C. § 721(b); *see also infra* note 22 (regarding investment partnerships).

[8] Section 1223(1) provides:

> In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231.

I.R.C. § 1223(1).

[9] As used herein, "section 1231 asset" refers to "property used in the trade or business" of a taxpayer, as such property is defined in section 1231(b). *See* I.R.C. § 1231(b). Section 1231 assets include, most significantly, business-use real estate and depreciable business-use personalty held by a taxpayer for more than one year. I.R.C. § 1231(b)(1). Other section 1231 assets include: certain items of timber, coal, or iron ore; certain livestock; and certain unharvested crops. I.R.C. § 1231(b)(2)-(4). Recognized gains or losses on sales or exchanges of section 1231 assets are treated as "section 1231 gains" or "section 1231 losses," as the case may be. *See* I.R.C. § 1231(a)(3)(A)(i), (a)(3)(B). If a taxpayer's section 1231 gains for a given taxable year exceed her section 1231 losses for such year, those gains and losses are treated as long-term capital gains and long-term capital losses, respectively. I.R.C. § 1231(a)(1). If the taxpayer's section 1231 losses for the year equal or

the partnership, her holding period for the contributed asset tacks to her holding period for the partnership interest. When and if the taxpayer sells her partnership interest, she will be deemed to have held the interest for (i) the time that she actually held it *plus* (ii) the time that she had held the contributed property before transferring it to the partnership.

Consider this simple example:

> Example 1: Amy contributes a parcel of unimproved land to the ABC partnership in exchange for an interest in the ABC partnership on May 1, 2024. Amy had purchased the land on May 1, 2022, and prior to the contribution she had held the land for investment.[10] On May 2, 2024, Amy sells her ABC partnership interest to Don. Assume that she recognizes $100 of capital gain on the sale. That gain is *long-term* capital gain. Even though Amy owned the partnership interest for only one day prior to the sale, she is deemed to have held it for two years and one day at the time of the sale. Her two-year holding period for the land tacks to her actual one-day holding period for the partnership interest.

In contrast, if a taxpayer contributes cash or an ordinary asset[11] to a partnership in exchange for an interest in the partnership, the taxpayer's holding period for the contributed property does *not* tack to the taxpayer's holding period for the partnership interest. Thus, in such a case, the taxpayer will be deemed to have held her partnership interest only for the time that she actually owned it, when and if she sells the interest.

Here is another brief example:

> Example 2: Diane contributes two used cars to the DEF partnership in exchange for an interest in the DEF partnership on May 1, 2024. Diane had purchased the cars on May 1, 2022, and prior to the contribution, she had held the cars as inventory in an automobile dealership that she operated as a sole proprietorship.[12] On May 2, 2024, Diane sells her DEF partnership interest to Pete. Assume that she recognizes $100 of capital gain on the sale. That gain will be *short-term* capital gain. Diane's two-year holding period for the cars does not tack to her actual one-day holding period for the partnership interest.

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exceed her section 1231 gains for the year, those losses and gains are treated as ordinary in character. *See* I.R.C. § 1231(a)(2).

[10] Because the taxpayer held the land for investment, rather than for use in a business, the land would not come within the section 1221(a)(2) exception to the definition of "capital asset." The land would be a capital asset in the taxpayer's hands.

[11] As used herein, "ordinary asset" refers to any item of noncash property that is neither a capital asset nor a section 1231 asset.

[12] Because the taxpayer held the cars in inventory for sale to customers, the cars are neither capital assets nor section 1231 assets in her hands. *See* I.R.C. §§ 1221(a)(1), 1231(b)(1)(A)-(B). Instead, in the taxpayer's hands, the cars are ordinary assets.

The application of the tacking rule is clear when a taxpayer contributes *one* asset to a partnership in exchange for an interest in the partnership. The clarity diminishes, however, if a taxpayer contributes *more than one* asset in exchange for a partnership interest. Often, the contributed assets have different tax characters. When a taxpayer contributes both (i) cash or an ordinary asset *and* (ii) a capital asset or section 1231 asset, the rules for determining the taxpayer's holding period for her partnership interest are more complicated. In such a case, the taxpayer's holding period for the contributed capital asset or section 1231 asset might tack to her holding period for only *part* of her partnership interest. This partial tacking gives the taxpayer a divided or "split" holding period for her partnership interest. As a result, the taxpayer could end up recognizing both short-term *and* long-term capital gain if she were to sell the partnership interest within one year.

Let us look at one other basic example:

> <u>Example 3</u>: Gail contributes both (i) $40 of cash and (ii) land with a fair market value of $60 to the GHI partnership in exchange for an interest in the GHI partnership on May 1, 2024. Gail had purchased the land on May 1, 2022, and had held it for investment. On May 2, 2024, Gail sells her GHI partnership interest to Tom. Assume that she recognizes $100 of capital gain on the sale. Also assume that, pursuant to applicable Treasury Regulations, Gail's two-year holding period for the land tacks to her holding period for 60 percent of her partnership interest. In such case, $60 (or 60 percent) of her gain will be long-term capital gain, and $40 (or 40 percent) of her gain will be short-term capital gain.

Whenever a partner contributes a combination of cash or an ordinary asset, on one hand, and a capital or section 1231 asset, on the other, calculating the portion of the partner's holding period for her partnership interest to which her holding period for the contributed capital or section 1231 asset tacks requires one to navigate through lengthy and densely-worded Treasury Regulations. One part of the Regulations sets forth the split-holding-period rule generally;[13] another part disregards the contribution of section 751 assets[14] when calculating a holding-period split;[15] and an additional part of the Regulation introduces further intricacies if a partner contributes section

[13] *See* Reg. § 1.1223-3(b)(1).

[14] As used herein, "section 751 assets" includes "unrealized receivables" as defined in section 751(c) and "inventory items" as defined in section 751(d). *See* I.R.C. § 751(c)-(d).

[15] *See* Reg. § 1.1223-3(b)(4).

1245 property[16] in exchange for her interest.[17] The rule concerning section 1245 property, especially, has caused consternation among tax practitioners and commentators.[18]

To help make sense of these rules, this Article provides a detailed explication of the split-holding-period Regulations for partnership interests. In the process, to place the Regulations in proper context, the Article also reviews related tax provisions that affect the operation of the split-holding-period rules—including, *inter alia*, sections 704(c), 751, and 1223(1). After explaining the rules, the Article then turns to a critical analysis of them.

The split-holding-period rules serve a necessary purpose—to preserve the character of deferred long-term capital gain on an asset that a partner contributes in exchange for a portion of her partnership interest. In their current formulation, however, the Treasury Regulations in question often create an unwarranted tax windfall for a partner who (i) contributes capital assets or section 1231 assets to her partnership in exchange for a portion of her partnership interest and (ii) then sell her interest within one year. In many such cases, the rules treat the selling partner's capital gain on what is essentially a different short-term investment in other partnership assets—*i.e.*, different from any continuing investment in the partner's contributed capital or section 1231 asset—as long-term capital gain. The Article sets forth exactly how the Regulations produce this inequitable result, as prelude to offering a solution to the problem.

After explaining how the split-holding-rules provide inappropriate long-term treatment of what should instead be short-term capital gain, this Article proposes specific textual revisions to the related Treasury Regulations, to

[16] Sections 167 and 168 provide for depreciation deductions on assets that are subject to wear and tear or exhaustion as they are used in a taxpayer's trade or business or held for the production of a taxpayer's income. *See generally* I.R.C. §§ 167, 168. A depreciation deduction reflects a statutorily-presumed reduction in the asset's fair market value due to such wear and tear or exhaustion. I.R.C. § 167(a). A taxpayer's basis in a depreciable asset is decreased, in each taxable year during the asset's applicable recovery period, by the amount of the depreciation deduction available on the asset for such taxable year. I.R.C. § 1016(a)(2). The basis reduction increases the amount of gain that the taxpayer receives if she subsequently sells or exchanges the asset, by an amount equal to her previous depreciation deductions on the asset. This ensures that the Treasury will recapture the previously-allowed depreciation deductions if the amount that the taxpayer recognizes on a disposition of the asset exceeds the asset's statutorily-presumed fair market value. Because depreciation deductions reduce ordinary taxable income, recapturing those deductions requires treating the gain resulting from depreciation-related basis deductions as ordinary (rather than capital) gain. Accordingly, section 1245 provides that recognized gain on certain capital assets or section 1231 assets for which depreciation deductions are available is ordinary income to the extent attributable to depreciation-related decreases in the taxpayer's basis. *See* I.R.C. § 1245(a)(1). The depreciable assets to which the section 1245 "recapture" provision applies are defined as "section 1245 property" in section 1245(a)(3). *See* I.R.C. § 1245(a)(3). Such assets include, first and foremost, depreciable personal property. *See* I.R.C. § 1245(a)(3)(A).

[17] *See* Reg. § 1.1223-3(e).

[18] *See infra* Part IV.C.4.

eliminate the loophole that currently exists. Adopting the recommendations in the Article would enable the split-holding-period rules to continue to preserve the character of deferred long-term capital gain on contributed partnership assets without providing an indefensible tax break to short-term holders of partnership interests.

II. A Partner Does Not Recognize Gain Or Loss When Contributing Property in Exchange for a Partnership Interest

The split-holding-period rules exist because recognition of a partner's realized gain or loss on the contribution of an asset in exchange for her partnership interest is deferred until she disposes of the interest in a taxable transaction. When the partner contributes a capital or section 1231 asset in such an exchange, the section 1223(1) tacking rule preserves the long-term character of any deferred long-term capital gain or loss on the asset if the partner disposes of her partnership interest within one year. Dividing the partner's holding period for her partnership interest facilitates application of the tacking rule when a partner contributes a capital or section 1231 asset in exchange for part, but not all, of her interest. Let us thus begin at the beginning—by reviewing the Code's mechanism(s) for deferring gain or loss on such contributions.

A. *The Nonrecognition Rule Eliminates a Tax Barrier to Beginning a Business as a Partnership*

When individuals join together to form a partnership, they have to infuse the new enterprise with capital. Accordingly, the business's founders contribute cash or other property to their new partnership in exchange for their respective interests in the partnership.[19] If a partner contributes property other than cash in exchange for her partnership interest, she generally realizes either a gain or a loss on the exchange. If the partner were required to *recognize* any gain at the time of her contribution, however, the resulting tax liability would create a substantial impediment to starting a new business as a partnership.

[19] *See* Leila Vaughn, *Partnerships—Formation and Contributions of Property or Services*, 711-3rd TAX MGMT. PORT. (BNA), Section II.A.1 [hereinafter BNA PORTFOLIO 711-3rd] ("Most partnerships are formed when the participants contribute money or other property to the common enterprise.").

To eliminate any such tax barrier to the choice of operating a new business as a partnership,[20] subchapter K[21] treats contributions of property in exchange for partnership interests as nonrecognition transactions. Section 721 generally provides that, when a partner contributes property to a partnership in exchange for interest in partnership, neither the contributing partner nor the partnership recognizes any gain or loss.[22] We typically associate these exchanges with the formation of a partnership, but such exchanges can also happen after a partnership has been created. For example, to raise new capital to fund the expansion of its business, an already-established partnership may admit additional partners—who contribute property in exchange for their interests. Or, an existing partner may contribute additional property in exchange for an increase in her partnership interest. It is thus important to note that the nonrecognition rule of section 721 applies to *all* contributions of noncash property in exchange for interests in a partnership[23] (other than an investment partnership[24]).

B. *The Contributing Partner's Unrecognized Gain or Loss Is Preserved Until a Subsequent Taxable Sale or Exchange of Either the Contributed Asset or the Partnership Interest*

While section 721's nonrecognition rule shields a partner who contributes property with built-in gain[25] from incurring tax liability at the time of the exchange, the rule does not allow the contributing partner to escape taxation on her realized gain forever. Section 721 is not an exclusion provision, but instead is a deferral provision. By operation of special basis rules in sections 722[26] and 723,[27] the contributing partner is later required to take into

[20] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 20 (noting that section 721(a)'s nonrecognition rule is "[c]onsistent with Congress' intent not to impose any tax barriers to prevent or impede parties from choosing the partnership form of doing business").

[21] The federal income tax treatment of partners and partnerships is governed by subchapter K of chapter 1 of subtitle A of the Code. Subchapter K comprises Code sections 701 through 777. *See* I.R.C. §§ 701-777.

[22] I.R.C. § 721(a). One exception is that a contributing partner recognizes gain (but not loss) that she realizes when contributing property to an investment partnership—*i.e.*, "a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated." I.R.C. § 721(b). For purposes of this rule, "investment company" status usually requires that at least 80 percent (by fair market value) of the entity's noncash assets be held for investment and be readily marketable. Reg. § 1.351-1(c)(ii).

[23] *See* Reg. § 1.721-1(a) ("This [nonrecognition] rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating.").

[24] *See supra* note 22.

[25] *See infra* note 36 (defining "built-in gain").

[26] I.R.C. § 722.

[27] I.R.C. § 723.

account any gain, or permitted to take into account any loss, that she had realized but not recognized when the contribution occurred. The partner's deferred recognition of such gain or loss occurs at the earlier of two times: (i) when the partnership disposes of the contributed property in a taxable sale or exchange (or, alternatively, takes all remaining available depreciation deductions on the property), or (ii) when the contributing partner disposes of her partnership interest in a taxable sale or exchange.

One commonly proffered rationale for this recognition-deferral is that, when a partner contributes property in exchange for her partnership interest, she simply changes the form—but not the substance—of her investment in the contributed property.[28] The hypothesis is that, after she contributes the property, the partner maintains her investment in such property because she takes an ownership interest in the entity to which the property has been transferred. On this view, the mere change in the investment's form is not an appropriate taxable event.[29] Rather, under this theory, any recognition of the partner's gain or loss should be deferred until there is a "real" change in her investment in the contributed property—*i.e.*, either a disposition by the partner of her interest in the partnership or a disposition by the partnership of the property itself.

This continuity-of-interest rationale does not withstand scrutiny. There plainly is a qualitative difference between owning a particular asset, on one hand, and holding an equity interest in an entity that owns the asset, on the other. For one thing, the partner's bundle of legal rights inherent in her investment changes significantly when she exchanges property for her partnership interest.[30] And, perhaps more to the point, the economic substance of her investment also changes dramatically.[31] Indeed, it is

[28] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 20; STEVEN SCHWARZ & DANIEL J. LATHROPE, CORPORATE AND PARTNERSHIP TAXATION 447 (7th ed. 2012); BNA PORTFOLIO 711-3rd , *supra* note 19, at Section I.C.

[29] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 20; *see also* SCHWARZ & LATHROPE, *supra* note 28, at 447; BNA PORTFOLIO 711-3rd , *supra* note 19, at Section I.C.

[30] For non-tax purposes, a partnership is governed by the partnership statute of the state in which it is organized. A majority of states and the District of Columbia base their respective partnership statutes on the Revised Uniform Partnership Act that was first approved by the National Conference of Commissioners on Uniform State Laws in 1994. Under those state statutes, a partnership has sole ownership of its assets. An equity interest in a partnership does not grant its holder a fractional undivided ownership interest in any of the partnership's assets. *See, e.g.*, REVISED UNIF. PARTNERSHIP ACT § 203 (2013) ("Property acquired by a partnership is property of the partnership and not of the partners individually."). At the same time, such an equity interest *does* entitle the holder to a liquidation share of the partnership's current capital and/or a share of the partnership's future profits. *See supra* note 2. In short, there is a significant difference between the legal rights inherent in owning a particular asset and the legal rights inherent in owning an interest in a partnership to which the asset has been contributed.

[31] One who holds a given asset is entitled to income generated by the asset, and to any economic gain (or loss) that may result from a disposition of the asset. After contributing that asset in

precisely because the change in investment is "real" that the exchange constitutes a realization event in the first place.[32]

Nonetheless, deferring a partner's gain on an exchange of property for a partnership interest furthers the important policy goal of removing what would otherwise be a significant tax obstacle to beginning a new business as a partnership. The most efficient way to effect such a deferral is through the operation of special carryover- or transferred-basis rules, such as those in sections 722 and 723.[33] Mechanically, such rules result in the deferred gain (or loss) becoming recognized when the taxpayer's "new" asset—to which the taxpayer's "old" basis has been carried over or transferred—is disposed of in a subsequent taxable sale or exchange. The conceit that there is no real change in the contributing partner's investment until a sale of either the contributed property or her partnership interest may provide a convenient—albeit not credible—pretext for deferring a partner's contribution-related gains (or losses) until such a disposition occurs. At the same time, however, overreliance on the pretext contributes to the creation of inequitable tax windfalls for some partners who sell their partnership interests, as explained below.[34]

C. *A Contributing Partner Recognizes Built-In Gain or Loss on a Contributed Asset if the Partnership Disposes of, or Depreciates, the Asset Before the Partner Disposes of Her Partnership Interest*

Section 723 generally provides that, when a partner contributes noncash property to a partnership in exchange for her partnership interest, the

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exchange for a partnership interest, however, one becomes entitled instead to a share of the profit or loss generated by the operations of a partnership that typically holds multiple assets and draws on the expertise of various partners. In addition, one becomes entitled to a share of any liquidation proceeds of that entire enterprise as well. In sum, the economic consequences of holding the partnership interest are quite different from those of owning the contributed asset.

[32] *See* BNA PORTFOLIO 711-3rd, *supra* note 19, at Section I.C (noting that, "even though a contribution of property to a partnership in exchange for an equity interest in the partnership *may be a realization event*, such transfers of property are generally treated as nonrecognition transactions under [section] 721") (emphasis added).

[33] *Cf.*, *e.g.*, I.R.C. § 358(a)(1) (generally providing for a carryover basis in corporate stock received in a section 351 exchange equal to the transferor-shareholder's adjusted basis in the property transferred to the corporation in the exchange); I.R.C. § 362(a) (generally providing for a transferred basis in property received by a corporation in a section 351 exchange equal to the transferor-shareholder's basis in such property); I.R.C. § 1031(d) (providing that, in a section 1031 "like-kind" exchange, a taxpayer takes an initial carryover basis in the property she receives that is generally equal to her adjusted basis in the property she transferred away in the exchange).

[34] For an explanation of how the split-holding-period rules under Regulation section 1.1223-3 often create inappropriate tax breaks for partners who sell their partnership within one year, see *infra* Part V.A. For a discussion of how an overly broad application of the continuity-of-interest rationale helps to lead to this outcome, see *infra* text preceding and accompanying notes 261-272.

partnership takes a transferred initial basis in the contributed property equal to the contributing partner's adjusted basis in that property on the contribution date.[35] By operation of the basis transfer, the property's built-in gain or built-in loss[36] passes from the partner to the partnership. Immediately after the exchange, the built-in gain or built-in loss is reflected on the partnership's balance sheet in a discrepancy between the property's book value and the partnership's basis in the property, and in a discrepancy between the contributing partner's book capital account balance and tax capital account balance.[37]

Section 704(c) requires a partnership to allocate any gain, loss and deductions attributable to contributed property among its partners "so as to take account of" any built-in gain or built-in loss on the property.[38] In furtherance of that rule, the section 704(c) Regulations require partnerships to allocate items of gain, loss, or deduction attributable to contributed property in ways that eliminate any discrepancy between the contributing partner's book and tax capital account balances.[39] To accomplish this, the Regulations require any built-in gain on contributed non-depreciable property to be allocated to the contributing partner when the partnership

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[35] I.R.C. § 723. If a partner recognizes gain on a contribution of property to an investment partnership pursuant to section 721(b), section 723 further provides that the partnership's initial basis in the contributed property shall be increased by the amount of such recognized gain.

[36] "Built-in gain" or "built-in loss" refers to the amount of tax gain or tax loss, respectively, that is inherent in the property at the time of the transfer—*i.e.*, the amount of gain or loss that the contributing partner would have recognized if she had sold or exchanged the property for fair market value in a taxable transaction on the contribution date.

[37] This presumes that the partnership maintains capital accounts in accordance with the rules set forth in Regulation section 1.704-1(b)(2)(iv). A book/tax discrepancy arises on a partnership's balance sheet if a partner contributes property in which the partner's adjusted basis differs from the property's fair market value on the contribution date. On the asset side of the balance sheet, the partnership's initial basis in the property equals the contributing partner's adjusted basis. I.R.C. § 723. At the same time, under the section 704(c) Regulations' capital accounting rules, the partnership must book the property at its fair market value on the contribution date. Reg. § 1.704-1(b)(2)(iv)(b). Similarly, the contributing partner's initial book capital account balance (which reflects her net contribution to the partnership's equity) equals the fair market value of the contributed property on the contribution date, net of any liabilities to which the property is subject or that are assumed from the partner by the partnership. Reg. § 1.704-1(b)(2)(iv)(d). In contrast, the contributing partner's initial *tax* capital account balance (which reflects her net contribution to the partnership's basis in its assets) equals the partnership's transferred initial basis in the property, net of any liabilities to which the property is subject or that are assumed from the partner by the partnership. *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 56-57.

[38] I.R.C. § 704(c)(1)(A) (providing that such allocations shall be made "so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution").

[39] *See* Reg. § 1.704-3.

disposes of the property[40]—subject to a so-called "ceiling rule."[41] In the case of contributed depreciable property, the Regulations instead require any built-in gain to be allocated to the contributing partner during the property's remaining cost recovery period, through special allocations[42] of the partnership's depreciation deductions—again, subject to ceiling rule limitations.[43]

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[40] When a partnership disposes of an item of contributed property at a gain equal to or greater than the built-in gain on that property at the time of the contribution, the partnership simply allocates the built-in gain to the contributing partner under the "traditional" method of section 704(c) allocations. Reg. § 1.704-3(b)(1). Because the partnership does not recognize (and therefore does not allocate) any book gain corresponding to the built-in gain for tax when it disposes of the property, this allocation of the built-in gain eliminates the book/tax discrepancy in the contributing partner's book and tax capital accounts.

[41] Under the "ceiling rule," the gain or income with respect to an item of contributed property that a partnership allocates to its partners for a particular partnership taxable year may not exceed the partnership's total gain or income with respect to such property for such year. Reg. § 1.704-3(b)(1). To prevent the ceiling rule limitation from shifting built-in gain from the contributing partner to the noncontributing partners, the Treasury Regulations permit a partnership to use either of two alternative section 704(c) allocation methods—a "traditional method with curative allocations" and a "remedial method." *See* Reg. § 1.704-3(c)(1), 3(d)(1).

[42] As used herein, "special allocation" refers to an allocation of an item of partnership income, gain, loss, deduction, or credit that differs from the proportion in which the partnership's tax items are generally allocated.

[43] The section 704(c) Regulations require allocating built-in gain on contributed depreciable property to the contributing partner prior to any disposition of the property by the partnership. When a partnership receives a contribution of depreciable property with built-in gain, the book value of the property on the partnership's balance sheet (which equals the property's fair market value at the time of the contribution) is greater than the partnership's transferred basis in the property. For this reason, as the partnership continues to take depreciation on the property, it has less tax depreciation than book depreciation to allocate among its partners. Thus, for depreciable contributed property, built-in gain is effectively allotted to the contributing partner by reallocating the partnership's tax depreciation deductions (but not book depreciation) on the contributed property away from the contributing partner and toward the non-contributing partners. Under the traditional method for such allocations, during each year remaining in the property's cost recovery period, the partnership allocates to each noncontributing partner a portion of the year's tax depreciation deduction on the property equal to such partner's share of the year's book depreciation on the property. The partnership then allocates any remaining tax depreciation on the property for the year to the contributing partner. Reg. § 1.704-3(b)(1). Under this method, the contributing partner's tax-depreciation allocation is less than her book-depreciation for the year. By virtue of these special allocations, the contributing partner effectively receives additional allocations of partnership taxable income that, by the end of the property's recovery period, equal (in aggregate) the built-in gain on the property. As a result, the book/tax discrepancy in the contributing partner's capital account balances is eliminated. For an example of this traditional allocation method, see *infra* note 165. The ceiling rule, however, prevents the traditional method from allocating all of the built-in gain to the contributing partner if the partnership's tax depreciation on the property is less than the noncontributing partners' aggregate shares of book deprecation on the property. *See* Reg. § 1.704-3(b)(2), Example (1(ii)). In such cases, the Regulations permit (but do not mandate) versions of the traditional method with curative

The section 704(c) Regulations also require a partnership to allocate built-in loss on contributed property to the contributing partner—*without* regard to the ceiling rule.[44] As with built-in gain, in the case of non-depreciable contributed property, any built-in loss is allocated when the partnership disposes of the property. And also like built-in gain, in the case of depreciable contributed property, the built-in loss is apportioned to the contributing partner through special allocations of the partnership's depreciation deductions during the property's remaining recovery period.

As a result of these section 704(c) allocations, a contributing partner ultimately takes into account—in the calculation of her taxable income for the year(s) to which the allocation(s) relate[45]—the gain or loss that she realized but did not recognize at the time of her contribution.

D. *A Contributing Partner Recognizes Deferred Gain or Loss on a Contributed Asset If the Partner Sells or Exchanges Her Partnership Interest Before the Partnership Disposes of, or Depreciates, the Asset*

Section 722 generally provides that, when a partner contributes noncash property in exchange for her interest in the partnership, she takes an initial carryover basis in her interest equal to her adjusted basis in the contributed property on the contribution date.[46] The basis carryover preserves, within the partnership interest itself, the contributing partner's built-in gain or built-in loss on the contributed property. By operation of section 722, the contributing partner takes any built-in gain on a contributed asset into income—or has her income reduced by the amount of any built-in loss on the contributed asset—if she disposes of her partnership interest in a taxable sale or exchange. Because she took a carryover initial basis in the partnership interest, the partner's recognized gain or loss upon a sale or exchange of the interest is increased by the amount of any such built-in gain or reduced by the amount of any such built-in loss on the contributed asset.

This assumes that, prior to the partner's sale or exchange of her interest, the partnership neither disposed of the contributed asset nor took all available

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allocations and the remedial method of allocations, to navigate around the ceiling rule. *See* Reg. §§ 1.704-3(c)(1), (c)(4), Example (1); 1.704-3(d)(2), (d)(7), Example (1).

[44] *See* I.R.C. § 704(c)(1)(C); Prop. Reg. § 1.704-3(f).

[45] The partner is required to take into account her allocation from the partnership of such gain or loss when computing her taxable income for her taxable year(s) within which end(s) the partnership taxable year(s) to which the gain or loss is attributable. *See* I.R.C. §§ 702(a)(1)-(3) & (7), 706(a).

[46] I.R.C. § 722. Section 722 further provides that, if a partner contributes cash in exchange for all or part of her partnership interest, her initial basis in her interest includes an amount equal to the contributed cash. Also, if a partner recognizes gain on a noncash contribution to an investment partnership pursuant to section 721(b), the partner's initial basis in her partnership interest will be increased by the amount of such recognized gain.

depreciation deductions on the asset. If the partnership disposes of, or depreciates, the asset while the contributing partner still holds her partnership interest, the partner's outside basis is adjusted—pursuant to section 705—to reflect her allocation of built-in gain or built-in loss at the time of the disposition or depreciation. This prevents the partner from being taxed on the same gain twice or from receiving the tax benefit of the same loss twice.[47] Section 722 thus ensures that the contributing partner will ultimately recognize her contribution-related gain or loss if she sells or exchanges her partnership interest, *unless* she has already taken account of such gain or loss by operation of sections 723 and 704(c).

The following example illustrates section 721's nonrecognition rule and the accompanying deferred-recognition mechanisms in sections 722 and 723:

> Example 4: Alice and Zelda form the AZ partnership. Alice contributes a parcel of undeveloped land with a fair market value of $500,000. She purchased the land two years earlier for $300,000 and held it for investment. On the contribution date, Alice's adjusted basis in the land is $300,000.[48] Zelda, in turn, contributes $500,000 of cash. In return for their respective contributions, Alice and Zelda each receive a 50-percent interest in the capital, profits, and losses of the partnership. Assume that, immediately after the exchanges described above, each partner's interest in the partnership has a fair market value of $500,000.

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[47] Under section 705, a partner's outside basis is increased by, *inter alia*, the amount of any partnership taxable income that is allocated to her. I.R.C. § 705(a)(1)(A). This includes any allocation to a contributing partner of built-in gain that the partnership recognizes upon the disposition of a contributed asset. Conversely, a partner's basis in her partnership interest is decreased (but not below zero) by, *inter alia*, the amount of any partnership losses that are allocated to her. I.R.C. § 705(a)(2)(A). This includes any allocation to a contributing partner of built-in loss that the partnership recognizes upon the disposition of a contributed asset. In the case of separately-stated special allocations of depreciation deductions to effect allocations to a contributing partner of built-in gain or loss on a contributed depreciable asset, those special allocations are included in the calculation of the amount by which the partner's outside basis is increased under section 705(a)(1)(A) (to reflect her overall allocation of partnership net income) or decreased under section 705(a)(2)(A) (to reflect her overall allocation of partnership net losses), as the case may be. Thus, when depreciation deductions on a contributed asset are allocated "away" from the contributing partner to allocate built-in gain, or when depreciation deductions on a contributed asset are allocated "toward" the contributing partner to allocate built-in loss, the allocations are reflected in corresponding adjustments to the partner's outside basis. In each such case, the basis adjustment prevents the partner from being taxed on the same gain, or from receiving the tax benefit of the same loss, twice.

[48] Alice's original cost basis in the land was $300,000. *See* I.R.C. § 1012(a). Assume that there were no adjustments to her basis due to, *inter alia*, any subsequent capital improvements to the land.

Alice's realized gain on her exchange of the land for her partnership interest is $200,000.[49] By virtue of section 721(a), she does not recognize any of that gain at the time of the contribution. Under section 722, Alice takes an initial outside basis of $300,000—equal to her adjusted basis in the land. Under section 723, the partnership takes a $300,000 initial basis in the land—equal to Alice's adjusted basis in the land.

Imagine that the partnership holds the land for investment for six months. Then, while Alice is still a partner, the partnership sells the land for $550,000 and recognizes $250,000 of gain.[50] Pursuant to section 704(c), the partnership allocates the first $200,000 of that gain—equal to the built-in gain on the land at the time of the contribution—to Alice.[51] Therefore, Alice must include that $200,000 in income for her taxable year that corresponds to the partnership's taxable year of the sale.[52] Through this mechanism, Alice is taxed on the $200,000 of gain that she did not recognize at the time of her contribution.[53]

Now, imagine instead that Alice sells her partnership interest to a third-party for its then-fair market value of $600,000, four months after her exchange of the land for the interest. Assume that, at such time, Alice's outside basis is $300,000.[54] Assume further that the partnership still holds the land when Alice sells her interest. At the time of the sale, Alice recognizes $300,000 of gain.[55] That gain consists of both (i) the partnership interest's $100,000 of appreciation in value since the contribution date and (ii) *the $200,000 of built-in gain in the land on the contribution date*. In this scenario, too, Alice is ultimately taxed on the $200,000 of gain that she did not recognize when she contributed the land to the partnership.

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[49] $500,000 (value of property received) – $300,000 (adjusted basis in transferred property) = $200,000 realized gain. *See* I.R.C. § 1001(a).

[50] The partnership took a $300,000 initial basis in the land from Alice. *See* I.R.C. § 723. Assume that there were no subsequent adjustments to the partnership's basis. $550,000 (amount realized on sale) – $300,000 (basis) = $250,000 realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[51] *See* I.R.C. § 704(c)(1)(A). The remaining $50,000 of the partnership's gain would be allocated equally between Alice and Zelda—*i.e.*, each partner would have a $25,000 distributive share of such gain—pursuant to the partnership's normal allocation rules.

[52] *See supra* note 45.

[53] Alice would also have to report (and would also be taxed on) her $25,000 distributive share of the partnership's recognized gain that had accrued on the property after the contribution. *See supra* note 51.

[54] Alice took a $300,000 initial outside basis in her partnership interest—equal to her $300,000 adjusted basis in the contributed land. *See* I.R.C. § 722(a). Assume that there are no subsequent adjustments to Alice's outside basis—*e.g.*, due to any partnership allocation of undistributed income, allocation of loss, distribution of property, or allocation of liabilities.

[55] $600,000 (amount realized on sale) – $300,000 (basis) = $300,000 realized and recognized gain. *See* I.R.C. § 1001(a), (c).

III. A Partnership Interest Sale Is Treated in Part As If It Were a Sale of Interests in the Partnership's Assets and, Thus, Some Gain on Such a Sale May Be Ordinary, Rather than Capital, in Character

Deferring a partner's gain or loss on a contributed asset requires preserving not only the amount, but also the tax character, of that gain or loss. When a partner contributes a capital asset or section 1231 asset to her partnership in exchange for part (but not all) of her partnership interest, the split-holding-period rules help to preserve the *long-term* character of any built-in long-term capital gain or loss on the contributed asset. Creating a separate holding period for the part of the interest that the partner received in exchange for the capital or section 1231 asset allows the partner's holding period for the contributed asset to tack to her holding period for that part of her partnership interest.[56] This, in turn, helps to ensure that the partner ultimately recognizes her deferred gain or loss on the contributed asset as long-term capital gain or loss if she sell her partnership interest before the partnership sells the contributed asset—even if the partner sells her interest within one year.

The split-holding-period rules affect how much of a partner's capital gain or loss on the sale of her partnership interest is long-term, and how much is short-term. Yet, to grasp the rules' myriad details, one must understand that not all gain or loss on the disposition of a partnership interest is always *capital* gain or loss. Depending on the character of the partnership's assets, a portion of the partner's recognized gain or loss on a sale or exchange of her interest may be *ordinary* instead. To account for that, the split-holding-period rules contain specific provisions for the treatment of contributed ordinary assets. And those particular provisions give rise to much of the rules' complexity.

Hence, to decipher the split-holding-period rules, we must first review the rules for determining the extent to which recognized gain or loss on a taxable sale or exchange of a partnership interest is ordinary in character.

A. *Subchapter K Adopts Elements of Both the Entity Approach and the Aggregate Approach to Partnership Taxation*

There are two alternative approaches to taxing business organizations and their equity-owners—the *entity* approach and the *aggregate* approach. The

[56] When a partner contributes a section 1231 asset in exchange for her partnership interest (or a portion thereof), the partner's holding period for the contributed section 1231 asset always tacks to her holding period for the applicable part of her interest. *See* Reg. § 1.1223-3(b). Implicit in this rule is an assumption that the partner would have recognized long-term capital gain or loss if she had sold or exchanged the section 1231 asset for fair market value on the contribution date. The rule does not account for the possibility that the partner's section 1231 losses might have exceeded her section 1231 gains in the year of the contribution, in which case any recognized gain or loss on the contributed section 1231 asset would have been ordinary gain or loss. *See* I.R.C. § 1231(a)(2). This is consistent with Subchapter K's policy of never treating any portion of the gain or loss on a sale of a partnership interest as section 1231 gain or loss, even if attributable to the partnership's section 1231 assets. *See infra* note 127.

entity approach treats a business organization as entirely separate and distinct from its owners. Under the entity approach, the organization's tax attributes—*i.e.*, its taxable income, gains, losses, deductions, credits, etc.—remain attributes of the entity itself, and the organization pays entity-level taxes. The clearest example of the entity approach is the federal income tax treatment of C corporations.

The aggregate approach, in contrast, treats a business organization not as a separate entity, but rather as merely an aggregation of the organization's individual owners. Under the aggregate approach, the income, gains, losses, deductions, and credits attributable to the business are tax attributes of the business's owners, because there is no recognized "entity" to which those tax attributes could otherwise belong. Accordingly, under the aggregate approach, a business organization is not subject to any entity-level tax. Instead, each of the business's owners includes her respective share of the income or loss attributable to the business in the calculation of her own taxable income or tax loss. The purest example of the aggregate approach is the federal income tax treatment of a sole proprietorship.

The federal income tax treatment of partnerships is a hybrid of the aggregate approach and the entity approach.[57] A partnership is treated as an aggregation of its partners in the most essential respect: A partnership does not pay an entity-level federal income tax.[58] Instead, the partnership's tax attributes pass through to its individual partners. Each partner takes account of her distributive share of the partnership's taxable income or loss for a given partnership taxable year when calculating her own taxable income or tax loss for her corresponding taxable year.[59]

At the same time, a partnership is treated as an entity to a limited but important extent: A partnership is viewed as a separate *accounting* entity for purposes of determining both the amount and the character of the partnership's income, losses, deductions, etc. to be passed through to the partners.[60] This is necessary to facilitate calculation of the partners' respective shares of the partnership's income and deductions for a given year. Those calculations would be unworkably complex if each partner had to report her

[57] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 16-17; *see also* JAMES R. REPETTI, WILLIAM H. LYONS & CHARLENE D. DUKE, PARTNERSHIP INCOME TAXATION 2-3 (6th Ed. 2018).

[58] I.R.C. § 701.

[59] I.R.C. § 702(a), (c). A partner's "distributive share" of a partnership's income, gain, deduction, loss, or credit is the portion of that partnership item that the partnership allocates to the partner—in accordance with rules set forth in section 704—for purposes of determining the amount of that item that the partner must take into account when determining her individual income tax for the applicable taxable year. *See* I.R.C. §§ 702(a), 704(a).

[60] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 17, 33; REPETTI ET AL., *supra* note 57, at 3.

share of partnership-related tax items on the basis of her own accounting method, her own method of depreciation, and so forth.[61]

Therefore, even though partnerships do not pay an entity-level federal income tax, subchapter K treats a partnership as an entity in some important ways.[62] For instance, a partnership must adopt its own method of tax accounting[63] and its own taxable year.[64] To calculate its taxable income, a partnership must make other entity-level elections, such as choosing an applicable tax depreciation method for its depreciable assets.[65] A partnership has its own tax basis in its assets. And the tax character of any passed-through income or loss that the partnership derives from those assets—including the character of any gain or loss that the partnership recognizes if it disposes of the assets—is generally determined at the partnership level.[66]

B. *The Treatment of a Partnership Interest Sale, in Particular, Reflects a Combination of the Entity and Aggregate Approaches*

Consistent with its approach to partnership taxation generally, subchapter K adopts a hybrid approach to the treatment of a partner's sale of her partnership interest.[67] The general rule in section 741 is that a partner's recognized gain or loss on a sale or exchange of her partnership interest "shall be considered as gain or loss from the sale or exchange of a capital asset."[68] This follows the entity approach, under which the transaction is treated as

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[61] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 17, 33.

[62] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 17.

[63] A partnership that has a C corporation as a partner, however, is foreclosed from using the cash receipts and disbursements method of accounting to determine its taxable income, unless the partnership is in the business of farming, the C corporation is a so-called "qualified personal service corporation," or the partnership has average annual gross receipts below a specified threshold. *See* I.R.C. § 448(a)(2), (b); *see also* I.R.C. § 448(c), (d)(2).

[64] I.R.C. § 706(b)(1)(A).

[65] I.R.C. § 703(b) (providing that, with only three narrow exceptions, "[a]ny election affecting the computation of taxable income derived from a partnership shall be made by the partnership"). *See* REPETTI ET AL., *supra* note 57, at 2-3 (discussing partnership elections under section 703(b)); *see also* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 33 (noting, in particular, partnership-level elections of depreciation method, tax accounting method, and taxable year).

[66] *See* I.R.C. § 702(b) ("The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."); *but see* I.R.C. § 724 (setting forth special rules for determination of "character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property").

[67] As two prominent commentators have observed, "[i]n no case is the tension between the entity and aggregate conceptions of partnerships more apparent than in the case of the sale of a partnership interest." CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 201.

[68] I.R.C. § 741.

the disposition of an interest in the partnership itself, rather than as a disposition of a portion of the partnership's assets.[69]

There are some significant exceptions and caveats to the general rule, however. First and foremost, section 751(a) treats a partner's gain or loss on the sale of her partnership interest as ordinary in character to the extent that the gain or loss is attributable to the partnership's ordinary assets.[70] This prevents the partner from converting ordinary gain (on her share of the partnership's ordinary assets) to long-term capital gain when she sells her interest. Similarly, a Treasury Regulation taxes a partner's long-term capital gain on the sale of her partnership interest at special rates if such gain is attributable to the partnership's collectibles or unrecaptured section 1250 gain.[71]

These exceptions and caveats treat the sale of a partnership interest more like a sale of the partner's proportionate share of each of the partnership's assets. This moves the taxation of partnership-interest dispositions far closer to the aggregate approach.[72] A sale or exchange of a partnership interest is not taxed in most cases *exactly* as if it were a sale or exchange of a corresponding share of the partnership's assets,[73] but the tax treatment generally is quite similar.

C. *Section 751(a) Treats Gain or Loss on a Partnership Interest Sale as Ordinary Gain or Loss to the Extent That Such Gain or Loss Is Attributable to the Partnership's Unrealized Receivables or Inventory Items*

The second sentence of section 741 states that a partner's recognized "gain or loss [on the sale or exchange of her partnership interest] shall be considered as gain or loss from the sale or exchange of a capital asset, *except as otherwise provided in section 751 (relating to unrealized receivables and inventory items)*.[74] Section 751(a), in turn, provides that a partner's amount realized on a sale or exchange of "all or a part of [her] interest in the partnership attributable to (1) unrealized receivables of the partnership, or (2) inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset."[75] In other words, to the

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[69] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 201 ("An entity approach would treat the sale [of a partnership interest] much like a sale of corporate stock: the seller would realize capital gain or loss . . . .").

[70] *See* I.R.C. § 751(a).

[71] *See* I.R.C. § 751(a); *see also* Reg. § 1.1(h)-1.

[72] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 201 ("An aggregate approach would treat the selling partner [in the sale of a partnership interest] as if she sold an undivided interest in each and every partnership asset to the buyer.").

[73] *See infra* note 127 and accompanying text.

[74] I.R.C. § 741 (emphasis added).

[75] I.R.C. § 751(a).

extent of a selling partner's deemed interest in her partnership's "unrealized receivables" or "inventory items" (as defined in section 751), a corresponding portion of the partner's gain or loss on the sale of her partnership interest will be treated as *ordinary*, rather than capital, gain or loss.

The underlying premise of section 751(a) is that a portion of a partner's gain or loss on the sale of her partnership interest arises from, or corresponds to, her distributive share of the gain or loss inherent in the partnership's unrealized receivables and inventory items. Section 751(a) treats that portion of a partner's gain or loss on her partnership-interest sale as ordinary gain or loss because the partnership's unrealized receivables and inventory are ordinary assets.[76]

1. *Unrealized Receivables Under Section 751(c)*

Section 751(c)'s definition of "unrealized receivables" encompasses a considerably broader group of assets than the terms might initially suggest. The definition includes a partnership's unrealized rights to receive payment for either "goods delivered, or to be delivered," or "services rendered, or to be rendered[,]" in each case "to the extent not previously includible in income under the [partnership's] method of accounting[.]"[77] This, of course, comports with what the phrase "unrealized receivable" generally connotes. Yet the section 751(c) definition also includes any inherent gain on a partnership's capital asset or section 1231 asset that would be "recaptured" as ordinary income if the partnership were to sell the asset for fair market value and recognize the gain.[78] This includes, most significantly, section 1245 recapture income that is inherent is a partnership's depreciable personalty assets.[79]

2. *An Example of Section 1245 Recapture Income as a Section 751(c) Unrealized Receivable*

Here is an example of how section 751(c) characterizes section 1245 recapture income inherent in a partnership's depreciable section 1231 asset or capital asset:

> <u>Example 5</u>: The JKL partnership is a calendar year partnership. In July 2019, Janice acquired from the partnership a 30-percent interest in the partnership's capital, profits, and losses, in exchange for a cash contribution to the partnership. In April 2020, the partnership purchased (and placed into service) office furniture for use in its business headquarters, at a cost of

[76] *See* I.R.C. § 1221(a)(1), (4).
[77] I.R.C. § 751(c)(1)-(2).
[78] I.R.C. § 751(c) (flush language).
[79] *See* I.R.C. § 751(c) (flush language) (referencing section 1245 property and the ordinary income rule in section 1245(a)).

$100,000. Assume that the partnership did not place any other depreciable assets into service during 2020. Between 2020 and 2023, the partnership took $68,760 of depreciation for tax on the office furniture.[80] As of January 1, 2024, the partnership's adjusted basis in the furniture was $31,240.[81] Assume that the furniture's fair market value on January 1, 2024 was $62,000.

As of January 1, 2024, there was $30,670 of tax gain inherent in the JKL partnership's office furniture[82]—even though the fair market value of the furniture declined by $38,000 since the partnership purchased it. The $30,670 of tax gain is due to reductions in the partnership's basis, pursuant to section 1016(a), that correspond to the partnership's depreciation deductions on the furniture.[83] The partnership's $68,760 of depreciation deductions reflect a statutory presumption that the fair market value of the furniture declined by $68,760, due to wear and tear, as the partnership used the furniture in its business during the period from April 2020 through December 2023.[84] In fact, however, the value of the furniture declined by "only" $38,000 during that period. This means that the partnership took $30,760 more in depreciation deductions than the furniture's actual decline in value warranted.

Because the depreciation deductions exceeded the partnership's related business expense, Treasury needs to "recapture" the excess deduction amount to prevent the partners from receiving (or keeping) an unfounded tax break.

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[80] Under the Modified Accelerated Cost Recovery System ("MACRS"), office furniture is 7-year property. I.R.C. § 168(e)(3)(C)(v). In the absence of any contrary election, the applicable tax depreciation method for 7-year property under MACRS is the 200-percent-declining-balance method. I.R.C. § 168(b)(1). Assume that the JKL partnership did not elect to depreciate the office furniture for tax under the straight-line method or under the alternative depreciation system ("ADS") described in section 168(g). *See* I.R.C. § 168(b)(3)(D), (5) (providing for election of straight-line method); I.R.C. § 168(g)(2) (defining "alternative depreciation system"); I.R.C. § 168(g)(7)(A) (providing for ADS election). Subject to section 168(d)(3) (which is inapplicable to this example), the half-year convention applies when using the 200-percent-declining-balance depreciation method. I.R.C. § 168(d)(1), (3). Assume that the partnership did not elect immediate expensing of the office furniture under section 179. *See generally* I.R.C. § 179. Also assume that the partnership elected not to take any additional first-year depreciation allowance on the office furniture pursuant to section 168(k). *See* I.R.C. § 168(k)(1) (providing for additional first-year depreciation allowance); I.R.C. § 168(k)(7) (providing for election out of additional allowance). The depreciation amount is calculated under depreciation table 1 in IRS Revenue Procedure 87-57. *See* Rev. Proc. 1987-57, § 8.01 (Table 1), 1987-2 C.B. at 696.

[81] The partnership took a $100,000 initial cost basis in the office furniture. *See* I.R.C. § 1012(a). The basis was subsequently reduced by $68,760 because of the depreciation deductions. *See* I.R.C. § 1016(a)(2). $100,000 – $68,760 = $31,240.

[82] $62,000 (fair market value) – $31,240 (adjusted basis) = $30,760.

[83] *See* I.R.C. § 1016(a)(2) (basis reduction in amount of available depreciation on asset); *see also supra* note 16 (discussing same) & note 81 (Example 5 basis reduction).

[84] *See supra* note 16.

The section 1016 reductions in the partnership's basis in the office furniture ensure that Treasury will recover the amount of the excess depreciation deductions when and if the partnership disposes of the furniture in a taxable transaction. The partnership's tax gain on the disposition will be greater—or its tax loss will be lower—by an amount equal to the "excess" portion of the depreciation deductions, because of the basis reductions.

Depreciation deductions are ordinary deductions; they reduce a taxpayer's ordinary taxable income. Therefore, to recapture all of the federal income tax that the partners avoided because of the partnership's excess depreciation deductions, any partnership gain on a disposition of the furniture that results from the section 1016 basis reductions must be treated as ordinary income—even though the furniture is a section 1231 asset.[85] Accordingly, section 1245 provides for that ordinary-income treatment.[86]

When a taxpayer disposes of section 1245 property[87] in a taxable transaction, section 1245(a) characterizes as ordinary income the gain on the disposition that stems from the reduction in the taxpayer's adjusted basis in the property corresponding to the tax depreciation that the taxpayer took on the property.[88] For instance, in Example 5, assume that the partnership had sold its office furniture for fair market value on January 1, 2024. In that case, the partnership's $30,760 of recognized gain would have resulted solely from the section 1016 reductions in partnership's adjusted basis in the furniture.[89] Therefore, under section 1245(a), that gain would have been ordinary income, rather than section 1231 gain, for the partnership.

By extension, to determine the ordinary gain on a sale of a JKL partnership interest, section 751 divides the value of the partnership's office furniture into two assets. Section 751(c) reclassifies as an "unrealized receivable"—*i.e.*, an ordinary asset—the portion of the furniture's inherent gain that would be

[85] *See* I.R.C. § 1231(b)(1) *see also supra* note 9.

[86] *See* I.R.C. § 1245(a)(1) (requiring ordinary-income treatment for gain recognized on dispositions of section 1245 property, to the extent that such gain corresponds to depreciation deductions on such property).

[87] "Section 1245 property" includes, *inter alia*, depreciable personal property used in a taxpayer's trade or business or held for production of taxpayer income. *See* I.R.C. § 1245(a)(3)(A); *see also supra* note 16 (discussing section 1245 property).

[88] In a taxable disposition of section 1245 property, section 1245(a) treats as ordinary income the excess of (i) the lower of (A) the taxpayer's "recomputed basis" in such property or (B) the taxpayer's amount realized on such sale or exchange *over* (ii) the taxpayer's adjusted basis in such property at the time of such sale or exchange. I.R.C. § 1245(a)(1). A taxpayer's "recomputed basis" in an item of section 1245 property, as of any given date, equals the sum of (i) the taxpayer's adjusted basis in such property on such date *plus* (ii) the amount by which the taxpayer's adjusted basis in such property has been reduced, up until such date, due to the taxpayer's depreciation deductions on such property. I.R.C. § 1245(b)(2)(A).

[89] *See supra* notes 82-83 and accompanying text.

section 1245 recapture income in a taxable disposition for fair market value.[90] The remainder of the furniture's value continues to be a section 1231 asset. As of January 1, 2024, the JKL partnership would thus be deemed under section 751(c) to have held (i) an unrealized receivable with a fair market value of $30,670 (and a basis of $0) and (ii) office furniture with a fair market value (and an adjusted basis) of $31,240.

If the partnership had sold the office furniture on January 1, 2024, then $9,201 (or 30 percent) of its $30,670 in gain would have been allocated to partner Janice. Because the partnership's gain would have been recaptured as ordinary income under section 1245(a), that partnership would have been allocated $9,201 of ordinary income to Janice in such case.[91] Under subchapter K's quasi-aggregate approach, a sale by partner Janice of her interest in the JKL partnership is treated similarly to a hypothetical sale of Janice's interest in each of the partnership's assets.[92] Hence, because Janice would have had to report $9,201 of ordinary income if the partnership had sold the office furniture on January 1, 2024, she would have recognized $9,201 of ordinary gain pursuant to section 751(a) if she had sold her partnership interest on that date.

3. *Inventory Items Under Section 751(d)*

Section 751(d)'s definition of "inventory items" is also far broader than the term initially suggests. The definition includes, of course, stock in trade held primarily for sale to customers[93]—*i.e.*, the assets that section 1221(a)(1) carves out from the definition of a "capital asset."[94] But it also includes any other noncash asset that is neither a capital asset nor a section 1231 asset—*i.e.*, any ordinary asset—in the partnership's hands.[95] Moreover, the

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[90] *See* I.R.C. § 751(c) (flush language) (defining as an "unrealized receivable" section 1245 property . . . to the extent of the amount which would be treated as gain to which section . . . 1245(a) . . . would apply if . . . such property had been sold by the partnership at its fair market value).

[91] Ordinary gain from the disposition of a partnership asset is not a separately passed-through item under section 702(a). Instead, as with ordinary income from a partnership's operations, such ordinary gain is included in the partnership's non-separately-computed net income or loss for the taxable year in question. *See* I.R.C. § 702(a)(8). Janice's distributive share of the JKL partnership's non-separately-computed net income (or loss) for 2024 thus would have included $9,201 (or 30 percent) of the section 1245(a) recapture income that the partnership would have recognized if it had sold the office furniture in 2024. *See* I.R.C. § 702(a)(8).

[92] The process for calculating the ordinary portion of a partner's gain on a sale or exchange of a partnership interest is described in Part III.D.

[93] I.R.C. § 751(d)(1) (cross-referencing section 1221(a)(1)).

[94] I.R.C. § 1221(a)(1)).

[95] I.R.C. § 751(d)(2).

definition includes any partnership asset that would be inventory or as another type of ordinary asset if it were in the selling partner's hands.[96]

Technically, section 751(d) subsumes all the assets within section 751(c) except for the recapture items. More to the point, section 751(c) "unrealized receivables" and section 751(d) "inventory items" collectively include all partnership assets that are ordinary in the partnership's hands or that would be ordinary in the selling partner's hands. Under section 751(a), therefore, a selling partner's gain or loss on her partnership interest is ordinary to the extent attributable to her interest in any partnership ordinary asset.

D. *The Treasury Regulations Provide Rules for Determining the Exact Portion of the Gain or Loss on a Partnership Interest Sale That Section 751(a) Treats as Ordinary in Character*

Regulation section 1.751-1(a)(2) sets forth a three-step process for calculating the amount (if any) of a partner's ordinary gain on a sale of her partnership interest:[97] *First*, determine the total amount of gain (or loss) that the seller recognizes when she sells her partnership interest.[98] *Second*, imagine that the partnership sold all of its assets for fair market value immediately before the partner sold her partnership interest. In this hypothetical sale, calculate how much of the gain or loss on the partnership's section 751 assets would be allocated to the partner who is selling her partnership interest.[99] *Third*, subtract (A) the selling partner's distributive share of gain on the hypothetical sale of the partnership's section 751 assets from (B) the selling partner's total gain on the sale of her partnership interest. This is the amount of the gain on the sale of the partnership interest that is *capital gain*.[100] The remainder of the gain on the sale of the partnership interest is *ordinary gain*.[101]

Let us review an example:

> <u>Example 6</u>: The MNO partnership is a calendar year partnership that operates a retail appliance store. In April 2006, Mary acquired from the partnership a 40-percent interest in the partnership's capital, profits, and losses, in exchange for a cash contribution to the partnership. On January 1, 2024, the MNO partnership owned the following assets: (i) appliances which the partnership held in inventory for sale to customers, and which it had purchased from a wholesaler in November 2023 for $175,000; (ii) the building in which the store was located, which the partnership had purchased for $300,000 and placed in service in March 2012; (iii) the parcel of land

[96] I.R.C. § 751(d)(3).
[97] *See* Reg. § 1.751-1(a)(2).
[98] *See id.*
[99] *See id.*
[100] *See id.*
[101] *See id.*

> which the building sits, which the partnership purchased in March 2012 for \$100,000; and (iv) the partnership's self-created goodwill for its business. Between 2012 and 2023, the partnership took \$90,711 of depreciation for tax on the store building.[102] Assume that, on January 1, 2024, the aggregate fair market value of the appliances was \$225,000, the store building's fair market value was \$600,000, the land's fair market value was \$200,000, and the fair market value of the partnership's goodwill was \$150,000. Also assume that, as of January 1, 2024, the partnership had no liabilities.[103] On January 1, 2024, Mary sold her interest in the MNO partnership to Ken for \$470,000. Assume that, at the time of that sale, Mary's outside basis in her partnership interest was \$200,000.

Mary recognizes \$270,000 of gain on the sale of her partnership interest.[104] How much of that gain is ordinary, and how much is capital in character?

Following Regulation section 1.751-1(a)(2), we hypothesize that the MNO partnership sells all of its assets for fair market value on January 1, 2024, immediately before Mary sells her partnership interest.[105] In that hypothetical sale, the partnership would recognize \$50,000 of gain on the

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[102] Under MACRS, the partnership's building is "nonresidential real property." *See* I.R.C. § 168(e)(2)(B). As such, it has a 39-year recovery period. I.R.C. § 168(c). The Omnibus Reconciliation Act of 1993 amended section 168(c) to extend the recovery period for placed in service on or after May 13, 1993 from 31.5 years to 39 years. Pub. L. No. 103-66, § 13151(a)-(b)(1), 107 Stat. 312, 448 (1993). The applicable tax depreciation method under MACRS for nonresidential real property placed into service after 1986 is the straight-line method. I.R.C. § 168(b)(3)(A); *see also infra* note 115. In applying the straight-line depreciation method to nonresidential real property, the mid-month convention applies. I.R.C. § 168(d)(2)(A), (4)(B). The depreciation amount is calculated under depreciation table A-7a in IRS Publication 946. *See* INTERNAL REVENUE SERV., PUBLICATION 946, HOW TO DEPRECIATE PROPERTY REVENUE PROCEDURE 73 (2021), https://www.irs.gov/pub/irs-pdf/p946.pdf [hereinafter IRS PUBLICATION 946] (Table A-7a). The partnership's original cost basis in the building was \$300,000. *See* I.R.C. § 1012(a). But as a result of the \$90,711 of depreciation deductions, as of January 1, 2024, the partnership's adjusted basis in the building was \$209,289. *See* I.R.C. § 1016(a)(2).

[103] A partner is allocated a share of any partnership liabilities. *See generally* I.R.C. § 752; Reg. § 1.752-2 (Partner's share of recourse liabilities); Reg. § 1.752-3 (Partner's share of nonrecourse liabilities). If a partner sells an interest in a partnership that has liabilities, her share of those liabilities is transferred to the purchaser of the interest. The seller's relief from her share of the liabilities is part of her amount realized on the sale. I.R.C. § 752(d); Reg. 1.1001-2(a)(1). The simplifying (if perhaps unrealistic) assumption in this example eliminates the complication of having to determine Mary's share of any partnership liabilities when calculating her amount realized on the sale of her partnership interest.

[104] \$470,000 (amount realized on sale) – \$200,000 (adjusted basis) = \$270,000 realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[105] *See* Reg. § 1.751-1(a)(2).

appliances,[106] $390,711 of gain on the store building,[107] $100,000 of gain on the land,[108] and $150,000 of gain on the goodwill.[109] The partnership would allocate 40 percent of each of those items of gain to Mary (who would still be a partner at the moment of the sale). We then determine, in particular, that Mary's distributive share of gain on the hypothetical sale of the partnership's section 751 assets—the appliances—would be $20,000.[110]

Next, we subtract the $20,000 of gain attributable to the partnership's section 751 assets from the $270,000 total of Mary's gain on the sale of her partnership interest.[111] The difference, $250,000, is the *capital* portion of Mary's gain on the sale of her interest. The remaining $20,000 of Mary's gain is *ordinary*.

E. *A "Look-Through" Rule in the Treasury Regulations Is Further in Keeping With a More Aggregate Approach to the Treatment of a Partnership Interest Sale*

In general, long-term capital gain on a partnership interest sale is taxed at 0 percent, 15 percent, or 20 percent, depending on the selling partner's filing status and her overall taxable income for the year in question.[112] A "look-through rule" in Regulation section 1.1(h)-1, however, requires the selling partner to determine whether any part of her capital gain under section 741 is attributable to the partnership's collectibles or unrecaptured section 1250 gain.[113] While most long-term capital gains are in the 0/15/20-percent category, long-term capital gains on "collectibles" are taxed at 28 percent,[114]

[106] The partnership's aggregate basis in the appliances is the $175,000 aggregate purchase price that it paid for those items. *See* I.R.C. § 1012(a). $225,000 (amount realized on hypothetical sale) – $175,000 (adjusted basis) = $50,000 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[107] The partnership's adjusted basis in the building, as of January 1, 2024, was $209,289. *See supra* note 102. $600,000 (amount realized on hypothetical sale) – $209,289 (adjusted basis) = $390,711 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[108] The partnership's basis in the land is the $100,000 purchase price that it paid for the land. *See* I.R.C. § 1012(a). $200,000 (amount realized on hypothetical sale) – $100,000 (adjusted basis) = $100,000 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[109] Given that the partnership created the goodwill, its basis therein is $0. $150,000 (amount realized on hypothetical sale) – $0 (adjusted basis) = $150,000 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[110] *See* Reg. § 1.751-1(a)(2). *See* Reg. § 1.751-1(a)(2). As stock in trade held primarily for sale to customers, the appliances constitute "inventory items" of the partnership under section 751(d)(1). $50,000 (partnership gain on hypothetical sale of appliances) x .40 = $20,000.

[111] *See* Reg. § 1.751-1(a)(2).

[112] I.R.C. § 1(h)(1)(B)-(D), (3).

[113] Reg. § 1.1(h)-1.

[114] I.R.C. § 1(h)(1)(F), (4)(A)(i), (B)(i), (5)(A). A "collectible" generally includes "(A) any work of art, (B) any rug or antique, (C) any metal or gem, (D) any stamp or coin, (E) any alcoholic beverage, or (F) any other tangible personal property specified by the Secretary [as a collectible]."

and unrecaptured section 1250 gain is taxed at 25 percent.[115] The look-through rule provides that, if part of the long-term capital gain on a sale of a partnership interest is attributable to the partnership's collectibles or to unrecaptured section 1250 gain inherent in the partnership's depreciable real estate, such gain will be taxed at the appropriate 28-percent or 25-percent rate.[116]

I.R.C. § 408(m)(2); *see also* I.R.C. § 1(h)(5)(A) (cross-referencing section 408(m)(2)). *But see* I.R.C. § 408(m)(3) (providing that certain specified coins and bullion shall not constitute collectibles).

[115] I.R.C. § 1(h)(1)(E). Section 1250 treats as ordinary income the portion of any recognized gain on a disposition of "section 1250 property" that is attributable to reductions in basis in the property corresponding to the portion of depreciation deductions allowable on the property equal to the excess of (i) any accelerated depreciation allowable on the property over (ii) straight-line deprecation on the property over the same period. I.R.C. § 1250(a)(1)(A), (b)(1). For a discussion of why Congress drafted section 1250 to recapture as ordinary income only the amount by which (i) the gain attributable to accelerated depreciation deductions on an item of real property exceeds (ii) the gain that would have been attributable to straight-line depreciation deductions on that property, see Richard L. Schmalbeck & Jay A. Soled, *Unifying Depreciation Recapture*, 48 CONN. L. REV. 531, 540-41 (2015). "Section 1250 property" consists of depreciable real property—*i.e.*, buildings and other depreciable improvements to land that are used in a trade or business or held for the production of income—other than the small subset of such property that is instead section 1245 property. I.R.C. § 1250(c); *see also* I.R.C. § 1245(a)(3)(C) (listing a few narrow categories of real property that come within the definition of "section 1245 property"). As part of MACRS, which was implemented as part of the Tax Reform Act of 1986, accelerated depreciation became unavailable for real property placed in service after 1986. Tax Reform Act of 1986, Pub. L. 99-514, §§ 201(a), 203(a)(1)(A), 100 Stat. 2085, 2121-22, 2143 (1986) (amending section 168(b)(3) to require straight-line depreciation of nonresidential real property and residential real property placed in service after December 31, 1986). Any depreciable real property placed in service on or before December 31, 1986 has long been fully depreciated, and all depreciable real property placed in service thereafter must be depreciated under the straight-line method. *See* I.R.C § 168(b)(3)(A)-(B). For these reasons, the section 1250 recapture provision rarely applies today; it has "essentially been rendered a nullity." Schmalbeck & Soled, *supra*, at 544 (discussing how section 1250 recapture now applies only in the "two extraordinarily limited exceptions" of "real property disposed of within one year of its acquisition and . . . certain fifteen-year land improvements and seven-year theme park structures"). As part of a more "general reform of capital gains provisions," however, Congress introduced in 1997 a special 25-percent long-term capital gain rate—intended to be between ordinary income rates and general long-term capital gain rates—on "unrecaptured section 1250 gain." *Id.* at 545. *See* Taxpayer Relief Act of 1997, Pub. L. 105-34, § 311, 111 Stat. 787, 832-33 (1997) (amending section 1(h) to add, *inter alia*, provisions related to taxation of unrecaptured section 1250 gain). The "unrecaptured section 1250 gain" to which the 25-percent rate applies is essentially the portion of any long-term capital gain recognized on a disposition of section 1250 property (held by the taxpayer for more than one year) that is attributable to the reduction in the taxpayer's adjusted basis in such property corresponding to straight-line depreciation deductions allowable on such property. *See* I.R.C. § 1(h)(1)(E) (25-percent rate on unrecaptured 1250 gain); I.R.C. § 1(h)(6) (defining "unrecaptured section 1250 gain").

[116] Reg. § 1.1(h)-1(b).

Regulation section 1.1(h)-1 provides that a partner's "look-through capital gain" on a sale or exchange of her partnership interest includes the portion (if any) of her long-term capital gain on the sale or exchange that constitutes either "collectibles gain" or "section 1250 capital gain."[117] For purposes of this rule, the partner's "collectibles gain" on the sale of her partnership interest equals the amount of gain that the partnership would allocate to her if the partnership sold all of its collectibles for fair market value immediately before she sold her interest.[118] Similarly, the partner's "section 1250 capital gain" on the sale of her partnership interest equals the amount of unrecaptured section 1250 gain that the partnership would allocate to her if the partnership sold all of its section 1250 property for fair market value immediately before she sold her interest.[119]

A partner's "collectibles gain" on a sale or exchange of her partnership interest is treated as if it were long-term capital gain on a sale or exchange of collectibles.[120] It is thus taxed at the 28-percent collectibles rate. Similarly, a partner's "section 1250 capital gain" on a sale or exchange of her partnership interest is treated as if it were unrecaptured section 1250 gain on a sale or exchange of section 1250 property.[121] It is thus taxed at the 25-percent rate for unrecaptured section 1250 gain. Regulation § 1.1(h)-1 defines as "residual long-term capital gain or loss" any long-term capital gain or loss on a sale or exchange of a partnership interest that is neither collectibles gain nor

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[117] Reg. § 1.1(h)-1(b)(1).

[118] Reg. § 1.1(h)-1(b)(2)(ii). For purposes of this rule, the amount of gain allocated to the partner in the hypothetical sale of its collectibles includes the allocation of gain on sales of collectibles that the partnership held for one year or less—as well, of course, as gain on sales of collectibles that the partnership held for more than one year. *See* Capital Gains, Partnership, Subchapter S, and Trust Provisions, 65 Fed. Reg. 57,092, 57,094 (Sept. 21, 2000) [hereinafter Explanation of Final Holding Period Rules] (noting a modification in final version of Regulation section 1.1(h)-1(b)(2)(ii) to clarify that a partnership's "holding period in the collectibles is not relevant in determining whether long-term capital gain recognized on the sale of an interest in the [partnership] is collectibles gain").

[119] Reg. § 1.1(h)-1(b)(3)(ii).

[120] Reg. § 1.1(h)-1(b)(2)(i).

[121] Reg. § 1.1(h)-1(b)(3)(i). A partner's section 1250 *capital* gain on a partnership-intertest sale is long-term capital gain—and not section 1231 gain—irrespective of the fact that it is allocable to gain inherent in section 1231 assets of the partnership. *See* Reg. § 1.1(h)-1(b)(3)(iii). Section 1250 capital gain is not included in the partner's section 1231 "hotchpot" to determine whether the partner has a net section 1231 gain or net section 1231 loss for the taxable year in question. Indeed, none of a partner's gain or loss on the sale or exchange of a partnership interest is ever section 1231 gain or loss—even if it is attributable to gain or loss on the partnership's section 1231 assets. *See* Capital Gains, Partnership, Subchapter S, and Trust Provisions, 64 Fed. Reg. 43,117, 43,119 (Aug. 8, 1999) [hereinafter Explanation of Proposed Holding Period Rules] (explaining that "no . . . look-through rule applies for purposes of applying section 1231" to the tax characterization of any gain or loss on a sale or exchange of a partnership interest).

section 1250 capital gain.[122] Residual long-term capital gain is taxed at the standard 0-percent, 15-percent, or 20-percent long-term capital gain rates for individual taxpayers.

In Example 6, $90,711 of the gain inherent in the partnership's building would be unrecaptured section 1250 gain.[123] If the partnership were to have sold the building on January 1, 2024, immediately before Mary sold her partnership interest, Mary would have received an allocation of $36,284 of unrecaptured section 1250 gain (in addition to an allocation of $120,000 of 0/15/20-percent long-term capital gain).[124] Thus, the Regulation section 1.1(h)-1 look-through rule provides that $36,284 of Mary's long-term capital gain on the sale of her partnership interest is section 1250 capital gain and is taxed at 25 percent.[125] The remaining $213,716 of her long-term capital gain on the sale is residual long-term capital gain and is taxed at either 15 percent or 20 percent, depending on Mary's filing status and her overall taxable income for 2024.[126] Like section 751(a), Regulation section 1.1(h)-1 ostensibly prevents a partner from converting gain in a higher-rate category to gain in a lower-rate category by selling her partnership interest before the partnership sells its assets.

Section 751(a) and the Regulation section 1.1(h)-1 look-through rule move the taxation of gain on a sale of a partnership from a pure entity approach—as initially reflected in section 741's general rule—to something far closer to an aggregate approach. Subchapter K does not treat a sale of a partnership interest in *precisely* the same way as a sale of the selling partner's proportionate "slices" of the partnership's assets; there are a few significant

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[122] Reg. § 1.1(h)-1(c).

[123] The building was depreciable under the straight-line method. *See* I.R.C. § 168(b)(3)(A). Because $90,711 of straight-line depreciation deductions were available on the building, the partnership's adjusted basis in the building was reduced by $90,711. As a result, $90,711 of the gain that the partnership would have recognized on a January 1, 2024 sale of the building would have been attributable to those basis reductions and thus would have constituted "unrecaptured section 1250 gain" under section 1(h)(6). *See supra* note 115.

[124] A partnership's unrecaptured section 1250 gain, on one hand, and net long-term capital gain (or loss) in the 0/15/20-percent category, on the other, are each separately passed through by the partnership to its partners. *See* IRS FORM 1065 SCHEDULE K-1 (2022), https://www.irs.gov/pub/irs-pdf/f1065sk1.pdf (9a and 9c) [https://perma.cc/5TFN-FNM6].

[125] *See* Reg. § 1.1(h)-1(b)(1), (3).

[126] *See* Reg. § 1.1(h)-1(c).

differences.[127] But the tax consequences generally are very *similar*—for both the seller and the purchaser[128] of the partnership interest.

As we shall see, these provisions—and sections 751(a), (b), and (c), in particular—figured prominently in the crafting of the split-holding-period Regulations.

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[127] For instance, if a partner sells her partnership interest after having held it for more than one year, and if the partnership owns a capital asset that it has held for one year or less, the portion of the partner's gain or loss on the sale of her partnership interest that is attributable to her distributive share of the gain or loss inherent in the partnership's short-term capital asset will be treated as *long*-term (not *short*-term) capital gain or loss. *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 209 (providing an example); *see also supra* note 118 (collectibles gain example). Similarly, if the partnership holds section 1231 assets, the portion of the partner's gain or loss on the sale of her partnership interest that is attributable to her distributive share of the gain or loss inherent in those assets will be treated as *capital* gain or loss (not section 1231 gain or loss that would be included the partner's individual section 1231 "hotchpot"). *See* Reg. § 1.1(h)-1(c) (gain or loss on a sale of partnership interest that is not treated as ordinary gain or loss under section 751(a) and is not treated as collectibles gain or section 1250 capital gain under the Regulation section 1.1(h)-1 look-through rule, is treated as "residual" capital gain or loss under section 741); *see also supra* note 121 (noting that gain or loss on a partnership-interest sale is never treated as section 1231 gain or less, even if attributable to gain or loss on the partnership's section 1231 assets).

[128] If the purchase of a partnership interest were really a purchase of the transferor partner's interests in the partnership's assets, the transferee partner would take a section 1012 cost basis in her interests in those assets. The parties can effectively achieve that result if the partnership makes a section 754 election in connection with the transfer. The section 754 election enables the partnership to make a section 743(b) adjustment relating to the basis in the partnership assets held at the time of the transfer. *See* I.R.C. §§ 743(b)-(c), 754. A section 743(b) basis adjustment does not actually change the partnership's inside basis in its assets, nor does it affect the amount of gain or loss that the partnership recognizes if it subsequently sells any of its assets. *See* I.R.C. § 743(b) (flush language) (providing that the adjustment applies only with respect to the transferee partner.) Instead, for purposes of determining partnership allocations to the transferee partner, the adjustment effectively treats the transferee as if she has an initial cost basis in her supposed interest in each asset that the partnership holds at the time of the transfer—*i.e.*, interests in those assets purportedly corresponding, in the aggregate, to the value of the transferred partnership interest. If the partnership sells an asset subject to the section 743(b) adjustment, the adjustment prevents the transferee partner from receiving any allocation of the partnership's gain or loss on the asset that accrued prior to the transferee's purchase of her partnership interest. For a further description of the purposes and mechanics of a section 754 election and a section 743(b) basis adjustment, see Steven Z. Hodaszy, *Exchange Traded Funds Use Section 852(B)(6) For Tax Avoidance, Not Just Tax Deferral: So Why Is This Loophole Still Open?*, 75 TAX LAW. 489, 589-90 n.552 (2022).

IV. The Split-Holding-Period Rules in Regulation Section 1.1223-3 Convert Capital Gain or Loss from Short-Term to Long-Term for Partners Who Hold Their Partnership Interests for One Year or Less

A. *The Split-Holding-Period Rules Apply When a Partner Contributes a Capital Asset or a Section 1231 Asset in Exchange for Part of Her Partnership Interest, as Well as When a Partner Acquires Portions of Her Partnership Interest at Different Times*

The split-holding-period rules for partnership interests are established in Regulation section 1.1223-3.[129] Treasury issued the Regulation in accordance with a specific grant of authority under the Taxpayer Relief Act of 1997[130] (the 1997 Act). Among many other reforms, the 1997 Act significantly reduced individual taxpayers' rates for long-term gains on most capital assets;[131] it also established special long-term capital gain rates for collectibles and unrecaptured section 1250 gain.[132] In conjunction with setting these new rates, section 311(a) of the 1997 Act added what is now section 1(h)(9) of the Code, which permits Treasury to "prescribe such regulations as are appropriate . . . to apply [the act's new long-term capital gains rates] in the case of sales and exchanges by pass-thru entities . . . and [sales and exchanges] of interests in such entities."[133]

Pursuant to that grant of authority, in August 1999, Treasury proposed Regulation section 1.1223-3.[134] At the same time, Treasury also proposed the Regulation section 1.1(h)-1 "look-through rule" for taxing a partner's collectibles gain or section 1250 capital gain on a sale of her partnership interest.[135] After receiving a number of comments on the Proposed Regulations, Treasury revised them significantly and published the final Regulations in October 2000.[136]

The impetus for dividing the holding periods for certain partnership interests is the "the long-established principle that a partner has a single basis in a partnership interest."[137] A partner has a unitary tax basis in her entire partnership interest, even if she purchased portions of the interest at different

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[129] *See* Reg. § 1.1223-3.

[130] Taxpayer Relief Act, Pub. L. No. 105-34, 111 Stat. 788 (1997).

[131] *Id.* at § 311(a)-(b), 111 Stat. at 831-35.

[132] *Id.* at § 311(a), 111 Stat. at 833 (amending I.R.C. § 1(h)(4)-(6)).

[133] *Id.*, 111 Stat. at 834.

[134] *See* Explanation of Proposed Holding Period Rules, *supra* note 121, at 43,119-20, 43,122-23 (proposing, and explaining rationale for, Prop. Reg. § 1.1223-3).

[135] *See id.* at 43,119, 43,120-21 (proposing, and explaining rationale for, Proposed Regulation section 1.1(h)-1).

[136] *See* Explanation of Final Holding Period Rules, *supra* note 118, at 57,092-101 (adopting, and explaining rationale for, Reg. §§ 1.1(h)-1 and 1.1223-3).

[137] Explanation of Proposed Holding Period Rules, *supra* note 121, at 43,119 (citing Rev. Rul. 84-53, 1984-1 C.B. 159).

times or if she acquired respective portions of the interest in exchange for different assets.

Suppose, for example, that a partner acquired a 15-percent capital interest in her partnership in March 2023 in exchange for a cash contribution to the partnership, and then acquired an additional 15-percent capital interest in the partnership in January 2024 in exchange for another cash contribution. The partner would not have a distinct basis in the half of her interest that she acquired in 2023 and a separate basis in the half of her interest that she acquired in 2024. Rather, she would have a single basis in her 30-percent partnership interest.

Similarly, imagine a partner who acquired, in March 2023, a 30-percent capital interest in a partnership in exchange for a contribution to the partnership of cash and a parcel of land. This partner would not have a distinct basis in the portion of the interest that she received in exchange for the cash and a separate basis in the portion of the interest that she received in exchange for the land. Instead, once again, she would have an undivided basis in the entire 30-percent partnership interest.

A partner's unitary basis in her partnership interest poses a challenge if the partner acquired portions of her interest at different times and the partner recognizes capital gain on a taxable disposition of her interest within one year of the date of her most recent acquisition. For instance, in the example from the second preceding paragraph, assume that the partner sells her entire 30-percent partnership interest in August 2024 and recognizes $100,000 of capital gain on the sale. Her $50,000 of gain on the half of the interest that she purchased in March 2023 should be treated as long-term capital gain;[138] however, her $50,000 of gain on the half of the interest that she purchased in January 2024 should be treated as short-term capital gain.[139] Given that the partner does not have a separate basis in each half of her partnership interest, there needs to be some other mechanism for splitting the long-term and short-term portions of her capital gain.

Similarly, a partner's unitary basis in her partnership interest creates challenges in applying section 1223(1)'s tacking rule when the partner (i) contributes both cash or an ordinary asset, on one hand, and a capital or section 1231 asset, on the other, in exchange for her partnership interest, and then (ii) sells her partnership interest within one year of having acquired it. Section 1223(1) applies in such a case because, under section 722, the initial basis that the partner takes in her partnership interest is determined in part by her adjusted basis in the capital or section 1231 asset she delivers in the exchange. Pursuant to section 1223(1), the partner's holding period for the

[138] The partner held such portion of her interest for more than one year before selling it. *See supra* note 5.

[139] The partner held such portion of her interest for approximately eight months—*i.e.*, for a period of one year or less—prior to the sale. *See supra* note 4.

capital or section 1231 asset that she contributed should tack to her holding period for the portion of her partnership interest for which she received an initial basis equal to her adjusted basis in the contributed capital or section 1231 asset.[140] Because the partner does not take a separate basis in that portion of her partnership interest, however, there has to be another mechanism for calculating the part of her interest to which her holding period for the contributed capital or section 1231 asset tacks.

In these scenarios, Regulation section 1.1223-3 provides the needed mechanism by ascribing separate holding periods to respective portions of a partnership interest, notwithstanding the partner's undivided basis in the interest.

B. *A Partner Has Different Holding Periods in Different Portions of Her Partnership Interest If She Acquired Those Portions at Different Times*

Regulation section 1.1223-3(a)(1) provides that a partner has a divided holding period for her partnership interest if she "acquired portions of [her] interest at different times[.]"[141] The appropriate division of the partner's holding period is generally clear in such cases. In short, the partner has separate holding periods for portions of the interest that she acquires at different times. The respective size of each portion of the interest is determined by dividing (i) the partner's total percentage interest in the partnership by (ii) the percentage interest in the partnership that the partner received by acquiring the portion in question.[142] Then, the standard holding-period rules apply to each portion.

Below is an example:

> Example 7: Patricia and Quentin formed the PQ partnership (a calendar year partnership) on February 1, 2022. On that date, Patricia contributed \$100,000 in cash to the partnership in exchange for a 20-percent interest in the partnership's capital, profits, and losses, and Quentin contributed \$400,000 in cash in exchange for an 80-percent interest in the partnership's capital, profits, and losses. On February 2, 2022, PQ purchased a number of assets for use in its business, at an aggregate cost of \$500,000. Between February 1, 2022 and December 31, 2022, the PQ partnership "broke even;" its gross income equaled its deductible expenses. Assume that, as of January 1, 2023, the aggregate fair market value of PQ's assets was \$558,000. On that date, Patricia contributed an additional \$62,000 in cash to the partnership in an exchange for an additional 10-percent partnership interest. Immediately thereafter, Patricia had a 30-percent interest (and Quentin had

[140] *See* I.R.C. §§ 722, 1223(1); *see also supra* text accompanying notes 7-11 (discussing section 1223(1) and its application to partnership interests).

[141] Reg. § 1.1223-3(a)(1).

[142] *See* Reg. § 1.1223-3(b)(1); *see also infra* text accompanying notes 150-153.

a 70-percent interest) in the PQ partnership's capital, profits, and losses. On January 2, 2023, the partnership purchased additional assets for use in its business, at an aggregate cost of $62,000. Between January 1, 2023 and October 31, 2023, PQ again broke even. Assume that, as of November 1, 2023, the aggregate fair market value of PQ's assets was $660,000; on that date, PQ's aggregate inside basis in its assets was $562,000.[143] Also assume that (i) as of November 1, 2023, the partnership had no liabilities, and (ii) at all times relevant hereto, all of PQ's assets were non-depreciable capital or section 1231 assets. *On November 1, 2023, Patricia sold her entire interest to Beverly for $198,000.* Immediately prior to the sale, Patricia's outside basis in her partnership interest was $162,000.[144]

Patricia recognizes $36,000 of capital gain on the sale of her partnership interest.[145] Of that amount, how much is long-term capital gain, and how much is short-term capital gain?

For purposes of the holding-period rules, Patricia's partnership interest is divided into two portions—the portion that she received in the February 1, 2022 transaction, and the portion that she received in the January 1, 2023 transaction. The February 1, 2022 portion comprises two-thirds of her interest, and the January 1, 2023 portion comprises one-third of her interest.[146] Thus, Patricia's holding period for two-thirds of her partnership interest begins on February 2, 2022, and, under the general rule for capital assets,[147] her holding period for one-third of her interest begins on January 2, 2023. As a result, $24,000 (*i.e.*, two-thirds) of her capital gain is long-term. The remaining $12,000 (or one-third) is short-term.

C. *The Split-Holding-Period Rules Facilitate the Tacking of a Partner's Holding Period for a Contributed Capital Asset or Section 1231 Asset to Her Holding Period for a Portion of Her Partnership Interest*

The split-holding-period rules become more complex when a partner contributes—at the same time, in one transaction—two or more assets with

[143] This is the sum of (i) the $500,000 initial basis that the partnership took in the assets it purchased on February 2, 2022 and (ii) the $62,000 initial basis that the partnership took in the assets it purchased on January 2, 2023. *See* I.R.C. § 1012(a). In this fact-pattern, there are no post-acquisition adjustments to the partnership's initial basis in any of its assets.

[144] This is the sum of (i) the $100,000 initial basis that Patricia took in the February 1, 2022 portion of her interest and (ii) the $62,000 initial basis that she took in the January 1, 2023 portion of her interest. *See* I.R.C. § 722(a). There are no subsequent adjustments to Patricia's outside basis due to, *inter alia*, any partnership allocation of income or loss, distribution of property, or allocation of liabilities.

[145] $198,000 (amount realized on sale) – $162,000 (adjusted basis) = $36,000 realized and recognized gain. *See* I.R.C. § 1001(a), (c); *see also* I.R.C. § 741.

[146] $.2 \div .3 \approx 0.67$; $.1 \div .3 \approx 0.33$.

[147] *See infra* note 158 and accompanying text.

different tax characters in exchange for her partnership interest. Regulation section 1.1223-3(a)(2) provides that a partner has a divided holding period for her partnership interest, even though she "acquired [her entire interest] at [one] time," if (i) the partner acquired her interest in exchange for a contribution of two or more assets to the partnership, and (ii) the contribution of those assets would "result[] in different holding periods [because of] section 1223[.]"[148] Under this rule, the partner may have different holding periods in different portions of her interest if at least one of the assets that she contributed is a capital asset or section 1231 asset *and* at least one of the assets that she contributed is *not* a capital or section 1231 asset.[149]

1. *The General Rule for Dividing a Partner's Holding Period for Her Partnership Interest When She Contributes a Capital Asset or Section 1231 Asset in Exchange for Part of Her Interest*

Regulation section 1.1223-3(b)(1) sets forth the general formula for dividing a partnership interest into portions with different holding periods.[150] Under that formula, each portion of a partner's partnership interest is a percentage of the interest, expressed as a fraction. The numerator of the fraction is "the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates[.]" The denominator of the fraction is "the fair market value of the entire partnership interest."[151] For both the numerator and the denominator, fair market value is "determined immediately after the transaction" in which the partner acquired the portion of the interest in question.[152]

The key to applying this formula is to identify "the portion of the partnership interest received in the transaction to which the holding period relates[,]" for the numerator of the fraction. This is easy when a partner receives portions of her partnership interest at different times. In such a case, she has a different holding period for each portion. Hence, any portion received at a given time in exchange for the contribution of an asset to the partnership at such time is a "portion of the partnership interest received in [a] transaction to which the holding period [for such portion] relates[.]"[153]

In contrast, when a partner receives her entire partnership interest at one time in exchange for a contribution to the partnership of both cash *and* at

[148] Reg. § 1.1223-3(a)(2).

[149] The section 1223(1) tacking rule applies only in substituted-basis exchanges of capital assets or section 1231 assets. *See* I.R.C. § 1223(1).

[150] *See* Reg. § 1.1223-3(b)(1).

[151] *Id.*

[152] *Id.*

[153] *See supra* notes 141-142 and accompanying text.

least one capital asset or section 1231 asset, "the portion of the partnership interest received in the transaction to which the holding period relates" refers, as applicable, to (i) the portion of her interest that the partner received in exchange for the cash or (ii) the portion that she received in exchange for a particular capital or section 1231 asset. By operation of section 1223(1), the partner has a different holding period for a portion of her partnership intertest she gets in exchange for a contributed capital or section 1231 asset than she has for a portion she gets in exchange for contributed cash.[154] Accordingly, in such a case, the partner is deemed to receive a distinct portion of her interest in exchange for each capital asset or section 1231 asset that she contributes to the partnership in the transaction, and she is deemed to receive a distinct portion in exchange for the cash that she contributes.[155]

Assume for instance that, in a single transaction in exchange for her partnership interest, a partner contributes (i) a section 1231 asset that she had held for two years, (ii) a capital asset that she had held for six months, and (iii) some cash. In that instance, for holding-period purposes, the partner's interest would consist of three portions—a portion she is deemed to have received in exchange for the capital asset, a portion she is deemed to have received in exchange for the section 1231 asset, and a portion she is deemed to have received in exchange for the cash.

Typically, for the numerator of the fraction in Regulation section 1.1223-3(b)(1), the fair market value of any given portion of a partnership interest equals the fair market value (at the time of the transaction) of the particular asset that the partner contributed to the partnership in exchange for such portion. This follows from the presumption that, in an arm's-length exchange, the value of the property transferred will equal the value of the property received.[156] By parity of reasoning, in the denominator of the fraction, the value of the partner's entire partnership interest generally equals the aggregate fair market value (at the time of the transaction) of *all* assets that the partner contributed to the partnership in exchange for her interest.

Therefore, when a partner contributes both capital or section 1231 assets and cash—in the same transaction—in exchange for her partnership interest, the percentage portion of the interest that the partner receives in exchange for any particular capital or section 1231 asset generally equals (i) the fair market value of such capital or section 1231 asset at the time of the contribution *divided by* (ii) the sum of (A) the cash and (B) the fair market

[154] *See infra* notes 158-159 and accompanying text.

[155] *See*, *e.g.*, Reg. § 1.1223-3(f), Examples (1) & (2).

[156] *See*, *e.g.*, CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 25 n.21 (making such presumption when applying Regulation section 1.1223-3(b)).

value, at the time of the contribution, of *all* of the capital assets and section 1231 assets that the partner contributes in exchange for her entire interest.[157]

Once a partnership interest is split into percentage portions under Regulation section 1.1223-3(b)(1), the normal rules apply for determining the partner's holding period for each such portion. Thus, if a partner contributes cash to her partnership in exchange for a given portion of her partnership interest, then the standard rule for determining an owner's holding period for a capital asset applies. Under that rule, the partner's holding period for such portion of her interest begins on the day after she acquires such portion and ends on the day when she disposes of her interest.[158]

By contrast, if a partner contributes a capital asset or a section 1231 asset to her partnership in exchange for a given portion of her partnership interest, then the tacking rule under section 1223(1) applies. In other words, the partner's holding period for the contributed capital or section 1231 asset tacks (is added) to the holding period that the partner would otherwise have in the portion of the interest she receives in exchange.[159] When these rules result in a partner having a split of (i) holding periods of more than one year in a certain percentage of her partnership interest and (ii) holding periods of one year or less in the remainder of her interest, any capital gain that the partner recognizes on a taxable sale or exchange of the interest is split between long-term capital gain and short-term capital gain in the same proportion.

For instance, if a partner contributes both a non-depreciable capital asset with a fair market value of $60 and of $40 of cash in exchange for her partnership interest, the partnership interest will presumably be valued at $100 immediately after the exchange. The partner thus will be deemed to have received $^{60}/_{100}$ (or 60 percent) of her partnership interest in exchange for her contribution of the capital asset, and she will be deemed to have received $^{40}/_{100}$ (or 40 percent) of her partnership interest in exchange for her contribution of the cash. Under section 1223(1), the partner's holding period for the contributed capital asset tacks to her holding period for 60 percent of her partnership interest. The partner's holding period for the remaining 40 percent of her interest begins on the day after the exchange.

[157] *See*, *e.g.*, Reg. § 1.1223-3(f), Example (1). Similarly, in such a case, the percentage portion of a partnership interest received in exchange for cash generally equals (i) the amount of such cash *divided by* (ii) the sum of (A) the cash plus (B) the aggregate fair market value, at the time of the contribution, of all of the capital assets and section 1231assets that the partner contributed in exchange for her entire partnership interest. *See id.*

[158] *See* Rev. Rul. 66-7, 1966-1 CB 188) ("conclud[ing] that the holding period of a capital asset begins to run on the day following the date of acquisition of the asset involved" and that "[t]he same rule applies in determining holding periods of [section 1231] property"); *see also* Rev. Rul. 99-5, 1999-1 CB 434 (applying this rule specifically to a partnership interest).

[159] *See*, *e.g.*, Rev. Rul. 99-5, 1999-1 CB 434 (applying section 1223(1) to determine a partner's holding period for a partnership interest received in exchange for the contribution of a capital asset).

Assume that the partner held the capital asset for two years before contributing it to the partnership. Also assume that the partner sells her entire partnership interest one week after acquiring it. In that case, the partner will be deemed to have held 60 percent of her interest for two years and one week, and to have held 40 percent of her interest for one week. As a result, 60 percent of any capital gain that the partner recognizes on the sale will be long-term capital gain, and the remaining 40 percent will be short-term capital gain.

2. A Detailed Example of How the General Rule Applies When a Partner Contributes Cash and a Capital Asset in Exchange for Her Partnership Interest

Below is a more comprehensive example, to illustrate how Regulation section 1.1223-3(b)(1)'s split-holding-period rule intersects with section 751(a), section 704(c), and Regulation section 1.1(h) in determining the total amount and tax character of a partner's gain on the sale of her partnership interest:

> Example 8: Roberta and Sam formed the RS partnership (a calendar year partnership) on January 2, 2023, for the purpose of owning and operating a designer clothing store. On January 2, 2023, Roberta contributed $200,000 in cash and a parcel of land to the partnership in exchange for a 50-percent interest in the partnership's capital, profits, and losses. Roberta purchased the land on May 7, 2021, for $270,000 and held it for investment; on January 2, 2023, the fair market value of the land was $300,000. Also on January 2, 2023, Sam contributed a building with a fair market value of $500,000 to the partnership in exchange for a 50-percent interest in the partnership's capital, profits, and losses. Sam purchased the building for $450,000 on December 1, 2020, and used it as a retail store in a prior business of his. Immediately before his contribution to the partnership, Sam's adjusted basis in the building was $426,442.[160] On January 4, 2023, the RS partnership purchased various items of clothing to hold in inventory for customers, at an aggregate cost of $200,000. The partnership then began to conduct business, using the building as a store and the land as a parking lot. Between January

[160] Sam's initial cost basis in the building was $450,000. *See* I.R.C. § 1012(a). Assume that Sam is a calendar year taxpayer and that he placed the building in service in his prior business in December 2020. Assume further that, between 2020 and 2022, Sam took $23,558 of depreciation for tax on the building. *See* IRS PUBLICATION 946, *supra* note 102, at 73 (depreciation table A-7a, for nonresidential real property with a 39-year recovery period). Because of the depreciation deductions, Sam's original basis in the building was reduced by $23,558. *See* I.R.C. § 1016(a)(2). $450,000 – $23,558 = $426,442.

4, 2023 and November 29, 2023, RS sold 50 percent of its inventory to customers for an aggregate price of $160,000, and it recognized an aggregate gain of $60,000 on those sales.[161] Between January 1, 2023 and December 1, 2023, RS paid $47,714 of deductible expenses.[162] For 2023, RS took a $10,478 depreciation deduction on the building.[163] On November 30, RS purchased additional clothing items to replenish its inventory, at an aggregate cost of $112,286. *On December 1, 2023, Roberta sold her entire interest in the RS partnership to Francine for $650,000.* RS allocated to Roberta $6,143 of its 2023 non-separately-computed net income[164] and $6,143 of its 2023

[161] $160,000 (amount realized on sale) – $100,000 (adjusted basis) = $60,000 realized and recognized gain. *See* I.R.C. § 1001(a), (c). Assume that the partnership's aggregate basis in the remaining (unsold) half of its inventory acquired on January 4, 2023 was $100,000.

[162] Assume that these included (i) $6,000 of organizational expenses deductible under section 709, (ii) $7,000 of "start-up expenditures" deductible under section 195, and (iii) $34,714 of operating expenses deductible under section 162. *See generally* I.R.C. §§ 162, 195, and 709. Also assume that the partnership's tax accounting method is the cash method.

[163] When Sam contributed the building to the RS partnership, the partnership stepped into Sam's shoes with respect to the continued tax depreciation of the building. *See* I.R.C. § 168(i)(7). Accordingly, the partnership takes depreciation deductions on the building—using the same straight-line method as Sam, and using the partnership's $426,442 transferred basis from Sam as the depreciable basis—over the building's remaining depreciable life. Section 706 provides that "[t]he taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise)." I.R.C. § 706(c)(2). Thus, with respect to Roberta, the RS partnership's 2023 taxable year is the period from January 1, 2023 to December 1, 2023—the date on which she sells her partnership interest. Consequently, for purposes of determining the partnership's allocations to Roberta for 2023, the partnership is deemed to take a depreciation deduction on the building for the period from January 1, 2023 to December 1, 2023. Applying (i) the depreciation table A-7a in IRS Publication 946 and (ii) the applicable mid-month convention (under which the partnership is deemed to have held the building for 11.5 months during taxable year 2023), the partnership's 2023 deemed depreciation deduction on the building is $10,478 (($426,442 x .02564) x (11.5 ÷ 12)). *See* IRS PUBLICATION 946, *supra* note 102, at 73 (table A-7a); I.R.C. § 168(d)(4)(B) (mid-month convention). In addition to tax depreciation, the partnership also takes book depreciation for the same period. The book value of the building on the partnership's balance sheet is $500,000 (the building's fair market value on the contribution date). Thus, the partnership has $12,286 of book depreciation on the building for such period (($500,000 x .02564) x (11.5 ÷ 12)).

[164] A partnership's non-separately-computed net income or loss for a given taxable year is its taxable income or gain for the year, net of its deductible expenses for the year, "*exclusive of items requiring separate computation*" pursuant to section 702(a)(1)-(7) and the Regulations thereunder. I.R.C. § 702(a)(8) (emphasis added). Generally, this amount equals (i) the partnership's aggregate ordinary taxable income or gain for the year *minus* (ii) the partnership's aggregate ordinary deductions for the year. *See* INTERNAL REV. SERV., U.S. RETURN OF PARTNERSHIP INCOME (FORM 1065) (2022), https://www.irs.gov/pub/irs-pdf/f1065.pdf (lines 1a – 22) [perma.cc/5TFN-FNM6]. As noted above, with respect to Roberta, the RS partnership's 2023 taxable year is from January 1, 2023 to December 1, 2023. *See supra* note 163. For that period, the partnership's non-separately-computed net income is $12,286. This equals $60,000 net

separately-stated depreciation deduction on the building.[165] Immediately prior to the sale of her partnership interest, Roberta's outside basis was $470,000.[166] Assume that, on December 1, 2023, the RS partnership held the following assets: (i) the building, which then had a fair market value of $600,000; (ii) the land, which then had a fair market value of $300,000; (iii) items of clothing in inventory, which then had an aggregate fair market value of $300,000; and (iv) goodwill that the partnership had created for its business, which then had a fair market value of $100,000. Also assume that, as of such date, the partnership had no liabilities. On December 1, 2023, the partnership's inside bases in its assets were: $415,964 adjusted basis in the building;[167] $270,000 basis in the

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income from inventory sales for the period *minus* $47,714 of ordinary deductions for the period (other than the depreciation deduction, which is a separately-stated item). Roberta receives a 50-percent (or $6,143) distributive share of such income pursuant to the partnership's standard allocation rules.

[165] The depreciation deduction is a separately-stated item because, presumably, the partnership makes a special allocation of the deduction—by using the "traditional" method of allocating built-in gain on contributed depreciable property to the contributing partner, Sam. *See* Reg. § 1.702-1(a)(8)(i) (requiring a partnership to state as a separate item, when calculating the partnership's income or loss, "any items of income, gain, loss, deduction, or credit subject to a special allocation . . . which differs from the allocation of partnership taxable income or loss generally"); *see also supra* note 43 (describing "traditional" allocation method). As noted above, for the period from January 1, 2023 to December 1, 2023, the partnership takes $12,286 of book depreciation and $10,478 of tax depreciation on the building. *See supra* note 163. Under the "traditional" allocation method, the partnership presumably: (i) allocates 50 percent (or $6,143) of the book depreciation to Roberta and 50 percent (or $6,143) of the book depreciation to Sam (consistent with the partnership's normal allocation rules); (ii) allocates to Roberta a $6,143 amount of tax depreciation, equal to Roberta's allocation of book depreciation; and (iii) allocates the remaining $4,335 of the tax depreciation to Sam. By allocating $1,808 less tax depreciation than book depreciation to Sam, the partnership effectively allocates $1,808 of the building's built-in gain to Sam.

[166] Roberta took a $470,000 initial basis in her partnership interest—the sum of (i) her $200,000 cash contribution *plus* (ii) her $270,000 basis in the contributed land. *See* I.R.C. § 722(a). There are no subsequent adjustments to Roberta's outside basis. Roberta does not receive any allocation of partnership income or loss for 2023 because her $6,143 distributive share of partnership non-separately-computed net income is offset by her $6,143 distributive share of the partnership's separately-stated depreciation deduction on the building.

[167] The partnership took a $426,442 initial basis in the building from Sam. *See* I.R.C. § 723. Basis was then reduced by $10,478 because of the partnership's depreciation deduction on the building. *See* I.R.C. § 1016(a)(2). $426,442 – $10,478 = $415,964 adjusted basis.

land;[168] $212,286 aggregate basis in the inventory;[169] and $0 basis in the self-created goodwill.

Roberta realizes and recognizes $180,000 of gain on the sale of her partnership interest.[170] Much of that gain is capital, but the portion that is attributable to the partnership's inventory is ordinary under section 751(a).[171]

To calculate the ordinary portion of Roberta's gain, we follow the process set forth in Regulation section 1.751-1(a)(2) and imagine that the partnership had sold all of its assets for fair market value immediately before Roberta's sale of her interest.[172] In that hypothetical transaction, the partnership would have recognized $87,714 of gain on the sale of the inventory.[173] The partnership would have allocated 50 percent—or $43,857—of that gain to Roberta, who still would have been a 50-percent partner at such time. Thus, $43,857 of Roberta's gain on the sale of her partnership interest is attributable to the inventory, and is ordinary gain. The remaining $136,143 of Roberta's gain on the sale of her interest is capital gain.

The next question is, how much of Roberta's $136,143 of capital gain is short-term, and how much is long-term? *This is where the split-holding-period rules come into play.* Under Regulation section 1.1223-3(a)(2), Roberta has a divided holding period for her partnership interest because she contributed both a capital asset (the land, which was then worth $300,000[174]) and $200,000 of cash in exchange for her interest. Under Regulation section 1.1223-3(b)(1), Roberta's partnership interest has two parts: (i) the portion she received in exchange for the land, and (ii) the portion she received in exchange for the cash.[175] The fair market value of Roberta's partnership interest, on the date she acquired it, presumably equaled the $500,000 aggregate fair market value of the assets she contributed in exchange for her

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[168] Roberta's initial cost basis in the land was $270,000. *See* I.R.C. § 1012(a). Assume that there were no adjustments to her basis in the land—*e.g.*, due to any capital improvements—after her purchase. The partnership took a $270,000 transferred basis in the land from Roberta at the time of the contribution. *See* I.R.C. § 723.

[169] This equals the sum of (i) the partnership's $100,000 aggregate cost basis in the unsold half of the inventory that it purchased on January 4, 2023 and (ii) the partnership's $112,286 aggregate cost basis in the unsold "replacement" inventory that it purchased on November 30, 2023. *See* I.R.C. § 1012(a).

[170] $650,000 (amount realized on sale) – $470,000 (adjusted basis) = $180,000 realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[171] *See* I.R.C. §§ 741, 751(a)(2); *see also supra* Part III.C.

[172] *See* Reg. § 1.751-1(a)(2); *see also supra* Part III.D.

[173] $300,000 (amount realized on hypothetical sale for fair market value) – $212,286 (partnership's adjusted basis) = $87,714 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[174] Prior to contributing it to the partnership, Roberta held the land for investment. Land that a taxpayer holds for investment is a capital asset in that taxpayer's hands. *See supra* note 10.

[175] *See supra* text accompanying notes 150-152 *and supra* text accompanying notes 154-155.

interest. It follows that Roberta received $^{300,000}/_{500,000}$ (or 60 percent)[176] of the interest's value in exchange for her contribution of the land and received $^{200,000}/_{500,000}$ (or 40 percent)[177] of the interest's value is exchange for her contribution of the cash. Therefore, the "land portion" constitutes 60 percent of Roberta's interest, and the "cash portion" constitutes 40 percent of her interest.[178]

Roberta's actual holding period for her partnership interest began on the day after she acquired the interest.[179] Under section 1223(1), however, the holding period that Roberta had for her contributed land tacks to her holding period for the 60-percent portion of her interest that she received in exchange. In contrast, nothing tacks to Roberta's holding period for the 40-percent portion of her interest that she received in exchange for the cash. By operation of these rules, Roberta is deemed to have held 60 percent of her interest for longer than one year at the time of her sale,[180] while she held the other 40 percent for less than one year before the sale. As a result, 60 percent (or $81,686) of Roberta's capital gain is long-term capital gain, and 40 percent (or $54,457) of her capital gain is short-term capital gain.

The building is a section 1231 asset in the partnership's hands,[181] and part of the gain inherent in the building is unrecaptured section 1250 gain because it stems from basis reductions corresponding to straight-line-depreciation deductions on the asset.[182] A portion of Roberta's long-term capital gain on the sale of her partnership intertest is attributable to that inherent unrecaptured section 1250 gain. Pursuant to Regulation section 1.1(h)-1,[183]

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[176] The portion of the partnership interest that Roberta is deemed to receive in exchange for the land equals a percentage, expressed as a fraction, (i) the numerator of which is $300,000 (the fair market value of the land and, thus, the presumed fair market value of such portion of the partnership interest) and (ii) the denominator of which is $500,000 (the aggregate fair market value of all of the assets that Roberta contributed and, thus, presumably the fair market value of the entire partnership interest). *See* Reg. § 1.1223-3(b)(1).

[177] The portion of the partnership interest that Roberta is deemed to receive in exchange for the cash equals a percentage, expressed as a fraction, (i) the numerator of which is $200,000 (the cash amount and, thus, the presumed fair market value of such portion of the partnership interest) and (ii) the denominator of which is $500,000 (the aggregate fair market value of all of the assets that Roberta contributed and, thus, presumably the fair market value of the entire partnership interest). *See* Reg. § 1.1223-3(b)(1).

[178] *See supra* text accompanying notes 156-157; *see also* Reg. § 1.1223-3(f), Example (1).

[179] *See supra* note 158 and accompanying text.

[180] Roberta's holding period for the land was from May 8, 2021 (the day after she purchased the land) to January 2, 2023 (the contribution date). Because of the tacking rule, Roberta is deemed to have held 60 percent of her interest from May 8, 2021 to December 1, 2023 (the partnership-interest-sale date).

[181] The building is business-use depreciable real estate in the partnership's hands. On December 1, 2023, the partnership had held the building for more than one year. *See* I.R.C. § 1231(b)(1).

[182] *See supra* note 115.

[183] *See supra* Part III.E.

this portion of Roberta's gain is section 1250 capital gain and is taxed at the special 25-percent rate for unrecaptured section 1250 gain.[184] The remainder of Roberta's long-term capital gain is "residual" and is taxed at a rate of 0 percent, 15 percent, or 25 percent, as applicable.[185]

To calculate the amount of Roberta's section 1250 capital gain, we return to the partnership's hypothetical sale of its assets immediately prior to Roberta's sale of her interest. In such a sale, Roberta would receive a $30,000 allocation of section 1231 gain on the land,[186] a $50,000 allocation of capital gain on the goodwill,[187] and a $56,143 allocation of section 1231 gain on the building.[188] Of the allocated gain on the building, $6,143 would be

[184] *See* Reg. § 1.1(h)-1(b)(3)(i)-(ii).

[185] *See* Reg. § 1.1(h)-1(c).

[186] Real estate that a taxpayer holds for more than one year and uses in its business is a section 1231 asset. I.R.C. § 1231(b)(1). In its hypothetical sale of the land, the partnership would recognize $30,000 of section 1231 gain. $300,000 (amount realized on hypothetical sale) – $270,000 (adjusted basis) = $30,000 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c). This is all built-in gain, and the partnership would have to allocate it to contributing partner Roberta. *See* I.R.C. § 704(c)(1)(A). To do so, the partnership presumably would use the "traditional method" of allocating built-in gain on non-depreciable property. *See* Reg. § 1.704-3(a)(1)-(3), (b)(1); *see also supra* note 40 and accompanying text. Under the traditional method, upon the sale of the land, the partnership would allocate the entire $30,000 of built-in gain to Roberta.

[187] Self-created goodwill in a business is a capital asset. (Because it is nonamortizable, it is outside section 1221(a)(2).) Because the partnership created the goodwill, its basis therein is $0. In the hypothetical sale of its goodwill, the partnership would recognize $100,000 of long-term capital gain. $100,000 (amount realized on hypothetical sale) – $0 (adjusted basis) = $100,000 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c). The partnership would allocate 50 percent (or $50,000) of such gain to Roberta pursuant to its normal allocation rules.

[188] The building is real estate that the partnership uses in its business and, thus, is a section 1231 asset in the partnership's hands. In its hypothetical sale of the building, the partnership would recognize $184,036 of section 1231 gain. $600,000 (amount realized on hypothetical sale) – $415,964 (adjusted basis) = $184,036 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c). When Sam contributed it to the partnership, the building had $73,558 of built-in gain. $500,000 (fair market value) – $426,442 (Sam's adjusted basis) = $73,558. Under section 704(c), the partnership must allocate that built-in gain to contributing partner Sam. *See* I.R.C. § 704(c)(1)(A). The partnership allocated $1,808 of the built-in gain to Sam through special allocations of depreciation deductions on the building. *See supra* note 165. Presumably, the partnership would allocate the remaining $71,750 of built-in gain to Sam upon the hypothetical sale of the building. *Cf.* Reg. § 1.704-3(b)(2), Example (1(iii)) (upon sale of contributed depreciable asset, partnership allocates to contributing partner an amount equal to (i) the built-in gain inherent in the asset on the contribution date, *minus* (ii) any built-in gain that was previously allocated to the contributing partner through allocations of depreciation deductions). After allocating $71,750 to Sam under section 704(c), the partnership would allocate the remaining $112,286 of its gain between the partners under its normal allocation rules. Accordingly, Roberta would receive a 50-percent (or $56,143) allocation of such gain.

unrecaptured section 1250 gain.[189] Thus, under Regulation section 1.1(h)-1, $6,143 of Roberta's long-term capital gain is section 1250 capital gain, and $75,543 is residual long-term capital gain.

In sum, Roberta recognizes $180,000 of gain on the sale of her partnership interest. Of that amount, $43,857 is ordinary gain; $54,457 is short-term capital gain; $6,143 is section 1250 capital gain, and $75,543 is residual long-term capital gain. The ordinary gain and the short-term capital gain are taxed at Roberta's federal income tax rate(s) for ordinary income. The section 1250 capital gain is taxed at 25 percent. The residual long-term capital gain is taxed at 15 percent or 20 percent, depending on Roberta's overall taxable income for the year.

3. *The Split-Holding-Period Rules Disregard a Partner's Contribution of Section 751 Assets*

If a partner contributes both a section 751 asset and either a capital asset or a section 1231 asset in exchange for her partnership interest, Proposed Regulation section 1.1223-3(b) would have counted the contribution of the section 751 asset in calculating the divided holding period for the partner's interest.[190] Under the Proposed Regulation, the partner would have been deemed to receive a portion of her partnership interest in exchange for her contribution of the section 751 asset. In turn, the value of the "section-751-

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[189] Sam and the partnership each depreciated the building for tax under the straight-line method. *See* I.R.C. §§ 168(b)(3)(A), (i)(7). Because they took a total of $34,036 in depreciation deductions, the building's adjusted basis decreased by $34,036. Thus, $34,036 of the gain that the partnership would recognize on its hypothetical sale of the building would be attributable to those basis reductions. Because the depreciation was straight-line, such gain would be "unrecaptured section 1250 gain" under section 1(h)(6). *See supra* note 115. Roberta and Sam should receive allocations of the partnership's unrecaptured section 1250 gain in respective amounts equal to their respective shares of tax depreciation taken on the building. *See* I.R.C. § 1(h)(6) ("unrecaptured section 1250 gain" is gain that would be treated as section 1250(a) recapture income if it were attributable to basis reductions corresponding to accelerated, rather than straight-line, depreciation); Reg. § 1.1250-1(f) (partnership's section 1250(a) recapture income to be allocated among partners consistently with Regulation section 1.1245-1(e) allocation rules); Reg. § 1.1245-1(e)(2) (partner's distributive share of partnership's recognized section 1245(a)(1) recapture income generally equal to lesser of (i) partner's share of total gain from disposition of the related property or (ii) "*partner's share of depreciation or amortization with respect to the property*") (emphasis added). Because of his pre-contribution depreciation deductions, Sam would receive a $23,558 allocation of unrecaptured section 1250 gain, which would be included within his built-in gain allocation. Because Sam got a $4,335 allocation of the partnership's post-contribution depreciation deduction, he would receive an additional $4,335 unrecaptured section 1250 gain allocation. Roberta would receive a $6,143 allocation of unrecaptured section 1250 gain, equal to her $6,143 allocation of the partnership's post-contribution depreciation deduction.

[190] *Compare* Prop. Reg. § 1.1223-3(b), 64 Fed. Reg. 43,117, 43,122 (1999) (not including final Regulation's paragraph (b)(4)), *with* Reg. § 1.1223-3(b) (2000) (including paragraph (b)(4), which provides for an "[a]djustment with respect to contributed section 751 assets").

asset portion" of the interest would have been included in determining the percentage of the interest that the partner was deemed to receive in exchange for her contribution of the capital or section 1231 asset.[191]

Consider this example:

> Example 9: In exchange for a 50-percent interest in the capital, profits, and losses of the TU partnership, Tabitha contributed to her partnership (i) a non-depreciable capital asset with a fair market value of $60 (which she had purchased two years earlier for $60) and (ii) section 751(d) inventory items with an aggregate fair market value of $40 (which she had purchased for an aggregate price of $40). At the same time, in exchange for the other 50-percent interest in the partnership, Umberto contributed a non-depreciable section 1231 asset with a fair market value of $100 (which he had purchased two years earlier for $100). Tabitha sold her partnership interest six months after acquiring it, for $115. Assume that the TU partnership had no liabilities and "broke even"—*i.e.*, incurred no net taxable income or tax loss—during its first six months. Also assume that, immediately prior to Tabitha's sale of her interest, the capital asset was worth $80, the inventory was worth $50, and the section 1231 asset was worth $100.

In Example 9, Tabitha recognizes $15 of gain on the sale of her partnership interest.[192] Of that gain, $5 is ordinary under section 751(a), and $10 is capital under section 741.[193] Under Proposed Regulation section 1.1223-3(b), Tabitha's partnership interest would have been split into two parts. Sixty percent of her interest would have been deemed to be received in

[191] *See*, *e.g.*, Prop. Reg. § 1.1223-3(e), Example (2), 64 Fed. Reg. 43,117, 43,122 (1999) (including contributed section 751(c) unrealized receivable in calculation of partner's divided holding period for her partnership interest).

[192] Tabitha's initial carryover basis in her partnership interest was $100 (sum of (i) $60 basis in contributed capital asset *plus* (ii) $40 basis in contributed inventory items). *See* I.R.C. §§ 722, 1012(a). There are no post-acquisition adjustments to Tabitha's basis. $115 (amount realized on sale) – $100 (adjusted basis) = $15 realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[193] The TU partnership took a $60 transferred basis in the capital asset, a $40 aggregate transferred basis in the inventory items, and a $100 transferred basis in the section 1231 asset. *See* I.R.C. §§ 723, 1012(a). In a hypothetical sale (for fair market value) of all of the partnership's assets immediately before Tabitha's sale of her partnership interest, the partnership would have recognized: $20 of gain on the capital asset ($80 (amount realized) – $60 (adjusted basis) = $20); $10 of gain on the inventory ($50 (amount realized) – $40 (adjusted basis) = $10); and $0 of gain or loss on the section 1231 asset ($100 (amount realized) – $100 (adjusted basis) = $0). *See* I.R.C. § 1001(a), (c). Pursuant to its normal allocation rules, the partnership would have allocated to Tabitha 50 percent (or $5) of the gain on the inventory and 50 percent (or $10) of the gain on the capital asset. The inventory items are section 751(d) assets. *See* I.R.C. §§ 751(d)(1), 1221(a)(1). Because Tabitha would receive a $5 allocation of gain on the inventory, $5 of her gain on the sale of her partnership interest is allocable to the inventory and is ordinary gain under section 751(a). The remaining $10 of Tabitha's gain on the sale of her interest is capital gain under section 741. *See* I.R.C. §§ 741, 751(a)(2); Reg. § 1.751-1(a)(2).

exchange for the capital asset,[194] and 40 percent would have been deemed to be received in exchange for the section 751(d) inventory.[195] Tabitha's two-year holding period for the capital asset would have tacked to her six-month holding period for 60 percent of her partnership interest. Accordingly, 60 percent (or $6) of Tabitha's capital gain would have been long-term, and 40 percent (or $4) would have been short-term.

During the review-and-comment period for Proposed Regulation section 1.1223-3, Treasury received objections to the manner in which contributions of section 751 assets would affect the division of a partner's short-term vs. long-term capital gain. Commentators argued that, "if a partner has a short-term holding period in a partnership interest on account of the contribution of [section 751 assets]," the combination of section 751(a) and "the proposed regulations [would] cause the section 751 assets to be counted twice" if the partner sold her interest "within 12 months of the contribution[.]"[196] Under section 751(a), the contributed section 751 assets would be counted first "to treat part of the [partner's recognized gain on the sale of her partnership interest] as ordinary income.[197] Then, under Proposed Regulation section 1.1223-3(b), the contributed section 751 assets would be counted "again in determining the selling partner's short-term capital gain."[198] The commentators contended that counting the contribution of section 751 assets the second time would result in understating the percentage of a partnership interest to which the partner's holding period for a contributed capital or section 1231 asset should tack.

Treasury made a number of revisions to Proposed Regulation section 1.1223-3(b) in the final Regulations. Among other changes, the general rule in the Proposed Regulation became Regulation section 1.1223-3(b)(1) in the

[194] If the contribution of the inventory were counted, the portion of her partnership interest that Tabitha would be deemed to receive in exchange for the capital asset would equal a percentage, expressed as a fraction, (i) the numerator of which would be $60 (the fair market value of the capital asset and, thus, presumably the fair market value of such portion of the partnership interest) and (ii) the denominator of which would be $100 (the aggregate fair market value of all of the assets that Tabitha contributed—*including the inventory*—and, thus, presumably the fair market value of the entire partnership interest). *See* Prop. Reg. § 1.1223-3(b), 64 Fed. Reg. 43,117, 43,122 (1999).

[195] If the contribution of the inventory were counted, the portion of her partnership interest that Tabitha would be deemed to receive in exchange for the inventory would equal a percentage, expressed as a fraction, (i) the numerator of which would be $40 (the fair market value of the inventory and, thus, presumably the fair market value of such portion of the partnership interest) and (ii) the denominator of which would be $100 (the aggregate fair market value of all of the assets that Tabitha contributed and, thus, presumably the fair market value of the entire partnership interest). *See id.*

[196] Explanation of Final Holding Period Rules, *supra* note 118, at 57,095.

[197] *Id.*

[198] *Id.*

final Regulation.[199] And, in response to the comments regarding how the Proposed Regulation treated contributions of section 751 assets,[200] Treasury added Regulation section 1.1223-3(b)(4).[201]

Paragraph (b)(4) of the Regulation applies when (i) a partner receives a portion of her partnership interest in exchange for her contribution to the partnership of a section 751 asset and (ii) the partner disposes of her partnership interest in a taxable sale or exchange within one year after having acquired it.[202] The rule provides that, when determining a split in the partner's holding period for her partnership interest under Regulation section 1.1223-3(b)(1), the partner's contribution of a section 751 asset "*shall be disregarded*" if the partner recognizes gain or loss "on account of" that section 751 asset within one year after acquiring her interest.[203] For purposes of this rule, a partner recognizes gain or loss "on account of" a contributed section 751 asset if either (i) the partnership sells the asset and allocates gain or loss on the sale to the partner or (ii) the partner sells her interest and, pursuant to section 751(a), recognizes ordinary gain or loss attributable to the asset.[204]

Disregarding the contribution of a section 751 asset under Regulation section 1.1223-3(b)(4) means ignoring the portion of the partnership interest that the partner received in exchange for the contributed section 751 asset, when applying the Regulation section 1.1223-3(b)(1) formula to determine the percentage of the partner's interest to which her holding period for a contributed capital or section 1231 asset should tack. It requires pretending that (i) the partner contributed *only* the capital assets, section 1231 assets, and/or cash that she actually contributed to the partnership and (ii) the partner received *only* the portion(s) of her partnership interest that she actually received in exchange for such capital assets, section 1231 assets, and/or cash.

Consider, for instance, the difference that Regulation section 1.1223-3(b)(4) makes in Example 9: Pursuant to Regulation section 1.1223-3(b)(4), partner Tabitha is deemed to have contributed only her $60 non-depreciable capital asset to the TU partnership, and she is deemed to have received only a partnership interest worth $60 in return. In turn, under Regulation section 1.1223-3(b)(1), Tabitha is deemed to have received $^{60}/_{60}$ (or 100 percent)[205]

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[199] *Compare* Prop. Reg. § 1.1223-3(b), 64 Fed. Reg. 43,117, 43,122 (1999), *with* Reg. § 1.1223-3(b)(1) (2000).

[200] Explanation of Final Holding Period Rules, *supra* note 118, at 57,095.

[201] *See* Reg. § 1.1223-3(b)(4).

[202] *Id.*

[203] *Id.* (emphasis added).

[204] *Id.*

[205] The partnership interest that Tabitha is deemed to receive in exchange for the capital asset equals a percentage, expressed as a fraction, (i) the numerator of which is $60 (the fair market value of the capital asset and, thus, presumably the fair market value of such partnership interest) and (ii) the denominator of which is the presumed $60 fair market value of such partnership interest). *See* Reg. § 1.1223-3(b)(1).

of her partnership interest in exchange for her contribution of the capital asset. Thus, under section 12231(1), Tabitha's two-year holding period for the capital asset tacks to her six-month holding period for *100 percent* of her partnership interest.

When Tabitha sells her partnership interest for $115, she still recognizes $15 of gain. And $5 of that gain is still ordinary gain under section 751(a). Disregarding the contributed section 751(d) inventory is *solely* for purposes of applying Regulation section 1.1223-3(b)(1). Section 751 assets are *not* disregarded when determining the actual amount of a selling partner's gain or loss, *nor* are they disregarded when determining the portion of any such gain or loss that is ordinary under section 751(a).

At the same time, $10 of Tabitha's gain is still capital gain under section 741. This is where Regulation section 1.1223-3(b)(4)—and its effect on Regulation section 1.1223-3(b)(1)—makes a difference. Because Tabitha's holding period for the capital asset tacks to her holding period for her *entire* partnership interest, *all $10 of her capital gain is long-term*. (Compare this to the $6 long-term/$4 short-term split that would have resulted under the Proposed Regulation.)

By operation of Regulation section 1.1223-3(b)(4), there is no division in a partner's holding period for her partnership interest when she contributes a section 751 asset and *one* non-section-751 asset in exchange for her interest. As illustrated in Example 9, if the non-section-751 asset is a capital asset or a section 1231 asset, then the partner's holding period for such asset tacks to her holding period for her entire partnership interest. Conversely, if the non-section-751 asset is cash, there is no tacking to the partner's holding period for any portion of her interest.

But what if a partner contributes a section 751 asset and *multiple* non-section-751 assets in exchange for her partnership interest? For instance, what if a partner contributes (i) a section 751 asset, (ii) a capital or section 1231 asset, *and* (iii) cash? In such a case, there *is* a split in the partner's holding period for her interest. Regulation section 1.1223-3(b)(4), however, affects the proportion of the split.

As a case in point, consider the following variation on Example 9:

> Example 10: Same facts as in Example 9 except that, in exchange for her partnership interest, Tabitha contributes to the TU partnership (i) a non-depreciable capital asset with a fair market value of $60 (which she had purchased two years earlier for $60), (ii) section 751(d) inventory items with an aggregate fair market value of *$20* (which she had purchased for an aggregate price of *$20*), *and (iii) $20 of cash*. On the following day, the partnership uses the contributed cash to purchase additional section 751(d) inventory items with an aggregate fair market value of $20.

In this version of the example, pursuant to Regulation section 1.1223-3(b)(4), Tabitha is deemed to have contributed her $60 non-depreciable capital asset and $20 of cash to the TU partnership, and she is deemed to have received a partnership interest with a fair market value of $80 in return. Under Regulation section 1.1223-3(b)(1), Tabitha is deemed to have received $^{60}/_{80}$ (or 75 percent)[206] of her partnership interest in exchange for her contribution of the capital asset, and she is deemed to have received $^{20}/_{80}$ (or 25 percent)[207] of her interest in exchange for her contribution of the cash. Tabitha's two-year holding period for the capital asset tacks to her six-month holding period for 75 percent of her partnership interest, pursuant to section 1223(1).

Tabitha sells her partnership interest, six months after acquiring it, for $115—just as in Example 9. Once again, she recognizes $15 of gain on the sale; $5 of the gain is ordinary under section 751(a), and $10 of the gain is capital under section 741. In Example 10, however, because of the 75/25 split in Tabitha's holding period for the partnership interest, $7.50 of her capital gain is long-term, and $2.50 is short-term capital again.

The theory underlying Regulation section 1.1223-3(b)(4) seems to be that, if a partner receives a portion of her partnership interest in exchange for contributing section 751 assets to her partnership, then such portion of her interest is not a capital asset. In other words, the apparent hypothesis is that a partnership interest—or a portion thereof—is a capital asset only if the partner receives it in exchange for a contribution of non-section-751 property. If that were true, it might make sense for the split-holding-period rules to account only for contributions of non-section-751 property—to determine a division of the contributing partner's holding period only for the "capital-asset portion" of her interest. After all, the distinction between short-term and long-term holding periods is relevant only to gain or loss that is recognized on a taxable disposition of a *capital* asset.

Yet, in actuality, such a notion is plainly inconsistent with relevant Code provisions. No exception or carve-out in section 1221 indicates that a partnership interest is a non-capital asset to the extent that the partner

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[206] The portion of the partnership interest that Tabitha is deemed to receive in exchange for the capital asset equals a percentage, expressed as a fraction, (i) the numerator of which is $60 (the fair market value of the capital asset and, thus, presumably the fair market value of such portion of the partnership interest) and (ii) the denominator of which is $80 (the sum of (A) the $60 fair market value of the capital asset and (B) the $20 of cash—and, thus, the presumed fair market value of the entire partnership interest that Tabitha is deemed to receive in exchange for the contribution of those assets). *See* Reg. § 1.1223-3(b)(1).

[207] The portion of the partnership interest that Tabitha is deemed to receive in exchange for the cash equals a percentage, expressed as a fraction, (i) the numerator of which is $20 (the cash amount) and (ii) the denominator of which is $80 (the sum of (A) the $60 fair market value of the capital asset and (B) the $20 of cash—and, thus, the presumed fair market value of the entire partnership interest that Tabitha is deemed to receive in exchange for the contribution of those assets). *See id.*

received it in exchange for a contribution of section 751 assets.[208] Nor does section 751(a) mandate ordinary-gain treatment for a percentage of gain on the sale of a partnership interest equal to the percentage of the interest that the partner had received in exchange for contributing section 751 assets. Instead, as "interpreted" under Regulation section 1.751-1(a)(2), section 751(a) requires ordinary-gain treatment of the portion of the selling partner's gain equal to *the gain that the partnership would have allocated to the partner if it had sold all of its section 751(a) assets immediately before the partner sold her partnership interest.*[209]

In many cases, the percentage of a selling partner's gain that is ordinary under section 751(a) is quite different from the percentage of the partnership interest that the partner received in exchange for her contribution of section 751 assets. In Example 9, for instance, partner Tabitha received 40 percent of her partnership interest in return for her contribution of section 751(d) inventory. In contrast, only one-third (or approximately 33.3 percent) of her gain was ordinary under section 751(a).

The following variation on Example 8 provides an even starker comparison:[210]

> <u>Example 11</u>: Same facts as in Example 8, except that, instead of contributing \$200,000 of cash, Roberta contributed items of clothing that she had purchased at an aggregate cost of \$200,000 and had held in inventory in a prior retail business of hers. On January 2, 2023 (the contribution date), the aggregate fair market value of the contributed inventory items was \$200,000. Because of this contribution, the partnership did not make the January 4, 2023 purchase of inventory that was referenced in Example 8. (All subsequent sales and purchases of inventory by the partnership are the same as in Example 8, however.)

Roberta recognizes \$180,000 of gain on the sale of her partnership interest, just as she did in Example 8.[211] And, just like in Example 8, \$43,857 of that amount is ordinary gain, while the remaining \$136,143 is capital gain.[212] The difference is whether any portion of the capital gain is short-term.

In Example 11, by application of Regulation section 1.1223-3(b)(4), Roberta is deemed to have contributed only the \$300,000 land to the partnership, and she is presumed to have received in return a partnership interest worth \$300,000. By extension, Roberta is deemed to have received

[208] *See* I.R.C. § 1221(a) (no such exceptions or carve-outs included in paragraphs (1)-(8)).
[209] *See* I.R.C. § 751(a); Reg. § 1.751-1(a)(2); *see also supra* Part III.C-D.
[210] For Example 8, see *supra* Part IV.C.2.
[211] *See supra* note 170 and accompanying text.
[212] *See supra* text following note 173.

$^{300,000}/_{300,000}$ (or 100 percent)[213] of her partnership interest in exchange for her contribution of the land, pursuant to Regulation section 1.1223-3(b)(1). In turn, under section 12231(1), Roberta's holding period for the land tacks to her holding period for 100 percent of her partnership interest. As a result, Roberta's entire $136,143 of capital gain in Example 11 is long-term. This is in sharp contrast to Example 8, in which 60 percent of Roberta's capital gain is long-term and 40 percent is short-term.[214] Even more strikingly, Roberta received 40 percent of her partnership interest in exchange for contributing section 751 assets in Example 11,[215] whereas only approximately 24 percent of the gain on the sale of her interest is ordinary under section 751(a).[216]

Perhaps commentators were rightly concerned about overweighting contributed section 751 assets in the formula that determines the long-term/short-term split in a partner's capital gain on the sale of her partnership interest. A more appropriate response, however, would have been to disregard the contributed section 751 assets *to the extent*—and *only* to the extent—of the partner's ordinary gain under section 751(a). Unfortunately, that is not how Regulation section 1.1223-3(b)(4) actually works.

For instance, in Example 11, approximately 24 percent of Roberta's gain on the sale of her partnership interest is ordinary gain, and approximately 76 percent of such gain is capital gain. Roberta had received 40 percent of her partnership interest in exchange for her contribution of section 751 assets. Hence, 40 percent of Roberta's gain on the sale of her interest derives from her contribution of the section 751 assets—even though not all of that 40 percent is attributable to inherent gain in the section 751 assets themselves. The 40 percent of her gain that Roberta received because she contributed the section 751 assets includes, of course, the 24 percent that is attributable to the section 751 assets and is ordinary under section 751(a). But that 40 percent also includes an additional 16 percent of Roberta's gain on the sale of her interest, which is *capital* gain. With this in mind, it may make sense to disregard $^{24}/_{40}$ of the contributed section 751 assets when applying Regulation section 1.1223-3(b)(1) to calculate Roberta's divided holding period for her partnership interest. Nevertheless, $^{16}/_{40}$ of the section 751 assets should still be *included* in the denominator of the Regulation section 1.1223-

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[213] The partnership interest that Roberta is deemed to receive in exchange for the land equals a percentage, expressed as a fraction, (i) the numerator of is $300,000 (the fair market value of the land and, thus, presumably the fair market value of such partnership interest) and (ii) the denominator of which is the presumed $300,000 fair market value of such partnership interest). *See* Reg. § 1.1223-3(b)(1).

[214] *See supra* text accompanying notes 174-180.

[215] *Cf. supra* note 177 and accompanying text.

[216] $43,857 (ordinary gain) ÷ $180,000 (total gain) = 0.24365.

3(b)(1) fraction—because Roberta contributed $^{16}/_{40}$ of those assets in return for a portion of her interest that generated capital gain.

As shown above, Regulation section 1.1223-3(b)(4) actually produces a very different result. In Example 11, Regulation section 1.1223-3(b)(4) disregards 40 percent of the partner's contribution of assets, even though only about 24 percent of the partner's gain on the sale of her partnership interest is ordinary. Similarly, in Example 9, Regulation section 1.1223-3(b)(4) disregards 40 percent of the partner's contribution of assets,[217] even though only about 33 percent of the partner's gain on the sale of her partnership interest is ordinary.[218] In each of those examples, Regulation section 1.1223-3(b)(4) causes an underweighting of the selling partner's contributed section 751 assets—and thereby increases the *over*-weighting of the partner's contributed capital asset or section 1231 asset—in the Regulation section 1.1223-3(b)(1) formula for dividing the partner's partnership interest into holding-period percentages. In turn, the partner's holding period for her contributed capital or section 1231 asset tacks to her holding period for a greater percentage of her partnership interest than Regulation section 1.1223-3(b)(1) would otherwise provide. As a result, a more inordinate share of the partner's capital gain on the sale of her partnership interest is treated as long-term, rather than short-term.

As discussed below, Regulation section 1.1223-3(b)(1) often provides a tax windfall to short-term holders of partnership interests. It does so by extending the benefit of preferential long-term rates to capital gain on a short-term sale of a partnership interest beyond any gain that is attributable to a selling partner's contributed capital or section 1231 asset.[219] The above-described flaw in Regulation section 1.1223-3(b)(4) exacerbates this tax windfall by further increasing the portion of a selling partner's gain that is subject to preferential long-term capital gain rates—without any technical or policy-based justification.

To see the arbitrary results that Regulation section 1.1223-3(b)(4) can produce—and how easily the Regulation can be manipulated—one need only compare the respective outcomes in Examples 8 and 11. The only difference in the two fact-patterns is that: (i) in Example 8, partner Roberta contributed cash, which the partnership immediately used to purchase inventory; and (ii) in Example 11, Roberta purchased the inventory and contributed it to the partnership directly. By virtue of Regulation section 1.1223-3(b)(4), one non-substantive change in Roberta's manner of funding the partnership's inventory converted 40 percent of Roberta's capital gain on the sale of her partnership interest from short-term to long-term. The resulting tax benefit

[217] *Compare supra* note 195 and accompanying text *with supra* note 205 and accompanying text.

[218] *See supra* notes 192-193 and accompanying text. \$5 (ordinary gain) ÷ \$15 (total gain) ≈ 0.33.

[219] *See infra* Part V.A.

to Roberta in Example 11 (via the preferential long-term rates) is difficult to rationalize.

4. *Section 1245 Recapture Income Inherent in a Contributed Capital Asset or Section 1231 Asset Is Treated as a Disregarded Section 751 Asset Under the Split-Holding-Period Rules*

a. *The Rule in Regulation Section 1.1223-3(e).* Imagine the following: On July 1, 2021, a farmer named Victoria purchased for $200,000 a combine harvester for harvesting grain and placed it in service in her farming business. On July 1, 2023, Victoria contributed the combine to a farming partnership in exchange for an interest in the partnership. On the contribution date, the combine's fair market value was $165,000, and Victoria's adjusted basis in the combine was $120,000.[220] Prior to the contribution, Victoria took a total of $80,000 in depreciation deductions on the combine.[221]

In this scenario, Victoria is deemed to have contributed *two* assets to her partnership—notwithstanding that she actually contributed only the combine. At the time of the contribution, the combine had $45,000 of built-in gain for tax, even though it was then worth $35,000 less than when Victoria purchased it. The built-in tax gain was due entirely to the reductions in Victoria's basis that resulted from her depreciation deductions on the combine.[222] Therefore, the $45,000 of built-in gain was inherent section 1245 recapture income.[223]

As discussed above, section 751(c) classifies section 1245 recapture income inherent in a partnership's capital asset or section 1231 asset as an unrealized receivable of the partnership that is separate from such capital assent or section 1231 asset.[224] Accordingly, for purposes of Regulation section

[220] Victoria's initial cost basis in the combine was $200,000. *See* I.R.C. § 1012(a). Her basis in the combine was subsequently reduced by $80,000 because of the $80,000 of depreciation deductions that she claimed. *See infra* note 221; *see also* I.R.C. § 1016(a)(2). $200,000 (initial cost basis) – $80,000 (depreciation-related basis reductions) = $120,000 adjusted basis.

[221] Under MACRS, farming machinery (such as a combine) is 5-year property. I.R.C. § 168(e)(3)(B)(vii). Assume the following additional facts: (1) Victoria is a calendar year taxpayer. (2) Victoria elected to depreciate the combine for tax under the straight-line method during the asset's 5-year recovery period. *See* I.R.C. § 168(b)(3)(D), (b)(5). (3) Victoria did not place any other depreciable assets in service during 2021, and the half-year convention applies to the depreciation of the combine. *See* I.R.C. § 168(d)(1). (4) Victoria did not elect immediate expensing of the combine under section 179. *See generally* I.R.C. § 179. (5) Victoria elected not to take any additional first-year depreciation allowance on the combine pursuant to section 168(k). *See* I.R.C. § 168(k)(1), (k)(7). On these facts, Victoria would have taken the following depreciation deductions on the combine: $20,000 for taxable year 2021; $40,000 for taxable year 2022; and $20,000 for taxable year 2023.

[222] *See supra* note 220.

[223] *See supra* note 16 (describing section 1245).

[224] *See supra* Part III.C.2-3.

1.1223-3(b)(1)'s split-holding-period formula, Regulation section 1.1223-3(e) treats section 1245 recapture income inherent in a contributed capital asset or section 1231 asset as a separately-contributed section 751 asset.[225] In the present scenario, $45,000 of the combine's $165,000 fair market value on the contribution date was attributable to inherent section 1245 recapture income. Therefore, for purposes of Regulation section 1.1223-3(e), partner Victoria contributed a section 751 asset with a fair market value of $45,000, as well as a section 1231 asset[226] with a fair market value of $120,000.

The treatment of built-in section 1245 recapture income as a section 751 asset under Regulation section 1.1223-3 should come as no surprise, given section 751(c)'s classification of inherent section 1245 recapture income as an unrealized receivable. Nonetheless, the Regulations' approach to section 1245 recapture has seemingly caused confusion since the Regulations were first proposed, and the rule in Regulation section 1.1223-3(e) eludes some commentators and practitioners even to this day.

In Proposed Regulation section 1.1223-3, Treasury included an "Example 2," in which a partner contributed $50,000 of cash and an item of business-use equipment with a fair market value of $100,000 in exchange for a partnership interest with a fair market value of $150,000.[227] In the example, $20,000 of the equipment's value was attributable to section 1245 recapture income inherent in the equipment. Thus, the partner was deemed to have contributed three assets to the partnership: $50,000 of cash, a $20,000 ordinary asset, and an $80,000 section 1231 asset.[228] (The ordinary asset was a section 751(c) unrealized receivable; however, contributed section 751 assets would not have been disregarded under the Proposed Regulation.[229]) Applying the formula in Proposed Regulation section 1.1223-3(b), the example concluded that the partner's holding period for the contributed equipment tacked to the partner's holding period for $^{80,000}/_{150,000}$ (or 53.33 percent) of the partnership interest.[230]

Perhaps Example 2 in Proposed Regulation section 1.1223-3(e) might have been more illuminating if it had included an express reminder that section 1245 recapture income inherent in a partnership asset is considered a separate asset—a partnership unrealized receivable—under section 751(c). Apart from that, though, the example was clear. Nonetheless, "[s]ome commentators" on the Proposed Regulations "raised questions on the

[225] *See* Reg. § 1.1223-3(e).

[226] As an item of depreciable business-use personalty, the contributed combine (exclusive of the inherent section 1245 recapture income) was a section 1231 asset in Victoria's hands. *See* I.R.C. § 1231(b)(1).

[227] *See* Prop. Reg. § 1.1223-3(e), Example (2), 64 Fed. Reg. 43,117, 43,122 (1999).

[228] *See id.*

[229] *See supra* text accompanying notes 190-195.

[230] Prop. Reg. § 1.1223-3(e), Example (2), 64 Fed. Reg. 43,117, 43,122 (1999).

position taken in this example."[231] In response, Treasury reiterated that "it is appropriate to characterize all properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder as separate assets that are not capital assets or [section 1231 assets]."[232] At the same time, Treasury apparently concluded that Example 2 did not adequately communicate this approach or explain the rationale for its result. "Accordingly," in the final Regulations, Treasury eliminated the example and, in its stead, added "*a specific rule . . . to provide for such a result*."[233]

The rule for inherent section 1245 recapture income (and other section 751(c) unrealized receivables) appears in final Regulation section 1.1223-3(e).[234] The Regulation states plainly that, "[f]or purposes of [Regulation section 1.1223-3], properties and potential gain treated as unrealized receivables under section 751(c) shall be treated as separate assets that are not capital assets or [section 1231 assets]."[235] This echoes Treasury's explanation of the rule it had intended to advance in Example 2 under Proposed Regulation section 1.1223-3(e). In introducing the final rule, however, Treasury made sure to clarify that the treatment of inherent section 1245 recapture income as a separately-contributed unrealized receivable is subject to the "disregard-of-section-751-assets" rule in final Regulation section 1.1223-3(b)(4).[236] In other words, as with any other section 751 asset, a contribution of inherent section 1245 recapture income is to be disregarded "in computing the holding period of a partnership interest where the interest is sold within one year after contribution."[237]

Building on the scenario above, here is a fuller example of how Regulation section 1.1223-3(e) applies:

> <u>Example 12</u>: Walter and Victoria formed the WV partnership (a calendar year partnership) on July 1, 2023, for the purpose of owning and operating a farming business. On July 1, 2023, Victoria contributed a combine harvester and $55,000 in cash to the partnership in exchange for a 50-percent interest in the partnership's capital, profits, and losses. Victoria had purchased the combine on July 1, 2021, for $200,000 and had used it in a prior farming business of hers. On July 1, 2023, the fair market value of the combine was $165,000, and Victoria's adjusted basis in the combine was $120,000.[238] Prior to the contribution, Victoria had taken $80,000 of

[231] Explanation of Final Holding Period Rules, *supra* note 118, at 57,095.
[232] *Id.* at 57,096.
[233] *Id.* (emphasis added).
[234] *See* Reg. § 1.1223-3(e) (2000).
[235] *Id.*
[236] *See* Explanation of Final Holding Period Rules, *supra* note 118, at 57,096.
[237] *Id.*
[238] *See supra* note 220.

depreciation deductions on the combine.[239] Also on July 1, 2023, Walter contributed $220,000 in cash to the partnership in exchange for a 50-percent interest in the partnership's capital, profits, and losses. On July 2, 2023, the WV partnership purchased a large parcel of farmland for $275,000. The partnership then began to conduct its farming business, using the land to grow grain and using the combine to harvest the grain. For 2023, the partnership took a $20,000 depreciation deduction on the combine.[240] During the period from July 1, 2023 to December 31, 2023, the partnership received $65,000 of gross income from its farming operations and paid $65,000 of deductible expenses.[241] *On January 1, 2024, Victoria sold her entire interest in the WV partnership to Kathy for $262,000.* Immediately prior to the sale, Victoria's outside basis in her partnership interest was $168,750.[242] Assume that, on January 1, 2024, the WV partnership held the following assets: (i) the combine, which then had a fair market value of $155,000; and (ii) the land, which then had a fair market value of $369,000. Also assume that, as of that date, the partnership had no liabilities. On

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[239] *See supra* note 221.

[240] When Victoria contributed the combine to the WV partnership in the middle of 2023, the partnership stepped into Victoria's shoes with respect to the continued tax depreciation of the asset. *See* I.R.C. § 168(i)(7). Thus, the partnership takes depreciation deductions on the combine—using the straight-line depreciation method that Victoria had elected, and using the partnership's $120,000 transferred basis from Victoria as the depreciable basis—over the combine's 2.5 years of remaining depreciable life. Accordingly, for 2023, the partnership has $20,000 of tax depreciation on the combine ($120,000 x $^1/_3$ x $^1/_2$). The book value of the combine on the partnership's balance sheet is $165,000 (the combine's fair market value on the contribution date). So, the partnership has $27,500 of book depreciation on the combine ($165,000 x $^1/_3$ x $^1/_2$) for 2023. The depreciation deduction is a separately-stated item because, presumably, the partnership uses the "traditional" method of specially allocating built-in gain on contributed depreciable property to the contributing partner. *See supra* note 43. Under the "traditional" method, the partnership: (i) allocates 50 percent (or $13,750) of the book depreciation apiece to Walter and Victoria (per the partnership's normal allocation rules); (ii) allocates $13,750 of tax depreciation to Walter (equal to Walter's allocation of book depreciation); and (iii) allocates the remaining $6,250 of tax depreciation to contributing partner Victoria.

[241] Assume that these expenses included (i) $6,000 of organizational expenses deductible under section 709, (ii) $5,000 of "start-up expenditures" deductible under section 195, and (iii) $54,000 of operating expenses deductible under section 162. Also assume that the partnership's tax accounting method is the cash method. The partnership's non-separately-computed net income (or loss) for 2023 is $0 ($65,000 – $65,000). After giving effect to its separately-stated depreciation deduction on the combine, the partnership's net tax loss for 2023 is ($20,000) ($0 – $20,000).

[242] Victoria took a $175,000 initial outside basis in her partnership interest—equal to the sum of (i) her $55,000 cash contribution *plus* (ii) her $120,000 adjusted basis in the contributed land. *See* I.R.C. § 722(a). Subsequently, her outside basis was reduced by $6,250 because of her 2023 allocation of tax depreciation on the combine (which, effectively, is an allocation of partnership loss). *See* I.R.C. § 705(a)(2)(A). Thus, as of January 1, 2024, Victoria's adjusted outside basis is $168,750 ($175,000 – $6,250).

January 1, 2024, the partnership's inside bases in its assets were: $100,000 adjusted basis in the combine,[243] and $275,000 basis in the land.[244]

Victoria recognizes $93,250 of gain on the sale of her partnership interest.[245] To determine the tax character of the gain, the first step is to determine how much is ordinary.

At the time of Victoria's sale, $55,000 of gain is inherent in the combine. The inherent gain is due entirely to basis reductions that resulted from depreciation deductions on the combine. If the partnership were to sell the combine for fair market value, the $55,000 of recognized gain would thus be section 1245 recapture income. Under section 751(c), the $55,000 of section 1245 recapture income inherent in the combine is deemed to be an unrealized receivable that is separate from the combine itself.[246] A portion of Victoria's gain on the sale of her partnership interest is attributable to the inherent gain in such unrealized receivable. Pursuant to section 751(a), that portion of Victoria's gain is ordinary.[247]

To calculate the amount of Roberta's ordinary gain, we hypothesize that the partnership sold all of its assets for fair market value immediately before Victoria's sale of her interest, as Regulation section 1.751-1(a)(2) directs.[248] In such a transaction, the partnership would have recognized $55,000 of gain on the combine.[249] Because the gain would have been section 1245 recapture income, section 751(c) would treat the hypothetical combine sale as (i) a sale of an unrealized receivable with a fair market value of $55,000 and an adjusted basis of $0 and (ii) a sale of a combine with a fair market value of $100,000 and an adjusted basis of $100,000. The partnership would have allocated $50,000 of its $55,000 in gain on the unrealized receivable to Victoria[250] (who would still have been a partner). Thus, $50,000 of Victoria's

[243] The partnership's initial basis in the combine was a $120,000 transferred basis from Victoria. *See* I.R.C. § 723. Subsequently, such basis was reduced by $20,000 because of the partnership's 2023 depreciation deduction on the combine. *See* I.R.C. § 1016(a)(2). Thus, as of January 1, 2024, the partnership's adjusted basis in the combine is $100,000 ($120,000 – $20,000).

[244] The partnership took a $275,000 initial cost basis in the land. *See* I.R.C. § 1012(a). Assume that there were no subsequent adjustments to such basis.

[245] $262,000 (amount realized on sale) – $168,750 (adjusted basis) = $93,250 realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[246] *See* I.R.C. § 751(c) (flush language).

[247] *See* I.R.C. § 751(a)(2); *see also supra* Part III.C.

[248] *See* Reg. § 1.751-1(a)(2).

[249] $155,000 (amount realized on hypothetical sale for fair market value) – $100,000 (partnership's adjusted basis) = $55,000 hypothetical realized and recognized gain. *See* I.R.C. § 1001(a), (c).

[250] Victoria should receive an allocation of the partnership's section 1245 recapture income equal to the lesser of (i) her distributive share of the partnership's total gain on the (hypothetical) disposition of the combine or (ii) the depreciation deductions on the combine that she took before the contribution or that the partnership allocated to her after the contribution. *See* Reg. § 1.1245-

gain on the sale of her partnership interest is attributable to the unrealized receivable, and that portion of her gain is ordinary. The remaining $43,250 of Victoria's gain on the sale of her interest is capital gain.

Even though Victoria did not hold her partnership interest for more than one year before selling it, part of her $43,250 of capital gain will be long-term capital gain. This is because her two-year holding period for the combine tacks to her holding period for a portion of her interest.

To determine the percentage of Victoria's interest to which her holding period for the combine tacks, we look to the split-holding-period rules—starting with Regulation section 1.1223-3(e). Under Regulation section 1.1223-3(e), Victoria is deemed to have contributed a $45,000 unrealized receivable and a $120,000 combine,[251] as well as $55,000 in cash, in exchange for a partnership interest then worth $220,000. Pursuant to Regulation section 1.1223-3(b)(4), however, the contribution of the unrealized receivable (a section 751(c) asset) is disregarded.[252] Thus, for purposes of Regulation section 1.1223-3(b)(1), Victoria is deemed to have contributed only a $120,000 combine and $55,000 in cash, in exchange for a partnership interest worth $175,000. Under Regulation section 1.1223-3(b)(1), Victoria is deemed to have received $^{120,000}/_{175,000}$ (or approximately 69 percent)[253] of her interest in exchange for the combine and to have received $^{55,000}/_{175,000}$ (or approximately 31 percent)[254] of her interest in exchange for the cash.

Accordingly, pursuant to section 1223(1), Victoria's two-year holding period for the combine tacks to her six-month holding period for 69 percent

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1(e)(2). Victoria's distributive share of the total gain on the hypothetical sale of the combine would be $50,000—equal to the combine's $45,000 of built-in gain on the contribution date *plus* 50 percent (or $5,000) of the combine's post-contribution accrued gain. Her aggregate depreciation deductions on combine equal $86,250—the $80,000 of pre-contribution deductions *plus* her $6,250 allocation of the partnership's 2023 deduction. Victoria's distributive share of the partnership's section 1245 recapture income recognized on the hypothetical sale of the combine would be $50,000 (the lesser of the two amounts).

[251] *See supra* text accompanying notes 220-226.

[252] *See supra* text accompanying notes 236-237.

[253] The portion of the partnership interest that Victoria is deemed to receive in exchange for the combine equals a percentage, expressed as a fraction, (i) the numerator of which is $120,000 (the deemed value of the combine and, thus, the deemed value of such portion of the partnership interest) and (ii) the denominator of which is $175,000 (the sum of (A) the $120,000 deemed value of the combine and (B) the $55,000 of cash—and, thus, the presumed value of the entire partnership interest that Victoria is deemed to receive in exchange for the contribution of those assets). *See* Reg. § 1.1223-3(b)(1).

[254] The portion of the partnership interest that Victoria is deemed to receive in exchange for the cash equals a percentage, expressed as a fraction, (i) the numerator of which is $55,000 (the cash amount) and (ii) the denominator of which is $175,000 (the sum of (A) the $120,000 deemed value of the combine and (B) the $55,000 of cash—and, thus, the presumed value of the entire partnership interest that Victoria is deemed to receive in exchange for the contribution of those assets). *See id.*

of her interest. In other words, Victoria is deemed to have held 69 percent of her partnership interest for two years and six months, while she held the other 31 percent for six months. As a result, 69 percent (or $29,843) of her $43,250 capital gain on the sale of her interest is long-term, and the remaining 31 percent (or $13,407) is short-term.

So, to recap: On the sale of her partnership interest, Victoria recognizes $50,000 of ordinary gain, $13,407 of short-term capital gain, and $29,843 of long-term capital gain.

b. *The Confusion That Regulation Section 1.1223-3(e) Has Caused.* Despite the relatively plain language of Regulation section 1.1223-3(e), some commentators and practitioners seem to be either unmindful of it or confused by it. Even in an otherwise outstanding instructional text on partnership tax, for instance, the authors ignore Regulation section 1.1223-3(e) and fail to separate a depreciable section 1231 asset from the asset's inherent section 1245 recapture income, in an example that is intended to illustrate the split-holding-period rules.[255]

Perhaps more curiously, another commentator opines that the ambit of Regulation section 1.1223-3(e) "is not completely clear"—and that taxpayers may choose whether to follow it—because the examples in Regulation section 1.1223-3 "do not specifically address the contribution of recapture property."[256] This view is misguided for a couple for reasons.

First, the commentator neglects to take proper account of Regulation section 1.1223-3(e)'s administrative history. It is of course true that final Regulation section 1.1223-3 does not include an example in which an asset's inherent recapture income is treated as separate from the asset in which it inheres. Yet, as noted above, this is precisely because Treasury decided to *replace* such an example (from the Proposed Regulation) *with an express provision* stating that such recapture income constitutes a separate section 751(c) asset for purposes of the split-holding-period rules.[257] Given that history, it is unreasonable to interpret the absence of a specific example the final Regulation as any sort of indication that Regulation section 1.1223-3(e) lacks meaning or effect.

Second, the commentator appears to base his approach on a nonexistent "rule" of regulatory interpretation that would be risky to follow. It is wrong

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[255] *See* CUNNINGHAM & CUNNINGHAM, *supra* note 2, at 24-25 & n.21 (in "Example #2," treating a contributed section 1231 asset with a $75 value and $25 of inherent section 1245 recapture income as a single $75 section 1231 asset—rather than as a $50 section 1231 asset and a separate $25 section 751 asset, as Regulation section 1.1223-3(e) requires).

[256] *See* Albert B. Ellentuck, *Contributed Property in the Hands of a Partnership*, THE TAX ADVISER, Apr. 1, 2014, https://www.thetaxadviser.com/issues/2014/apr/casestudy-apr2014-vm.html (contending that "[t]here seem to be two [reasonable] filing positions"—either following or not following Regulation section 1.1223-3(e)).

[257] *See supra* text accompanying notes 227-233.

to conjecture that taxpayers may ignore *any* given provision within a Treasury Regulation simply because the Regulation's examples do not include a specific illustration of that provision. For instance, the Regulation section 1.1223-3(f) examples also omit to include any fact-pattern in which a partner acquires portions of her partnership interest at different times.[258] Are we to conclude, on the basis of that omission, that Regulation section 1.1223-3(a)(1) is ineffective surplusage and that such a partner would not have a divided holding period for her interest?[259] Of course not.

V. The Split-Holding-Period Rules Often Create Inequitable Tax Breaks for Selling Partners, and the Rules Should Be Reformed

A. *The Split-Holding-Period Rules Create a Tax Loophole That Should Be Closed*

Regulation section 1.1223-3 often provides an unwarranted tax windfall to a partner who (i) contributes a capital or section 1231 asset to her partnership in exchange for part of her partnership interest and (ii) sells her interest within one year after acquiring it. By operation of Regulation section 1.1223-3(b)(1)'s formula for dividing a partner's holding period for her partnership interest, the partner's holding period for the contributed capital or section 1231 asset tacks to a portion of her interest that has a fair market value equal to the fair market value of the contributed asset.[260] Frequently, under that formula, the portion of the selling partner's capital gain on her interest that gets treated as long-term is considerably greater than the portion of her gain that derives from her contributed capital or section 1231 asset.

The section 1223(1) tacking rule ensures that, when a taxpayer exchanges one asset for another in a nonrecognition transaction, any realized-but-unrecognized long-term capital gain on the transferred asset retains its long-term character when the taxpayer later recognizes such gain upon a sale of the received asset—even if the taxpayer sells the received asset within one year after the exchange. That is a proper outcome, of course.

Mechanically, however, section 1223(1) typically results in the treatment of *all* capital gain on the received asset as long-term when the taxpayer sells the received asset within one year of the exchange. This may be proper when the nonrecognition exchange constitutes a change merely in the *form* (rather than the substance) of the taxpayer's investment. In contrast, if a nonrecognition exchange alters the *substance* of the taxpayer's investment and the taxpayer sells the asset received in the exchange within one year, treating all of the capital gain on the sale of the received asset as long-term is decidedly inappropriate. In such a case, if the recognized capital gain on the sale of the

[258] *See generally* Reg. § 1.1223-3(f) (no acquisition-at-different-times examples).

[259] *See* Reg. § 1.1223-3(a)(1) (establishing divided holding period when partner acquires portions of partnership interest at different times).

[260] *See supra* text accompanying notes 156-157.

received asset exceeds the taxpayer's realized-but-unrecognized capital gain on the transferred asset, taxing the excess gain at preferential long-term rates provides the taxpayer with an unjustified windfall.

Some nonrecognition exchanges can be plausibly characterized as changes in the form, but not the substance, of the taxpayer's investment. A section 1031 "like-kind" exchange of one item of domestic business-use or investment real estate for another such item of equal value might be one example.[261]

A taxpayer's investment any given capital asset or section 1231 asset, however, is substantively different from an investment in a partnership to which the taxpayer contributes such asset. As noted above, an interest in the partnership will provide the taxpayer with a different bundle of legal rights and different set of economic benefits and burdens than did ownership of the contributed asset.[262] When a partner exchanges any particular asset for her partnership interest, what she receives in the exchange is more than just an indirect interest in the contributed asset. She also receives an indirect interest in the partnership's other assets, as well as a share of the income or loss that the partnership realizes through the operation of its business.

Typically, when a partner recognizes gain on a sale of her partnership interest, that gain is not attributable solely to gain inherent in the assets that the partner contributed in exchange for her interest. Instead, the gain on the partnership interest is usually attributable in significant part to gain inherent in the partnership's other assets. If the partner sells her interest within one year after having acquired it, the only portion of her capital gain on the sale that should be long-term due to the tacking of her holding period for a contributed capital or section 1231 asset is the portion attributable to gain inherent in such contributed asset.

There are two potential rationales for tacking a partner's holding period for a contributed capital or section 1231 asset to her holding period for a portion of her partnership interest. The first is to preserve the long-term character of any long-term capital gain that the partner realized when she contributed the asset to the partnership—but that she does not recognize until she sells her interest. The second is the argument that a partner's exchange of a contributed asset for a portion of her partnership interest is a change in only the form, but not the substance, of the partner's original investment in the contributed asset.[263] Yet the only extent to which the substance of a partner's investment in a contributed asset can possibly be argued to continue intact following her contribution is the extent of her interest in any gain or loss on the asset that accrues after the contribution. Therefore, under either of the two rationales, applying the section 1223(1) tacking rule to a partner's holding period for part of her partnership interest

[261] *See generally* I.R.C. § 1031.

[262] *See supra* notes 30-31 and accompanying text.

[263] *See supra* text accompanying notes 28-32 (describing this argument and its inherent flaws).

makes sense only insofar as it ensures long-term treatment of (i) the portion of the capital gain that the partner recognizes on a sale of her interest, which is (ii) attributable to gain inherent in a capital or section 1231 asset that the partner held for longer than one year before contributing it to the partnership.

In contrast, when the partner holds her interest for no longer than one year before selling it, applying section 1223(1) to grant long-term status to capital gain on the sale that corresponds to gain inherent in any other partnership assets is entirely uncalled-for. In such a case, the tacking rule converts the partner's gain on a new short-term investment—*i.e.*, one that is different from her prior investment in the contributed asset—to long-term capital gain. The result is an undue tax break on such gain. The partner ends up being taxed at lower preferential rates on gain that should be taxed (as short-term capital gain) at her ordinary marginal rate. Unfortunately, Regulation section 1.1223-3 is prone to produce this result.

In Example 8, for instance, partner Roberta contributed a capital asset (a parcel of land that she had held for investment) to her partnership in return for a portion of her partnership interest.[264] In that transaction, Roberta received much more than just a continuing interest in any gain or loss inherent in the land. In exchange for the land, Roberta also received a portion of her interest in the gain or loss inherent in the partnership's other assets—*i.e.*, the partnership's building, inventory, and goodwill—and she received a portion of her interest in the partnership's income or loss from its business.[265]

The fair market value of the land on the contribution date constituted 60 percent of aggregate the fair market value of the assets that Roberta contributed in return for her partnership interest. Therefore, Roberta was deemed to have received 60 percent of her partnership interest in exchange for the land pursuant to Regulation section 1.1223-3(b)(1).[266] Accordingly, under section 1223(1), Roberta's holding period for the contributed land tacked to her holding period for 60 percent of her partnership interest.[267] By operation of these rules, 60 percent (or $81,686) of the capital gain that Roberta recognized on the sale of her partnership interest was treated as long-term capital gain—even though she sold her interest only eleven months after acquiring it.[268]

Far less than 60 percent of Roberta's capital gain on the sale of her interest was attributable to her distributive share of the gain inherent in the land, however. In fact, of her $136,143 of capital gain,[269] only $30,000—or

[264] *See supra* Part IV.C.2. (Example 8).
[265] *See id.*
[266] *See supra* text accompanying notes 174-178.
[267] *See supra* text accompanying notes 179-180.
[268] *See supra* text following note 180.
[269] *See supra* text following note 173.

approximately 22 percent—was attributable to gain inherent in the contributed land.[270] The remaining $106,143—or approximately 78 percent—of Roberta's capital gain was attributable to her distributive share of gain inherent in the partnership's building and goodwill.[271] That $106,143 was gain on Roberta's short-term investment in an asset (or an interest in a group of assets) other than the contributed land. Nevertheless, because of the split-holding-period formula in Regulation section 1.1223-3(b)(1), nearly 50 percent (or $51,686) of that gain was taxed at preferential long-term capital gain rates[272] rather than the higher ordinary rate that should apply to short-term capital gains.

As described above, when a partner contributes both a capital or section 1231 asset and a section 751 asset in exchange for her partnership interest, Regulation section 1.1223-3(b)(4) disregards the contributed section 751 asset for purposes of the Regulation section 1.1223-3(b)(1) formula to divide the partner's holding period for her interest.[273] As previously noted, this provides the partner with an even greater tax windfall if she sells her interest within one year after acquiring it.[274] Recall, for instance, Example 11—the variation on Example 8 in which partner Roberta contributes (i) $200,000 worth of section 751 assets (rather than $200,000 of cash) and (ii) the $300,000 parcel of land, in return for her partnership interest.[275] In Example 11, by operation of Regulation section 1.1223-3(b)(4), Roberta's holding period for the land tacks to her holding period for 100 percent (rather than 60 percent) of her interest. As a result, in that version of the example, *all* of Roberta's $106,143 in non-land-attributable capital gain is taxed at preferential long-term rates when she sells her interest after only eleven months.[276]

Converting that $106,143 of capital gain from short-term to long-term in Example 11 gratuitously reduces Roberta's federal income tax on such gain by a very substantial amount. Assume, for instance, that Roberta is in the 37-percent marginal bracket for ordinary income and the 20-percent marginal bracket for 0/15/20-percent long-term capital gains. In that case, if the $106,143 of capital gain were treated as short-term, it would be taxed at 37 percent, and Roberta's tax on the gain would be $39,273.[277] Because the

[270] *See supra* note 186 and accompanying text. $30,000 ÷ $136,143 ≈ 0.22.

[271] $56,143 of Roberta's gain was attributable to gain inherent in the partnership's building, and $50,000 of her gain was attributable to gain inherent in the partnership's self-created goodwill. *See supra* notes 187-188 and accompanying text. $106,143 ÷ $136,143 ≈ 0.78.

[272] $81,686 (long-term capital gain) – $30,000 (gain attributable to land) = $51,686. $51,686 ÷ $106,143 ≈ 0.49.

[273] *See supra* Part IV.C.3.

[274] *See supra* text accompanying notes 217-219.

[275] *See supra* text accompanying notes 210-216 (Example 11).

[276] *See supra* text accompanying notes 213-214.

[277] $106,143 x 0.37 = $39,272.91.

$106,143 is instead treated as long-term capital gain, however, $100,000 of such gain is taxed at 20 percent, and $6,143 is taxed at 25 percent.[278] Roberta's total federal income tax on the gain is thus $21,536.[279] In this example, the preferential long-term treatment reduces Roberta's federal income tax liability on such gain by $17,737—a remarkable 45-percent decrease.[280] That is a relatively enormous tax reduction to give to a high-income taxpayer for no defensible reason.

B. *A Proposal for Reforming the Split-Holding-Period Rules, to Eliminate Tax Inequities and Needless Complexities*

Regulation section 1.1223-3 should be revised to prevent the split-holding-period rules from generating inappropriate tax breaks for affluent taxpayers who hold appreciated partnership interests for one year or less. To eliminate those tax breaks, the application of section 1223(1) to partnership interests needs to be adjusted to recalibrate the long-term portion of capital gain that a partner recognizes on a short-term sale of a partnership interest. As explained earlier, section 1223(1) should ensure that, in a short-term partnership interest sale, the only long-term capital gain is that which is attributable to the selling partner's contributed capital assets or section 1231 assets.[281]

This requires reconfiguring the Regulation section 1.1223-3(b)(1) formula for calculating the portion of a partnership interest to which a selling partner's holding period for a contributed capital asset or section 1231 asset tacks. In particular, such a reconfiguration is necessary for cases contemplated under Regulation section 1.1223-3(a)(2)—in which a partner contributes both (i) a capital or section 1231 asset and (ii) cash or an ordinary asset, in the same transaction, in exchange for her partnership interest.[282] When applied in those cases, the Regulation section 1.1223-3(b)(1) formula should provide that a selling partner's holding period for her contributed capital or section 1231 asset tacks to her holding period for a percentage of her partnership interest equal to the percentage of her capital gain on the sale of the interest that is attributable to such contributed asset. The amount of gain attributable to the contributed asset, in turn, should be determined under Regulation section 1.751-1(a)(2)—*i.e.*, the amount of gain that the partnership would have allocated to the selling partner if the partnership had sold the asset immediately before the partner sold her interest.[283]

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[278] Pursuant to Regulation section 1.1(h)-1, $6,143 of Roberta's long-term capital gain is section 1250 capital gain, and the remainder is residual long-term capital gain. *See supra* note 189 and accompanying text.

[279] $100,000 x 0.20 = $20,000. $6,143 x 0.25 = $1,535.75.

[280] $39,273 – $21,536 = $17,737. $17,737 ÷ $39,273 ≈ 0.45.

[281] *See supra* text preceding and accompanying notes 263-264.

[282] *See* Reg. § 1.1223-3(a)(2); *see also supra* text accompanying notes 148-149 (discussing same).

[283] *See* Reg. § 1.751-1(a)(2); *see also supra* Part III.D. (discussing same).

Modifying the Regulation section 1.1223-3(b)(1) formula in this way would ensure two important outcomes if the partner sells her interest within one year after acquiring it: First, the selling partner would be taxed at the applicable long-term rate(s) on any built-in capital gain, as well as her share of any post-contribution capital gain, accrued on a contributed asset that she had held for more than one year. Second, however, the partner would be taxed at her ordinary marginal rate on all other capital gain that she recognizes on the short-term sale. Under this approach, the partner would still be protected against over-taxation of any deferred capital gain on a long-term contributed asset that she recognizes when she sells her short-term partnership interest. At the same time, the partner would no longer receive a groundless tax break on capital gain that she effectively derives from a short-term investment in other assets.

Accordingly, Regulation section 1.1223-3(b)(1)'s current language should be removed and replaced with the following:

> (b) Accounting for holding periods of an interest in a partnership—(1) General rule. *For purposes of applying paragraph (a)(2) of this section,*[284] *t*he portion of a *taxpayer's* partnership interest to which a holding period relates shall be determined by reference to a fraction, *(A)* the numerator of which is the *amount of the taxpayer's recognized capital gain on the taxable sale or exchange of the partnership interest that is attributable to the asset which the taxpayer transferred to the partnership in exchange for* the portion of the partnership interest received in the transaction to which the holding period relates, *as determined pursuant to § 1.751-1(a)(2),* and *(B)* the denominator of which is the *entire amount of the taxpayer's recognized capital gain on the taxable sale or exchange* of the partnership interest (determined immediately after the *taxpayer's sale or exchange of the partnership interest*).[285]

This reformulation would guarantee that, upon a short-term sale of a partnership interest, strictly the capital gain on the sale that is attributable to the selling partner's contributed capital asset or section 1231 asset would be long-term capital gain by operation of section 1223(1)'s tacking rule.

Consider, for instance, how this proposed, revised version of Regulation section 1.1223-3(b)(1) would change the outcome in Example 8. Recall once again that, in Example 8, partner Roberta recognized a total of $136,143 in

[284] This proposed formula need not apply in cases contemplated under Regulation section 1.1223-3(a)(1)—in which a partner acquires portions of her partnership interest at different times. *See* Reg. § 1.1223-3(a)(1). In those cases, the size of any such portion can be determined simply by dividing (i) the partner's total percentage interest in the partnership by (ii) the percentage interest in the partnership that the partner received by acquiring such portion. *See supra* text accompanying note 142.

[285] The "new" language in this proposed version of Regulation section 1.1223-3(b)(1) is italicized.

capital gain when she sold her partnership interest,[286] and $30,000 of such capital gain was attributable to the land that she had contributed to her partnership.[287] Under this proposal, Roberta's holding period for the contributed land would tack to her holding period for $^{30,000}/_{136,143}$ (or approximately 22.036 percent) of her partnership interest. As a result, upon the sale of her partnership interest after eleven months, $30,000 (or approximately 22.036 percent) of Roberta's $136,143 in recognized capital gain would be treated as long-term—the same amount as was attributable to the land. The remaining $106,143 (or approximately 77.964 percent) of her capital gain—which was attributable to other partnership assets—would be short-term. This would be far more appropriate than the 60-percent long-term / 40-percent short-term split that results under current Regulation section 1.1223-3(b)(1).[288]

The proposal above would also obviate the need for any "special" rules within Regulation section 1.1223-3 regarding contributed section 751 assets[289] or inherent section 1245 recapture income in contributed section 1231 assets.[290] The modified fraction in Regulation section 1.1223-3(b)(1) would include only amounts of capital gain, in both the numerator and the denominator. Thus, ordinary-gain-producing assets would become irrelevant in the formula to divide a partnership-interest holding period. This change would eliminate the opportunity that currently exists—as Example 11 shows[291]—to manipulate the split-holding-period rules to a selling partner's benefit by switching the partner's would-be cash contribution to a contribution of section 751 assets with equivalent value.

For instance, under the proposed, reformulated Regulation section 1.1223-3(b)(1), the division of partner Roberta's holding period for her partnership interest would be exactly the same in Example 11 as in Example 8. Remember that, in Example 11, too, Roberta recognized $136,143 in capital gain on the sale of her interest, and $30,000 of that gain was attributable to the contributed land.[292] Therefore, just as in Example 8, Roberta's holding period for the land would tack to her holding period for $^{30,000}/_{136,143}$ (or approximately 22.036 percent) of her partnership interest. If the proposed change were adopted, Roberta would no longer be able to increase the portion of her partnership interest to which her holding period for the land tacks, simply by choosing to contribute $200,000 of inventory—rather than $200,000 in cash—in exchange for the remainder of her

[286] *See supra* text following note 173.
[287] *See supra* note 186 and accompanying text.
[288] *See supra* text accompanying notes 174-180.
[289] *See* Reg. 1.1223-3(b)(4); *see also supra* Part IV.C.3. (discussing same).
[290] *See* Reg. 1.1223-3(e); *see also supra* Part IV.C.4. (discussing same).
[291] *See supra* text accompanying notes 210-216 (Example 11).
[292] *See supra* text accompanying note 212.

interest.[293] In other words, substituting contributed section 751 assets for contributed cash would no longer enable Roberta to garner unwarranted long-term treatment of capital gain that she derives from a short-term investment in capital or section 1231 assets other than her contributed land. In short, under the proposal above, Roberta would pay a fairer share of tax on her gain from the short-term sale of her partnership interest.[294]

Rendering the "special" rules for section 751 assets and inherent section 1245 income superfluous would also help greatly to simplify and clarify the split-holding-period rules. Much of the complexity in the current rules arises from Regulation section 1.1223-3(b)(4) and Regulation section 1.1223-3(e).[295] The latter section, in particular, has been a demonstrable source of confusion for tax professionals.[296] Eliminating those complicated provisions would make Regulation section 1.1223-3 considerably easier to interpret and apply. Accordingly, in conjunction with the above-proposed revision to Regulation section 1.1223-3(b)(1), paragraphs (b)(4) and (e) of Regulation section 1.1223-3 should be repealed.

Lastly, there should also be a corresponding revision to Regulation section 1.1(h)-1.[297] If the split-holding-period rules were modified so that section 1223(1) creates long-term treatment only for capital gain attributable to a partner's contributed capital or section 1231 asset, application of the Regulation section 1.1(h)-1 look-though rule would need to be limited appropriately. Under the proposed rule, if there were a short-term sale of a partnership interest, the only portion of the selling partner's capital gain that would be proper to treat as look-through capital gain under Regulation section 1.1(h)-1 would be any collectibles gain or section 1250 capital gain that is attributable to a partnership asset that the partner had contributed in exchange for a portion of her interest.[298]

In Example 8, for instance, included within the $136,143 of capital gain that partner Roberta recognized on the sale of her partnership interest was, *inter alia*, $30,000 of capital gain attributable to the land that she had contributed and $6,143 of unrecaptured section 1250 gain attributable to the partnership's building.[299] As noted, under the above-proposed modification to Regulation section 1.1223-3(b)(1), only the $30,000 attributable to the land would be long-term. In such case, it would be inappropriate to treat $6,143 of that $30,000 as section 1250 capital gain pursuant to Regulation

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[293] *See supra* text following note 219.

[294] For the calculation of that "fairer" share of tax, see *supra* text accompanying note 277.

[295] *See supra* Part IV.C.3.-4.

[296] *See supra* Part IV.C.4.b.

[297] *See* Reg. § 1.1(h)-1; *see also supra* Part III.E. (discussing same).

[298] *See* Reg. § 1.1(h)-1(b)(1)-(3) (defining "look-through capital gain," "collectibles gain," and "section 1250 capital gain"); *see also supra* text accompanying notes 117-122 (discussing same).

[299] *See supra* text accompanying notes 186-189.

section 1.1(h)-1. To do so would be to overtax Roberta on $6,143 of her long-term capital gain, given that the underlying $6,143 of unrecaptured section 1250 gain was inherent in a partnership asset other than the land.[300]

If Regulation section 1.1223-3 is revised as suggested, then to prevent any such over-taxation, Regulation section 1.1(h)-1 should be amended to add a new paragraph (b)(4) that would provide as follows:

> (4) *Coordination with § 1.1223-3(a)(2).* In the case of a partnership interest asset with a divided holding period by operation of § 1.1223-3(a)(2), if such interest is disposed of in a taxable sale or exchange after being held for not more than one year, capital gain on such sale or exchange to be treated as look-through capital gain, as defined in paragraph (b)(1) of this section, shall be limited to look-through capital gain (if any) that is attributable to an asset contributed to the partnership by the transferor of the interest, as determined pursuant to § 1.751-1(a)(2).

VI. Conclusion

The split-holding-period rules under Regulation section 1.1223-3 have a legitimate purpose. In a nontaxable exchange in which a taxpayer's long-term capital gain on her transferred asset is deferred, section 1223(1) prevents the deferred gain from being recharacterized as short-term capital gain if the taxpayer sells the asset she received in the exchange within one year after the exchange. Section 1223(1) accomplishes this by causing the taxpayer's holding period for the transferred asset to tack to her holding period for the received asset in the exchange. In a case in which a taxpayer contributes a capital asset or a section 1231 asset to a partnership in return for part, but not all, of her interest in the partnership, there must some mechanism for determining the portion of the partnership interest to which the taxpayer's holding period for the contributed asset tacks under section 1223(1). Regulation section 1.1223-3 provides such a mechanism.

Unfortunately, however, the mechanism in the current iteration of Regulation section 1.1223-3 often does more than ensure continued long-term treatment of capital gain arising from a partner's contributed capital or section 1231 asset. In many cases in which the contributing partner sells her partnership interest within one year of the contribution, Regulation section 1.1223-3 causes section 1223(1) to apply in a way that converts short-term capital gain arising from *other* partnership assets to long-term capital gain. To the extent that Regulation section 1.1223-3 accords long-term treatment to short-term capital gain that is not attributable to the selling partner's

[300] If $6,143 of Roberta's long-term capital gain were treated as section 1250 capital gain, Roberta would be taxed at a 25-percent rate on such portion of that gain, instead of at the 0-percent, 15-percent, or 20-percent rate that should apply to such gain, depending on her total taxable income and total long-term capital gain for the year. *See supra* text accompanying and following note 189.

contributed asset, the Regulation provides the partner with an unwarranted tax windfall. In such a case, when the partner recognizes capital gain upon the sale of her interest within a year, she is taxed at preferential long-term rates on what really is short-term capital gain.

In an era in which long-term capital gains arguably are already undertaxed in relation to ordinary earned income, it is incumbent upon policymakers to eliminate tax loopholes for converting short-term capital gain to long-term capital gain. Regulation section 1.1223-3 currently provides such a loophole. It should be fixed.

In addition to its propensity for inequitable results, the current version of Regulation section 1.1223-3 is needlessly complex. Paragraphs (b)(4) and (e) of the Regulation—which deal with contributed section 751 assets and section 1245 recapture income inherent in contributed section 1231 assets, respectively—are particularly complicated and have proven to be confusing. Removing such complexities would make the split-holding-period rules much more workable or "user-friendly."

This Article proposes revisions to Regulation section 1.1223-3 that would eliminate both the inequities and the needless intricacies from the current split-holding-period rules. Most importantly, the proposed revisions would include a new formula in Regulation section 1.1223-3(b)(1) for calculating the portion of a partnership interest to which the partner's holding period for a contributed capital asset or section 1231 asset tacks under section 1223(1). The formula would provide that, if the partner sold her interest within one year of the contribution, the only portion of her recognized capital gain on the sale that could be treated as long-term would be the portion attributable to the contributed asset. Under the proposed formula, capital gain on a short-term sale of a partnership interest that derives from any partnership assets other than assets contributed by the selling partner would remain short-term capital gain, as it should.

Moreover, if the proposed reformulation of Regulation section 1.1223-3(b)(1) were implemented, paragraphs (b)(4) and (e) of Regulation section 1.1223-3 would become superfluous and could be repealed entirely. This would remove a prime source of complexity and confusion in the present Regulation.

In sum, the changes to Regulation section 1.1223-3 that this Article recommends would enable the split-holding-period rules to serve their legitimate purpose of preserving the character of any long-term capital gain on an asset that a partner contributes to her partnership in exchange for a portion of her partnership interest. At the same time, the suggested changes would prevent those rules from being misused to convert any other gain on a short-term sale of a partnership interest to long-term capital gain. In the process, the changes would also make Regulation section 1.1223-3 significantly easier to understand and implement. For these reasons, the recommended changes should be adopted.