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SECTION 197 AND PARTNERSHIP TRANSACTIONS

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SECTION 197 AND PARTNERSHIP TRANSACTIONS

PART ONE: INTRODUCTION

I. INTRODUCTION

- A. Enacted as part of the Omnibus Budget Reconciliation Act of 1993 (“OBRA of 1993”), section 197¹ governs the tax treatment of acquired intangible assets. Pub. L. No. 103-66, § 13261, 107 Stat. 312, 532.
- B. Section 197 comes into play whenever there is an allocation of consideration to an acquired amortizable section 197 intangible. In partnership transactions, the possibility of abuse arises upon the contribution of assets to a partnership, the transfer of an interest in a partnership, or the termination of a partnership.
- C. PART ONE of this Outline provides an introduction to section 197, as it relates to partnerships. PART TWO illustrates the application of section 197 in various partnership transactions.

II. SECTION 197

A. Application of Section 197

- 1. Section 197 and its 15-year amortization period apply to any "amortizable section 197 intangible."
- 2. Section 197(c) defines the term "amortizable section 197 intangible" as a section 197 intangible that is
 - a. acquired after the date of enactment of the statute (August 10, 1993), and
 - b. held in connection with the conduct of a trade or business or an activity described in section 212. See Treas. Reg. § 1.197-2(d)(1).
- 3. The term amortizable section 197 intangible does not include certain section 197 intangibles created by the taxpayer (self-created intangibles). See section 197(c)(2); Treas. Reg. § 1.197-2(d)(2)(i).
 - a. An intangible is self-created to the extent the taxpayer makes payments or otherwise incurs costs for its creation or improvement,

¹ All section references are to the Internal Revenue Code of 1986, as amended, (the “Code”) unless otherwise noted.

whether the actual work is done by the taxpayer or by another person under a contract with the taxpayer. Treas. Reg. § 1.197-2(d)(2)(ii).

b. The following self-created intangibles are excluded from the definition of amortizable section 197 intangibles:

- (i) goodwill;
- (ii) going concern value;
- (iii) workforce in place;
- (iv) information-based intangibles;
- (v) know-how intangibles;
- (vi) customer-based intangibles;
- (vii) supplier-based intangibles; and
- (viii) any similar items.

Section 197(c)(2), (d)(1).

c. The exception for self-created intangibles does not apply, however, if the intangible is created in connection with a transaction involving the acquisition of assets constituting a trade or business or a substantial portion thereof. Section 197(c)(2); see Treas. Reg. § 1.197-2(d)(2)(iii)(B). Thus, intangibles created in connection with such an acquisition will be treated as amortizable section 197 intangibles.

- (i) A group of assets constitutes a trade or business or a substantial portion thereof if their use would constitute a trade or business under section 1060 (that is, if goodwill or going concern value could, under any circumstances, attach to the assets). Treas. Reg. § 1.197-2(e)(1).
- (ii) Whether acquired assets constitute a "substantial portion" of a trade or business is based on all the relevant facts and circumstances. Treas. Reg. § 1.197-2(e)(4).

d. Pre-section 197 law continues to control the tax treatment of assets excluded from section 197.

B. Nonrecognition Transfers

1. If a section 197 intangible is acquired in a nonrecognition transaction (e.g., section 721 or 731), the transferee generally stands in the shoes of the transferor to the extent of the transferor's basis for purposes of section 197. See section 197(f)(2); Treas. Reg. § 1.197-2(g)(2).
2. To the extent the transferee's adjusted basis in a section 197 intangible acquired in a nonrecognition transaction exceeds the transferor's adjusted basis in the intangible, such portion of the intangible is treated in the same manner for purposes of section 197 as an intangible acquired from the transferor in a transaction other than a nonrecognition transaction (e.g., a section 1001 transaction). See Treas. Reg. § 1.197-2(g)(2).

C. Partnership Transactions

1. A transaction in which a taxpayer acquires an interest in a partnership that owns an intangible will be treated as an acquisition of a section 197 intangible only to the extent that the taxpayer obtains a basis greater than the partnership's basis for the asset. See section 197(f)(9)(E).
2. The acquiring partner will step into the shoes of the selling partner as to the remaining pre-existing basis in any such intangible owned by the partnership.
3. If a section 197 intangible is transferred or is deemed to be transferred due to a termination under section 708(b)(1)(B), the terminated partnership is treated as the transferor and the new partnership is treated as the transferee with respect to any section 197 intangible held by the terminated partnership immediately preceding the termination. Treas. Reg. § 1.197-2(g)(2)(iv).
4. Section 197 regulations provide rules for the application of sections 704(c)(1)(A), 732(b), 732(d), 734(b), and 743(b) to section 197. Treas. Reg. § 1.197-2(g)(3), (4); see also Treas. Reg. § 1.197-2(k) exs. 13-19.
 - a. In general, any increase in the adjusted basis of a section 197 intangible under sections 732(b) or 732(d) (relating to a partner's basis in distributed property), section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property after a distribution of property to a partner), or section 743(b) (relating to the optional adjustment to the basis of partnership property after the transfer of a partnership interest) is treated as a separate section 197 intangible acquired at the time of the transaction causing the basis increase. Treas. Reg. § 1.197-2(g)(3).

- b. Note: Prior to the American Jobs Creation Act of 2004 (the “AJCA of 2004”), Pub. L. No. 108-357 (Oct. 22, 2004), adjustments to the basis of partnership property pursuant to section 734(b) and section 743(b) occurred only if the partnership made a valid election under section 754. The AJCA of 2004 broadens the circumstances in which section 734(b) and 743(b) apply. In general, section 734(b) and section 743(b) will apply (i) to all relevant transactions (i.e., transfers of partnership interests and distributions of property) if the partnership has made a valid election under section 754 or (ii) on a transaction-by-transaction basis in the absence of such election if, with respect to a particular transaction, the adjusted bases of the partnership’s assets would have been decreased by more than \$250,000 if the partnership had made a valid election under section 754. See sections 734(b), (d) (defining a “substantial basis reduction”), 743(b), (d) (defining a “substantial built-in loss”). The section 197 regulations do not address the impact (if any) of the broadening of the circumstances in which section 734(b) and section 743(b) apply on section 197 intangibles held by a partnership.
- c. To the extent that an intangible was an amortizable section 197 intangible in the hands of the contributing partner, a partnership may make allocations of amortization deductions with respect to the intangible to all its partners under any of the permissible methods described in the regulations under section 704(c). Treas. Reg. §§ 1.197-2(g)(4), 1.704-3 (describing the traditional method, the traditional method with curative allocations, and the remedial allocation method); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (ruling that, when a partnership revalues a section 197 intangible pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) that is amortizable in the hands of the partnership, the partnership may make allocations (i.e., “reverse section 704(c) allocations”) of amortization deductions with respect to the built-in gain or loss from the revaluation to all its partners under any of the permissible methods described in Treas. Reg. § 1.704-3).
- d. To the extent that an intangible was not an amortizable section 197 intangible in the hands of the contributing partner, the intangible is not amortizable under section 197 by the partnership. However, if a partner contributes a section 197 intangible to a partnership and the partnership adopts the remedial allocation method for making section 704(c) allocations of amortization deductions, the partnership generally may make remedial allocations of amortization deductions with respect to the contributed section 197 intangible in accordance with Treas. Reg. § 1.704-3(d). Treas. Reg. § 1.197-2(g)(4); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (confirming that the same rules apply to reverse section 704(c)

allocations with respect to intangibles that were not amortizable in the hands of the partnership at the time of a revaluation of partnership assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f).

- e. Note: The AJCA of 2004 includes an additional rule under section 704(c) aimed at preventing the shift of a built-in loss in contributed property from a contributing partner to other partners. See section 704(c)(1)(C). Under the rule, such built-in loss may be taken into account only in determining the amount of items allocated to the contributing partner, and, except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution. Id. The section 197 regulations do not address the impact (if any) of this additional rule on section 197 intangibles contributed to a partnership.

D. Anti-Churning Rules

1. Extensive anti-churning rules are intended to prevent pre-existing non-amortizable intangibles from being converted into amortizable section 197 intangibles in transactions where effectively the user does not change or where the ownership of the intangible does not change. Unlike the proposed regulations, the final regulations expressly state this purpose of the anti-churning rules and provide that the rules are to be applied in a manner that carries out their purpose. Treas. Reg. § 1.197-2(h)(1)(ii). Broad anti-abuse rules disqualify any asset acquired in a transaction designed to avoid the anti-churning rules. See section 197(f)(9)(F); Treas. Reg. § 1.197-2(h)(11), -2(j).
2. An amortization deduction under section 197 may not be taken for an asset that, but for section 197, would not be amortizable (i.e., a “section 197(f)(9) intangible”²) if (1) it was acquired after August 10, 1993, and (2) either (i) the taxpayer or a related person held or used the intangible (or an interest therein) at any time on or after July 25, 1991 and on or before August 10, 1993 (the “Interim Period”), (ii) the intangible was acquired from a person that held the intangible at any time during the Interim Period and, as part of the transaction, the user of the intangible does not change, or (iii) the taxpayer grants the right to use the intangible to a person that held or used the intangible at any time during the Interim Period (or a person related to that person) and the grant of the right to use the intangible and the acquisition of the intangible by the taxpayer are part of a series of related transactions. See Treas. Reg. § 1.197-2(h)(2).

² The most common types of section 197(f)(9) intangibles are goodwill and going concern value. Treas. Reg. § 1.197-2(h)(1)(i).

3. The anti-churning rules do not apply to intangible assets that have generated deductions otherwise allowable under section 1253(d) (as in effect prior to the enactment of section 197) (i.e., franchises, trademarks, or trade names) or Treas. Reg. § 1.162-11 (i.e., certain leasehold interests). See Treas. Reg. § 1.197-2(h)(3).
4. The anti-churning rules do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a). Treas. Reg. § 1.197-2(h)(5)(i).
5. For purposes of the anti-churning rules, a person is related to another person if (i) the person bears a relationship to that person which would be specified in section 267(b) (and, by substitution, section 267(f)(1)) or 707(b)(1) if such sections were amended by substituting 20 percent for 50 percent, or (ii) the persons are engaged in trades or businesses under common control. See Treas. Reg. § 1.197-2(h)(6).
 - a. In case of single transaction, a person is treated as related to another person if such relationship exists immediately before or after the acquisition of the intangible. Treas. Reg. § 1.197-2(h)(6)(ii)(A).
 - b. The regulations provide that in the case of a series of related transactions (or a series of transactions that together comprise a qualified stock purchase under section 338), the relationship is tested immediately before the earliest transaction and immediately after the last transaction. Treas. Reg. § 1.197-2(h)(6)(ii)(B). For purposes of determining whether persons are related, transitory relationships are disregarded. Treas. Reg. § 1.197-2(h)(6)(iii).
6. In order to determine whether the anti-churning rules apply with respect to any increase in basis of partnership property under section 732, 734, or 743, determinations are made at the partner level and each partner is to be treated as having owned or used such partner's proportionate share of the partnership property. See section 197(f)(9)(E); Treas. Reg. § 1.197-2(h)(12)(i). In order to determine whether the anti-churning rules apply with respect to other transactions (e.g., section 721 or 1001 transactions), determinations generally are made at the partnership level. Treas. Reg. § 1.197-2(h)(12)(i).
 - a. The regulations provide that the anti-churning rules do not apply to an increase in basis of partnership property under section 732(d) (or section 743(b)) if the distributee partner, (or acquiring partner) was not related to the person transferring the partnership interest. See Treas. Reg. § 1.197-2(h)(12)(iii), (v).

- (i) Query whether the anti-churning rules do not apply to a section 743(b) basis increase if the acquirer owns more than a 20-percent interest in the partnership prior to the acquisition, and, if the anti-churning rules do not apply, whether such acquiring partner could be allowed to amortize goodwill such acquiring partner originally contributed to the partnership.
 - (ii) Discussions with officials from the Internal Revenue Service (the “Service”) indicate that an acquiring partner that already owns a greater than 20 percent interest in the partnership should be allowed to amortize all goodwill attributable to a section 743(b) adjustment, even if some of that goodwill was originally unamortizable and contributed by such acquiring partner to the partnership. However, such discussions also indicate that if the contribution of such unamortizable goodwill and the acquisition that results in the section 743(b) adjustment are part of a series of related transactions, the anti-churning rules will apply to deny amortization with respect to the goodwill contributed by the acquiring partner. It is unclear, however, how the regulations can be read to provide such an exception to the general rule that an acquiring partner may amortize goodwill attributable to a section 743(b) adjustment if such partner is not related to the selling partner.
- b. The Service issued proposed regulations on the treatment of basis adjustments under sections 732(b) and 734(b) in January 2000. In November 2000, the Service finalized the proposed regulations, with some modifications. T.D. 8907 (effective November 20, 2000).
 - (i) For purposes of applying the anti-churning rules to basis adjustments under section 732(b), the final regulations provide that the distributee partner is deemed to acquire the distributed intangible directly from the continuing partners. Treas. Reg. § 1.197-2(h)(12)(ii); Preamble, T.D. 8907. The regulations contain a favorable stacking rule that treats the distributee partner as acquiring the intangible first from the continuing partners for whom transfers would not be subject to the anti-churning rules. Treas. Reg. § 1.197-2(h)(12)(ii); Preamble, T.D. 8907.
 - (ii) Under the final regulations, the anti-churning rules generally do not apply to a continuing partner's share of a section 734(b) basis increase. Treas. Reg. § 1.197-2(h)(12)(iv).

- (a) A partner's share of a section 734(b) basis increase is equal to:
- i) The total basis increase under section 734(b) allocable to the intangible, multiplied by:
 - ii) the amount of the continuing partner's post-distribution capital account over the total amount of the post-distribution capital accounts of all continuing partners. Capital accounts are determined immediately after the distribution in accordance with the capital accounting rules of Treas. Reg. § 1.704-1(b)(2)(iv).
- (b) Note: The final regulations substantially changed the second part of this calculation. The proposed regulations focused on the unrealized appreciation from the intangible that would have been allocated to the continuing partner if the partnership had sold the intangible immediately before the distribution. That yielded incorrect results, because in many situations all of the unrealized appreciation would be allocated to the noncontinuing partner.
- (iii) If a distribution that results in a section 734(b) adjustment is undertaken as part of a series of related transactions that include a contribution of the intangible to the partnership by the continuing partner, the anti-churning rules will apply to deny amortization for the continuing partner with respect to the section 734(b) adjustment to the contributed intangible. Treas. Reg. § 1.197-2(h)(12)(iv)(E)(2).
- c. The final regulations address the situation where a partner is or becomes a user of a partnership intangible. If an “anti-churning partner” (or a related person other than the partnership) becomes (or remains) a direct user of an intangible that is treated as transferred in the transaction (as a result of the partners being treated as having owned their proportionate share of partnership assets), the anti-churning rules apply to the “anti-churning partner’s” proportionate share of such intangible. Treas. Reg. § 1.197-2(h)(12)(vi)(A).
- (i) The anti-churning partner is generally a partner that acquired an interest in the partnership on or before August 10, 1993 (with respect to intangibles held by the partnership on or before that date), or a partner that

acquired an interest in the partnership on or before the date the partnership acquired an intangible subject to the anti-churning rules that is not amortizable with respect to the partnership (with respect to intangibles acquired after August 10, 1993). Treas. Reg. § 1.197-2(h)(12)(vi)(B).

- (ii) For example, assume that A and B form a partnership. A transfers a non-amortizable section 197 intangible in exchange for a 60-percent interest, and B transfers cash in exchange for a 40-percent interest. A licenses the intangible from the partnership. The partnership makes a section 754 election. A subsequently sells its interest to unrelated C. Ordinarily, the anti-churning rules would not apply to an increase in the basis of partnership property under section 743(b). However, because A is an anti-churning partner that remains a user of the intangible, the anti-churning rules will apply. See Treas. Reg. § 1.197-2(k) ex. 27.

d. Curative and remedial allocations under section 704(c)

- (i) Under the final regulations, where the intangible is amortizable by the contributing partner, the anti-churning rules do not apply to the curative or remedial allocations of amortization deductions with respect to the intangible. Treas. Reg. § 1.197-2(h)(5)(ii), -2(h)(12)(vii)(A); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (ruling that similar rules apply to reverse section 704(c) allocations of amortization deductions attributable to section 197 intangibles that are revalued by a partnership pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f)).
- (ii) Where the intangible is nonamortizable by the contributing partner, the final regulations do not permit curative allocations. However, the regulations do allow remedial allocations of amortization under section 704(c), unless the noncontributing partner is related to the partner that contributed the intangible or, as part of a series of related transactions that includes the contribution of the intangible to the partnership, the contributing partner or a related person (other than the partnership) becomes or remains a direct user of the contributed intangible. Treas. Reg. § 1.197-2(h)(12)(vii)(B); see also Rev. Rul. 2004-49, 2004-21 I.R.B. 1 (ruling that similar rules apply to reverse section 704(c) allocations of amortization deductions attributable to section 197 intangibles that are revalued by a partnership pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f)).

(iii) Note: The final regulations permit remedial allocations and not curative allocations, because, under section 704(c), remedial allocations treat the amortizable portion of contributed property like newly purchased property with a new holding period and determinable allocation of tax items. See Preamble, T.D. 8865. However, curative allocations are not determined as if the applicable property were newly purchased property. Id.

7. The application of the anti-churning rules to any section 197 intangible is limited if (i) the intangible is acquired from a person with generally a less than 50 percent relationship to the acquirer, (ii) the seller elects to recognize gain on the disposition of the intangible, and (iii) the seller agrees, notwithstanding any other provision of the Code, to pay a tax on such gain which, when added to any other Federal income tax imposed on such gain, equals the product of the gain and the highest rate of tax imposed by the Code on such seller. Treas. Reg. § 1.197-2(h)(9). The anti-churning rules will continue to apply to such an intangible only to the extent the acquiring taxpayer's basis in the intangible exceeds the gain recognized by the seller. Id.

a. The proposed regulations did not prescribe procedures for making the election. The final regulations provide such guidance. Treas. Reg. § 1.197-2(h)(9)(iii).

8. A section 197(f)(9) intangible acquired by a taxpayer after the applicable effective date (i.e., August 10, 1993) does not qualify for amortization under section 197 if one of the principal purposes of the transaction in which it is acquired is to avoid the operation of the anti-churning rules. A transaction will be presumed to have a principal purpose of avoidance if it does not effect a significant change in the ownership or use of the intangible. Treas. Reg. § 1.197-2(h)(11).

E. General Anti-Abuse Rule

1. Any section 197 intangible acquired by a taxpayer from another person is subject to a general anti-abuse rule. Under this rule, a section 197 intangible may not be amortized if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (i) avoid the effective date of section 197 or (ii) avoid any of the anti-churning rules described above. Section 197(f)(9)(F). The regulations permit the Service to "recast" a transaction as appropriate to achieve tax results consistent with the purpose of section 197. Treas. Reg. § 1.197-2(j).

F. Retroactive Election

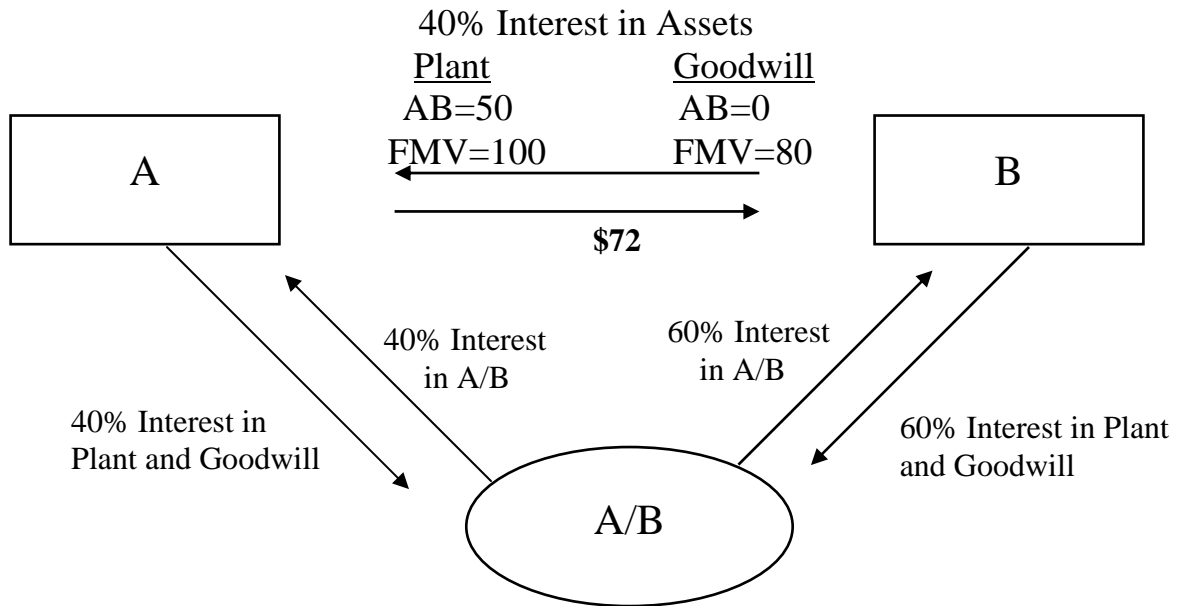
1. Section 13261(g)(2) of OBRA of 1993 generally provides that a taxpayer may elect to apply section 197 to property acquired by the taxpayer after July 25, 1991 and on or before August 10, 1993 (i.e., the retroactive election). Pursuant to this election, a section 197 intangible can be an amortizable section 197 intangible if the taxpayer acquires it after July 25, 1991 (rather than only after August 10, 1993). Furthermore, with respect to property acquired by the taxpayer on or before August 10, 1993, only holding or use of such property on July 25, 1991 shall be taken into account in applying the anti-churning rules. See also Temp. Treas. Reg. § 1.197-1T.
 - a. Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property upon a transfer of a partnership interest) will be taken into account under section 197 by a partner as if the increased portion of the basis were attributable to the partner's acquisition of the underlying partnership property on the date the distribution or transfer occurs. For example, if a section 754 election is in effect and, as a result of its acquisition of a partnership interest, a taxpayer obtains an increased basis in an intangible held through the partnership, the increased portion of the basis in the intangible will be treated as an intangible asset newly acquired by that taxpayer on the date of the transaction. Temp. Treas. Reg. § 1.197-1T(b)(8).
 - b. If property is transferred in a nonrecognition transaction (e.g., section 721 or section 731) and the property was subject to a retroactive election in the hands of the transferor, the property remains subject to the retroactive election with respect to so much of its adjusted basis in the hands of the transferee as does not exceed its adjusted basis in the hands of the transferor. However, the transferee is not required to make a retroactive election for any other property it owns. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(A).
 - c. If property is transferred in a nonrecognition transaction and the transferee makes a retroactive election, the transferor is not required to apply the retroactive election rules to any of its property. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(B).
 - d. For purposes of determining whether a taxpayer "acquired" property after July 25, 1991 and on or before August 10, 1993, property (other than exchanged basis property) acquired in a nonrecognition transaction generally is treated as acquired when the transferor acquired (or was treated as acquiring) the property (or predecessor property). However, if the adjusted basis of the

property in the hands of the transferee exceeds the adjusted basis of the property in the hands of the transferor, the property is treated as acquired at the time of the transfer to the extent of that excess basis. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(E).

- e. In case of an intangible held by a partnership that is eligible for a retroactive election, the partnership must make the election generally. However, in case of an increase in basis of such an intangible due to a section 754 election that is treated as a newly acquired intangible by a particular partner under Temp. Treas. Reg. § 1.197-1T(b)(8), only that partner can make the election. Temp. Treas. Reg. § 1.197-1T(c)(2). Notice 94-41, 1994-1 C.B. 353, changes this rule with respect to section 734(b) basis adjustments. Only the partnership is eligible to make a retroactive election with respect to a basis increase under section 734(b).
 - f. In general, a retroactive election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the taxable year that includes August 10, 1993. If, however, the taxpayer's original Federal income tax return for the taxable year that includes August 10, 1993, is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i).
2. Note: The Small Business Job Protection Act of 1996 ("Small Business Act"), Pub. L. No. 104-188, § 1703(l), 110 Stat. 1755, 1877, clarified that, if a taxpayer and related parties make an election to apply the amortization rules to acquisitions after July 25, 1991, "the anti-churning rules do not apply when property acquired from an unrelated party after July 25, 1991 (and not subject to the anti-churning rules in the hands of the acquiring party) is transferred to a taxpayer related to the acquirer [after August 10, 1993]." H. Rep. No. 104-586 (May 23, 1996); see also Small Business Act, § 1703(l).
 3. International trademarks reacquired by a corporation are not subject to the anti-churning rules and are amortizable intangibles. See P.L.R. 9630015 (Apr. 26, 1996) (ruling that trademarks sold to an unrelated buyer and later reacquired from such buyer's subsidiary, after the seller had itself been acquired by the buyer were amortizable intangibles).

PART TWO: EXAMPLES

I. Transfer of Interest in Assets Followed by Partnership Formation



A. Assume

1. All assets acquired by B before July 25, 1991.
2. A and B are unrelated prior to formation of A/B.

B. Steps

1. A purchases from B a 40% interest in plant and goodwill on January 1, 1993.
2. A and B contribute their interests in plant and goodwill to A/B on January 1, 1997.

C. Consequences

1. No Retroactive Election. If A has not made the retroactive election, A will not be allowed amortization deductions with respect to the goodwill in the hands of A, because A acquired the goodwill on or before August 10, 1993. Treas. Reg. § 1.197-2(d)(1). However, a question arises as to whether A may amortize the goodwill through A/B after the transfer to A/B in 1997.³ If A has not made the retroactive election described below, although A has a cost basis in the contributed assets, A will be denied amortization with respect to the goodwill because it was held by B prior to August 10, 1993 and B is "related" to A/B for purposes of applying the anti-churning rules. Section 197(f)(9)(C); Treas. Reg. § 1.197-2(h)(6), -2(k) ex. 18. The determination of relatedness is not made at the partner level since A did not get its step-up under section 732, 734, or 743. See section 197(f)(9)(E).
 - a. The result would be the same if B transferred goodwill to A/B in a sale transaction or a disguised sale under section 707(a)(2)(B). Because A gets its share of the partnership's cost basis under section 1012, and not section 732, 734 or 743, the determination of relatedness for purposes of the anti-churning rules is made at the partnership level. See section 197(f)(9)(E); Treas. Reg. § 1.197-2(k) ex. 17.
 - b. Note also that B cannot make the gain recognition election out of the anti-churning rules because it owns 60% of A/B. See section 197(f)(9)(B); Treas. Reg. § 1.197-2(h)(9).
2. Retroactive Election Made. If A has made a retroactive election to apply section 197 to all intangible assets acquired after July 25, 1991 and on or before August 10, 1993, (i) A will be allowed amortization deductions with respect to the goodwill in the hands of A, (ii) the anti-churning rules will not apply, and (iii) A will continue to be allowed amortization deductions with respect to the goodwill in the hands of A/B. Small Business Act, § 1703(l); H. Rep. No. 104-586; see also Treas. Reg. § 1.197-2(d)(1), (h)(1)(ii).
 - a. The Small Business Act clarified that, if a taxpayer and its related parties make the retroactive election, the anti-churning rules will not apply when property acquired from an unrelated party after July 25, 1991 is transferred to a taxpayer related to the acquirer after August 10, 1993. H. Rep. No. 104-586. The effect of this new provision is questionable, as it was enacted in 1996, well after the last date A is allowed to make the retroactive election (i.e., A

³ B may not amortize any portion of the goodwill through A/B under the nonrecognition transfer rule of Treas. Reg. § 1.197-2(g)(2). See Treas. Reg. § 1.197-2(k) ex. 18.

must make the election by the due date (including extensions) of A's tax return that includes August 8, 1993).⁴ Treas. Reg. § 1.197-1T(c)(3). If A has not made a retroactive election in time, the rules in section I.C.1., supra, apply.

- b. If property is transferred in a transaction described in section 721 or 731, and the retroactive election is made by the transferor, the property remains subject to section 197 in the hands of the transferee to the extent of the basis of the property in the hands of the transferor.⁵ Treas. Reg. § 1.197-1T(c)(1)(iv). Thus, section 197 will apply to the goodwill transferred to A/B to the extent of A's basis, but appreciation from the time A received the goodwill from B to the time A transferred it to A/B will not be subject to section 197 unless A/B, too, has made a retroactive election.⁶
- c. This rule applies as long as A acquired the goodwill from B after July 25, 1991, and transferred the goodwill to A/B after August 10, 1993.⁷

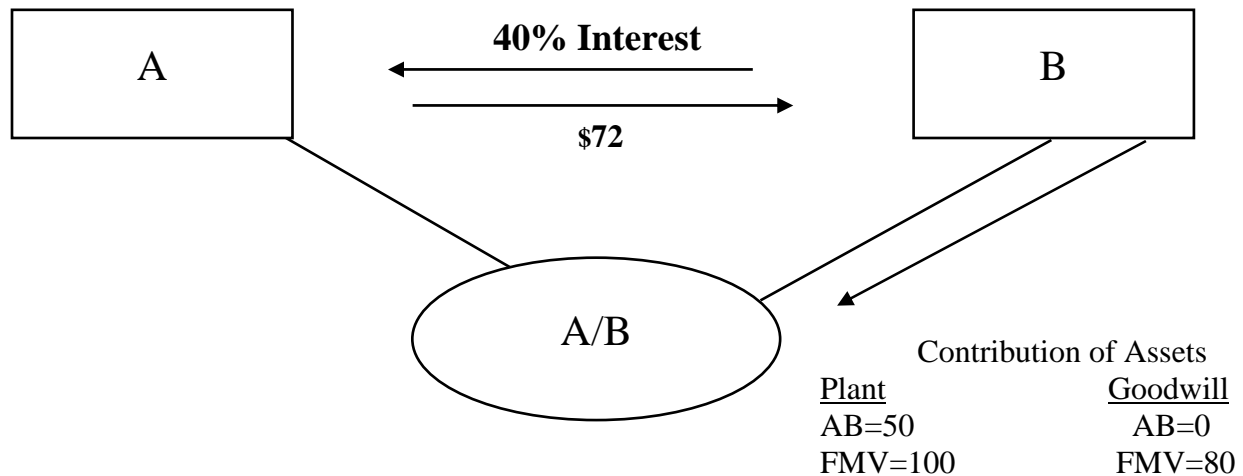
⁴ If A's tax return is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i).

⁵ The transferee does not have to make the retroactive election and, thus, does not have to apply section 197 to any other property it owns from July 25, 1991 to August 10, 1993. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(A).

⁶ Obviously, if A/B does not exist until 12/31/96, it cannot make the retroactive election. See section I.C.2.a., supra.

⁷ A must be "related" to A/B in order for this rule to apply.

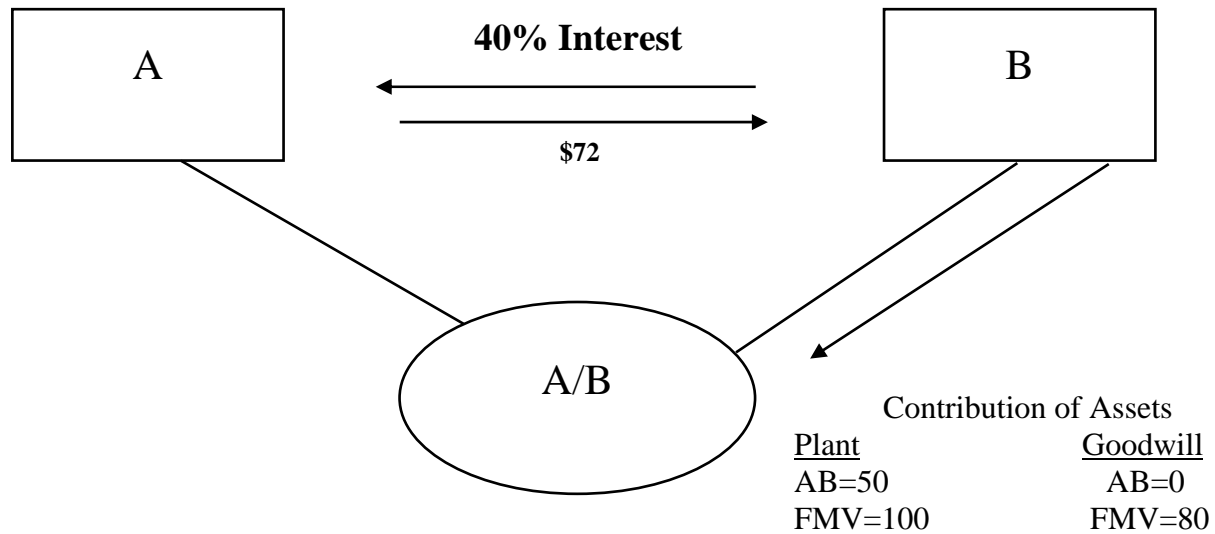
II. Transfer of Partnership Interest: No Section 754 Election



- A. Assume
1. All assets acquired by B prior to August 10, 1993.
 2. A and B are unrelated prior to formation of A/B.
- B. Steps
1. B and accommodation partner (not shown) contribute assets to A/B.
 2. A purchases from B 40% interest in A/B.
- C. Consequences
1. No goodwill amortization. The acquisition of all of the goodwill by A/B is disregarded for purposes of determining when A/B “acquired” the goodwill. See Treas. Reg. § 1.197-2(g)(2)(ii) (nonrecognition transaction rule); Treas. Reg. § 1.197-2(g)(3) (no section 754 election). The goodwill is treated as being acquired by A/B prior to August 10, 1993. Accordingly, the goodwill is not an amortizable section 197 intangible in the hands of A/B, absent a retroactive election. See Treas. Reg. § 1.197-2(d); see also Treas. Reg. § 1.197-2(k) exs. 13, 16.

2. Assume B had a 10 basis in the goodwill. If there is no section 754 election in effect, A steps into the shoes of B and receives no amortization deductions. See Treas. Reg. § 1.197-2(k) ex. 13.

III. Transfer of Partnership Interest: Section 754 Election Made

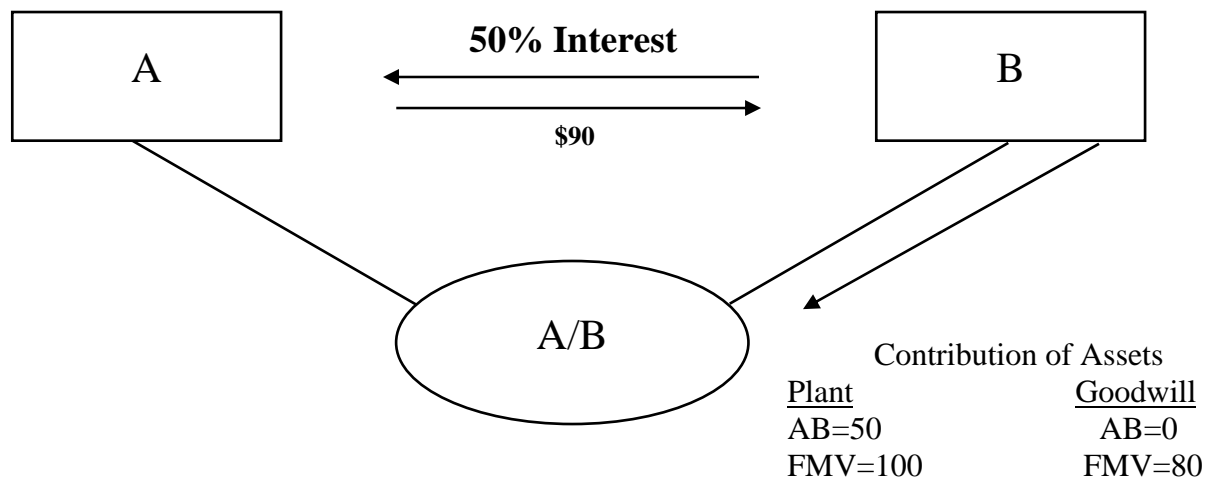


- A. Assume
1. All assets acquired by B prior to August 10, 1993.
 2. A and B are unrelated prior to formation of A/B.
- B. Steps
1. B and accommodation partner (not shown) contribute assets to A/B.
 2. A purchases from B 40% interest in A/B.
 3. A/B makes section 754 election.
- C. Consequences
1. Due to the section 754 election, A/B's adjusted basis in its assets with respect to A is increased by \$52 (i.e., \$72 - \$20) under section 743, \$32 of which is allocated to A's proportionate interest in goodwill (since A would be allocated \$32 of gain attributable to the goodwill upon a hypothetical sale of all of A/B's assets for their fair market value). See Treas. Reg. §§ 1.743-1, 1.755-1(b).⁸

⁸ On June 6, 2003, the Service issued final regulations under section 755 that replace Temp. Treas. Reg. § 1.755-2T and that provide rules for determining the value of section 197 intangibles (and goodwill and going concern value that would not qualify as section 197

2. With regard to the goodwill, A is treated as if A/B owned two assets. See Treas. Reg. § 1.197-2(g)(3), -2(k) exs. 16, 19. For one asset, A's share of A/B's adjusted basis is the same as B's share (i.e., \$0). Thus, no amortization is allowed for the asset. For the other asset, A's proportionate share of the newly adjusted basis of A/B's goodwill due to the section 743 adjustment (i.e., \$32) is amortized over a 15 year period. Thus, A is entitled to allocations of amortization deductions equal to the \$32 basis increase attributable to the goodwill over a 15-year period.

IV. Partnership Termination



- A. Assume
1. All assets acquired by B prior to August 10, 1993
 2. A and B are unrelated prior to formation of A/B
- B. Steps
1. B and accommodation partner (not shown) contribute assets to A/B.
 2. A purchases from B 50% interest in A/B.
- C. Consequences
1. Acquisition of 50% interest terminates A/B. This causes a deemed contribution of its assets to a new partnership in exchange for an interest in the new partnership, and an immediate distribution of such interest in the new partnership to A and B pro rata, in liquidation of the terminated

intangibles) using the residual method of allocation as required by section 1060(d). These regulations are discussed below in greater detail at section V.B.

partnership. Treas. Reg. § 1.708-1(b)(1)(iv) (applying to terminations on or after May 9, 1997, or if treated consistently, May 9, 1996).

2. A takes the distributed partnership interest with a basis of \$90, equal to its basis in its A/B interest. Section 732(b).
 - a. Prior to the amendment of Treas. Reg. § 1.708-1(b)(1)(iv) in 1997, the acquisition of the 50% interest terminated A/B, causing a deemed distribution of its assets pro rata to A and B, who were deemed to recontribute the assets to A/B. See Old Treas. Reg. § 1.708-1(b)(1)(iv); T.D. 8717, 1997-1 C.B. 125 (amending Treas. Reg. § 1.708-1(b)(1)(iv)). Under the old rules, A took the distributed assets with an aggregate basis of \$90. Assuming no distribution of inventory or receivables, the basis was allocated to the assets in proportion to their bases in the hands of the partnership. Section 732(c). Thus, with respect to A's interest in A/B after the assets are recontributed, the plant had a basis of \$90 and the goodwill had a basis of \$0. If the plant had a depreciable life of greater than 15 years, benefits were lost as a result of this allocation.
3. If A/B makes a section 754 election, A's aggregate basis step-up of \$65 (\$90 - \$25) is allocated by dividing the partnership's assets into 2 classes: (a) capital assets and section 1231 assets, and (b) all other assets. Treas. Reg. §§ 1.743-1, 1.755-1(b). The basis adjustment is allocated between the two classes (and among the assets within the two classes) based upon the amount of income, gain, or loss with respect to each class (and with respect to each asset within a class) that the transferee partner would be allocated if, immediately after the transfer, all of the partnership's assets were disposed of in a taxable transaction at fair market value. Treas. Reg. § 1.755-1(b); see *infra* at section V.B.3.f. (discussing recently finalized regulations that provide rules for determining the fair market value of section 197 intangibles for purposes of allocating basis adjustments under sections 743(b) and 734(b)). In this example, since A would be allocated \$40 of gain attributable to the goodwill and \$25 of gain attributable to the plant in a hypothetical sale of all of A/B's assets for their fair market value, the \$65 of step-up is allocated \$40 to the goodwill and \$25 to the plant. See Treas. Reg. § 1.755-1(b).
4. As noted in the example in section III., *supra*, with respect to the goodwill held by A/B, A is treated as if A/B owns two assets. See Treas. Reg. § 1.197-2(g)(3), -2(k) exs. 16, 19. For one asset, A's share of A/B's adjusted basis is the same as B's share (i.e., \$0). Thus, no amortization is allowed for the asset. For the other asset, A's proportionate share of the newly adjusted basis of A/B's goodwill due to the above adjustment (i.e., \$40) is amortized over a 15-year period. Thus, A is entitled to receive allocations

of amortization deductions equal to the \$40 basis increase attributable to the goodwill over a 15-year period.

5. Note: A section 732(d) election cannot be made in this situation after the amendment to Treas. Reg. § 1.708-1(b)(1)(iv) in 1997, because the property deemed to be distributed to the partner under the new regulation is an interest in a new partnership rather than assets held by a partnership. Thus, the new regulations eliminate partners' ability to use the section 732(d) election as a backstop to the partnership's failure to make a section 754 election.
6. Note: A risk exists that the transfer of a partnership interest that terminates the partnership will be recharacterized as a transfer of assets by B to A, followed by contributions to A/B, as in the example in section I. See McCauslin v. Commissioner, 45 T.C. 588 (1966) (purchase of all partnership interests, terminating partnership, recast as purchase of partnership assets); Rev. Rul. 99-6, 1999-1 C.B. 432 (ruling same with respect to two transactions that are factually similar to that in McCauslin).

V. Transfers of Partnership Interests

A. No Section 754 Election

1. Partnership AB was formed by individuals A and B. A contributed a depreciable business asset with a value of \$300 and basis of \$400,⁹ and self-generated goodwill (i.e., zero basis) valued at \$150 to AB in exchange for a 75 percent interest in AB. B contributed \$150 to AB in exchange for a 25 percent interest in AB.
2. A sells one-third of his interest in AB (a 25 percent interest) to C for \$150.¹⁰ No section 754 election is made and an adjustment to AB's assets is not otherwise required under section 743(b) and (d). C's basis in his partnership interest is \$150.
3. Section 1060 does not apply to this transaction. Amortization of the goodwill is not allowed. See section 197(c)(2), (f)(2).

B. Section 754 Election Made

⁹ Section 704(c)(1)(C) applies to this asset, because its basis exceeds its value at the time of its contribution to AB.

¹⁰ Although C acquires one-third of A's interest in AB, it appears that C is not treated as acquiring any portion of A's section 704(c) built-in loss attributable to the depreciable business asset. See section 704(c)(1)(C). But see Treas. Reg. § 1.704-3(a)(7) (apparently invalid now to the extent inconsistent with section 704(c)(1)(C)).

1. Same facts as in the example in section V.A.1., supra, except that AB has made an election under section 754.
2. Section 743 provides that the basis of partnership property is to be adjusted in the event of a transfer of a partnership interest where a section 754 election has been made or, in the absence of a section 754 election, in the event of a transfer of a partnership interest where the aggregate adjusted basis of all partnership property exceeds the aggregate fair market value of such property by more than \$250,000.
 - a. The partnership increases (and/or decreases) its "inside basis" in its assets to reflect the transferee's basis in the partnership interest.
 - b. The basis adjustments are made only with respect to the transferee partner. Section 743(b).
 - c. The aggregate basis adjustment is the difference between the transferee's basis for the transferred partnership interest and the transferee's share of the inside basis of partnership property. Treas. Reg. § 1.743-1(b).
 - (i) The transferee's share of the inside basis of partnership property is equal to the sum of (i) the transferee's interest as a partner in the partnership's previously taxed capital and (ii) the transferee's share of partnership liabilities. Treas. Reg. § 1.743-1(d).
 - (ii) A transferee's interest as a partner in the partnership's previously taxed capital is equal to (i) the amount of cash that the transferee would receive on liquidation of the partnership following a hypothetical sale (immediately after the transfer of the partnership interest to the transferee) of the partnership's assets in a fully taxable transaction for cash equal to the fair market value of the assets (the "hypothetical transaction"), (ii) increased by the amount of tax loss that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest), (iii) decreased by the amount of tax gain that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest). Id.
 - d. In this case, without considering the potential effect of section 704(c)(1)(C), there will be an aggregate basis adjustment of \$16.67 as a result of C's purchase of a 25 percent interest in AB. C's basis for its transferred interest is \$150 under sections 742 and 1012. C's share of the inside basis of AB's assets is \$133.33 under Treas.

Reg. § 1.743-1(d) (i.e., \$150 cash receipt on deemed liquidation after hypothetical transaction plus \$33.33 allocable tax loss from depreciable business asset less \$50 allocable tax gain from the goodwill).

- e. The determination of C's share of the inside basis of AB's assets has become uncertain as a result of the enactment of section 704(c)(1)(C). In particular, the determination of C's interest as a partner in the partnership's previously taxed capital has become uncertain. Without considering section 704(c)(1)(C), \$33.33 of the tax loss attributable to the depreciable business asset from the hypothetical transaction is taken into account for this purpose. However, it appears that, pursuant to section 704(c)(1)(C), \$0 of such tax loss is now taken into account, because the inside basis of the depreciable business asset is treated as \$300 (rather than \$400) for purposes of determining how much gain or loss is allocable to C from the hypothetical disposition of such asset. As a result, it appears that C's share of the inside basis of AB's assets is now \$100 (i.e., \$150 cash receipt on deemed liquidation after hypothetical transaction plus \$0 allocable tax loss from depreciable business asset less \$50 allocable tax gain from the goodwill). Accordingly, it appears that C's aggregate basis adjustment under section 743(b) is \$50 (rather than \$16.67).

3. The aggregate basis adjustment under section 743(b) then is allocated among the individual items of partnership property under section 755. Treas. Reg. § 1.743-1(e). The first step in allocating such adjustment is to determine the value of each item of partnership property. Treas. Reg. § 1.755-1(a)(1). Section 1060(d) provides that the allocation rules of section 1060(a) must be applied to determine the fair market value of any section 197 intangibles held by a partnership for purposes of applying section 755. Note, however, that the allocation of any basis adjustment under section 755 among the assets of a partnership is governed by Treas. Reg. § 1.755-1 rather than by section 1060.

- a. Under Treas. Reg. § 1.755-1, for purposes of allocating a section 743(b) aggregate basis adjustment among partnership assets, the partnership's assets are divided into two classes -- (a) capital assets and section 1231 assets, and (b) all other assets (i.e., ordinary income assets). Treas. Reg. § 1.755-1(a)(1), (b).
- b. The aggregate section 743(b) basis adjustment is allocated between these two classes. Within each class, the allocated basis adjustment is then further allocated among the assets of the class. Treas. Reg. § 1.755-1(a)(1), (b).

- c. Regulations under section 755 provide for allocations of basis adjustments under section 743 (between the two classes and then among the assets within each class) based on the amount of income, gain, or loss that the transferee partner would be allocated if, immediately after the section 743(b) transfer, all of the partnership's assets were disposed of in a taxable transaction at “fair market value.” See Treas. Reg. § 1.755-1(b)(1)(ii).
 - (i) The allocation of the section 743(b) aggregate basis adjustment under section 755 has become uncertain as a result of the enactment of section 704(c)(1)(C). It appears that, with respect to each partnership property with a section 704(c) built-in loss, allocations of loss attributable to such property to a transferee partner that is not otherwise the contributing partner will be made under the assumption that such property’s adjusted basis equaled such property’s fair market value at the time of its original contribution to the partnership (i.e., none of the section 704(c) built-in loss apparently will be allocable to noncontributing transferee partners). See section 704(c)(1)(C)(ii).
- d. For purposes of applying these allocation rules and to carry out the intent of section 1060(d), recently finalized regulations under section 755 provide rules for determining the “fair market value” of a partnership’s “section 197 intangibles,” which is defined for purposes of section 755 to include all section 197 intangibles plus goodwill and going concern value that does not qualify under section 197(d) as a section 197 intangible. Treas. Reg. § 1.755-1; T.D. 9059 (June 6, 2003). These regulations replace Temp. Treas. Reg. § 1.755-2T and modify portions of Treas. Reg. § 1.755-1 as it existed prior to June 6, 2003.
- e. The final regulations are generally effective for transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999; however, subsections 1.755-1(a) and 1.755-1(b)(3)(iii) of the new final regulations are effective for transfers of partnership interests and distributions of property from a partnership that occur on or after June 6, 2003.
- f. Under the final regulations, partnerships must determine the “fair market value” of section 197 intangibles (including goodwill and going concern value that do not qualify as section 197 intangibles) for purposes of allocating basis adjustments under section 743(b) as follows:

- (i) First, the partnership must determine the aggregate fair market value of all partnership assets, excluding section 197 intangibles. Treas. Reg. § 1.755-1(a)(3).
 - (ii) Second, the partnership must determine the amount that, if assigned to all partnership property, would allow the transferee-partner to receive in a liquidating distribution an amount equal to the transferee's basis in his partnership interest, minus the basis attributable to partnership liabilities (the "partnership gross value"). Treas. Reg. § 1.755-1(a)(4)(i)(A).
 - (iii) Third, compare the aggregate value of the partnership assets (excluding section 197 intangibles) with the partnership gross value.
 - (a) If the aggregate value of the partnership assets (excluding section 197 intangibles) equals or exceeds the partnership gross value, the section 197 intangibles are deemed to have a "fair market value" of zero.
 - (b) If the partnership gross value exceeds the aggregate value of the partnership assets (excluding section 197 intangibles), such excess is the "fair market value" of the section 197 intangibles. Treas. Reg. § 1.755-1(a)(5).
 - (iv) To the extent that the section 197 intangibles have a positive "fair market value," this value generally is allocated among the partnership's various section 197 intangibles as follows:
 - (a) first, to section 197 intangibles (other than goodwill and going concern value) up to their respective fair market values;
 - (b) second, to goodwill and going concern value. Id.; see generally Treas. Reg. § 1.755-1(a)(2).
4. Under the new final regulations, the value of partnership AB's section 197 intangibles (i.e., the goodwill) is determined as follows:
- a. The aggregate value of the partnership assets (excluding section 197 intangibles) is \$450 (\$300 depreciable asset plus the \$150 cash);

- b. The partnership gross value is \$600 (the amount that the partnership must be worth in order for C to receive a liquidating distribution equal to his \$150 outside basis);
- c. The “fair market value” of the partnership’s section 197 intangibles (i.e., the goodwill) is \$150 (\$600 partnership gross value minus the \$450 aggregate value of the partnership’s assets, excluding section 197 intangibles);
- d. This \$150 of section 197 intangible “fair market value” is allocated entirely to the goodwill.
5. Without considering the effect of section 704(c)(1)(C), the \$16.67 aggregate basis adjustment in the partnership's assets (with respect to C) is allocated in accordance with C’s distributive share of income, gain, or loss from the hypothetical sale transaction in Treas. Reg. § 1.755-1(b)(1)(ii). Since C would be allocated \$50.00 of gain from the hypothetical sale of the goodwill pursuant to section 704(c)(1)(A) and \$33.33 of loss from the sale of the depreciable business asset pursuant to section 704(c)(1)(A), a \$50.00 upward basis adjustment is made to AB’s goodwill (only with respect to C) and a \$33.33 downward basis adjustment is made to AB’s depreciable business asset (only with respect to C). See also Treas. Reg. § 1.755-1(b)(2)(ii) exs. 1, 2, -1(b)(3)(iv) exs. 1, 2.

- a. The partnership's basis in its assets (with respect to C) is thus:

Cash	\$37.50
Depreciable Asset	66.66
Goodwill	50.00

- b. Under these facts, the section 743(b) basis adjustment to the goodwill is treated as a separate asset acquired by AB on the date C purchased its interest in AB, and, therefore, that separate asset is treated as an amortizable section 197 intangible the basis of which (i.e., \$50) is amortized over 15 years (but only with respect to C). See Treas. Reg. § 1.197-2(g)(3), -2(k) ex. 19.
6. Had C purchased directly a 25 percent interest in the assets of AB for \$150, consideration (and thus basis) would have been allocated under section 1060 and would have been:

Cash	\$37.50
Depreciable Asset	75.00
Goodwill	37.50

See Treas. Reg. §§ 1.338-6, 1.1060-1(c).

7. Taking section 704(c)(1)(C) into account, it appears that the aggregate basis adjustment in the partnership's assets (with respect to C only) is \$50. Such amount is allocated in accordance with C's distributive share of income, gain, or loss from the hypothetical sale transaction in Treas. Reg. § 1.755-1(b)(1)(ii). C's distributive share of income, gain, or loss from the goodwill is unaffected by section 704(c)(1)(C), because the goodwill had no built-in loss at the time of its contribution to AB. However, C's distributive share of income, gain, or loss from the depreciable business asset is affected by section 704(c)(1)(C), because such asset had a built-in loss at the time of its contribution to AB. For purposes of determining C's distributive share of income, gain, or loss from the depreciable business asset, it appears that the inside basis of the depreciable business asset should be treated as \$300 at the time of such asset's contribution. Thus, assuming that there were no adjustments to the inside basis of the depreciable business asset from the time of contribution to the time of A's sale to C, there is no gain or loss allocable to C attributable to the depreciable business asset in the hypothetical asset sale under Treas. Reg. § 1.755-1(b)(1)(ii). Thus, it appears that C will continue to be allocated \$50.00 of gain from the hypothetical sale of the goodwill pursuant to section 704(c)(1)(A) but will be allocated \$0 of loss from the sale of the depreciable business asset pursuant to section 704(c)(1)(C). Accordingly, it appears that a \$50.00 upward basis adjustment is made to AB's goodwill (only with respect to C) and no basis adjustment is made to AB's depreciable business asset. See also Treas. Reg. § 1.755-1(b)(2)(ii) exs. 1, 2, -1(b)(3)(iv) exs. 1, 2.
- a. It appears that the partnership's basis in its assets (with respect to C) is thus:

Cash	\$37.50
Depreciable Asset	75.00 ¹¹
Goodwill	50.00

¹¹ Although there appears to be no special basis adjustment to the depreciable business asset under section 743(b) due to section 704(c)(1)(C), it appears that the partnership's basis in the depreciable asset (with respect to C) should not be considered as remaining \$100 (i.e., 25 percent of the actual \$400 inside basis of such asset) in light of section 704(c)(1)(C). Rather, to carry out the apparent purpose of section 704(c)(1)(C), the inside basis of such asset should be treated as \$300 for this purpose, and C's share of the inside basis of such asset should be treated as \$75 (i.e., 25 percent of \$300). Thus, in effect, section 704(c)(1)(C) appears to have decreased the inside basis of the depreciable business asset (with respect to C) by \$25, where, without the application of section 704(c)(1)(C), the decrease to the inside basis of such asset would be \$33. This difference creates a disparity between C's share of the inside basis of AB's assets (i.e., \$162.50) and C's basis in its interest in AB (i.e., \$150) where no difference existed prior to the enactment of section 704(c)(1)(C).

- b. The application of section 704(c)(1)(C) does not appear to affect the amortization of the goodwill under these facts. The section 743(b) basis adjustment to the goodwill is treated as a separate asset acquired by AB on the date C purchased its interest in AB, and, therefore, that separate asset is treated as an amortizable section 197 intangible the basis of which (i.e., \$50) is amortized over 15 years (but only with respect to C). See Treas. Reg. § 1.197-2(g)(3), -2(k) ex. 19.

C. Distribution of partnership property under section 734(b)

1. While section 1060(d) on its face applies to basis adjustments under section 734(b), the old temporary regulations explaining section 1060 made no mention of basis adjustments under section 734(b). Until the recent issuance of the new final section 755 regulations, which do provide rules for basis adjustments under section 734(b), such omission may have been viewed as indicating that the Service did not interpret section 1060(d) as applying in the case of basis adjustments under section 734(b). Note, however, that section 1060(d), which was added to the Code as part of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, was enacted on November 10, 1988, some four months after the issuance of Treas. Reg. § 1.755-2T.
2. In general, the new final section 755 regulations use the same method of determining and allocating the “fair market value” of section 197 intangibles for purposes of section 734(b) as they do for purposes section 743(b). See Treas. Reg. § 1.755-1(a)(2).
3. However, there is one difference, which concerns the definition of partnership gross value.
 - a. For purposes of section 734(b), partnership gross value equals the value of the entire partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution. Treas. Reg. § 1.755-1(a)(4)(iii).
 - b. For purposes of section 743(b), partnership gross value equals the amount that, if assigned to all partnership property, would allow the transferee-partner to receive in a liquidating distribution an amount equal to the transferee’s basis in his partnership interest, minus the basis attributable to partnership liabilities. Treas. Reg. § 1.755-1(a)(4)(i)(A).
4. Note: The aggregate basis adjustment under section 734(b) is determined and allocated among the undistributed assets of the partnership in a manner different than the way an aggregate basis adjustment under section

743(b) is determined and allocated among partnership assets. In general, the aggregate basis adjustment under section 734(b) is determined merely by adding (i) the amount of gain or loss recognized by the distributee partner from the distribution and (ii) the difference between the inside basis of the distributed properties immediately before their distribution and the adjusted basis of such properties in the hands of the distributee partner (i.e., the step-up or step-down to the adjusted basis of the distributed property by reason of the distribution). Treas. Reg. § 1.734-1(b). The aggregate basis adjustment under section 734(b) then is allocated generally to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose (e.g., capital gain property or ordinary income property). See Treas. Reg. § 1.755-1(c)(1). But see Treas. Reg. § 1.755-1(c)(1)(ii) (section 734(b) adjustments arising by reason of the recognition of gain or loss from a distribution are allocated only to capital gain property). An allocation of basis from a section 734(b) adjustment to a particular class of property (e.g., capital gain property) then is allocated generally among the assets within such class in proportion to their “unrealized appreciation” or “unrealized depreciation,” depending on the direction of the allocated section 734(b) adjustment. Treas. Reg. § 1.755-1(c)(2).

5. The application of section 704(c)(1)(C) in determining the aggregate basis adjustment under section 734(b) and the allocation of such adjustment to particular items of partnership property appears to be more uncertain than in the section 743(b) context. The additional uncertainty arises by reason of the section 734(b) rules focusing on the step-up or step-down to the adjusted basis of the distributed property and on the “unrealized appreciation” and “unrealized depreciation” in undistributed property rather than focusing on how any gain or loss would be “allocated” to the partners as under the section 743(b) rules. Compare Treas. Reg. §§ 1.734-1(b), 1.755-1(c) with Treas. Reg. §§ 1.743-1(b), (d), 1.755-1(b). Section 704(c)(1)(C) only modifies the adjusted basis of section 704(c) built-in loss property for purposes of determining the amount of items “allocated” to noncontributing partners. Section 704(c)(1)(C)(ii). Based solely on the words used by Congress in section 704(c)(1)(C), it does not appear that section 704(c)(1)(C) can affect determinations that are not based on actual or hypothetical allocations of partnership items (such as the determination of an aggregate section 734(b) adjustment and its allocation among remaining partnership property). Thus, this appears to create an additional difference between how section 734(b) inside basis adjustments are determined and allocated among partnership property and how section 743(b) adjustments are determined and allocated among partnership property.

VI. The Section 197 Anti-Churning Rules

A. Basic fact pattern

Target operates a major newspaper operation. Target's assets (as of December 31, 1993) include the following:

<u>Asset</u>	<u>Basis</u>	<u>Fair Market Value</u>
Equipment	\$-0-	\$5,000,000
Customer list	1,000,000	10,000,000
Goodwill	<u>1,000,000</u>	<u>10,000,000</u>
Total	\$2,000,000	\$25,000,000

The customer list is not an amortizable section 197 intangible while owned by Target. Target's goodwill is self-created and, therefore, is ineligible for section 197 treatment in the hands of Target. Both intangible assets have been held by Target since 1991. Target's tangible assets have been fully depreciated (hence the zero basis). Target and P (an unrelated taxpayer) are negotiating the terms of an agreement by which P would acquire in 1994 a 60 percent interest in Target's newspaper operation for \$15 million cash. Target and P are analyzing the following forms for the acquisition:

1. A direct purchase of a 60 percent interest in the assets by P for \$15 million, followed by a contribution by P of the acquired 60 percent interest in the assets to a newly-organized limited liability company ("LLC")¹² in exchange for a 60 percent interest in the LLC (whose interest will be contributed to a special purpose subsidiary), and a contribution by Target of the remaining 40 percent interest in the assets to the LLC (excluding the cash proceeds) in exchange for a 40 percent interest in the LLC (the "asset acquisition method");
2. A contribution by Target of the newspaper assets to an LLC, followed by a sale of a 60 percent interest in the LLC to P for \$15 million, with P contributing the LLC interest to a special purpose subsidiary (the "deemed asset acquisition method");
3. A contribution by Target of the newspaper assets to an LLC in exchange for a 99 percent interest in the LLC, and a contribution by an accommodation party of cash to the LLC in exchange for a 1 percent interest in the LLC that will make a timely election under section 754, followed by Target's sale of a 60 percent interest in the LLC to P for \$15 million, with P contributing the LLC interest to a special purpose subsidiary (the "partnership acquisition method"); or
4. A contribution by Target of 60 percent of its newspaper assets to a newly-organized wholly owned subsidiary ("Newco"), followed by a sale of the Newco stock to P for \$15 million, where a section 338(h)(10) election is made, with Newco contributing the assets to an LLC in exchange for a 60

¹² Assume that the LLC will be treated as a partnership for Federal income tax purposes.

percent interest in the LLC and Target contributing the balance of the assets (excluding the cash proceeds) to the LLC in exchange for a 40 percent interest in the LLC (the "stock acquisition method").

B. Same operating structure

In each of the methods, the operating structure is generally the same:

- a. As to P, the acquired assets are owned by an LLC, 60 percent of which is owned by a wholly-owned subsidiary of P,¹³ where P has a FMV basis in (i) its proportionate share of the LLC assets, (ii) the LLC interest, and (iii) the stock of the special purpose subsidiary.
- b. As to Target, its interest in the newspaper assets is owned by an LLC, 40 percent of which is owned by Target,¹⁴ where Target has a carryover basis in the LLC interest.
- c. The only difference in operating structure concerns the partnership acquisition method, under which Target owns a 39 percent interest in the LLC and the underlying assets of the LLC.

C. Application of section 197

The application of section 197, however, differs dramatically depending on the form of the acquisition:

1. Asset acquisition method

a. No Retroactive Election Made

- (i) If the acquisition takes the form of the asset acquisition method, it appears that the anti-churning rules would apply to disallow any amortization deduction by the LLC under section 197 with respect to the goodwill if no retroactive election is made in time. See Treas. Reg. § 1.197-2(k) ex. 18.
- (ii) The anti-churning rules apply to any goodwill "which is acquired by the taxpayer after [August 10, 1993], if the intangible was held or used at any time on or after July 25, 1991, and on or before [August 10, 1993] by the taxpayer or a related person. . . ." Section 197(f)(9)(A)(i).

¹³ Assume that P and the special purpose subsidiary file a consolidated Federal income tax return.

¹⁴ In order to simplify the example, Target is the direct owner of the LLC interest.

- (iii) For purposes of the anti-churning rules, a person is related to another person if the related person bears a relationship to such person as provided in section 267(b) or 707(b), except that the 50 percent threshold is reduced to 20 percent. Section 197(f)(9)(C)(i)(I) (and flush language). See Treas. Reg. § 1.197-2(h)(6).
- (iv) In this example, after taking into account the reduced threshold levels, the LLC is "related" to Target pursuant to section 707(b)(1)(A). Since the goodwill was held by Target before August 10, 1993, it appears that the goodwill contributed by P would not be treated as an amortizable section 197 intangible. See Treas. Reg. §§ 1.197-2(h)(6), -2(k) ex. 16. There is no policy reason for this result, provided that Target does not receive any benefit of the amortization deduction.
- (v) Assuming the anti-churning rules apply, the LLC's basis in the contributed goodwill equals \$6.4 million (\$400,000 carryover basis in the goodwill contributed by Target plus \$6 million carryover basis in the goodwill contributed by P). Similarly, the LLC would have a \$6.4 million basis in the customer list, and a \$3 million basis in the tangible assets.
 - (a) P's basis in the acquired goodwill and the customer list would be recoverable under section 197 in the hands of P. See, e.g., Treas. Reg. § 1.197-2(k) ex. 18.
 - (b) Since the anti-churning rules generally apply only to goodwill and going concern value,¹⁵ the rules would not apply to the customer list in the hands of the LLC. See Treas. Reg. § 1.197-2(h)(1)(i). Therefore, the LLC would be entitled to an annual amortization deduction under section 197 equal to \$400,000 (\$6 million/15 years) with respect to the portion of the customer list attributable to P.
 - (c) The \$400,000 portion of the carryover basis in the customer list attributable to Target would not

¹⁵ In addition to goodwill and going concern value, the anti-churning rules apply to any other section 197 intangible "for which depreciation or amortization would not have been allowable but for [section 197]. . . ." Section 197(f)(9)(A).

qualify as an amortizable section 197 intangible.
Section 197(f)(2).

b. Retroactive Election Made

- (i) If P has made a retroactive election to apply section 197 to all intangible assets acquired after July 25, 1991 and on or before August 10, 1993, the anti-churning rules will not apply, and P will be allowed amortization deductions from the LLC with respect to the goodwill and customer list held by the LLC. Treas. Reg. § 1.197-1T.
 - (a) The Small Business Act clarified that, if a taxpayer and its related parties make the retroactive election, the anti-churning rules will not apply when property acquired from an unrelated party after July 25, 1991 is transferred to a taxpayer related to the acquirer after August 10, 1993. H. Rep. No. 104-586. The effect of this new provision is questionable, as it was enacted in 1996, well after the last date P is allowed to make the retroactive election (i.e., P must make the election by the due date, including extensions, of P's tax return that includes August 8, 1993).¹⁶ Treas. Reg. § 1.197-1T(c)(3). If P has not made a retroactive election in time, the rules in section I.C.1., supra, apply.
 - (b) The temporary regulations provide that if property is transferred in a transaction described in section 721 or 731, and the retroactive election is made by the transferor, the property remains subject to section 197 in the hands of the transferee to the extent of the basis in the hands of the transferor.¹⁷ Treas. Reg. § 1.197-1T(c)(iv). Thus, section 197 will apply to the intangibles transferred to LLC to the extent of P's basis, but appreciation from the time P received the goodwill from Target to the time P transferred it to LLC will not be subject to

¹⁶ If P's tax return is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i).

¹⁷ The transferee does not have to make the retroactive election and thus does not have to apply section 197 to any other property it owns from July 25, 1991 to August 10, 1993. Temp. Treas. Reg. § 1.197-1T(c)(1)(iv)(A).

section 197 unless LLC, too, has made a retroactive election.¹⁸

- (c) This rule applies as long as P acquired the goodwill from Target after July 25, 1991, and transferred the goodwill to LLC after August 10, 1993.

2. Deemed asset acquisition method

- a. Unless Target checks the box to treat the LLC as an association for Federal tax purposes, the LLC, and Target's contribution thereto, are disregarded for tax purposes. See Treas. Reg. § 301.7701-2(a). The assets of the newspaper operation are treated as owned directly by Target. See id.
- b. Under Rev. Rul. 99-5, 1999-1 C.B. 434, Target is treated as selling directly to P a 60 percent interest in the assets of the newspaper operation, followed by a contribution by Target and P (or P's wholly owned subsidiary) of the assets of the newspaper operation to a newly formed partnership (the LLC) in section 721 transactions.
- c. Thus, the results should be exactly the same as the asset acquisition method.

3. Partnership acquisition method

- a. As previously discussed, in a partnership acquisition with a section 754 election in effect, section 197 applies only to the extent of any increase in the basis of partnership property under section 732, 734, or 743.
- b. P's proportionate share of the aggregate adjusted basis of the LLC's assets is \$1.2 million. See Treas. Reg. § 1.743-1. P's aggregate basis adjustment under section 743(b)(1) equals \$13.8 million (i.e., \$15 million outside basis less \$1.2 million share of inside basis). See id.
- (i) As described in section V., the LLC's assets are divided into two classes: (i) capital assets and section 1231 assets, and (ii) all other assets, and
- (ii) the aggregate basis adjustment is allocated between the two classes (and then among the assets within each class) based

¹⁸ Obviously, if LLC does not exist until after the final date to make the retroactive election, it cannot make such election.

upon the amount of income, gain, or loss attributable to the two classes of assets (and then with respect to each asset within each class) that would be allocated to P if, immediately after the section 743(b) transfer, all of the partnership's assets were disposed of in a taxable transaction at fair market value. Treas. Reg. § 1.755-1(b).

- c. Under section 755, the \$13.8 million aggregate basis adjustment in the LLC's assets (with respect to P) is allocated as follows:

Equipment	\$3.0 million
Customer list	5.4 million
Goodwill	5.4 million

- d. With respect to each of the LLC's section 197 intangibles, the LLC is treated as owning two assets for purposes of allocating amortization deductions to P. See Treas. Reg. § 1.197-2(g)(3), - 2(k) exs. 16, 18.
- (i) For one asset, P's share of the LLC's adjusted basis is the same as Target's share. Thus, no amortization is allowed for the asset.
- (ii) For the other asset, P's proportionate share of the newly adjusted basis of the section 197 intangible (due to the section 743 adjustment) is amortized over a 15 year period.
- e. Thus, P would be entitled to receive from the LLC an annual allocation of amortization deductions equal to \$720,000 (\$10.8 million/15 years) attributable to the goodwill and customer list.
- f. The anti-churning rules do not apply in the partnership acquisition method.
- (i) With respect to an increase in the basis of partnership property under section 732, 734, or 743, the anti-churning rules are applied at the partner level, and each partner is treated as having owned and used such partner's proportionate share of the partnership assets. Section 197(f)(9)(E).
- (ii) Under the final section 197 regulations, P is not related to Target, and the anti-churning rules do not apply.¹⁹ Treas. Reg. § 1.197-2(h)(12)(v).

¹⁹ The other situations in which the anti-churning rules could apply, namely, where the

- (iii) Note that in the proposed regulations, the anti-churning rules did not apply in the partnership acquisition method only if the formation of the partnership and the sale of the interests were “unrelated.” Prop. Treas. Reg. § 1.197-2(k) ex. 17. The final regulations remove the requirement that the transactions be unrelated. See Treas. Reg. § 1.197-2(k) ex. 19. The Preamble states, however, that if the transaction is not properly characterized as a sale of a partnership interest, then section 197 will apply to the transaction as recast to reflect its true economic substance. Preamble, 65 Fed. Reg. at 3,822; see, e.g., Rev. Rul. 70-140, 1970-1 C.B. 73.
- (iv) The disparate tax treatment as between the asset acquisition method (and the deemed asset acquisition method) and the partnership acquisition method makes little sense and is fundamentally inconsistent with the purpose of section 754. The anti-churning rules should be amended so that in an asset acquisition followed by a contribution to a partnership, the acquiring partner is in the same tax position for purposes of section 197 as it would have been had it obtained an increased basis in the partnership assets pursuant to section 754. Although commentators suggested such a change, the suggestion was not adopted in final regulations. See Preamble, 65 Fed. Reg. at 3,822.

4. Stock acquisition method

- a. Section 197 applies to any section 197 intangible that is treated as acquired under section 338. See Treas. Reg. § 1.197-2(e)(5), -2(f)(4)(ii), -2(h)(8).
- b. In this example, the acquisition of the Newco stock is treated as an acquisition of the Newco assets. P takes a basis in the Newco stock equal to \$15 million. Section 1012.
 - (i) Newco's aggregate inside basis of its assets is equal to its AGUB, which in this example equals \$15 million. Treas. Reg. § 1.338-5; Treas. Reg. § 1.338(h)(10)-1(d).

user of the intangible remains unchanged (section 197(f)(9)(A)(ii)) or the prior owner continues to use the intangible (section 197(f)(9)(A)(iii)) do not exist in this example.

- (ii) Under the residual method prescribed by Treas. Reg. § 1.338-6, the AGUB is allocated as follows:

Equipment	\$3.0 million
Customer list	6.0 million
Goodwill	6.0 million

- c. The contribution by Newco of the assets to the LLC is a transfer to which section 721 applies. The LLC steps into the shoes of Newco for purposes of applying section 197. Section 197(f)(2).

- (i) For the reasons explained above under the asset acquisition method, the anti-churning rules seem to prevent the LLC from claiming an amortization deduction with respect to the acquired goodwill if no retroactive election is made.
- (ii) This rather undesirable result could be avoided by either making the retroactive election, or merely reversing the sequence of events -- i.e., have Target contribute the assets to the LLC (with a timely election under section 754 in effect), and have Target contribute 60 percent of the LLC interest to Newco, prior to P's purchase of the Newco stock.²⁰ Subsequently, when the parties make the joint election under section 338(h)(10), the basis in the goodwill is increased by reason of section 743, and for the reasons described in connection with the partnership acquisition method, the anti-churning rules would not apply.

²⁰ In order for this to work, however, the LLC must have at least one additional member. Without two members, the LLC cannot be treated as a partnership for Federal tax purposes. See Treas. Reg. § 301.7701-2(a). Under these circumstances, the LLC should not be permitted to make a valid section 754 election.