March 2, 2011

The Effect of Like-Kind Property on the Section 704(c) Anti-Mixing Bowl Rules

Bradley T. Borden, Brooklyn Law School
Douglas L. Longhofer

Available at: https://works.bepress.com/brad_borden/36/
The Effect of Like-Kind Property on the Section 704(c) Anti-Mixing Bowl Rules

by Bradley T. Borden, Esq.
Brooklyn Law School
Brooklyn, NY
and Douglas L. Longhofer, Esq.
Martin, Pringle, Oliver, Wallace & Bauer, LLP
Wichita, KS

I. INTRODUCTION

Partnership tax law generally treats both contributions to a partnership, and distributions from a partnership, as tax-free nonrecognition transactions. Because of this general principle, taxpayers have historically attempted to use partnerships as tax avoidance devices. In short, opportunistic taxpayers would use a partnership to complete transactions tax-free when they would otherwise be taxable outside a partnership. Perhaps the most common of these transactions involved using a partnership as a “mixing bowl” and completing a tax-free exchange of properties that would not qualify for nonrecognition outside a partnership.

To curb the abusive mixing bowl transactions, Congress enacted the complex anti-abuse rules found in §§704(c)(1)(B) and 737. One of the primary exceptions to the mixing bowl rules — which generally require gain recognition despite the tax-free contribution and distribution rules of subchapter K — is the like-kind property exception in §704(c)(2). The §704(c)(2) heading suggests that the rule provides nonrecognition to transactions that could be tax-free outside the partnership. The language of the provision does not necessarily reflect the essence of the heading, and the regulations published under §704(c)(2) appear to be inconsistent with an understanding of the rule derived from the provision’s heading. In fact, commentators have been fairly critical of the rules, stating that the gain reduction rule in the regulations is “inconsistent with the statute, which contemplates a reduction based on the value of the distributed like-kind property (as opposed to the built-in gain).”

This article asserts that the language of the statute does not do all that the heading implies it might do, and that the regulations are a reasonable interpretation of the statute. The article first reviews the anti-mixing bowl rules. Then it carefully examines the language in §704(c)(2) and the accompanying regulations, illustrating that the language of the statute is subject to multiple interpretations. Finally, it argues that the interpretation in the regulations is not an unreasonable interpretation of the statute. In fact, the regulations appear to adopt the most reasonable interpretation of the statute.

The article uses the following example to illustrate concepts that are relevant to interpreting §704(c)(2). Danielle owns unimproved real estate (land) with a basis of $150,000 and a fair market value of $300,000. Lindsey owns improved real estate (building) with a basis of $75,000 and a fair market value of $200,000.
of $300,000. Maggie owns a ranch (ranch) with a basis of $200,000 and a fair market value of $300,000. Danielle holds the land for investment, Lindsey rents the building to commercial tenants, and Maggie’s family and friends use the ranch for recreation. The following table illustrates the relevant information about the properties in the hands of the parties before they contribute the property to form a partnership.

Pre- Contribution Built-in Gain

<table>
<thead>
<tr>
<th>Partner</th>
<th>Property</th>
<th>FMV</th>
<th>Basis</th>
<th>Built-in Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Danielle</td>
<td>Land</td>
<td>$300,000</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Lindsey</td>
<td>Building</td>
<td>$300,000</td>
<td>$75,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>Maggie</td>
<td>Ranch</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Danielle, Lindsey and Maggie contribute their respective properties to form DLM Partnership. DLM Partnership holds the property for use in business activities. Under §721, a contribution of cash or other property to a partnership in exchange for a partnership interest is generally a tax-free event for both the contributing partner and the partnership. The partnership takes the partners’ bases in the contributed properties, and each partner takes a basis in the partnership equal to the basis of the contributed property. The following table presents the information about the partnership following its formation.

Formation of DLM Partnership

<table>
<thead>
<tr>
<th>Assets</th>
<th>Tax</th>
<th>Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$150,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Building</td>
<td>$75,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Ranch</td>
<td>$200,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total</td>
<td>$425,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th>Tax</th>
<th>Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Danielle</td>
<td>$150,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Lindsey</td>
<td>$75,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Maggie</td>
<td>$200,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

Assume that, five years after forming DLM Partnership, the partners decide to distribute the ranch to Danielle and the land to Maggie. To simplify the analysis, assume further that the basis and value of the properties is the same on the date of distribution as it was on the date of contribution. The partners must determine whether they should recognize gain or loss on such distributions and what basis each will take in the property received upon distribution. The §704(c)(1)(A) rules governing the allocation of pre-contribution gain, the general §704(c)(1)(B) anti-mixing bowl rules, and the §704(c)(2) like-kind property rule determine the tax consequences of the distributions.

II. TAXATION OF PRE-CONTRIBUTION GAIN AND THE ANTI-MIXING BOWL RULES

Distributions of property from a partnership to a partner are generally tax-free, unless the distributee partner receives cash in excess of his tax basis in his partnership interest. As a corollary to the general nonrecognition treatment for both contributions and distributions, partnership tax law provides basis rules to preserve any unrecognized gain or loss inherent in contributed property after contribution and to preserve any unrecognized gain or loss inherent in distributed

---

2 §721(a). Unless otherwise indicated, all references to “section” or “§” are to the Internal Revenue Code (Title 26, United States Code) or to the Treasury Regulations promulgated thereunder (Title 26, Code of Federal Regulations).

3 §§722–723.

4 See §731(a).
property upon distribution to a partner.\(^5\) Returning to the DLM Partnership hypothetical, assume the partnership distributes the land to Danielle, the building to Lindsey, and the ranch to Maggie in complete liquidation. These are the same properties that each partner contributed. The partnership should recognize no gain or loss on the transaction under §731, and the partners should take the bases they had in the property before contribution (assuming the bases had not changed while the partnership held the property).

### Liquidation under Sections 731 & 732
#### Distributions to Contributing Partners

<table>
<thead>
<tr>
<th>Partner</th>
<th>Property</th>
<th>Gain</th>
<th>FMV</th>
<th>Basis</th>
<th>Built-in Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Danielle</td>
<td>Land</td>
<td>$0</td>
<td>$300,000</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Lindsey</td>
<td>Building</td>
<td>$0</td>
<td>$300,000</td>
<td>$75,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>Maggie</td>
<td>Ranch</td>
<td>$0</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Now assume the partnership distributes the ranch to Danielle, the building to Lindsey, and the land to Maggie in complete liquidation. In this scenario, Danielle and Maggie each receive property different from the property they contributed. If §704(c) did not exist, §§731 and 732(b) would provide that the partners do not recognize gain on the distribution and they take bases in the property that equal the bases they had in the partnership. The results are the same as those obtained when the partnership distributed the property to the contributing partners, but in this case, the partners were able to shift the bases of the ranch and the land. As result, the ranch ended up with a lower basis.

### Liquidation under Sections 731 & 732
#### Distributions to Other Partners

<table>
<thead>
<tr>
<th>Partner</th>
<th>Property</th>
<th>Gain</th>
<th>FMV</th>
<th>Basis</th>
<th>Built-in Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Danielle</td>
<td>Ranch</td>
<td>$0</td>
<td>$300,000</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Lindsey</td>
<td>Building</td>
<td>$0</td>
<td>$300,000</td>
<td>$75,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>Maggie</td>
<td>Land</td>
<td>$0</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Congress enacted §704(c) to prevent such shifting of basis. Commentators have stated that the rules set forth in §704 — governing the allocation of items of income and loss from partnership operations — are the “‘operational lifeblood of partnership taxation, dictating who receives such allocations, as well as their amount and timing.’”\(^6\) The general rule in §704(a) states that a partner’s share of income, gain, loss, deduction, or credit is determined by the partnership agreement.\(^7\) But, if the partnership agreement fails to address the allocation of a particular tax item or if the allocation lacks substantial economic effect,\(^8\) then §704(b) provides that the allocation must be made in accordance with the partner’s interest in the partnership.\(^9\) Through §704(b) and its accompanying regulations, partnership tax law “achieves a sensible balance between flexibility and [the principle that tax consequences should parallel economic consequences].”\(^10\)

This balance is disrupted, however, when a partner contributes property to a partnership.\(^11\) In almost all incidences, the contributed property will have a fair market value that differs from the contributing partner’s tax basis in the property. Thus, the contributed property has inherent built-in gain or loss and there will be a disparity between the book value and tax basis of the contributed property for both the partnership and the partner.\(^12\) Section 704(c)(1) addresses the issue of an in-kind contribution of property to a partner in the partnership independent of tax consequences. See Regs. §1.704-1(b)(2)(ii)(a).

---


\(^7\) §704(a).

\(^8\) Under the partnership tax rules, a partner’s tax investment and economic investment are measured separately. A partner’s economic investment or book value is measured by her partnership capital account, and a partner’s tax investment is measured by her outside basis. See Monroe, note 6 above, at 1386. Generally, allocations of income, loss, etc. must mirror book allocations and be properly reflected in the partner’s capital account and tax basis. In subchapter K terms, the allocations must have “substantial economic effect.” See Regs. §1.704-1(b)(2)(i). In short, an allocation is substantial if it affects the partner’s economic investment

---

\(^9\) §704(b)(1), (2).

\(^10\) Monroe, note 6 above, at 1386.

\(^11\) See id. at 1387.

\(^12\) The book value of the contributed property for both the partnership’s account and the partner’s capital account will be fair market value. Yet, because the contribution is a nonrecognition event, the gain or loss is preserved, and the partner’s outside basis is equal to his basis in the property at the time of contribution
ship and is undoubtedly one of the most complex, but yet fundamental, provisions of subchapter K.

Under §704(c)(1)(A), “income, gain, loss, and deduction with respect to property contributed by a partner shall be shared among the partners 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 . . . .” 13 This provision requires a contributing partner to recognize built-in gain or loss inherent in contributed property when the partnership recognizes that property’s built-in gain or loss.14 “[T]he guiding principle [of §704(c)(1)(A)] is that allocations related to differences in fair market value and basis at the time of contribution of property to a partnership are to be made in a manner that reduces the disparity between the partners’ book and tax account.” 15 Effectively, the rule of §704(c)(1)(A) prohibits shifting built-in gain or loss from the contributing partner to other partners.

Section 704(c)(1)(A) applies to taxable dispositions of contributed property by the partnership. The

and the partnership’s inside basis in the contributed property is equal to the partner’s basis at the time of contribution. See §§722 and 723.

13 §704(c)(1)(A).

14 The Treasury Regulations provide detailed rules for partnership allocations with respect to “704(c) property,” which is defined as property with a book value different from its tax basis at the time of contribution. Regs. §1.704-3(a)(1).


<table>
<thead>
<tr>
<th>Partner</th>
<th>Property</th>
<th>Liquidation under Section 704(c)(1)(B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Danielle</td>
<td>Ranch</td>
<td>$150,000</td>
</tr>
<tr>
<td>Lindsey</td>
<td>Building</td>
<td>$0</td>
</tr>
<tr>
<td>Maggie</td>
<td>Land</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Because the properties the parties received on the liquidating distribution are like-kind, the parties might hope to avoid gain recognition on the distribution. A quick glance at §704(c)(2) suggests that it will provide significant relief for Maggie and Danielle on the liquidation. A close examination of the statute reveals, however, that the relief may not be as complete as expected.

III. SECTION 704(c)(2)

The examination of §704(c)(2) begins with the paragraph heading, which is: “Special rule for distributions where gain or loss would not be recognized outside the partnership.” That heading implies that if Maggie and Danielle could exchange property tax-

§704(c)(1)(B) anti-mixing bowl rules apply to distributions of contributed property to prevent the shifting of built-in gain or loss from one partner to another. Under §704(c)(1)(B), if a partnership distributes contributed property to a non-contributing partner within seven years after the contribution, the contributing partner must recognize §704(c)(1)(A) gain or loss at the time of the distribution.16 Thus, the distributions of property to non-contributing partners in the DLM Partnership example would trigger gain recognition under the general anti-mixing bowl rules of §704(c)(1)(A). The distribution of the land to Danielle (the non-contributing partner) would trigger $100,000 of gain recognition to Maggie (the contributing partner), and distribution of the ranch to Maggie (the non-contributing partner) would trigger $150,000 of gain recognition to Danielle (the contributing partner). The bases of the respective properties would increase to reflect the gain recognized by the partners.17 Before the distributions, the basis of the ranch would increase to $300,000 to reflect Maggie’s $100,000 gain, and the basis of the land would increase to $300,000 to reflect Danielle’s $150,000 gain. Consequently, they would each take a $300,000 basis in the distributed property. The following table illustrates the §704(c)(1)(B) consequences of the distribution.

16 See Regs. §1.704-4(a)(1). If there is remaining built-in gain or loss after allocation under §704(c)(1)(B), this gain or loss should be allocated according to the §704(c) method used by the partnership. See Regs. §1.704-4(a)(5). Section 704(c)(1)(B) only applies if a transaction is not treated as a disguised sale under §707(a)(2)(B). See Regs. §1.704-4(a)(2).

17 See §704(c)(1)(B)(iii).

18 See §7806(b).
examination of the statute reveals meaning that the more casual reading overlooks.

A careful reading reveals that the reference to §1031 has limited significance. Section 704(c)(2) uses §1031 for the sole purpose of defining like-kind property. Section 704(c)(2) does not adopt the §1031 requirement that the transferred property and the acquired property be held for productive use in a trade or business or for investment. It does not adopt the §1031 definition of exchange. It does not adopt the §1031(d) basis rules. Instead, it merely adopts the definition of like-kind property and then uses the 180-day period, which is also found in §1031. Because §704(c)(2) does not adopt §1031’s other requirements, the result obtained under §704(c)(2) will likely be different from the result that would obtain if two partners had exchanged the same properties outside the partnership. Consequently, the result will not necessarily reflect what the heading of the paragraph suggests it might. To the extent §704(c)(2) does not adopt the §1031 rules, the rules of subchapter K will apply. Therefore, the basis rules in subchapter K will apply to property distributed in a §704(c)(2) transaction. Those rules are an important part of any effort to interpret §704(c)(2).

With that introduction, carefully examine §704(c)(2). Section 704(c)(2) provides an exception to the general rule in §704(c)(1)(B) when a partnership distributes contributed property to a non-contributing partner and distributes “other property of a like kind (within the meaning of §1031)” to the contributing partner. However, the distribution to the contributing partner must occur not later than the 180th day after the distribution to the non-contributing partner. If the distributions satisfy those requirements, §704(c)(2) treats the contributing partner as contributing the like-kind property, to the extent of the fair market value of the like-kind property. An examination of the actual language of the rule helps flush out its possible meanings and effects.

The operative provision of §704(c)(2) provides that “to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).” The relevant part of §704(c)(1)(B) provides “if any property so contributed is distributed ... by the partnership (other than to the contributing partner) within 7 years of being contributed ... the contributing partner shall be treated as recognizing gain or loss ... .” (Emphasis added.) The §704(c)(2)(B) language can be restated as follows: If a contributing partner receives like-kind property as part of a §704(c)(1)(B) transaction, the contributing partner shall be treated as contributing the like-kind property to the partnership. Apparently, the rule could have one of two mutually exclusive effects.

One possible effect of the §704(c)(2) rule is that it nullifies §704(c)(1)(B). The nullification of §704(c)(1)(B) disarms the anti-mixing bowl rule, and the partners could distribute contributed property without gain recognition, regardless of the bases the partners take in the distributed property. Another possible effect of the §704(c)(2) rule is that it recasts the partner’s contribution. The recast contribution treats the partner as contributing the like-kind property instead of the property actually contributed. In recasting the transaction, an important part of the analysis will be to determine the basis the contributing partner takes in the like-kind property. That basis should affect the tax treatment of the distribution.

The interpretation of §704(c)(2) will determine its effect. The following discussion will examine the two possible interpretations in turn. The discussion will demonstrate that recasting the transaction appears to be the more appropriate interpretation of §704(c)(2). The discussion will also illustrate that the regulations appear to adopt this interpretation.

A. Section 704(c)(1)(B) Nullification Interpretation

The §704(c)(1) nullification interpretation applies §§704(c)(2) and 704(c)(1)(B) literally. A condition of §704(c)(1)(B) is that contributed property must be distributed to someone other than the contributing partner, so §704(c)(1)(B) does not apply if contributed property is distributed to the contributing partner. Section 704(c)(2) treats the contributing partner as contributing the like-kind property. The contributing partner also receives the like-kind property on the subsequent distribution. Thus, the contributing partner receives property the contributing partner is deemed to have contributed. As a consequence, the transaction would fail to meet a condition of §704(c)(1)(B) with respect to the like-kind property, and the anti-mixing bowl rule would not apply. If the anti-mixing bowl rule does not apply with respect to the distributed like-kind property, the partner that actually contributed the property would not recognize gain on the distribution.

But even if §704(c)(1)(B) would not trigger gain recognition on the distribution of the like-kind property, the partners still must determine the basis of the property distributed to the non-contributing partner. 19
and the basis of the like-kind property. Assuming §1031 does not apply to the distribution of the like-kind property, §704(c)(2) would govern. Because §704(c)(2) does not import or incorporate any basis rules, the subchapter K basis rules in §732 would determine the basis the partners would take in the properties. Thus, under the nullification interpretation, the partners would recognize no gain on the distribution and take a §732 basis in the distributed property.

Returning to the example helps illustrate the effect of the nullification interpretation. Because the properties Danielle and Maggie receive are of like kind to the properties they contribute and the distributions are simultaneous, §704(c)(2) should apply to their liquidation. Assuming §704(c)(2) nullifies §704(c)(1)(B), the transaction would be subject to §§731 and 732. Thus, neither Danielle nor Maggie would recognize gain on the transaction, and they would take bases in the properties that equal the respective bases they have in their partnership interests. The following table illustrates the effect of a liquidating distribution that would obtain under the nullification interpretation.
This example illustrates that the nullification interpretation allows the partners to shift the bases of the properties using §704(c)(2). That may allow them to engage in tax arbitrage by shifting high basis to property the partners wish to dispose of and shifting low basis to property the partners wish to retain. The result would be similar to that obtained in a related-party like-kind exchange, which §1031(f) prohibits when the exchange is tax-motivated.

Shifting basis could be less of a problem in the case of current distributions, if a partner’s outside basis limited the basis a partner took in the like-kind property. For example, if the DLM Partnership distributed the ranch to Danielle, §732(a)(2) would prevent her from taking a basis in the ranch in excess of the $150,000 basis she had in her partnership interest. If the partnership distributed the land to Maggie in a current distribution, Maggie would take a basis in the land equal to the $150,000 basis the partnership had in the land.

If, however, Danielle had sufficient outside basis, the partners could shift the basis of property from one partner to another. Thus, Danielle would take the ranch with a basis equal to the basis Maggie had in it, and Maggie would take the land with a basis equal to the basis Danielle had in it.

In this last illustration, Danielle gets property that has $50,000 more of basis than the property she contributed had. Thus, she appears to gain basis in the transaction. That suggests the outcome is not ideal. In fact, the nullification interpretation in general does not appear to prevent basis shifting, which suggests that the nullification interpretation is not appropriate.21

### B. Recast- Contribution Interpretation

The second interpretation would recast the contribution and treat the contributing partner as contributing the like-kind property instead of contributing the original property. This interpretation can be illustrated by adding language to §704(c)(2) as follows: “[T]o the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B),” instead of contributing the property actually contributed. Stated more simply: If a contributing partner receives like-kind property as part of a §704(c)(1)(B) transaction, §704(c)(1)(B) shall treat the contributing partner as contributing the like-kind property, instead of contributing the property actually contributed. The question this interpretation raises is what basis the tax law should deem the contributing partner to have in the like-kind property it is deemed to contribute. The basis the contributing partner is deemed to have in the like-kind property could be (1) the partnership’s basis in the like-kind property (i.e., the transferred basis) or (2) the basis the contributed partner had in the property actually contributed (i.e., the exchanged basis).

#### 1. Transferred Basis of Like-Kind Property

First consider the result that obtains if the recast transaction treats the partner as contributing the like-kind property with a basis equal to the basis the partner takes in the like-kind property under §732 (i.e., transferred basis). The DLM Partnership hypothetical helps illustrate the result of this hypothetical. Recall that the partnership took a $200,000 basis in the ranch. Assume that Danielle’s basis in DLM Partner-

---

21 Section 704(c)(1)(C) would limit abusive current distributions involving loss property, so the potential for abuse appears to be lower if the partnership makes current distributions.
ship is greater than $200,000. Now assume the partnership distributes the land to Maggie and the ranch to Danielle in a transaction that qualifies for §704(c)(2) treatment. If Danielle were to receive the ranch in a current distribution, she would take a $200,000 basis in the ranch under §732(a). By recasting the transaction, §704(c)(2) treats Danielle as contributing the ranch to the partnership. If it treats her as contributing it to the partnership with a $200,000 basis, she would have to recognize $50,000 of gain to account for the difference between the basis of the property she actually contributed and the basis of the property she is deemed to have contributed.

If Danielle recognizes $50,000 of gain on the distribution, she must account for that gain in the basis of some property. Arguably, the gain should be added to the basis of the land Danielle contributed to the DLM Partnership and her basis in her partnership interest.

Now consider the effect these rules must have on the distribution from Maggie’s perspective. Section 704(c)(1)(B) would generally apply to her as well because the partnership distributed the ranch to Danielle within seven years after Maggie contributed it. Maggie receives the land worth $300,000. After the adjustment to reflect the gain Danielle recognized on the distribution, the basis in the land should be $200,000, which is the basis Maggie should take in the land under §732(a). Maggie’s built-in gain on the land would be $100,000. According to the regulations, Maggie would reduce by $100,000 the gain she would otherwise recognize under §704(c)(1)(B). Therefore, Maggie would recognize no gain on the transaction.

The following table summarizes the consequences of the recast transaction.

<table>
<thead>
<tr>
<th>Partner</th>
<th>Property</th>
<th>Recast Transaction with Transferred Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Danielle</td>
<td>Ranch</td>
<td>Gain $50,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FMV $300,000 Basis $200,000 Built-in Gain $100,000</td>
</tr>
<tr>
<td>Maggie</td>
<td>Land</td>
<td>Gain $0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FMV $300,000 Basis $200,000 Built-in Gain $100,000</td>
</tr>
</tbody>
</table>

This result appears to be a reasonable interpretation of §704(c)(2) because it accounts for the basis the partners take in the distributed property using subchapter K rules, it requires the party that realizes a basis increase to recognize gain, and it prevents basis shifting. At this point, the comparison of this result to the result that would obtain using the regulations help illustrate that the regulations adopt a reasonable interpretation of §704(c)(2). The regulations require the contributing partner to recognize some gain. The regulations determine the amount of gain recognized by reducing the gain or loss otherwise recognized under §704(c)(1)(B) by the amount of built-in gain or loss in the distributed like-kind property.

Under §704(c)(1)(B), Danielle would generally recognize $150,000 of gain on the distribution of the land to Maggie within seven years after Danielle contributed the property to the partnership. Because Maggie would take a $200,000 basis in the ranch immediately after distribution, the ranch would have $100,000 of built-in gain in Danielle’s hands immediately after the distribution. The regulations would allow Danielle to reduce her $150,000 §704(c)(1)(B) gain by the $100,000 of built-in gain. She would therefore recognize only $50,000 of gain on the distribution — the same amount she recognized under the recast-contribution method. The regulations in effect require her to account for the difference between the basis of the property she actually contributed and the basis of the property she received. She accounts for that difference by recognizing gain.

The §704(c)(2) result would be different if §732 limited the basis that Danielle took in the like-kind property. If, for example, her basis in the partnership were $150,000 at the time of the distributions, she would take a $150,000 basis in the ranch under §732(a)(2). Danielle’s built-in gain would be $150,000, which would equal the amount of gain she would generally recognize under §704(c)(1)(B), so Danielle would recognize no gain on the distribution. Because Danielle would recognize no gain or loss on the distribution, there would be no adjustment to the basis of the land, and Maggie would therefore take a
$150,000 basis in the land.\textsuperscript{27}

\begin{tabular}{|c|c|c|c|c|}
\hline
 Partner & Property & Gain & FMV & Basis & Built-in Gain \\
\hline
 Danielle & Ranch & $0 & $300,000 & $150,000 & $150,000 \\
 Maggie & Land & $0 & $300,000 & $150,000 & $150,000 \\
\hline
\end{tabular}

Again, this is the same result that would obtain using the formula in the regulations. Danielle’s §704(c)(1)(B) gain would be $150,000, and the built-in gain of the property she receives would be $150,000. Thus, she would recognize no gain under the formula in the regulations. Similarly, Maggie’s §704(c)(1)(B) gain would be $100,000, but the built-in gain of the property she receives would be $150,000. Therefore, she too would recognize no gain using the formula in the regulations. Thus, the formula in the regulations appears to reach the same result one reaches by recasting the contributions and using the subchapter K basis rules.

The facts in the example in the regulations are slightly different from the facts in the DLM Partnership hypothetical. Applying the recast-contribution interpretation to the example provides another opportunity to compare its results to the results obtained in the regulations. In the example in the regulations the contributing partner had contributed Property A to the partnership. Property A had $10,000 of built-in gain ($20,000 fair market value and $10,000 basis). The partnership distributed Property A to another partner within seven years after the contribution.\textsuperscript{28} The partnership distributed Property A to another partner within seven years after the contribution. The partnership distributed Property B to the contributing partner. Property B was like-kind to Property A. It was worth $10,000, had a basis of $8,000, and had a built-in gain of $2,000. The partnership had acquired Property B for cash. Notice that Property B ($10,000 value) is worth half the value of Property A ($20,000 value).

If §704(c)(2) did not apply to the transaction, the contributing partner would have recognized all $10,000 of built-in gain when the partnership distributed Property A to the other partner. However, §704(c)(2) does apply to the transaction, but only to the extent of the $10,000 fair market value of property distributed to the contributing partner. Because $10,000 is only half the value of Property A, §704(c)(2) shields only half of the distribution from §704(c)(1)(B) treatment. The other half will be subject to §704(c)(1)(B). One-half of Property A is worth $10,000 and one-half of the basis of Property A is $5,000. Consequently, the contributing partner will recognize $5,000 of gain on the distribution of one-half of Property A to the other party. As a result of that gain, the basis of Property A and the contributing partner’s basis in the partnership would increase by $5,000 under §704(c)(1)(B)(iii).

Section 704(c)(2) will govern the tax treatment of the distribution of the other one-half of Property A. That treatment depends upon the attributes the contributing partner takes in Property B. On the distribution of Property B, the contributing partner would take an $8,000 basis in Property B under §732(a). If the contribution were recast, the contributing partner would be deemed to have contributed Property B with a basis of $8,000. Property B was worth $10,000, which is half of the value of Property A. Recasting the contribution would therefore treat the contributing partner as contributing $10,000 of property with a basis of $8,000 instead of contributing $10,000 property with a basis of $5,000. Because the basis of the property contributed in the recast transaction is $3,000 greater than the basis of the property actually contributed, the contributing partner must recognize $3,000 of gain on the transaction. That gain would result in an increase in the basis of Property A and the contributing partner’s basis in the partnership under §704(c)(1)(B)(iii).

The tax consequences to the contributing partner are the sum of the tax consequences of the two halves of the transaction. The contributing partner recognized $5,000 of gain on the distribution of one-half of Property A. That gain resulted because §704(c)(2) shielded only one-half of the transaction from §704(c)(1)(B). The contributing partner also recognized $3,000 of gain from the part of the transaction that qualified for the §704(c)(2) shield. In total, the contributing partner recognized $8,000 of gain on the transaction. That $8,000 gain required an equal adjustment to the contributing partner’s basis in the partnership and to Property A. As a consequence, the other partner would take an $18,000 basis (the contributing partner’s original $10,000 basis plus $8,000 of gain the contributing partner recognized) in Property A. This is the same result that obtains using the formula in the regulations.

\textsuperscript{27} Maggie’s basis in the partnership would be $50,000 after the distribution, and she would recognize that amount as a loss if the partnership were to liquidate. That amount would offset the extra $50,000 of built-in gain that she has in the land.

\textsuperscript{28} Regs. §1.704-4(d)(4).
The contributing partner would have recognized $10,000 of gain under §704(c)(1)(B). The contributing partner took Property B, which was worth $10,000, with a $8,000 basis. As a result, the contributing partner took Property B with a $2,000 built-in gain. The formula provides that the contributing partner’s gain is the excess of the §704(c)(1)(B) gain over the built-in gain of the like-kind property. Thus, the contributing partner would recognize $8,000 of gain on the distribution. This is the same amount the contributing partner recognized using the recast-contribution interpretation. The similar results further suggest that the regulations provide a reasonable interpretation of the statute.

2. Exchanged Basis in Like-Kind Property
The recast-contribution interpretation could treat the partner as contributing the like-kind property with a basis equal to the basis the partner had in the property actually contributed. This result is more difficult to justify through either statutory interpretation or the policy of §704(c). The contributing partner must have some statutory justification for taking a basis in the distributed property equal to the basis of the contributed property (i.e., exchanged basis). Section 1031 would allow the contributing partner to take the exchanged basis in the distributed like-kind property, but §1031 will not apply to §704(c)(2) distributions. Consequently, the partners cannot rely upon §1031 to claim an exchanged basis in the distributed property. Instead, the contributing partner’s basis in the like-kind property depends upon the basis rules in subchapter K. Those rules provide that a contributing partner generally must take a transferred basis in the distributed property. The basis the contributing partner takes in the distributed like-kind property could be some amount less than the basis the partnership had in the property, if the contributing partner’s basis in the partnership is less than the partnership’s basis in the like-kind property. That limit could cause the contributing partner to take a basis in the like-kind property that equals the basis of the contributed property. The result would thus be similar to the contributing partner taking an exchanged basis in the like-kind property, but the statute does not automatically provide for the exchanged basis. The contributing partner takes an exchanged basis by chance under §732(a). Thus, the statute does not support the contributing partner taking an exchanged basis in the property.

The discussion above illustrates that the partners are not able to shift basis if they take the transferred basis in the like-kind property, whereas if they take an exchanged basis, they can shift basis from one property to another. In the example above, Danielle would take a $200,000 basis in the ranch, and Maggie would take a $150,000 basis in the land, if each partner took an exchanged basis in the distributed property. That is the result that §704(c) was designed to prevent, so the policy of §704(c) does not support the partners taking the exchanged basis in the property. Consequently, this sub-interpretation of §704(c)(2) does not appear to be viable.

IV. CONCLUSION
The §704(c)(2) rule and accompanying regulations are not a paragon of clarity. This article illustrates, however, that the regulations provide a reasonable interpretation of the statute. As a consequence, taxpayers may be hard pressed to convince a judge that some other interpretation of the statute would be more appropriate.

This article focuses on the actual language of the statute. That leaves open the question of whether the statute does what Congress intended it to do. The heading of the statute and its reference to §1031 leaves some doubt. Perhaps Congress intended the statute to adopt the §1031 exchanged basis rules and allow complete nonrecognition of gain on §704(c)(2) transactions. That may have been the case, but the failure to incorporate the §1031 basis rules into §704(c)(2) makes such an interpretation hard to fathom.

29 Id.
30 See §732(a)(1).
31 See §732(a)(2).