

Section 721

Code, the assets treated as received by the sole shareholder of the corporation are the historical corporate assets or a partnership interest if the historical assets were transferred to the partnership by the corporation in exchange for the partnership interest as the first step in the liquidation. See Rev. Rul. 77-321, page 98.

26 CFR 1.721-1: Nonrecognition of gain or loss on contribution.

Whether gain or loss is recognized by either the merged or the merging partnerships in a partnership merger. See Rev. Rul. 77-458, page 220.

Section 722.—Basis of Contributing Partner's Interest

26 CFR 1.722-1: Basis of contributing partner's interest.

Whether a limited partnership's increase in basis attributable to a nonrecourse liability of a second limited partnership in which it is a partner passes through to the partners of the first limited partnership for purposes of the limitation on losses under section 704(d) of the Code. See Rev. Rul. 77-309, page 216.

Section 723.—Basis of Property Contributed to Partnership

26 CFR 1.723-1: Basis of property contributed to partnership.

Determination of the basis to the merged partnership of property contributed by the merging partnerships in a merger of several partnerships. See Rev. Rul. 77-458, page 220.

Subpart B.—Distributions by a Partnership

Section 731.—Extent of Recognition of Gain or Loss on Distribution

26 CFR 1.731-1: Extent of recognition of gain or loss on distribution.

Whether gain or loss is recognized by the partners of merging partnerships. See Rev. Rul. 77-458, page 220.

Section 732.—Basis of Distributed Property Other Than Money

26 CFR 1.732-1: Basis of distributed property other than money.

Basis of the partnership interest received by a partner in a partnership merger. See Rev. Rul. 77-458, page 220.

Subpart C.—Transfers of Interests in a Partnership

Section 741.—Recognition and Character of Gain or Loss on Sale or Exchange

26 CFR 1.741-1: Recognition and character of gain or loss on sale or exchange. (Also Sections 671, 752; 1.671-1, 1.752-1 (d).)

Transfer of partnership interest; grantor trust powers renounced. An individual who creates an irrevocable trust classified as a grantor trust, purchases, as trustee, an interest in a partnership generating losses derived from accelerated depreciation deductions that reduce the basis of the partnership interest almost to zero, and who renounces the powers that cause the grantor trust classification just before the partnership begins generating income, has recognized gain or loss under section 741 of the Code measured by the difference between the trust's adjusted basis of the partnership interest and its share of the partnership's liabilities.

Rev. Rul. 77-402

Advice has been requested whether, under the circumstances described below, gain or loss on the sale or exchange of a partnership interest is recognized under section 741 of the Internal Revenue Code of 1954.

A, an individual, created *T*, an irrevocable trust. *A* and *B* (*A*'s spouse) are the trustees. All trust income is currently distributable for life to *C*, *A* and *B*'s child. At *C*'s death, the corpus is distributable to *D*, *A* and *B*'s grandchild. *A* has expressly retained certain powers of the kind described in subpart E of part I of subchapter J of the Code. Therefore, for Federal income tax purposes, *T* is a "grantor trust" and *A* is considered the owner of the entire trust.

A, as the trustee, then used the funds that *A*, as grantor, initially contrib-

uted to *T*, to purchase on behalf of the trust an interest in *P*, a partnership. The principal activity of *P* is investing in real property, and *P* uses both recourse and nonrecourse financing. *P* properly elected to deduct accelerated depreciation, which generated large operating losses that *P*'s partners were entitled to deduct on their income tax returns. *A*, as owner of *T*, deducted the distributive share of partnership losses attributable to the partnership interest held by *T*.

When the adjusted basis of the partnership interest held by *T* had been reduced nearly to zero, and just before the so-called "cross-over point" (when *P* no longer generated losses but began generating income), *A*, as grantor, renounced the powers previously and expressly retained that initially resulted in *T* being classified as a grantor trust. Consequently, *T* ceased to be a grantor trust and *A* was no longer considered to be the owner of the trust. Thereafter, *C*, as life beneficiary, was subject to tax on the income generated by the trust.

Section 671 of the Code provides, where it is specified in sections 673 through 679 that a grantor or another person shall be treated as the owner of any portion of a trust, that there shall be included in computing the taxable income and credits of the grantor or other person, the items of income, deductions, and credits of the trust attributable to the portion of the trust considered owned by such grantor or other person to the extent such items would be taken into account in computing the taxable income or credits of an individual.

Section 741 of the Code provides that in the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner.

Section 752(d) of the Code provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connec-

tion with the sale or exchange of property not associated with partnerships.

In the instant case, since *A* was the owner of the entire trust, *A* was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since *A* was considered to be the owner of the partnership interest, *A*, not *T*, was considered to be the partner in *P* during the time *T* was a "grantor trust" under subpart E of part I of subchapter J of the Code.

However, at the time *A* renounced the powers that gave rise to *T*'s classification as a grantor trust, *T* no longer qualified as a grantor trust, with the result that *A* was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, *A* is considered to have transferred ownership of the interest in *P* to *T*, now a separate taxable entity, independent of its grantor, *A*.

When a transfer of an interest in a partnership occurs and the transferor's share of partnership liabilities is reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the share of liabilities reduced or eliminated. Under section 752(d) of the Code, the amount realized by the transferor *A* includes the reduction in or elimination of such liabilities. See Rev. Rul. 74-40, 1974-1 C.B. 159; Rev. Rul. 75-194, 1975-1 C.B. 80; and *Johnson v. Commissioner*, 495 F.2d 1079 (6th Cir. 1974), *aff'g* 59 T.C. 791 (1973), *cert. denied*, 419 U.S. 1040 (1975). Any gain or loss realized on a sale or exchange of a partnership interest is recognized pursuant to section 741 of the Code.

Accordingly, in the instant case, *A* realized an amount equal to the share of partnership liabilities that existed immediately before *T* converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by *A* is the difference

between the amount realized from the reduction of the share of *P*'s liabilities and the adjusted basis in the partnership interest under section 705 of the Code immediately prior to the change in *T*'s tax status. The gain or loss so realized must be recognized by *A* under section 741.

Furthermore, the result would be the same if the trust ceases to be a grantor trust by reason of the expiration or lapse of the powers. The result would also be the same if the trust were treated as a grantor trust by reason of powers exercisable by a party other than the grantor and ceased to be a grantor trust upon the release or renunciation of those powers by such other party or upon the expiration or lapse of such powers.

Subpart D.—Provisions Common to Other Subparts

Section 751.—Unrealized Receivables and Inventory Items

26 CFR 1.751-1: Unrealized receivables and inventory items.

Partnership liquidation; non-pro rata distribution of section 751 property. Section 751(b) of the Code applies to a non-pro rata distribution of section 751 property in complete liquidation of a two person partnership so that, to the extent either partner receives section 751 property in exchange for other partnership property or receives other partnership property in exchange for section 751 property, the distribution is considered as a sale or exchange of property between the distributee partner and the partnership that consisted, after the distribution, of a single individual.

Rev. Rul. 77-412

Advice has been requested concerning the Federal income tax consequences upon the complete liquidation of a two person partnership

involving the non-pro rata distribution of "section 751 property" to the partners.

Section 751 of the Internal Revenue Code of 1954 governs the treatment of unrealized receivables of the partnership (as defined in section 751(c)) and inventory items of the partnership that have appreciated substantially in value (as defined in section 751(d)), insofar as they affect sales or exchanges of partnership interests and certain distributions by a partnership. Unrealized receivables and substantially appreciated inventory items are referred to as "section 751 property."

Under section 751(a) of the Code, the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of such partner's interest in the partnership attributable to section 751 property, is considered an amount realized from the sale or exchange of property other than a capital asset. Thus, any gain or loss attributable to the sale or exchange of section 751 property would be ordinary income or loss.

Section 751(b)(1) of the Code provides that where a partner receives, in a distribution, partnership section 751 property in exchange for all or a part of such partner's interest in other partnership property (including money), or receives other partnership property (including money) in exchange for all or a part of an interest in partnership section 751 property, such transaction shall be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution). Consequently, section 751(b) of the Code applies to that part of the distribution to a partner that consists of the non-pro rata distribution of the partnership section 751 property in exchange for other property, or the non-pro rata distribution of other partnership property in exchange for section 751 property.