Utah Law Review

Volume 2018 | Number 5 Article 2

12-2018

Tax Law's Loss Obsession

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Abstract

This Article will address tax law's inconsistent treatment of gains and losses—focusing in particular on certain instances in which a taxpayer is prevented from shifting a built-in loss to another taxpayer but would be allowed to shift a built-in gain to another taxpayer. The article will explore whether any legitimate justification can explain the inconsistency. Finding no such legitimate justification for at least some of the examples, this Article will conclude that lawmakers ought to have also addressed gains and the failure to do so results from lawmakers crafting an overly narrow response that addressed only the most recent, high-profile gimmick in engineering transactions to reduce tax liability.

INTRODUCTION

Regulatory gamesmanship by sophisticated parties is pervasive. Wealthy, well-advised businesses, individuals, and other regulated parties craft their transactions and organize their affairs to obtain the most favorable possible outcomes, given the existing legal framework. Sophisticated enterprises arrange their activities to reduce the effective tax rate applicable to the income generated by those activities, and they take steps to mitigate the burden imposed by other regulatory regimes. When regulators become apprised of the convoluted maneuvers undertaken to evade existing regulations, sometimes those regulators respond with law reform measures to close the existing loopholes, putting an end to the most recent schemes. Sophisticated parties respond, in turn, by uncovering new loopholes and crafting new strategies to mitigate the effects of the new regulations. Then the cycle repeats.

 Professor, DePaul University College of Law. The author would like to thank Jeffrey Kahn, Jeffrey Kwall, Andrea Monroe, Gregg Polsky, Larry Zelenak, and the editors of the *Utah Law Review* for their helpful comments. The author would also like to thank Noora Shubbak for excellent research assistance.

The story in the preceding paragraph is a familiar tale and a true one.[1] When telling this story, it is easy to portray as *inevitable* the recurrent cycle of gamesmanship by sophisticated parties, followed by regulatory response, followed, in turn, by new tricks to evade the spirit of the new regulations. While the inevitability of the cycle, to some extent, cannot be denied, this Article will argue that in some circumstances, the short-sightedness of the regulatory response is at least partially to blame for the perpetuation of the cycle. In particular, some regulatory measures foreclose opportunities to engage in whatever transaction has caught the relevant regulator's attention most recently but fail to address other, very closely related (and, therefore, very predictable) transactions.

As an example, this Article will address tax law's inconsistent treatment of gains and losses—focusing particularly on certain instances in which a taxpayer is prevented from shifting a built-in loss to another taxpayer but would be allowed to shift a built-in gain to another taxpayer. This Article will explore whether any legitimate justification can explain the inconsistency. Finding no such legitimate justification for at least some of the examples, this Article will conclude that the inconsistency represents an example of short-sightedness in the lawmaking process that sustains the continued cycle of regulated parties outmaneuvering the new regulations and regulators responding but always staying at least one step behind.

At this point, further explanation of the examples used by this Article is in order. If a taxpayer holds an asset that has increased (or decreased) in value,

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[1] *See, e.g.*, Calvin H. Johnson, *H.R. ____, The Anti-Skunk Works Corporate Tax Shelter Act of 1999*, 1999 TAX NOTES 443, 445 ("Loopholes can be created in any human tax system unless the system is defended and repaired. Shelters take razor-thin fissures of no material concern and turn them into gaping holes in the tax base."); Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 33 (2004) ("[P]romoters could easily concoct new abusive transactions that literally complied with the rule."); Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010) ("[T]he most effective techniques are more pernicious, crafted by lawyers to meet the letter of the law while undermining its spirit, successful only until the government discovers and closes the loophole."); Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 366 (2005) ("[I]t simply is not possible to write tax laws that are devoid of all unintended loopholes."); Martin J. McMahon Jr., *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 2003 TAX NOTES 1721, 1722 ("The mechanical terms of specific rules . . . provide a tremendous temptation to treat the rules as an instruction manual for creating and structuring transactions outside the ordinary course of business or normal investments in which the taxpayer would not engage except as a result of the tax avoidance potential of the inventive transaction."); Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401, 409 (2010) [hereinafter Monroe, *What's in a Name*] ("[T]hese flaws create a playground for those who engage in transactions that comply with . . . literal language, yet result in tax consequences that Congress did not contemplate."); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 2002 TAX NOTES 511, 512–13; David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 860 (1999) [hereinafter Weisbach, *Formalism*] ("[T]axpayers have been able to manipulate the rules endlessly to produce results clearly not intended by the drafters").

generally, the taxpayer will not realize the resulting gain (or loss) for tax purposes until the taxpayer sells the asset for cash or exchanges it for other consideration.[2] If and when the taxpayer does sell or exchange the asset, the taxpayer will realize the resulting gain (or loss). At that time, in the case of gain, generally the taxpayer includes the resulting gain in income, subjecting the gain to tax at the taxpayer's effective tax rate,[3] and, in the case of loss, the taxpayer may be entitled to deduct the loss (saving tax at the taxpayer's effective tax rate).[4]

Instead of selling an asset, an individual might transfer the asset to another individual as a gift. If the asset has *increased* in value in the donor's hands, the donor will not recognize the accrued gain (referred to as "built-in gain") at the time of the gift, but, upon a subsequent sale of the property, the donee will recognize that gain, provided that the asset maintains its value.[5] If the donor had sold the property, the built-in gain would have been subject to tax at the donor's effective tax rate, but, as a result of the gift, the built-in gain will be subject to tax at the donee's effective tax rate instead.[6] This maneuver results in tax savings if the effective tax rate of the donee is lower than that of the donor.[7] If the asset has *decreased* in value in the donor's hands, the donor will not recognize the accrued loss (referred to as "built-in loss") at the time of the gift, and, upon a subsequent sale of the property, the donee will also not recognize that loss, assuming the value of the property remains constant.[8] Thus, taxpayers are prevented from shifting the tax consequences of an existing built-in loss (a strategy that would save tax if the donee could deduct the loss from income that was subject to a higher effective tax rate than the rate applicable to income, if any, against which the donor could deduct the loss). In summary, in the context of gifts, taxpayers *can* shift the tax consequences of an existing *built-in gain* from one taxpayer to another but *cannot* transfer the tax

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[2] For discussion of this requirement that gain or loss is generally not realized until a sale for cash or exchange for other consideration, see generally Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77 (2011).

[3] The taxpayer would include the gain in income unless a non-recognition provision applied and assuming that the gain was not subject to exclusion from income under special provisions, such as Section 121 (which excludes gain, up to certain dollar amounts, from sale of a principal residence, in some cases).

[4] Assuming a non-recognition provision does not apply, the taxpayer will recognize loss, and the taxpayer's ability to deduct the loss will depend on how the asset was held (as Section 165 provides different rules for deductibility of loss depending on how the taxpayer held the asset) and other factors, such as whether the sale occurred between related parties, as discussed below. *See infra* Part II.A.

[5] *See infra* Part I.A.

[6] This assumes that the "kiddie tax" imposed by Section 1(g) of the Internal Revenue Code would not apply to the gain recognized by the donee, because, for instance, the donee does not meet the age requirements of Section 1(g)(2)(A). *See* I.R.C. § 1(g) (2012).

[7] Because most gifts involve the transfer of capital assets and because the tax rates that apply to net capital gain are not as steeply graduated as those that apply to ordinary income, the ability to reduce tax liability through gifts is somewhat limited.

[8] *See infra* Part I.A.

consequences of an existing *built-in loss*. A similar dynamic is at play in the context of the contribution of property to a partnership and the allocation of tax gain or loss recognized upon a subsequent sale of the property, governed by Section 704(c).[9]

The current rules regarding gifts were adopted in the 1930s during the Great Depression.[10] At that time, the magnitude of accrued investment losses likely dwarfed the amount of accrued investment gains. Thus, understandably, lawmakers at that time likely perceived the ability to shift the tax consequences of built-in losses from one taxpayer to another as representing a far more significant threat to the tax base than the ability to shift the tax consequences of built-in gains. However, the failure to address built-in gains at the same time (or since that time) seems short-sighted. In the recently enacted tax legislation, Congress once again did nothing to address the ability to shift the tax consequences of built-in gains.

The provisions just described are not the only instances in which tax law treats losses with greater caution than gains. However, in the case of many of the other ways in which tax law provides stricter treatment to losses than gains, a legitimate justification for the inconsistent treatment exists. Namely, greater potential for tax-motivated transactions involving losses can explain the decision to address losses but not gains.[11] Some of the parameters of these provisions are not perfectly designed to achieve the goal of preventing tax-motivated transactions. Therefore, each may warrant some revision, as discussed below. However, in general terms, the decision to address losses but not gains in the context of these examples is a sensible one, and, therefore, not an example of the phenomenon that this Article intends to highlight. Examples of provisions that fall in this second category (in which the varying treatment of losses and gains can be rationalized) include Section 267(a)(1) and Section 362(e)(2). A detailed description of each of these provisions is deferred until Part II below. For now, suffice it to say that, in the case of each of these examples, harsher treatment is granted to losses than gains. However, this harsher treatment can be explained by the fact that the provisions prevent tax savings from transactions involving losses in situations in which parallel transactions involving gains do not present the same threat to the tax base. This is true because either the comparable transactions involving gains are already addressed by other provisions or the parallel transactions involving gains would result in no tax savings (or, in many cases, would result in increased tax liability).

At the outset, it is worth noting that inconsistent treatment of gains and losses is not the only way in which tax law does not treat similar transactions in a parallel fashion, and this Article does not contend that consistent treatment is always required or even desirable.[12] Rather, this Article observes that inconsistent treatment

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[9] *See infra* Part I.B.

[10] *See infra* notes 133–134 and accompanying text.

[11] To be clear, this Article does not claim that tax-motivated transactions are always undesirable or that tax motivation should always be relevant. Instead, this Article is taking an interpretative approach—it assumes that lawmakers might have the goal of discouraging tax-motivated transactions and it assesses whether or not the provisions serve that goal.

[12] For discussion of other examples involving non-parallel treatment, see generally Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and*

can sometimes be a signal that lawmakers have taken steps to deter some tax-motivated transactions while overlooking the potential for other, similar tax-motivated transactions. In the examples discussed in this Article, lawmakers took action to prevent tax-motivated transactions involving losses without addressing parallel transactions involving gains. In those instances, addressing the parallel transactions involving gains may be desirable for the sake of preventing tax-motivated transactions; not out of a desire to achieve consistency for consistency's sake. In some of these instances, lawmakers could achieve the goal of preventing tax-motivated transactions involving gains by adopting rules that were not parallel to the rules applicable to losses. For instance, lawmakers might address tax-motivated gifts of built-in gain property by requiring the donor to recognize gain at the time of the gift, while, at the same time, preventing deduction of losses in the case of a gift of built-in loss property.

This Article will proceed as follows. Part I will provide examples of provisions that grant harsher treatment to losses than gains in circumstances in which the inconsistent treatment is not founded upon any legitimate rationale. In order to provide useful contrasting examples, Part II will discuss provisions that justifiably treat losses more harshly than gains. Part III will explore rationales that might explain handling losses with more caution than gains. In particular, it will consider whether greater potential for tax-motivated transactions involving losses explains the unequal treatment, and it will conclude that this concern does not explain the unequal treatment in the case of the examples discussed in Part I but does explain the unequal treatment in the case of the examples discussed in Part II (at least if some of those provisions were modified to more accurately target tax-motivated transactions). As a second potential explanation, Part III will consider whether the unequal treatment of losses and gains is attributable to the difficulty of crafting an acceptable, parallel provision that would address gains, and Part III will conclude that this explanation might describe some of the examples but not all. Finally, Part IV will conclude that, in the case of examples for which no explanation justifies disparate treatment, the logical inference is that lawmakers ought to have also addressed gains, and the failure to do so results from lawmakers crafting an overly narrow response that addressed only the most recent, high profile gimmick in engineering transactions to reduce tax liability.

I. EXAMPLES OF QUESTIONABLE INCONSISTENT TREATMENT

In some instances, current law treats losses more harshly than gains even though the harsher treatment cannot be explained by greater potential for tax-

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Horizontal Equity, 57 HASTINGS L.J. 645 (2006). *See also* Rodney P. Mock & Jeffrey Tolin, *What's Mine is Mine: Taxing Pre-Contribution Gains*, 29 AKRON TAX J. 105, 106 (2014) ("Of course, from a policy perspective there is no blanket rule (or theory) in the Code, its regulations, or tax literature that transaction-related tax items such as gains and losses must achieve absolute parity in treatment.").

motivated transactions involving losses or, at least in some cases, by any legitimate rationale. Examples of this phenomenon include Section 1015, which prevents a donor from shifting a built-in loss to a donee but would allow the donor to shift a built-in gain, and Section 704(c), which prevents the shifting of a built-in loss in property contributed to a partnership from the contributing partner to other partners but allows, in some fact patterns, the shifting of a built-in gain. Each of these examples is discussed, in turn, below.

A. Basis in Property Received by Gift

In the context of gifts made during a donor's lifetime, Section 1015(a) prevents shifting the tax consequences of an existing built-in loss from the donor to the donee for purposes of allowing the donee to realize a loss on later sale of the property, but the same provision allows shifting the tax consequences of an existing built-in gain.[13] In order to demonstrate the existing rules, consider the following examples.

> **Example 1.** Mother acquires stock for $50. As a result, Mother's basis in the stock is $50.[14] Mother gives the stock to Daughter at a time when the stock is worth $150. Mother does not realize gain as a result of the gift,[15] and Daughter does not include the value of the stock in income.[16] Daughter's basis in the stock will be $50 (Mother's basis in the stock).[17] If Daughter sells the stock for $150, Daughter realizes $100 of gain (so the tax consequences of the gain that accrued while the stock was held by Mother have been shifted to Daughter).[18]

> **Example 2.** Mother acquires stock for $50. As a result, Mother's basis in the stock is $50.[19] Mother gives the stock to Daughter at a time when the stock is worth $20. Mother does not realize loss as a result of the gift, and Daughter does not include the value of the stock in income.[20] Daughter's basis in the stock will be $20 (the fair market value at the time of the gift) for purposes of

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[13] Specifically, Section 1015(a) provides: "If the property was acquired by gift . . . the basis shall be the same as it would be in the hands of the donor. . . except that if such basis . . . is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value." I.R.C. § 1015(a) (2012).

[14] *See id.* § 1012.

[15] Although no clear realization requirement is contained in the Code, the closest thing to statutory authority is I.R.C. § 61(a)(3) (providing that gains derived from dealings in property are included in gross income) combined with I.R.C. § 1001(a) (describing the amount of gain realized).

[16] *See* I.R.C. § 102(a) (2012).

[17] *See id.* § 1015(a).

[18] Her gain realized will be the excess of the $150 received on the sale over her $50 basis in the stock. *Id.* § 1001(a).

[19] *See id.* § 1012.

[20] *See id.* § 102(a).

> determining loss realized on a subsequent sale and $50 for purposes of determining gain realized on a subsequent sale.[21] If Daughter sells the stock for $20, Daughter realizes no loss (because $20 is not less than her $20 basis for purposes of determining loss) and no gain (because $20 is not more than her $50 basis for purposes of determining gain).[22] Thus, the $30 loss that accrued while Mother held the stock cannot be shifted to Daughter.

To summarize the examples above, assume a donor acquires property that increases in value in the donor's hands. The donor will not realize the gain that had accrued in the property at the time of the gift, and, therefore, the donor will not be subject to tax on the increase in value that occurred while the donor held the property. Assuming the property maintains its value, the donee will realize the built-in gain that accrued in the donor's hands upon a subsequent sale of the property by the donee. Thus, the donee (and not the donor) eventually will be subject to tax on the gain that accrued while the donor held the property. As discussed in more detail in Part III.A.1 below, if the donee's effective tax rate is lower than that of the donor, the overall effect of the current regime is to reduce the amount of tax imposed on the gain. In Example 1 above, for instance, if Mother's effective tax rate is 20% and Daughter's effective tax rate is 15%, the $100 gain that accrued in the stock will result in $15 of tax ($100 times 15%) when Daughter sells the stock instead of the $20 of tax ($100 times 20%) that would have been imposed if Mother had sold the stock.[23]

By contrast, assume that property declines in value in the donor's hands. The donor will not realize the accumulated loss at the time of the gift, and, therefore, the donor will not be allowed to potentially deduct a resulting tax loss so that the donor will forgo potential tax savings. Assuming the property does not decline in value further in the donee's hands, the donee also will realize no loss upon a subsequent sale of the property. Thus, no one, neither the donor nor the donee, will obtain any tax deduction for the loss that accrued while the donor held the property. As discussed in more detail in Part III.A.1 below, the current regime prevents the potential tax savings that would result if the rules regarding losses were symmetrical to the rules regarding gains. In particular, if the rules regarding losses mirrored the rules regarding gains, then, upon a subsequent sale of the property, the donee would realize the loss that accrued while the donor held the property, assuming the property

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[21] *See id.* § 1015(a).

[22] If Daughter sold the stock for $60, Daughter would recognize a gain of $10 because Daughter's basis in the stock is $50 for purposes of determining a subsequent gain. *See id.* Essentially the $40 increase in value that accrued in Daughter's hands can be offset by the $30 built-in loss that existed at the time of the gift.

[23] Because most gifts involve the transfer of capital assets and because the tax rates that apply to net capital gain are not as steeply graduated as those that apply to ordinary income, the ability to reduce tax liability through gifts is somewhat limited. Furthermore, this example assumes that the "kiddie tax" imposed by Section 1(g) of the Internal Revenue Code would not apply to the gain recognized by Daughter, because, for instance, Daughter does not meet the age requirements of Section 1(g)(2)(A).

did not recover the lost value by the time of the subsequent sale. If the donee's effective tax rate were higher than that of the donor, the overall effect of this alternative regime would be to increase the amount of tax savings resulting from the loss. In Example 2 above, for instance, if Mother's effective tax rate is 0% and Daughter's effective tax rate is 15%, the $30 loss that accrued in the stock would result in $0 of tax savings ($30 times 0%) if Mother sold the stock, but, if the loss could be shifted to Daughter, it would result in $4.50 of tax savings ($30 times 15%) when Daughter sold the stock. Because the loss cannot be shifted to Daughter, however, the loss results in no tax savings for either individual.

B. Subsequent Sale of Property Contributed to a Partnership

As discussed above in Part I.A, current law allows a donor to shift, to the donee, the tax consequences of a built-in gain that has accrued in property while in the donor's hands. By contrast, current law does not allow a donor to shift the tax consequences of a built-in loss to the donee. Similarly, when a taxpayer contributes to a partnership property that has appreciated in value in the taxpayer's hands, in some circumstances, tax law allows the taxpayer to shift to the other partners the tax consequences of a portion of the gain that accrued while the partner held the property. By contrast, current law forbids similar shifting of the tax consequences of an accrued loss. Demonstrating the varying rules requires some background regarding the tax consequences of contributing property to a partnership and the subsequent sale of the property by the partnership.

When a partner contributes property to a partnership, the partner and the partnership generally do not recognize any gain or loss for tax purposes as a result of the contribution.[24] In order to demonstrate, consider the following example:

> **Example 3**. An individual, A, owns a piece of land that A acquired some time ago for $5,000. The value of the land has increased over time so that the land is currently worth $15,000. A and B, another individual, form an entity that is treated as a partnership for tax purposes. A contributes the land and B contributes $15,000 cash to this newly formed AB partnership, each in exchange for a 50% interest in the AB partnership.

Under the facts of Example 3, A will not be required to recognize (and possibly pay tax on) the $10,000 built-in gain that exists in the land at the time of the contribution.[25] However, in order to ensure that the $10,000 built-in gain is preserved to be potentially recognized at a future point in time, the AB partnership will obtain a tax basis in the land equal to $5,000 (A's basis in the land),[26] and A will obtain a tax basis in A's interest in the partnership equal to $5,000 (A's basis in

[24] *See* I.R.C. § 721 (2012).
[25] *See id.* § 721(a).
[26] *See id.* § 723.

the land).[27] As a result, if A sold his or her interest in the partnership for $15,000 after the contribution, A would recognize $10,000 of tax gain, and if the AB partnership sold the land for $15,000 after the contribution, the AB partnership would recognize $10,000 of tax gain. Moreover, a partnership does not itself pay tax at an entity level on income recognized by the partnership but, rather, allocates items of taxable income, gain, loss and deduction among its partners so that its partners will take such items into account for purposes of computing their taxable income.[28] Consequently, this $10,000 of tax gain recognized by the partnership would be allocated to the partners.[29]

Regarding how the $10,000 tax gain would be allocated, § 704(c)(1)(A) provides:

> "[I]ncome, gain, loss, and deduction with respect to property contributed to the partnership 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 the contribution."[30]

In other words, under the facts of Example 3, if the AB partnership sells the land for $15,000 so that the AB partnership recognizes $10,000 of tax gain, the $10,000 tax gain must be allocated between A and B in a manner that takes into account the difference between the basis of the land ($5,000) and the fair market value of the land ($15,000) at the time A contributed the land to the partnership.[31] Section 704(c)(1)(A) leaves to the Treasury Regulations the task of specifying how allocations should take into account built-in gain or built-in loss that exists in property at the time at which it is contributed to a partnership.[32] The Treasury Regulations under § 704(c) provide that allocations must be made using a "reasonable method" that is consistent with the purpose of § 704(c). This purpose, according to the Treasury Regulations, is to "prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss."[33] The

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[27] *See id.* § 722.

[28] *Id.* §§ 701–702.

[29] Likewise, if the value of the land had declined in value over time prior to the contribution so that, while A acquired the land for $25,000, the land was worth $15,000 at the time of the contribution, A would not be allowed to recognize the $10,000 built-in loss that existed in the land at the time of the contribution. *See id.* § 721. If A sold his or her interest in the partnership for $15,000 after the contribution, A would recognize $10,000 of tax loss. *Id*. § 722. If the AB partnership sold the land for $15,000 after the contribution, the AB partnership would allocate $10,000 of tax loss to A. *See id.* § 704(c)(1)(C).

[30] *Id.* § 704(c)(1)(A).

[31] If, instead of land, a partner contributes depreciable property to a partnership, section 704(c) also governs the allocation of tax depreciation deductions with respect to the property with the same goal of preventing a shift of tax consequences among partners with respect to pre-contribution gain or loss. *See id.* § 704(c).

[32] *Id*. § 704(c)(1)(A).

[33] Treas. Reg. § 1.704–3(a)(1) (2017).

Treasury Regulations describe three methods that are "generally reasonable."[34] These three methods are the "traditional method," the "traditional method with curative allocations," and the "remedial allocation method."[35] The Treasury Regulations do not require that partnerships use any particular method, and, in fact, the Treasury Regulations provide that a partnership may use different methods with respect to different items of contributed property as long as the "overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of section 704(c)."[36]

1. Contribution of Appreciated Property

If a partner contributes property that has increased in value before contributing it to a partnership and the property declines in value after the contribution, use of the "traditional method" will result in shifting the tax consequences of, at least some of, the built-in gain away from the contributing partner and to the other partners. By contrast, use of the "remedial allocation method" would prevent shifting the tax consequences to the other partners.[37] Furthermore, in the case of depreciable property, the method elected by the partnership can affect the allocation of depreciation deductions even if the value of the property does not decline, and in this area as well, the remedial method most consistently guarantees that tax consequences will not be shifted from the contributing partner to a non-contributing partner.[38] In order to demonstrate the potential for gain-shifting, consider the

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[34] *Id.*

[35] *Id.* §§ 1.704-3(a)(1)–(d)(1).

[36] *Id.* § 1.704-3(a)(2). In addition, the Treasury Regulations contain an anti-abuse rule that places some constraints on the flexibility afforded by the Regulations. *Id.* § 1.704-3(a)(10). For further discussion of the anti-abuse rule, see Emily Cauble, *Making Partnerships Work for Mom and Pop and Everyone Else*, 2 COLUM. J. TAX L. 247, 261–63 (2011).

[37] Treas. Reg. § 1.704-3(d)(1) (2017). Use of the "traditional method with curative allocations" may or may not prevent shifting the tax consequences of the gain to the other partners, depending on other items recognized by the partnership. Because discussion of this method is not necessary to illustrate the observations made by this Article, further discussion of it is omitted.

[38] This can be illustrated with an example that is a simplified version of the facts of *Castle Harbour*. TIFD III-E, Inc. v. United States (Castle Harbour), 459 F.3d 220 (2d Cir. 2006). Assume T and TE form an entity that is treated as a partnership for tax purposes. T is subject to U.S. tax on income allocated to T from the partnership, but TE is not subject to U.S. tax on income allocated to TE from the partnership. T contributes airplanes to the partnership. The airplanes are depreciable. At the time of the contribution, the airplanes are worth $1,000, but the airplanes have a tax basis of $100. Furthermore, the airplanes have a remaining depreciation recovery period of one year. TE contributes $1 of cash to the partnership. The partnership leases the airplanes to a third party and earns $1,000 of rental income for one year. The partnership sells the airplanes for $0 and liquidates in year 10. Assume the partnership agrees that, for purposes of determining the partners' book capital accounts that will measure the amount each partner is entitled to receive on liquidation of

following example:

> **Example 3A**. An individual, A, owns a piece of land that A acquired some time ago for $5,000. The value of the land has increased over time so that the land is currently worth $15,000. A and B, another individual, form an entity that is treated as a partnership for tax purposes. A contributes the land and B contributes $15,000 cash to this newly formed AB partnership, each in exchange for a 50% interest in the AB partnership. As a result of the contribution, A does not recognize any tax gain.[39] Following the contribution,

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the partnership, all book income and loss will be allocated 99% to TE and 1% to T. In year 1, the book items that are allocated 99% to TE and 1% to T consist of: (1) book depreciation of $1,000 (measured as: $1,000 beginning book value of airplanes x ($100 tax depreciation/$100 beginning tax basis of airplanes) per Treas. Reg. § 1.704–1(b)(2)(iv)(g)(3)); and (2) $1,000 of rent received. Thus, on net $0 of book gain is allocated 99% ($0) to TE and 1% ($0) to T. Consequently, capital account balances of T and TE remain $1,000 for T (T's initial capital account balance since T contributed property worth $1,000) and $1 for TE (TE's initial capital account balance since TE contributed $1 of cash) at the end of year 1. As a result, even though 99% of book items are allocated to TE, when the partnership distributes the $1,001 of cash that it holds on liquidation, TE receives $1 and T receives $1,000. Regarding the allocation of tax items in year 1, if the partnership uses the traditional method for making § 704(c) allocations with respect to the airplanes (as the taxpayer did in *TIFD III-E, Inc.*), the results will be as follows. First, because $1,000 of book income attributable to rent received by the partnership is allocated 99% to TE and 1% to T, $1,000 of taxable income recognized by the partnership as a result of rent received by the partnership will be allocated 99% ($990) to TE and 1% ($10) to T. Second, because $1,000 of book depreciation is allocated $990 to TE and $10 to T, tax depreciation from the airplanes would be allocated in the same manner if it was available. However, the only tax depreciation available is $100, which is allocated in its entirety to TE to get as close as possible to matching the allocation of book depreciation. Thus, in total, taxable income is allocated $890 to TE who is not subject to tax and $10 to T. If the partnership instead uses the remedial method for making I.R.C. § 704(c) allocations with respect to the airplanes, for one thing, book depreciation of the airplanes would be spread over a longer period of time per Treas. Reg. § 1.704-3(d)(2). Also, the partnership would invent notional tax items of depreciation to match book depreciation allocated to TE and equal, offsetting notional tax items of operating income from the airplanes to allocate to T. For the sake of simplicity, if we focus on the second modification made by the remedial method, then total tax items allocated in year 1 would be: $0 to TE (which consists of $990 of rental income, $100 of actual tax depreciation, and $890 of notional tax depreciation) and $900 to T (which consists of $10 of actual rental income and $890 of notional operating income from the airplanes). Consequently, T's taxable income effectively equals $1000 of rental income minus $100 of remaining tax depreciation on the airplanes, and no taxable income is shifted from T (who is subject to tax) to TE (who is not subject to tax). If both modifications made by the remedial method are applied, then even under the remedial method, some taxable income could be shifted temporarily from T to TE, but the shift would be less drastic than what occurs under the traditional method.

[39] *See* I.R.C. § 721(a) (2012).

> the partnership's basis in the land is $5,000,[40] A's basis in his or her interest in the partnership is $5,000,[41] and B's basis in his or her interest in the partnership is $15,000.[42] One year after the partnership was formed, the AB partnership sells the land for $10,000. Two years after selling the land, the AB partnership distributes the cash that it holds ($25,000) equally to A and B ($12,500 each).

Under the facts of Example 3A, because the partnership's basis in the land is $5,000, the partnership recognizes $5,000 of tax gain upon sale of the land for $10,000. If the partnership uses the traditional method for allocating items under § 704(c) with respect to the land, $5,000 of tax gain will be allocated to A and no tax gain or loss will be allocated to B. In effect, use of the traditional method, under the facts of Example 3A, results in a shift from A to B of $2,500 of the $10,000 tax gain attributable to the increase in value of the land that occurred while it was owned by A. Prior to A's contribution of the land, the land increased in value by $10,000 (to $15,000), and A benefited economically from that increase in value in its entirety because A was able to exchange the land for a 50% interest in a partnership that held assets worth $30,000. Subsequent to A's contribution of the land to the AB partnership, the value of the land declined by $5,000. Because A and B share the economic benefits and burdens of the AB partnership equally, this decline in value will be shared equally by A and B ($2,500 each), so that, for example, when the partnership distributes the cash that it holds ($25,000) in liquidation, each of A and B receive $12,500 ($2,500 less than the value that each contributed to the partnership). Consequently, if A and B were each allocated taxable gain and loss in an amount that matched economic gain and loss, A would be allocated $10,000 of tax gain from sale of the land and $2,500 of tax loss from sale of the land (or $7,500 of tax gain from sale of the land on net), and B would be allocated $2,500 of tax loss from sale of the land. However, because the only tax item recognized by the partnership as a result of sale of the land is $5,000 of tax gain, $5,000 of tax gain is allocated to A to get as close as possible to the result described above, while using only tax items actually recognized by the partnership from sale of the land.[43] Compared to what should have been allocated to the partners based on their economic gain and loss, A is allocated $2,500 less tax gain than what A should have been allocated, and B is allocated $2,500 less tax loss than what B should have been allocated. In effect, $2,500 of tax gain has been inappropriately shifted from A to B.[44]

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[40] *See id.* § 723.

[41] *See id.* § 722.

[42] *See id.*

[43] Limiting the partnership to using tax items actually recognized from sale of the land is called the "ceiling rule." Abiding by the "ceiling rule" is the distinguishing feature of the traditional method. *See, e.g.*, Leigh Osofsky, *Unwinding the Ceiling Rule*, 34 VA. TAX. REV. 63, 64 (2014).

[44] This shift occurs because the $5,000 tax gain recognized by the partnership is effectively the net result of the $10,000 of gain that accrued prior to contribution of the land and the $5,000 of loss that accrued after contribution of the land. Netting the two figures

Moreover, while this shift may be temporary, it can, nevertheless, significantly affect the tax consequences experienced by A and B. After the allocation of the $5,000 tax gain from sale of the land to A, A's basis in his or her interest in the partnership will increase to $10,000,[45] and B's basis in his or her interest in the partnership will remain $15,000. If the partnership distributes $12,500 cash to each of A and B in liquidation of the partnership, A will recognize $2,500 of tax gain (the excess of $12,500 cash over A's $10,000 basis in his or her interest in the partnership), and B will recognize $2,500 of tax loss (the excess of B's $15,000 basis in his or her interest in the partnership over $12,500).[46] The $2,500 tax loss recognized by B corresponds to the $2,500 tax loss from sale of the land that should have been but was not allocated to B at the time of the sale of the land, as a result of shifting $2,500 of tax gain from A to B. Likewise, the $2,500 tax gain recognized by A corresponds to the $2,500 tax gain from sale of the land that should have been allocated to A but was instead shifted from A to B. However, recognition of a $2,500 tax loss (or gain) on liquidation by B (or A) does not fully compensate for the earlier shift in tax gain from A to B. For one thing, tax gain and loss from sale of the land could be of a different character, with different resulting tax consequences, than tax gain or loss recognized on liquidation. For another, the tax loss (or gain) on liquidation may be recognized years later if substantial time elapses between sale of the land and liquidation of the partnership.[47]

Unlike the traditional method, the remedial method does not rely on tax gain or loss recognized on liquidation of the partnership to potentially correct for an earlier shift in tax consequences attributable to a pre-contribution change in asset value. Rather, under the remedial method, the partnership invents purely fictional tax items of precisely the right amount and the right character to ensure that any shift in tax consequences attributable to a pre-contribution change in asset value is completely offset at the exact time that it would otherwise occur.

In order to illustrate the operation of the remedial method, we return to the facts of Example 3A set forth above. In that example, when the partnership sells the land for $10,000, on net, A has realized $7,500 of economic gain with respect to the land. This $7,500 net economic gain can be separated into two components: (1) $10,000 of economic gain that accrued between the time A acquired the land for $5,000 and the time A exchanged the land for a 50% interest in a partnership that held assets worth $30,000 and (2) A's 50% share of the $5,000 of economic loss that accrued between the time A contributed the land and the time the partnership sold the land. In total, B has realized $2,500 of economic loss with respect to the land, which represents B's 50% share of the $5,000 economic loss that accrued after the land was contributed to the partnership. Therefore, if A and B were allocated tax gain and

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results in $2,500 of the tax gain attributable to the pre-contribution increase in value of the land that economically benefited A offsetting the portion of the tax loss attributable to the post-contribution decline in value of the land that economically burdened B.

[45] *See* I.R.C. § 705(a)(1)(A) (2012).

[46] *See id.* § 731(a).

[47] For discussion of additional ways in which unwinding the shift of tax consequences could be delayed or prevented, see Osofsky, *supra* note 43.

loss in connection with a sale of the land in an amount that precisely matched economic gain and loss realized by each partner, A would be allocated $7,500 of tax gain and B would be allocated $2,500 of tax loss. However, under the traditional method, the partnership allocates $5,000 of tax gain to A because that is the only tax item actually recognized by the partnership. Thus, under this method, A is allocated $2,500 less tax gain than what should be allocated to A, and B is allocated $2,500 less tax loss than what should be allocated to B because $2,500 of tax gain has effectively been shifted from A to B. Under the remedial method, on the other hand, the partnership invents a fictional item (which is treated in the same manner as an actual item) of $2,500 of tax loss from sale of the land and an equal and offsetting fictional item (which, again, is treated in the same manner as an actual item) of $2,500 of tax gain from sale of the land. In addition to allocating $5,000 of actual tax gain to A, the partnership allocates the $2,500 of fictional tax gain to A, so that A recognizes, in total, $7,500 of tax gain—an amount that precisely matches economic gain realized by A. Likewise, the partnership allocates the fictional item of $2,500 of tax loss to B, which precisely matches economic loss realized by B. As a result, the partnership shifts no tax gain from A to B. Furthermore, because the partnership has allocated tax items to A and B in an amount that matches economic gain and loss realized and the partnership has not shifted any tax gain from one partner to the other, A and B will not recognize any further tax gain or loss when they each receive $12,500 of cash on liquidation. In particular, after the partnership allocates: (i) $7,500 of tax gain from sale of the land to A and (ii) $2,500 of tax loss from sale of the land to B, A's basis in his or her interest in the partnership will increase to $12,500,[48] and B's basis in his or her interest in the partnership will decrease to $12,500.[49] Therefore, when the partnership distributes $25,000 of cash equally to A and B on liquidation ($12,500 each), A and B will not recognize gain or loss as a result of the liquidation.[50]

2. *Contribution of Depreciated Property*

As illustrated above, when a partner contributes property with a built-in gain to a partnership and the property subsequently declines in value, the tax consequences of the built-in gain may be shifted from the contributing partner to other partners, at least temporarily. Such a shift occurs when the partnership uses the "traditional method" under Section 704(c) but is prevented if the partnership uses the "remedial method." By contrast, if a partner contributes property with a built-in loss to a partnership, Section 704(c)(1)(C) prevents shifting the loss from the contributing partner to other partners, regardless of the method used by the partnership under Section 704(c). In order to demonstrate, consider the following example.

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[48] *See* I.R.C. § 705(a)(1)(A) (2012).
[49] *See id.* § 705(a)(2)(A).
[50] *See id.* § 731(a).

> **Example 4**. Assume two individuals, A and B, form a partnership. A contributes land with a basis of $200 and a fair market value of $150 to the partnership in exchange for a 50% interest in the partnership. B contributes $150 cash to the partnership in exchange for a 50% interest in the partnership. As a result of the contribution, A does not recognize any tax loss.[51] One year after the partnership was formed, the AB partnership sells the land for $200. Two years after selling the land, the AB partnership distributes the cash that it holds ($350) equally to A and B ($175 each).

If it were not for Section 704(c)(1)(C), use of the traditional method would have the effect of shifting some of the built-in loss from A to B, and use of the remedial method would prevent any such shifting. Because of Section 704(c)(1)(C), no transfer of the built-in loss will occur regardless of the method used.

In particular, absent Section 704(c)(1)(C) and assuming the partnership used the traditional method, the results would be as follows. When the partnership sold the land for $200, the partnership would recognize $0 of tax gain or loss given that the partnership's basis in the land would be $200 (A's basis in the land). B would have experienced a $25 economic gain (B's 50% share of the $50 increase in the value of the land that occurred after the partnership was formed), and, therefore, B should be allocated $25 of tax gain. However, B would be allocated no tax gain because the partnership would recognize no tax gain. A would have experienced a $25 economic loss (the $50 loss that accrued as the land declined in value prior to A contributing it to the partnership netted against A's 50% share of the $50 increase in the value of the land that occurred after the partnership was formed). Therefore, A should be allocated $25 tax loss, but A would be allocated no tax loss because the partnership recognizes none. Thus, at the time of sale, A would be allocated $25 too little tax loss and B would be allocated $25 too little tax gain because, in effect, $25 of tax loss would have been shifted from A to B.[52]

Even without Section 704(c)(1)(C), if the partnership used the remedial method, no transfer of the tax consequences of the built-in loss would occur. In particular, upon sale of the land, if the partnership recognized no actual tax gain or loss, the partnership would invent $25 of tax gain to allocate to B (to match B's $25 economic gain), and the partnership would invent an equal, offsetting $25 of tax loss to allocate to A (to match A's $25 economic loss).[53]

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[51] *See id.* § 721(a).

[52] Under the facts above, upon liquidation, A would recognize a $25 tax loss and B would recognize a $25 tax gain to compensate, to some degree, for the earlier shift in tax loss. This occurs because A's basis in his or her partnership interest would be $200 so the receipt of a $175 cash liquidating distribution results in A recognizing a $25 loss, and B's basis in his or her partnership interest would be $150 so the receipt of a $175 cash liquidating distribution results in B recognizing a $25 gain. *See* I.R.C. §§ 705, 731(a) (2012). For discussion regarding why this later adjustment does not fully compensate for the earlier shift in tax consequences, see *supra* note 47 and accompanying text.

[53] Furthermore, under these facts, A and B would recognize no tax gain or loss on

The adoption of Section 704(c)(1)(C) prevents the partnership from transferring the tax consequences of the existing built-in loss from A to B even if the partnership uses the traditional method. In particular, as clarified by Treasury Regulations proposed in 2014,[54] under the facts of Example 4, the partnership will be treated as having a basis in the land of \$150 (the fair market value of the land at the time of the contribution), and A (the contributing partner) will be entitled to a \$50 "basis adjustment" with respect to the land (where \$50 is the amount of the built-in loss that existed in the land at the time of the contribution). When the partnership sold the land for \$200, the partnership would recognize \$50 of tax gain (\$200 minus the partnership's \$150 tax basis), and the partnership would allocate the tax gain equally to each partner (\$25 each), consistently with how the partners share the corresponding economic gain. In determining the amount that is allocated to A (the contributing partner), however, the partnership would factor in A's \$50 basis adjustment which has the effect of transforming A's \$25 gain into a \$25 loss (\$25 minus \$50). The basis adjustment has no effect on the gain allocated to B. Thus, when the dust settles, the partnership allocates \$25 tax loss to A and \$25 tax gain to B, amounts which precisely match each partner's economic gain or loss. As a result, none of the existing built-in loss is shifted from A to B.[55]

3. *Summary*

In summary, when a taxpayer contributes to a partnership property that has appreciated in value in the taxpayer's hands, in some circumstances, tax law allows the taxpayer to shift to the other partners the tax consequences of a portion of the gain that accrued while the partner held the property. By contrast, current law forbids similar shifting of the tax consequences of an accrued loss. This pattern closely resembles what occurs in the context of gifts because, in that context as well, tax law allows for the tax consequences of a built-in gain to be shifted from a donor to a

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liquidation. A's basis in his or her partnership interest would be \$175 (\$200 minus \$25 tax loss allocation) so the receipt of a \$175 cash liquidating distribution results in A recognizing no tax gain or loss, and B's basis in his or her partnership interest would be \$175 (\$150 plus \$25 tax gain allocation) so the receipt of a \$175 cash liquidating distribution results in B recognizing no tax gain or loss. *See* I.R.C. §§ 705, 731(a) (2012).

[54] Prop. Treas. Reg. § 1.704–3(f), 79 Fed. Reg. 3042 (Jan. 16, 2014). Prior to the adoption of the proposed regulations, there was some confusion regarding how Section 704(c)(1)(C) would operate, and the proposed regulation does not necessarily dispel all of the uncertainty. For further discussion, see Osofsky, *supra* note 43, at 104–105; Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381, 1419–20 (2009).

[55] Furthermore, under these facts, A and B would recognize no tax gain or loss on liquidation. This occurs because A's basis in his or her partnership interest would be \$175 so the receipt of a \$175 cash liquidating distribution results in A recognizing no tax gain or loss, and B's basis in his or her partnership interest would be \$175 so the receipt of a \$175 cash liquidating distribution results in B recognizing no tax gain or loss. *See* I.R.C. §§ 705, 731(a) (2012).

donee but restricts the ability to transfer the tax consequences of a built-in loss. As will be explored below in Part III, the varying treatment of gains and losses in the context of these examples is difficult to rationalize in any satisfactory way. However, there are examples of ways in which tax law treats gains and losses asymmetrically that do not defy logical explanation. Part II below will turn to a discussion of examples that fall in this latter category.

II. EXAMPLES OF JUSTIFIABLY INCONSISTENT TREATMENT

As Part I above discussed, for both gifts of property and contributions of property to a partnership, tax law allows the tax consequences of an existing built-in gain to be shifted from one taxpayer to another taxpayer but prohibits a similar transfer of the tax consequences of an existing built-in loss. As will be described below in Part III, in the context of gifts and contributions of property to a partnership, the harsher treatment allotted to built-in losses cannot be justified based upon a greater potential for tax-motivated transactions involving losses than gains. However, in other instances, greater potential for tax-motivated transactions involving losses can explain provisions that address losses but not gains. Some of the parameters of these provisions are not perfectly designed to achieve the goal of preventing tax-motivated transactions. Therefore, each may warrant some revision, as discussed below in Parts III.A.3 and III.A.4. However, in general terms, the decision to address losses but not gains in the context of these examples is a sensible one. Examples of provisions that fall in this second category (in which the varying treatment of losses and gains can be rationalized) include Section 267(a)(1) and Section 362(e)(2), each of which is discussed, in turn, below.

A. Sale to a Related Party

Like the examples discussed above in Part I, Section 267(a)(1) treats losses differently from gains. In particular, Section 267(a)(1) disallows the deduction of losses recognized on sale of property between certain related parties.[56] If such a sale resulted in recognition of gain, however, the resulting gain generally would be included in income. In order to demonstrate, consider the following examples.

> **Example 5**. Mother acquires stock for \$50. As a result, Mother's basis in the stock is \$50.[57] Mother sells the stock to Daughter for \$20 at a time when the stock is worth \$20. Mother recognizes \$30 of loss from the sale, but Mother cannot deduct the \$30 loss.[58] Daughter's basis in the stock will be \$20 (cost

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[56] *Id.* § 267(a)(1) ("No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b)."). Related parties include not only family members but also various related entities, as well as individuals and entities in which individuals own sufficient interests. *Id.* §§ 267(b)–(c).

[57] *See id.* § 1012.

[58] *See id.* § 267(a)(1).

> basis). If Daughter sells the stock for $20, Daughter recognizes no loss (because $20 is not less than her $20 basis). Thus, the $30 loss that accrued while Mother held the stock cannot be recognized by Mother and is never recognized because Daughter takes a cost basis in the stock.[59]
>
> **Example 6**. Mother acquires stock for $50. As a result, Mother's basis in the stock is $50.[60] Mother sells the stock to Daughter for $150 at a time when the stock is worth $150. Mother recognizes and includes in income $100 of gain as a result of the sale.[61] Daughter's basis in the stock will be $150 (cost basis).[62] Thus, the $100 gain that accrued while Mother held the stock is recognized by Mother and included in her income at the time of the sale.

Thus, current law grants harsher treatment to losses than gains in transactions involving the sale of property between related taxpayers. Any resulting losses cannot be deducted, while any resulting gains generally are included in income.

B. Section 362(e)(2)

When a shareholder, or group of shareholders, contributes property to a corporation in exchange for stock, the shareholder(s) will not recognize the gain or loss built into the property as long as the contributing shareholder(s) own(s) a controlling interest in the corporation immediately after the contribution.[63] To ensure that any built-in gain or loss that is not recognized at the time of the contribution is, instead, recognized at the time of a future transaction, the built-in gain or loss will be preserved.

In order to demonstrate, consider the facts of the following example.

> **Example 7**. Assume an individual acquires a parcel of land for $100. Over time, the value of the land decreases to $75. The individual contributes the land to a newly formed corporation in exchange for all of the corporation's stock. The individual will not recognize any tax loss as a result of this exchange.[64]

Under law that existed prior to 2004, under the facts of Example 7, the individual's basis in the stock received would be $100 (the same as the individual's

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[59] If Daughter sold the stock for $60, Daughter would recognize a gain of $10, because Daughter can offset the $40 gain recognized ($60 minus $20 basis) by the $30 loss that Mother recognized and could not deduct. *See id.* § 267(d)(1)(B). The resulting treatment, in effect, parallels the treatment that follows from a gift of property with a built-in loss. *See supra* note 22.

[60] I.R.C. § 1012 (2012).

[61] *See id.* § 1001.

[62] *See id.* § 1012.

[63] *Id*. § 351.

[64] *See id.* § 351(a).

basis in the land),[65] and the corporation's basis in the land would be $100 (the same as the individual's basis in the land).[66] Thus, if the individual were to sell the stock for $75, the individual would recognize a $25 tax loss. Likewise, if the corporation sold the land for $75, the corporation would recognize a $25 tax loss. Therefore, the individual would have incurred one $25 economic loss (having acquired land that decreased in value by $25), but, rather than sell the land directly and recognize only one $25 tax loss, the individual could create two $25 tax losses—one to be recognized by the individual and one to be recognized by the corporation.

In 2004, Congress enacted legislation to combat the prospect of an individual contributing built-in loss property to a corporation in order to extract two tax losses from one economic loss.[67] Under rules in effect since 2004, the built-in loss may be preserved at only one level.[68] However, taxpayers can decide whether to preserve the loss at the shareholder level or at the corporate level.[69] In particular, if no election is filed, the built-in loss will be preserved at the shareholder level only.[70] Thus, in Example 7 above, the individual's basis in the stock would be $100 (preserving a $25 built-in loss in the stock), but the corporation's basis in the land would be $75 (preserving no built-in loss in the land). However, if the individual and the corporation both make an election under Section 362(e)(2)(C), the built-in loss will be preserved at the corporate level only.[71] In the example above, if such an election were made, the individual's basis in the stock would be $75 (preserving no built-in loss in the stock), but the corporation's basis in the land would be $100 (preserving a $25 built-in loss in the land).

As just described, if built-in loss property is contributed to a corporation in a transaction in which the loss is not recognized at the time of the contribution, the loss will be preserved only once (either in the stock held by the shareholder or in the asset held by the corporation). This treatment prevents the duplication (for tax purposes) of an existing economic loss. By contrast, if built-in gain property is contributed to a corporation in a transaction in which the gain is not recognized, the gain is duplicated for tax purposes. It will be preserved in the stock held by the shareholder and in the asset held by the corporation. In order to demonstrate, consider the following example.

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[65] *See id.* § 358(a)(1).

[66] *See id.* § 362(a).

[67] For additional discussion, see Douglas A. Kahn & Jeffrey H. Kahn, *Prevention of Double Deductions of a Single Loss: Solutions in Search of a Problem*, 26 VA. TAX REV. 1 (2006).

[68] I.R.C. § 362(e)(2) (2012).

[69] *Id.* § 362(e)(2).

[70] *Id.* § 362(e)(2)(A).

[71] *Id.* § 362(e)(2)(C).

Example 8. Assume an individual acquires a parcel of land for $50. Over time, the value of the land increases to $75. The individual contributes the land to a newly formed corporation in exchange for all of the corporation's stock. The individual will not recognize any tax gain as a result of this exchange.[72]

Under the facts of Example 8, the individual's basis in the stock received is $50 (the same as the individual's basis in the land),[73] and the corporation's basis in the land is $50 (the same as the individual's basis in the land).[74] Thus, if the individual were to sell the stock for $75, the individual would recognize a $25 tax gain. Likewise, if the corporation sold the land for $75, the corporation would recognize a $25 tax gain. Therefore, the individual would have benefited from only one $25 economic gain (having acquired land that increased in value by $25), but, rather than sell the land directly and recognize only one $25 tax gain, the contribution creates two tax gains in the future. One $25 tax gain will be recognized by the individual and one $25 tax gain will be recognized by the corporation.

In summary, when property with a built-in loss is contributed to a corporation in a transaction in which the loss is not recognized, the loss will be preserved at only one level—either in the contributing shareholder's basis in the stock or in the corporation's basis in the asset, but not in both. This result prevents potential duplication of tax losses. By contrast, when property with a built-in gain is contributed to a corporation in a transaction in which the gain is not recognized, the gain will be preserved at two levels—both in the shareholder's basis in the stock and in the corporation's basis in the asset. Thus, while tax losses are not duplicated, tax gains are.

III. POTENTIAL RATIONALES

As evidenced by the provisions discussed in Parts I and II, examples of ways in which tax law administers stricter treatment to losses than gains are plentiful.[75]

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[72] *See id.* § 351(a).

[73] *See id.* § 358(a)(1).

[74] *See id.* § 362(a).

[75] The examples discussed above in Parts I and II, although numerous, do not constitute the entire universe of provisions that grant harsher tax treatment to losses than gains. Other examples include: (1) the tax treatment of non-liquidating property distributions by corporations (I.R.C. § 311 provides that a corporation generally will recognize gain when it distributes appreciated property but will not recognize loss when it distributes depreciated property); (2) the tax treatment of liquidating distributions by corporations (I.R.C. § 336 provides that, except for liquidations governed by Section 337, a corporation generally will recognize gain or loss when it distributes appreciated or depreciated property in a liquidating distribution, but I.R.C. § 336(d) describes circumstances in which loss will not be recognized); (3) in the partnership context, mandatory basis adjustments are required to prevent potential duplication of large tax losses, but gain duplication is allowed unless the taxpayer opts otherwise, per I.R.C. §§ 734, 743, and 754; (4) I.R.C. § 737 requires partners

This Part III will explore whether any legitimate rationale justifies the more severe approach to losses. It will first consider whether a greater potential for tax-motivated transactions involving losses offers a suitable explanation.[76] As discussed below, this rationale does not justify the varying treatment of losses and gains following from the provisions discussed in Part I, but it could satisfactorily explain the contrasting treatment of losses and gains afforded by the provisions discussed in Part II (granting that the provisions discussed in Part II could, in many cases, benefit from better design to more accurately achieve this goal).

As a second potential justification for the provisions that are not explained by the goal of preventing tax-motivated transactions, this Part III will consider whether the difficulty of crafting a parallel provision to address tax-motivated transactions involving gains accounts for the inconsistent treatment of losses and gains. As discussed below, this possibility might, to some degree, shed light on the discrepancy between the treatment of gifts of property with built-in gains and the treatment of gifts of property with built-in losses. However, it leaves unexplained the inconsistent treatment that arises in the context of property contributed to a partnership.

A. Greater Potential for Tax-Motivated Transactions

In some cases, lawmakers might craft more draconian rules for transactions involving losses than those involving gains if the former are more likely to be tax-motivated. This part will discuss whether this possibility explains the varying treatment of losses and gains in the context of each of the provisions described in Parts I and II above, evaluating each provision, in turn.

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to recognize gain on certain property distributions; (5) I.R.C. § 362(e)(1) prevents shifting built-in tax losses from certain shareholders to a corporation, generally in situations in which the shareholders would not be able to deduct the loss for U.S. tax purposes; (6) I.R.C. § 707(b) prevents the deduction of losses recognized on sales between certain related partnerships and between partnerships and certain of their partners; and (7) the wash sale rules contained in I.R.C. § 1091 prevent the deduction of losses recognized on certain sales of stocks or securities when the taxpayer reacquires an interest in the stock within a certain time period or in other circumstances. Furthermore, inconsistent treatment of gains and losses is not the only way in which tax law does not treat similar transactions in a parallel fashion. For discussion of other examples involving non-parallel treatment, see Kahn, *supra* note 12. *See also* Mock & Tolin, *supra* note 12, at 106 ("Of course, from a policy perspective there is no blanket rule (or theory) in the Code, its regulations, or tax literature that transaction-related tax items such as gains and losses must achieve absolute parity in treatment.").

[76] To be clear, this Article does not claim that tax-motivated transactions are always undesirable or that tax motivation should always be relevant. Instead, this Article is taking an interpretative approach – it assumes that lawmakers might have the goal of discouraging tax-motivated transactions and it assesses whether or not the provisions serve that goal.

1. Basis in Property Received by Gift

As discussed above in Part I.A, in the context of gifts made during a donor's lifetime, Section 1015(a) prevents shifting the tax consequences of an existing built-in loss from the donor to the donee for purposes of allowing the donee to realize a loss on later sale of the property, but the same provision allows shifting the tax consequences of an existing built-in gain. Absent the special rules governing built-in loss property, taxpayers might arrange gifts of built-in loss property with the goal of reducing aggregate tax liability. However, it is equally true that taxpayers can, even under the current rules, arrange gifts of built-in gain property with the goal of reducing the tax imposed on the gain.

To illustrate the potential for tax-motivated transactions involving losses that would exist if the rules regarding losses were consistent with the rules regarding gains, consider the following example.

> **Example 9.** Mother acquires stock for $50. As a result, Mother's basis in the stock is $50.[77] Over time, the stock decreases in value to $20. Assume that, if Mother were to sell the stock and recognize a $30 loss, Mother would not save any taxes immediately as a result of the loss because Mother has earned no income from which she could deduct the loss. Assume Daughter could deduct a $30 loss from income that would otherwise be subject to a tax rate of 15%.

Given the facts of Example 9, if the rules regarding gifts of property with built-in losses were consistent with the rules regarding gifts of property with built-in gains, Mother could give the stock to Daughter and Daughter could sell the stock, resulting in Daughter recognizing a loss from sale of the stock of $30, saving $4.50 in tax liability. By contrast, if Mother sold the stock rather than Daughter, Mother would recognize the $30 loss and save no tax liability. Provided that Mother wishes to transfer $20 of value to Daughter (or is at least not resistant to the notion of doing so), the parties might engage in this transaction merely to increase the amount of tax savings resulting from the stock's decline in value.

Under the law as currently in effect, however, Mother cannot shift the existing built-in loss to Daughter. If Mother sells the stock for $20, Mother would recognize $30 of loss and save no tax liability. If Mother gives the stock to Daughter, instead of the Daughter taking a basis in the stock of $50 (Mother's basis) for all purposes, Daughter's basis in the stock will be $20 (fair market value at the time of the gift) for purposes of measuring loss on a subsequent sale. Therefore, when Daughter sells the stock for $20, Daughter will recognize no loss and save no tax liability.[78] As a

[77] *See* I.R.C. § 351 (2012).

[78] Because of the current tax treatment of gifts of built-in loss property, well-advised taxpayers likely do not transfer built-in loss property by gift. However, if the tax treatment were changed so that losses could be shifted to related taxpayers, well-advised taxpayers might very well engage in such transactions.

result, the parties can no longer arrange for a gift of the stock in order to increase the amount of tax savings reaped from the stock's fall in value.

To illustrate the potential for tax-motivated transactions involving gains that exists even under current law, consider the following example.

> **Example 10.** Mother acquires stock for $50. As a result, Mother's basis in the stock is $50.[79] Over time, the stock increases in value to $150. Assume that, if Mother were to sell the stock and recognize a $100 gain, Mother would incur tax liability of $20 because Mother's effective tax rate is 20%. Assume Daughter's effective tax rate on gain from sale of the stock would be 15%.

Given the facts of Example 10 and given the law that actually exists, Mother could give the stock to Daughter and Daughter could sell the stock, resulting in Daughter recognizing a gain from sale of the stock of $100, yielding $15 tax liability.[80] By contrast, if Mother sold the stock rather than Daughter, Mother would recognize the $100 gain and incur tax liability of $20. Provided that Mother wishes to transfer $150 of value to Daughter (or is at least not resistant to the notion of doing so), the parties might engage in this transaction merely to decrease the amount of tax liability resulting from the stock's appreciation.

Thus, properties with built-in gains present as much of an opportunity for tax-motivated gifts as properties with built-in losses, and current law, while it addresses the latter possibility, does nothing to prevent the former. This discrepancy is puzzling, particularly given that the potential for tax-motivated gifts involving built-in gains may be even more significant than the parallel possibility involving built-in losses. As Professors Schmalbeck and Zelenak observe in their Federal Income Taxation case book:

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[79] *See* I.R.C. § 1012 (2012).

[80] Because most gifts involve the transfer of capital assets and because the tax rates that apply to net capital gain are not as steeply graduated as those that apply to ordinary income, the ability to reduce tax liability through gifts is somewhat limited. Furthermore, this example assumes that the "kiddie tax" imposed by § 1(g) of the Internal Revenue Code would not apply to the gain recognized by Daughter, because, for instance, Daughter does not meet the age requirements of Section 1(g)(2)(A). *Id.* § 1(g).

> Apparently, Congress is concerned that, in the absence of a special rule for gifts of property with built-in losses, a low-income donor could make a gift of loss property to a high income donee, who could then sell the property and deduct the loss against income taxed in the donee's higher tax bracket. If that is the concern, though, Congress seems to be straining at the proverbial gnat while swallowing the proverbial camel. Surely more tax is avoided by the transferring of gains to lower bracket donees than would ever be avoided by the transferring of losses to higher bracket donees—both because investment gains are more common than investment losses and because the natural direction of gifts is from higher bracket to lower bracket taxpayers. Yet Congress blesses the more serious tax avoidance technique while clamping down on the less serious one.[81]

As a last-ditch effort to finding redeeming logic in current law, one might suppose that Congress envisioned a world in which taxpayers, at the time of initial acquisition of an asset, would plan for resulting tax consequences upon eventual sale and would use that planning as a guide for determining who would acquire the asset. Furthermore, at the outset taxpayers would presumably assume that the investment asset would increase in value (rather than decrease) or they would not acquire it in the first place. Based on this prediction, taxpayers might arrange for the taxpayer who was likely to be subject to a lower rate of tax to hold the asset from the outset, so that gifts to shift built-in gains would be unnecessary if predictions about effective tax rate proved to be true, and gifts of built-in loss property would be the greater threat (if built-in losses could be shifted).

In other words, economic gains are expected, but economic losses are unexpected. For tax planning purposes, family members, therefore, would arrange their transactions, to the extent possible, so that the family member who is subject to a lower effective tax rate acquires the asset originally. When the asset, contrary to their expectations, accrues a loss, the person who acquired it might gift the asset to the family member who is subject to a higher effective tax rate, if doing so would shift the built-in loss to that family member.

For example, Mother and Daughter plan to buy stock. They expect the stock will increase in value, so Daughter, who is subject to a lower effective tax rate, acquires the stock. As it turns out, the stock falls in value, so Daughter would like to shift the loss to Mother. Hence, the tax-motivated transaction under this fact pattern would involve shifting losses rather than gains.

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[81] RICHARD SCHMALBECK & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 297–98 (3d ed. 2011). As discussed below in Part IV, one answer to this mystery may be that the rules regarding basis in gifts of property with a built-in loss were enacted during the Great Depression at a time when investment losses were much more prevalent than investment gains. Thus, at the time of enactment, at least, Congress was addressing the camel rather than the gnat.

The problem with this account of the inconsistent treatment is that tax-motivated transactions involving gains can occur even when those gains are expected if the parties did not accurately predict the individuals' effective tax rates.[82] For example, Mother and Daughter plan to buy stock. They expect the stock will increase in value, so Daughter, who is subject to a lower effective tax rate, acquires the stock. They are correct about their prediction for the stock (it does increase in value). However, contrary to their expectations, Daughter's effective tax rate is higher than Mother's (perhaps because Mother has recognized unexpected losses from another source). Therefore, the parties engage in a tax-motivated transaction to shift the built-in gain in the stock to Mother, and current law does not prevent them from doing so.

Because gifts involving built-in gain property can be tax-motivated to the same extent, or a greater extent, than gifts involving built-in loss property, lawmakers concerned with tax-motivated gifts ought to address the possibility in the gain context as well as the loss context. For administrative reasons and other reasons, measures adopted to prevent tax-motivated gifts of built- in gain property might not be parallel to provisions adopted to prevent tax-motivated gifts of built-in loss property. For instance, as discussed in more detail below in Part III.B, lawmakers might address tax-motivated gifts of built-in gain property by requiring the donor to recognize gain at the time of the gift while at the same time preventing deduction of losses in the case of a gift of built-in loss property.

2. Subsequent Sale of Property Contributed to a Partnership

As described above in Part I.B, when a taxpayer contributes to a partnership property that has appreciated in value in the taxpayer's hands, in some circumstances, tax law allows the taxpayer to shift to the other partners the tax consequences of a portion of the gain that accrued while the partner held the property. By contrast, current law forbids similar shifting of the tax consequences of an accrued loss. This asymmetrical treatment of gains and losses cannot be explained by the existence of greater potential for tax-motivated transactions involving built-in loss property than built-in gain property. Just as partners could reap benefits by shifting the tax consequences of a built-in loss from a low-tax-rate partner to a high-tax-rate partner, so too could they attain aggregate tax savings by shifting the tax consequences of a built-in gain in the opposite direction. In fact, at least one high profile transaction undertaken by sophisticated parties involved shifting the tax consequences between partners of income from contributed property rather than loss.[83]

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[82] Such transactions could also occur if the taxpayers did not, at the outset, plan for the lower tax bracket family member to acquire the stock.

[83] *See supra* note 38.

3. Sale to a Related Party

As described above in Part II.A, current law grants harsher treatment to losses than gains in transactions involving the sale of property between related taxpayers. Any resulting losses cannot be deducted at the time of the sale, while any resulting gains generally are included in income at the time of the sale. This asymmetry can be explained by greater potential for manipulation in the case of losses.

In particular, if the asset is sold at a price equal to its fair market value, tax-motivated transactions generally will involve losses and not gains. If an asset is sold at an amount differing from fair market value, tax-motivated transactions between related parties could involve either losses or gains, but in such a transaction, the IRS has available other mechanisms to address the potential abuse in some cases. In other cases, the failure to address the potential abuse involving gains is simply an artifact of the failure to address the potential abuse involving gains in the context of gifts.

First, consider the possibility for tax-motivated transactions that involve a sale at a price that is equivalent to fair market value. If a taxpayer holds an asset that has increased (or decreased) in value, generally, the taxpayer will not realize the resulting gain (or loss) for tax purposes until the taxpayer sells the asset for cash or exchanges it for other consideration. If and when the taxpayer does sell or exchange the asset, the taxpayer will realize the resulting gain (or loss). At that time, in the case of gain, generally the taxpayer includes the resulting gain in income, subjecting the gain to tax at the taxpayer's effective tax rate, and, in the case of loss, the taxpayer may be entitled to deduct the loss (saving tax at the taxpayer's effective tax rate).

In the case of a loss, generally, a taxpayer would prefer to recognize the loss as soon as possible, so that the taxpayer can benefit from tax savings in the earliest possible year. By contrast, a taxpayer would prefer to defer recognition of gain (and imposition of tax) for as long as possible. Thus, when considering only the resulting tax consequences, a taxpayer would opt to sell assets with built-in losses early and often but retain ownership of assets with built-in gains for as long as possible. For non-tax reasons, however, a taxpayer may desire to retain ownership of an asset with a built-in loss. If losses recognized upon sale to a related party were deductible, a taxpayer who held an asset with a built-in loss but desired to retain control of the asset for non-tax reasons could achieve the best of both worlds by selling the asset to a related party for a price equal to fair market value. Doing so would allow the taxpayer to recognize the loss for tax purposes currently, while still maintaining control over the asset.[84] Section 267(a)(1), by disallowing the deduction of any loss recognized on such a sale, prevents this type of tax-motivated transaction.

[84] *See* Robert I. Keller, *At a Loss: A Half Century of Confusion in the Tax Treatment of Transfers of Depreciated Property Between Related Taxpayers*, 44 TAX LAW. 445, 450 (1991) ("[I]n a system of voluntary realization, Congress can reasonably demand that before a taxpayer be allowed to recognize a loss . . . he transfer title to such property to a person or entity whose economic interests are not virtually identical to his own.").

By contrast, because deferring recognition of tax gain for as long as possible is generally desirable, a sale at an arms-length price between related parties of an asset with a built-in gain often will not be tax-motivated.[85] Hence, lawmakers' decision to refrain from addressing parallel transactions involving gains is an understandable one.

A sale between related parties that occurs at a price differing from fair market value could be tax-motivated regardless of whether the sale results in gain or loss. In particular, if the seller is subject to a higher effective tax rate than the buyer, the parties might engage in a tax-motivated sale of an asset with a built-in gain by selling the asset at a below-market price. Doing so would minimize the amount of gain that is taxed at the seller's high tax rate and shift some of the gain to the buyer to be subject to tax at the buyer's low tax rate upon a subsequent sale by the buyer.[86] However, in some cases, this scheme is already addressed by provisions other than Section 267. For instance, in the case of a sale between related organizations, trades, or businesses, Section 482 allows the IRS to adjust the effect of the transaction to reach the result that would follow from a sale at an arms-length price.

If the related parties are individuals and the sale is not a sale that implicates Section 482 (because it is not a sale between organizations, trades, or businesses), the transaction would likely be characterized as a part-sale, part-gift transaction. For instance, consider the following example.

> **Example 11.** Mother acquires stock for $50. As a result, Mother's basis in the stock is $50.[87] Over time, the stock increases in value to $150. Assume that, if Mother were to sell the stock and recognize a $100 gain, Mother would incur tax liability of $15 because Mother's effective tax rate is 15%. Assume Daughter's effective tax rate on gain from sale of the stock would be 0%. Mother sells the stock to Daughter for $120 ($30 less than fair market value).

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[85] Such a sale could be tax-motivated in some circumstances. Perhaps the parties predict that the asset will increase in value further and the buyer is subject to a lower tax rate than the seller, for instance. In that case, the parties might engage in the sale for tax-motivated reasons. However, doing so involves taking steps to reduce the expected tax rate applicable to gains expected in the future (not gains already accrued), and tax law is generally less hostile to planning decisions made based upon future predictions. For discussion of this phenomenon generally, see Emily Cauble, *Rethinking the Timing of Tax Decisions: Does a Taxpayer Ever Deserve a Second Chance?*, 61 CATH. U. L. REV. 1013 (2012). Such a sale could also be tax-motivated if there are benefits to the buyer obtaining a high basis in the property, particularly if the seller can offset resulting gain with existing losses. This possibility, at least in some situations, is partially addressed by provisions such as Section 1239 of the Internal Revenue Code.

[86] By contrast, if the seller is subject to a lower effective tax rate than the buyer, the parties might engage in a tax-motivated sale of an asset with a built-in loss by selling the asset at an above-market price. Doing so would minimize the amount of loss recognized by the seller (who saves little tax from recognizing loss given the seller's low tax rate) and shift some of the loss to the buyer to be recognized upon a subsequent sale, saving tax at the buyer's high tax rate.

[87] *See* I.R.C. § 1012 (2012).

The transaction described in Example 11 would likely be treated as, in part, a sale and, in part, a gift. Under the facts of Example 11, Mother would recognize a gain from sale of the stock of $70 ($120 minus $50),[88] and Daughter would take a basis in the stock of $120.[89] Thus, if Daughter were to subsequently sell the stock for $150, Daughter would recognize $30 of tax gain. As a result, the parties succeeded in shifting a portion of the existing built-in gain (in particular $30 of the $100 built-in gain) from Mother to Daughter. Thus, this type of potentially tax-motivated sale between related parties is not prevented by current law. It is also true that, under current law, Mother could have transferred the stock to Daughter as a gift and shifted the entire $100 of built-in gain to Daughter. Thus, the failure to address tax-motivated transactions involving a sale at a below-market price to a related party is, in essence, a by-product of not addressing tax-motivated transactions involving gratuitous transfers of property between related parties. Once lawmakers made the decision to allow individuals to shift the tax consequences of the entire built-in gain to related individuals by transferring the property as a gift, logically they would allow the lesser evil of shifting the tax consequences of only a portion of the built-in gain by selling the property at a below-market price.

In summary, it is possible to rationalize the asymmetric treatment of gains and losses recognized on sales between related parties. In the case of sales that occur at an arms-length price, greater potential for tax-motivated transactions involving losses offers a rationale for the disparate treatment. In the case of sales that occur at a price that differs from fair market value, the potential for tax-motivated transactions involving gains is either already addressed by other provisions (like Section 482) or is not addressed (in the case of part-gift, part-sale transactions). However, in the latter case, the failure to address the potential for tax-motivated transactions is a logical extension of the failure to address the same potential for tax-motivated transactions in the context of gifts of built-in gain property.

Thus, greater potential for tax-motivated transactions involving losses can explain the decision to address losses but not gains in the context of sales between related parties. Some of the parameters of Section 267(a)(1) are not perfectly designed to achieve the goal of preventing tax-motivated transactions. However, in general terms, the decision to address losses but not gains in this context is a sensible one.

Section 267(a)(1) is not perfectly designed to achieve the objective of preventing tax-motivated transactions involving losses because it can be overly broad.[90] Related parties might engage in a sale of property that had declined in value for non-tax reasons alone, but, even though such a sale is not tax motivated, Section

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[88] *See* Treas. Reg. § 1.1001–1(e) (2017).

[89] *See id.* § 1.1015–4.

[90] A preferable solution would involve abandoning the realization requirement and requiring taxpayers to report gains and losses on a mark-to-market basis. In such a system, the timing of a sale would have no effect on tax consequences, and so tax-motivation would not encourage or discourage a sale. However, this Article takes as a given the realization requirement.

267(a)(1) prevents deduction of the resulting loss. In addition, Section 267(a)(1) may be harsher than necessary even in the case of a tax-motivated transaction. In particular, not only does the provision prevent deduction of the loss at the time of the sale to a related party, but, in many cases, it prevents the taxpayers from deducting the loss forever. Consider, for instance, the following example.

> **Example 12**. Mother acquires stock for \$50. As a result, Mother's basis in the stock is \$50.[91] Mother sells the stock to Daughter for \$20 at a time when the stock is worth \$20. Mother recognizes \$30 of loss from the sale, but Mother cannot deduct the \$30 loss.[92] Daughter's basis in the stock will be \$20 (cost basis). If Daughter sells the stock for \$20, Daughter recognizes no loss (because \$20 is not less than her \$20 basis). Thus, the \$30 loss that accrued while Mother held the stock cannot be recognized by Mother and is never recognized because Daughter takes a cost basis in the stock.[93]

The purpose of preventing tax-motivated sales involving losses could be achieved in a less severe way. In particular, tax law could allow Mother to deduct the loss recognized upon sale to Daughter but defer the time at which she deducts the loss until the time that Daughter sells the property to a third party. This approach, however, would present administrative difficulties similar to those discussed below in connection with a similar hypothetical approach to treating property transferred by gift.[94]

4. Section 362(e)(2)

As described above in Part II.B, if built-in loss property is contributed to a corporation in a transaction in which the loss is not recognized at the time of the contribution, Section 362(e)(2) provides that the loss will be preserved only once (either in the stock held by the shareholder or in the asset held by the corporation). This treatment prevents the duplication (for tax purposes) of an existing economic loss. By contrast, if built-in gain property is contributed to a corporation in a transaction in which the gain is not recognized, the gain is duplicated for tax purposes. It will be preserved in the stock held by the shareholder and in the asset held by the corporation. This inconsistent treatment could be explained by the greater potential for tax-motivated transactions involving assets with built-in losses.

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91 *See* I.R.C. § 1012 (2012).

92 *See id.* § 267(a)(1).

93 The loss would only be utilized by Daughter to offset resulting gain if the stock increased in value in the Daughter's hands. If Daughter sold the stock for \$60, Daughter would recognize a gain of \$10, because Daughter can offset the \$40 gain recognized (\$60 minus \$20 basis) by the \$30 loss that Mother recognized and could not deduct. *See* I.R.C. § 267(d)(1)(B) (2012). The resulting treatment, in effect, parallels the treatment that follows from a gift of property with a built-in loss. *See supra* note 22.

94 *See infra* notes 111–117 and accompanying text. *See also* Keller, *supra* note 84, at 463 (discussing a similar possible approach to sales between related parties).

In particular, imagine a taxpayer acquires an asset and anticipates that the asset will increase in value. Such a taxpayer might initially hold the asset directly, rather than through an entity treated like a corporation for tax purposes.[95] If the asset does appreciate in value, the taxpayer could continue to hold the asset directly so that, when the taxpayer sold the asset, the economic gain realized would only result in one tax gain (rather than two levels of tax gain which would occur if the asset was always held through a corporation or if the asset was contributed to a corporation after the appreciation in value occurred). If, contrary to the taxpayer's initial expectations, the asset depreciated in value, the taxpayer could contribute the asset to a corporation, and, absent Section 362(e)(2), the one economic loss would result in recognition of two tax losses (rather than just one tax loss, which would occur if the taxpayer continued to hold the asset directly).[96]

Section 362(e)(2) prevents this type of tax-motivated transaction.[97] Given the existence of Section 362(e)(2), if the taxpayer initially holds an asset directly based on the assumption that it will appreciate in value and, instead, the asset depreciates in value, the taxpayer typically cannot create two tax losses from the one existing economic loss. Regardless of whether the taxpayer continues to hold the asset directly or contributes it to a corporation, only one tax loss can be recognized as a result of the existing economic loss.

By contrast, adopting a parallel provision related to gains would be unlikely to dissuade taxpayers from engaging in tax-motivated contributions of built-in gain property to corporations. This is not to say that a taxpayer cannot have a tax reason to contribute property with a built-in gain to a corporation. Rather, the point is that if a taxpayer already has a tax reason to contribute an appreciated asset to a

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[95] Alternatively, the taxpayer may hold the asset through an entity (such as a limited liability company) that is disregarded as separate from the taxpayer for tax purposes.

[96] Even absent I.R.C. § 362(e)(2), this strategy could be subject to a potentially successful challenge by the IRS. In particular, if the asset were sold very shortly after the individual contributed the asset to the corporation, the Service could claim that transaction should be treated as if the individual, rather than the corporation, had sold the asset, so that only one loss would be recognized. Such a challenge is more likely to be successful if the corporation distributes the cash from sale of the asset to the shareholder very soon after the sale. The likelihood of a successful challenge would also increase if the individual had negotiated the sale of the asset to the third party prior to contributing the asset to the corporation. *See*, *e.g.*, Comm'r v. Court Holding, 324 U.S. 331, 334 (1945) (characterizing the sale by a shareholder of an asset following its distribution by a corporation as, instead, a sale of the asset by the corporation).

[97] The legislative history surrounding the enactment of Section 362(e)(2) also supports the conclusion that its goal was preventing duplication of an existing loss. *See* S. REP. NO. 108-192, at 125 (2003) ("The Joint Committee on Taxation staff's investigative report of Enron Corporation and other information reveal that taxpayers are engaging in various tax motivated transactions to duplicate a single economic loss and, subsequently, deduct such loss more than once. . . . [T]he Committee believes that a single economic loss should not be deducted more than once."); *see also* Kahn & Kahn, *supra* note 67, at 47 ("It seems to the authors that the objection centers on the potential for a manipulative transfer of depreciated assets to be made for the principal purpose of doubling the use of the excess basis.").

corporation, the taxpayer would have even more of a tax reason (or, certainly, no less of a tax reason) to engage in the same transaction if the contribution would not result in the duplication of the gain for tax purposes.[98]

The parameters of Section 362(e)(2) could be adjusted so that it better serves the goal of preventing tax-motivated transactions that result in loss duplication. However, in general terms, lawmakers' decision to address losses but not gains, in this context, can be understood as an attempt to focus on the type of duplication (losses not gains) that is more likely to provide a tax-related inducement to contribute property to a corporation.

As mentioned above, Section 362(e)(2) is not perfectly designed for the goal of preventing tax-motivated contributions of built-in loss property.[99] First, it does not necessarily discriminate between contributions that duplicate a loss and contributions that do not duplicate a loss; and, second, it does not necessarily sort between tax-motivated contributions and non-tax-motivated contributions.[100]

Regarding the first flaw, Section 362(e)(2) applies on an aggregated basis. Thus, if a shareholder contributes one asset that has a basis of $100 and a fair market value of $40 and, at the same time, contributes a second asset that has a basis of $100 and a fair market value of $160, Section 362(e)(2) will not apply because the total basis of all assets contributed ($200) is not more than the total value of all assets contributed ($200). It does not apply even though this transaction might have been designed to reap a greater benefit from an accrued loss (if, for instance, the taxpayer planned to contribute the built-in gain asset for non-tax reasons and decided to

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[98] For a proposal regarding how tax law could be modified to prevent gain duplication, see Mock & Tolin, *supra* note 12, at 154–55.

[99] Section 362(e)(2) is also flawed in the context of S Corporations, where the ability to elect to reduce a shareholder's basis in stock rather than the corporation's basis in an asset allows loss to be shifted from the contributing shareholder to other shareholders. *See, e.g.*, Martin J. McMahon, Jr. & Daniel L. Simmons, *When Subchapter S Meets Subchapter C*, 67 TAX L. 231, 245–46 (2014).

[100] *See also* Kahn & Kahn, *supra* note 67, at 47 ("It seems to the authors that the objection centers on the potential for a manipulative transfer of depreciated assets to be made for the principal purpose of doubling the use of the excess basis. If, instead, the depreciated property were transferred primarily for a business purpose, the doubling of the use of the excess basis would merely be an element of the system adopted for the treatment of section 351 exchanges and does not warrant any restrictive treatment.") It might also be the case that contributions that are entirely tax-motivated should not receive non-recognition treatment in the first place, so that section 362(e)(2) is unnecessary. For further discussion, *see id.* at 48–49 ("There is authority that a condition of qualifying an exchange with a corporation for section 351 treatment is that a bona fide purpose of the exchange be a non-tax business purpose. It seems likely that when there is a manipulative tax purpose for making a transfer to a corporation of a depreciated asset, that purpose will be evident in most cases, and especially so when the depreciated asset is sold soon after the corporation acquires it. Consequently, the abusive use of the doubling of excess basis rule will not be possible because the exchange with the corporation will not qualify for section 351 treatment (or for the accompanying basis rules).").

include the built-in loss asset in the transaction for tax reasons).[101] Section 362(e)(2) would be more precisely targeted to the goal of preventing tax-motivated contributions if it applied asset-by-asset rather than on an aggregated basis. Thus, in the example above, it would apply to the asset with a basis of $100 and a fair market value of $40, even if it was contributed at the same time as other assets with an offsetting amount of built-in gain.

Regarding the second flaw, Section 362(e)(2) does not necessarily discriminate between contributions that are tax-motivated and contributions that are not tax-motivated because it conclusively presumes that any contribution of assets that have a net built-in loss is tax-motivated.[102] Thus, if a shareholder contributes one asset that has a basis of $100 and a fair market value of $40, Section 362(e)(2) effectively assumes that the shareholder's contribution is tax-motivated even though it is possible that the shareholder contributes the asset to the corporation to obtain non-tax benefits. To remedy this shortcoming, Professors Kahn & Kahn have suggested, among other potential solutions, that if a shareholder contributes built-in loss property to a corporation and the corporation sells the property within some fairly short period of time, those facts would establish a presumption that the contribution was tax-motivated so that loss duplication would be disallowed; however, the presumption would be rebuttable rather than conclusive.[103]

B. Difficulty of Crafting an Appropriate Parallel Provision

As discussed above in Part III.A, in the context of two examples (the first involving gifts and the second involving property contributed to a partnership), tax law takes steps to prevent tax-motivated transactions involving losses but not gains, despite the fact that there is no greater danger of tax-motivated transactions in the

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[101] *See also* Mock & Tolin, *supra* note 12, at 130 ("If enough gain property is transferred, loss duplication is not restricted. Section 362(e)(2) does not apply when the aggregate fair market value of the transferred properties equals or exceeds the aggregate adjusted bases of the assets transferred. For this to work, the shareholder must have sufficient gain property to transfer and such must be part of the economic bargain.").

[102] *See also* Kahn & Kahn, *supra* note 67, at 48 ("The authors agree that it is appropriate for Congress to prevent manipulation of ownership for the principal purpose of doubling a deduction. However, the principal statutory provision aimed at that problem, section 362(e)(2), is overly broad. It improperly applies to situations. . . even when the transferor's principal reason for contributing the depreciated asset to the corporation was non-tax profit motivated.").

[103] *See id.* at 49 ("If Congress is concerned that a business purpose rule [discussed above in note 100] will not be adopted by some courts, it could address that issue by expressly adding that requirement to section 351. That approach would attack a narrow problem with a scalpel rather than with an axe. If Congress is concerned that the vagaries of factual determinations may permit too many taxpayers to establish a business purpose when none actually exists, Congress could impose a greater burden of proof on taxpayers on that issue or create a rebuttable presumption that if a transferred depreciated asset is sold by the corporation within some specified time period, such as two years, the transfer to the corporation will be presumed to be tax motivated.").

loss context than in the gain context. Therefore, a heightened risk of tax-motivated transactions involving losses cannot satisfactorily explain the inconsistent treatment in these contexts. Perhaps, instead, the inconsistent treatment arises because of the difficulty of crafting symmetrical provisions to address tax-motivated transactions involving gains. This part will explore this possibility in the context of each of the two examples, in turn.

1. Basis in Property Received by Gift

When an individual holds property that has either fallen in value or appreciated in value and gives the property to another individual, there are, in general, six ways that tax law could treat the transaction:[104]

(1) **Option 1**. Tax law could treat the disposition of the property as an event that causes the donor to recognize any gain or loss built into the property. In other words, at the time of the gift, the donor would be treated as if he or she had sold the property for its fair market value. The donor would be required to include the resulting gain in income, and the donor could deduct the resulting loss notwithstanding Section 267(a)(1), even if the donee was a related person. The donee would take a basis in the property equal to the fair market value at the time of the gift, so that the donee would recognize gain or loss on a subsequent sale only if the property increased or decreased in value in the donee's hands.

(2) **Option 2**. Option 2 is the same as Option 1[105] except that the donor's ability to deduct the resulting loss would be constrained by Section 267(a)(1), discussed above in Part II.A.[106]

(3) **Option 3**. At the time of the gift, the donor does not recognize any gain or loss. The donee takes a basis in the property equal to the **donor's basis** for purposes of determining gain or loss recognized upon a subsequent sale by the donee.

(4) **Option 4**. At the time of the gift, the donor does not recognize any gain or loss. The donee takes a basis in the property equal to **fair market value** at the time of the gift for purposes of determining gain or loss recognized upon a subsequent sale by the donee.

(5) **Option 5**. At the time of the gift, the donor does not recognize any gain or loss. The donee takes a basis in the property equal to **fair market value** at the time of the gift for purposes of determining gain or loss recognized upon a subsequent sale by the donee. *In addition, at the time the donee sells the*

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[104] The options below take, as a given, that the U.S. does not adopt a mark-to-market system for taking into account changes in asset value.

[105] Professor Kwall has made a proposal that would be equivalent to Option 2. *See* Kwall, *supra* note 2.

[106] The donee's subsequent gain or loss would be determined under rules similar to those contained in Section 267 discussed above. *See supra* note 59 and accompanying text.

property, the donor will recognize any built-in gain or loss that existed in the property at the time of the gift.[107]

(6) **Option 6**. Option 6 is the approach taken by current law. In particular, at the time of the gift, the donor does not recognize any gain or loss. The donee takes a basis in the property equal to the donor's basis for purposes of determining gain recognized upon a subsequent sale by the donee, but, if the property has a built-in loss at the time of the gift, the donee takes a basis in the property equal to fair market value at the time of the gift for purposes of determining loss recognized upon subsequent sale.

Of the possibilities described above, the only options that treat built-in gain property and built-in loss property symmetrically are Options 1, 3, 4, and 5. Option 1, however, invites tax-motivated gifts of built-in loss property. Option 4 provides leeway to engage in tax-motivated gifts involving built-in gain property to such a degree that it would be entirely untenable, and Option 3 enables tax-motivated gifts involving both built-in gains and built-in losses. Option 5 addresses gains and losses in a symmetrical fashion and prevents tax-motivated gifts involving either type of property. However, it would be challenging to administer. Option 2 deters tax-motivated gifts involving both built-in gain property and built-in loss property, but it does so in a way that is asymmetrical. Although this asymmetry is not necessarily problematic from a policy perspective,[108] it may present a formidable obstacle from a political perspective. In particular, lawmakers' failure to adopt this approach might be explained by concerns about adopting a provision that seemed overly draconian. Each of these observations is explained in more detail below.

Option 1 invites tax-motivated gifts of built-in loss property. By allowing the donor to recognize and deduct a loss at the time of the gift, this regime could encourage individuals to donate depreciated property to relatives in order to accelerate the time at which a loss was recognized without giving up genuine control of the property because the property would continue to be held by a relative. In other words, Option 1 would allow taxpayers to circumvent the purpose of Section

[107] Professor Keller also discussed this as a possible option, and, in addition, suggested that this approach could be used only when the subsequent sale happened within a short time of the gift (perhaps because that suggests the gift was tax-motivated) and, if the subsequent sale happened later, Option 3 could provide the applicable tax treatment. *See* Keller, *supra* note 84, at 455. For additional discussion of this possibility, see Douglas A. Kahn & Jeffrey H. Kahn, *"Gifts, Gafts, and Gefts" – The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441, 473 (2003) ("Congress could have provided that the donee's gain on a disposition of the donated asset would be taxed to the donor to the extent attributable to the appreciation at the time of the gift."). As a related alternative, the donee could be taxed at the time of the later sale, but the donor's tax rate could be applied to the gain (at least to the extent of the built-in gain that existed at the time of the gift). For discussion of this possibility, see *id.* ("Alternatively, it could be taxed to the donee at the marginal tax rate at which it would have been taxed to the donor.").

[108] *See supra* note 12 and accompanying text.

267(a)(1), discussed above in Parts II.A and III.A.3, by simply giving away property to a relative rather than selling it to that same person. For these reasons, Option 1 is not a feasible approach.

Option 4 provides leeway to engage in tax-motivated gifts involving built-in gain property. In particular, anytime a taxpayer held an asset that appreciated in value, he or she could avoid paying tax on the gain through the simple maneuver of giving the property to a related taxpayer for that related person to sell it. The donor would not recognize the built-in gain in the property, and the related person would recognize no gain on sale, given that his or her basis would equal fair market value. Thus, Option 4 is entirely untenable.[109]

Option 3 enables tax-motivated gifts involving both built-in gains and losses. Like current law, it allows related taxpayers to reduce their aggregate tax liability by having a taxpayer with a higher effective tax rate make a gift of appreciated property to a taxpayer with a lower effective tax rate, so that, on subsequent sale, the built-in gain is taxed at the donee's lower tax rate instead of the donor's higher tax rate. Unlike current law, it would also allow related taxpayers to reduce their aggregative tax liability by making gifts of built-in loss property in the opposite direction (in other words, from a taxpayer subject to a lower effective tax rate to a taxpayer subject to a higher effective tax rate, so that more tax would be saved when the donee recognized the resulting loss than the tax that would have been saved had the donor recognized the loss).[110]

Option 5 treats gains and losses symmetrically, and it prevents tax-motivated gifts of both built-in gain property and built-in loss property. In order to demonstrate, consider the following examples.

> **Example 13**. Mother acquires stock for $50. Over time, the stock increases in value to $150. When the stock is worth $150, Mother gives the stock to Daughter. Mother does not recognize any gain at the time of the gift. Daughter later sells the stock to a third party for $180. At the time of the sale to the third party, Daughter would recognize $30 of gain (the appreciation in the stock's value that accrued while Daughter held the stock), and Mother would recognize $100 of gain as if she had sold the stock to the third party for a $100 gain (so that Mother is taxed on the $100 increase in value that occurred while she

[109] *See also* Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 432 (2001) ("If the basis-equals-value rule were to apply to gifts as well as to bequests, families and friends would be able to 'launder' all taxable gain out of the system at will by making inter vivos gifts among themselves of appreciated assets."). As Professor Zelenak notes, prior to 1921, Option 4 was the law in that the donee received fair market value basis in property received by gift. LAWRENCE ZELENAK, FIGURING OUT THE TAX: CONGRESS, TREASURY, AND THE DESIGN OF THE EARLY MODERN INCOME TAX 92 (2018).

[110] Because of the current tax treatment of gifts of built-in loss property, well-advised taxpayers likely do not transfer built-in loss property by gift. However, if the tax treatment were changed so that losses could be shifted to related taxpayers, well-advised taxpayers might very well engage in such transactions.

owned the stock).[111] Thus, if Daughter's tax rate is lower than Mother's tax rate, the parties are no longer able to engage in a tax-motivated gift to shift the $100 built-in gain from a high-tax-rate individual to a low-tax-rate individual.

Example 14. Mother acquires stock for $50. Over time, the stock falls in value to $30. When the stock is worth $30, Mother gives the stock to Daughter. Mother does not recognize any loss at the time of the gift. Daughter later sells the stock to a third party for $25.[112] At the time of the sale to the third party, Daughter would recognize $5 of loss (the decline in the stock's value that transpired while Daughter held the stock), and Mother would recognize $20 of loss as if she had sold the stock to the third party for a $20 loss (so that Mother recognizes a loss attributable to the fall in value that occurred while she owned the stock). Thus, if Daughter's tax rate is higher than Mother's tax rate, the parties cannot engage in a tax-motivated gift to shift the $20 built-in loss from a low-tax-rate individual to a high-tax-rate individual. At the same time, as a comparison with Example 13 demonstrates, gains and losses would be treated in a symmetrical fashion, unlike under current law.

Of all of the options discussed, Option 5 is the only one that both achieves the goal of preventing tax-motivated gifts of built-in gain property and built-in loss property and does so in a fashion that treats gains and losses consistently. However, Option 5 would be challenging to administer. Professor Keller, when discussing this potential approach, observed that it would present two practical problems: (1) it would require valuation of the property at the time of the gift and (2) it would "require[] the donor to keep track indefinitely of what the donee does with the property."[113]

The first problem might not be as serious as it first appears. As Professor Kwall observes, the parties likely already value property (at least in an approximate sense) at the time of a gift for non-tax reasons. As Professor Kwall writes,

> When property is transferred, the transferor will normally confront the question of valuation regardless of whether the tax system mandates valuation at the time of transfer. For example, when a donor decides to make a gift, the donor will normally determine the amount of the gift

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[111] If Daughter instead sold the stock to a third party for $140, Daughter would recognize a $10 loss on sale of the stock (the decline in value that occurred while Daughter owned the stock), and, at the time of the sale to a third party, Mother would still recognize $100 of gain as if she had sold the stock to the third party for a $100 gain (so that Mother is taxed on the $100 increase in value that occurred while she owned the stock).

[112] If Daughter instead sold the stock to a third party for $37, Daughter would recognize a $7 gain on sale of the stock (the rise in value that occurred while Daughter owned the stock), and, at the time of the sale to a third party, Mother would still recognize $20 of loss as if she had sold the stock to the third party for a $20 loss (so that Mother recognizes a loss attributable to the fall in value that occurred while she owned the stock).

[113] Keller, *supra* note 84, at 455.

> before making it. In the case of a cash gift, the donor must decide a specific amount to give (unless she simply reaches into her pocket and hands over a wad of cash). In the case of a gift of property, the donor is also likely to go through a mental process of valuing the property before she conveys it. Although a donor would not normally secure a professional appraisal of the gifted property, the donor undoubtedly will engage in a conscious or unconscious exercise of determining that the property in question is within a range of values that the donor is inclined to bestow on a particular donee.[114]

Second, as Professor Kwall observes, there may be tax reasons why taxpayers already value property at the time of the gift, in particular because federal and state transfer taxes might be imposed.[115] Finally, even under current law, valuation at the time of the gift is required for income tax purposes if the property has a built-in loss (because, in that event, the donee's basis in the property will be fair market value at the time of the gift for purposes of determining loss on a subsequent sale), and, in all cases, at least approximate valuation would be required to determine whether the property has a built-in loss (so that the donee would know whether the special basis rule related to losses applied).

However, the second problem may be more serious—namely, Option 5 would require the donor to monitor, indefinitely, whether or not the donee has disposed of the property received by gift. This difficulty might not be insurmountable—after all, the parties are not likely to be strangers.[116] Furthermore, steps could be taken to facilitate the donor receiving the relevant information (for instance, the donee could be subject to an information reporting obligation to provide the donor with notice of the date of a subsequent sale). However, Option 5, undeniably, involves greater administrative complexity than current law.[117]

If Option 5 is too difficult to administer, the remaining viable options are current law (Option 6) and Option 2. Current law addresses tax-motivated gifts of built-in loss property but not tax-motivated gifts of built-in gain property. Option 2 prevents tax-motivated gifts of both built-in gain property and built-in loss property. However, it does so in an inconsistent fashion. In particular, in the case of a gift of built-in gain property, the donor would be required to recognize the gain at the time of the gift (so that the gain would be subject to tax at the donor's tax rate), but if the parties were related, in the case of a gift of built-in loss property, the donor would not receive a deduction for the built-in loss and, in some circumstances, no party would ever receive a reduction in tax liability as a result of the existing built-in loss.[118] The latter result (the treatment of built-in losses) is the same as what occurs

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[114] Kwall, *supra* note 2, at 97–98.

[115] *Id*. at 97.

[116] Although, it is possible that they could be.

[117] This would be particularly true if the donee, in turn, transfers the property to another individual by gift.

[118] The donee would only receive a benefit from the accrued loss if the property increased in value in the donee's hands. In that case, Section 267(d) allows the donee to

under current law. However, the former result (taxing the donor on built-in gain at the time of the gift) differs from current law (under which the donor is not taxed on the built-in gain, but, instead, the donee is potentially taxed on the built-in gain at the time of a later sale).

It might be that lawmakers, once they decided to deny any tax benefit to any built-in loss that exists at the time of a gift, did not have the appetite for also insisting that donors recognize any built-in gain that exists at the time of the gift.[119] It might also be that they feared adopting tax rules that would discourage gifts that would have been made for non-tax reasons. Thus, the result of current law might be explained as what remains after the elimination of other alternatives that either do a poorer job of preventing tax motivated transactions, are infeasible for administrative reasons, or are impractical for political reasons.

From a policy perspective, as discussed above, consistency should not be a goal for consistency's sake.[120] However, lawmakers concerned with preventing tax-motivated gifts should not ignore the potential for tax-motivated gifts of built-in gain property. To address such transactions, lawmakers ought to adopt either Option 2 or Option 5. Because of the inherent administrative difficulties, Option 5 may be inferior from a policy perspective. However, the political difficulties of adopting Option 2 cannot be ignored, and these difficulties stem, in part, from the fact that the asymmetric treatment it entails brings the harsh treatment of losses into sharper focus.

2. Subsequent Sale of Property Contributed to a Partnership

As described above in Part III.B.1, in the context of gifts, law's inconsistent treatment of gains and losses might arise because of the difficulty of crafting a symmetrical provision to address tax motivated transactions involving gains. In the context of property that is contributed to a partnership, this explanation is less satisfying. A ready solution exists that would limit, in symmetrical fashion, the ability to shift the tax consequences of both built-in gains and built-in losses from a contributing partner to other partners. In particular, lawmakers could require that partnerships use the "remedial method" for making Section 704(c) allocations. In many ways, this solution parallels Option 5 for the treatment of gifts discussed above

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reduce the amount of gain recognized by the loss that the donor could not deduct.

[119] In the context of the sale of property between related taxpayers, lawmakers do take the approach of requiring gain recognition but disallowing tax benefits for any resulting loss, in many cases. See the discussion of Section 267 above in Part II.A. However, in the context of the sale of property for consideration, there is less political resistance to the idea of imposing tax on the resulting gain than there is in the context of gratuitous transfers of property. *See*, *e.g.*, Kwall, *supra* note 2, at 99–100 (discussing political resistance to a mark-to-market system and stating, "The view that 'paper gains' should not be taxed is firmly embedded in the current culture, and it would be very difficult to mobilize popular support for a system that taxes asset appreciation as it occurs.").

[120] *See supra* note 12 and accompanying text.

in Part III.B.1.[121] Under Option 5, upon ultimate sale of the property by the donee, the donor would recognize whatever amount of built-in gain or built-in loss existed in the property at the time of the gift, and the donee would recognize gain or loss based on any increase or decrease that occurred in the property's value while held by the donee. If a partnership uses the "remedial method" for making Section 704(c) allocations, upon ultimate sale of the property by the partnership, the contributing partner would recognize whatever amount of built-in gain or built-in loss existed in the property at the time of the contribution, and each partner would recognize gain or loss based on such partner's share of any increase or decrease that occurred in the property's value while held by the partnership.[122]

The practical objections to utilizing Option 5 in the context of gifts carry significantly less weight when evaluating the merits of adopting a similar approach in the partnership context. As discussed above, one objection raised in the gift context is that the method requires that the parties value the property at the time of the gift.[123] In the partnership context, perhaps even more so than in the gift context, the parties would value the property at the time it is contributed to a partnership for non-tax reasons even if they were not required to do so for tax reasons. Even for gifts, parties might obtain an approximate value, as discussed above.[124] In the partnership context, assuming the partners are unrelated, business considerations would require a valuation at the time of the contribution to determine the partners' economic rights.[125] Furthermore, in the partnership context, valuation of the property at the time of the contribution is required to properly apply any method under Section 704(c), not just the remedial method.[126]

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[121] For discussion of another approach that would have similar effects and bears even more similarity to Option 5, see Monroe, *supra* note 54 (discussing the deferred sale method). For an additional proposal to prevent shifting of tax gains and losses, see Osofsky, *supra* note 43, at 107 ("For the reasons suggested in this article, Congress, if not the Treasury Department, should take this step and finally unwind the ceiling rule itself."). *See also* Gregory J. Marich, Barksdale Hortenstine & Barksdale Penick, *The Remedial Allocation Method: A Viable Cure for the Ceiling Rule*, 65 TAX NOTES 1267, 1290 (1994) ("[T]here are still some bugs that need to be worked out of the remedial method . . . In any event, whatever course is taken, we believe that the remedial method represents a long overdue and relatively manageable cure to the ceiling rule.").

[122] The results are somewhat more complex if the property is depreciable.

[123] *See supra* notes 113–114 and accompanying text.

[124] *Id.*

[125] For further discussion, see Cauble, *supra* note 36, at 299–300 ("[A] partnership needs to value an asset at the time it is contributed to a partnership in order to effectuate the economic deal among the partners. If A and B form a partnership, where A contributes land to the partnership, B contributes cash to the partnership, and the partners intend to share equally in the economic returns of the partnership, the partners will need to value the land in order to determine how much cash B should contribute.").

[126] For further discussion, see *id.* at 299. In addition, as Professor Monroe observes, valuation is necessary if a partnership maintains capital accounts in accordance with the regulations under Section 704. *See* Monroe, *supra* note 54, at 1433–44.

As discussed above, another objection to implementing Option 5 in the gift context is that it would require the donor to monitor whether the donee has sold the property. In the partnership context, the partnership will already be tracking when the partnership sells the property and will already be reporting to the contributing partner the correct amount of tax gain or loss to take into account at that time.

Historical resistance to a requirement that partnerships use the "remedial method" or a similar approach has been driven, in part, by the view that use of such a method is overly complex.[127] The perceived complexity stems from two sources. First, the requirement that the property must be valued at the time of contribution causes complexity.[128] However, as discussed above, valuation must occur under any Section 704(c) method and for non-tax reasons. Second, the method is viewed as computationally complex.[129] However, as I have argued elsewhere, requiring use of the remedial method would not increase tax law's complexity in any meaningful way, and could, in some respects, simplify existing partnership tax law.[130] Complexity can affect taxpayers at two different points in time—first, when a taxpayer contemplates engaging in a transaction and seeks to predict its tax consequences and, second, when a taxpayer must report the tax consequences of a transaction in which it has already engaged. The additional computational complexity inherent in the remedial method may somewhat increase the difficulty of calculating the tax consequences that a taxpayer must report; however, any additional difficulty can be ameliorated by tax software.[131] At the planning stage, the remedial method may actually be easier than the traditional method in that it results in tax consequences corresponding more closely to economic consequences, a result that is likely more consistent with most taxpayers' intuitive expectations.[132] Furthermore, *requiring* use of the remedial method simplifies planning by obviating the need to evaluate the results of multiple methods.

IV. OVERLY NARROW LEGISLATIVE RESPONSES

As discussed above, tax law takes steps to prevent transactions that would involve shifting built-in losses but allows transactions that involve shifting built-in gains in the context of property transferred by gift and, in some cases, in the context of property contributed to a partnership. This asymmetric treatment prevails despite the fact that there is no greater danger of tax-motivated transactions involving losses than tax-motivated transactions involving gains. Therefore, a heightened risk of tax-

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[127] Treasury also did not mandate use of this method, in part, because of a belief that it lacked authority to do so. However, even if this belief is correct, Congress could require use of the method. For further discussion, see Laura Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93, 116–17 (1996); Cauble, *supra* note 36, at 272; Osofsky, *supra* note 43, at 107.

[128] *See* Cauble, *supra* note 36, at n.82–83 and accompanying text.

[129] *See id.* at n.84 and accompanying text.

[130] *See id.* at 291–301.

[131] *Id.*

[132] *Id.*

motivated transactions involving losses cannot satisfactorily explain the inconsistent treatment in these contexts. In the gift context, the inconsistent treatment might arise because of the practical difficulty of crafting symmetrical provisions to address tax-motivated transactions involving gains. However, a similar rationale does not provide a satisfactory explanation for the lack of parallel treatment in the partnership context, and, even in the gift context, it is not clear that the practical or political considerations should outweigh concerns about the possibility of tax-motivated transactions involving gains. Asymmetric treatment, in both of these contexts, might, in part, be attributable to lawmakers crafting an overly narrow response that addressed only the tax-revenue reducing transactions that were the most salient at the time of enactment.

As Professor Keller observed, 1934, the year in which Congress adopted the current rules governing basis in property received by gift, was a year "in which Congress was obsessed with the potential effect of taxpayer losses on the revenue of the United States."[133] This obsession stemmed from the fact that, during the Great Depression when the rules were enacted, investment losses were much more common than investment gains. As Professor Keller observed, "[g]iven this concern with losses in 1934, the [rules regarding basis in property received by gift] may simply have been a knee-jerk, unreasoned reaction to the revenue problem, with Congress giving no thought whatever to the fact that it was closing one door [to tax planning opportunities involving gifts of built-in loss property] . . . while leaving the other wide open [for tax planning opportunities involving gifts of built-in gain property]."[134]

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[133] Keller, *supra* note 84, at 457.

[134] *Id.* Professor Keller goes on to note that lawmakers may have been particularly concerned about the ability to shift losses because, at the time that they were drafting the new basis rules, limitations on the ability to deduct capital losses were not yet in place. *Id.* at 458. Given the amount of time that has elapsed, this explanation likely does not account for the continuing failure to address tax-motivated gifts of built-in gain property. Instead, this continuing failure might be explained, in part, by the practical and political difficulties of addressing built-in gain property discussed above in Part III.B and, in part, by the fact that the ability to reduce tax liability through gifts is somewhat limited because most gifts involve the transfer of capital assets and the tax rates that apply to net capital gain are not as steeply graduated as those that apply to ordinary income. Furthermore, in some cases, the "kiddie tax" of Section 1(g) of the Internal Revenue Code would limit the tax savings from such transfers. In addition, in some cases, gift tax may be imposed on the transfer which could act as an impediment to tax-motivated gifts. Furthermore, if the donor held the property until death, the recipient would inherit the property with a fair market value basis under Section 1014, so that the built-in gain would escape income tax altogether. Therefore, compared to a baseline that involves subjecting the gain to no income tax at all, subjecting it to tax at a lower rate may not seem like significant tax avoidance. In addition, the current treatment may persist because of a decision to treat the donor and the donee as one taxpaying unit with respect to gift property (at least when it does not have a built-in loss at the time of the gift). For further discussion of this view, see Kahn & Kahn, *supra* note 107, at 471–73. The current tax treatment of gifts may also be attributable, in part, to the long-standing nature of the existing rules. *See generally* Zelenak, *supra* note 109 (providing a further discussion of their

In the partnership context, lawmakers' obsession with losses is more puzzling because they did not appear to have in mind any particular transaction in which losses were shifted among partners. In fact, at least one high profile transaction undertaken by sophisticated parties involved shifting the tax consequences between partners of income from contributed property rather than loss.[135] It may be that lawmakers were focused on losses because other transactions undertaken at the time, outside of the partnership context, involved losses. For example, transactions undertaken by Enron that were part of the apparent impetus for adopting Section 362(e)(2) (preventing duplication of tax losses in the corporate context)[136] might have also inspired a fixation on the potential to shift losses in the partnership context. Thus, lawmakers apparently had enough foresight to look beyond tax-motivated loss transactions in the corporate context to anticipate tax-motivated loss transactions in the partnership context. However, it appears that their powers of prediction may have only extended that far, as they did not address parallel tax-motivated transactions involving gains in the partnership context.

CONCLUSION

In certain instances, a taxpayer is prevented from shifting a built-in loss to another taxpayer but would be allowed to shift a built-in gain to another taxpayer. This occurs in the context of property transferred by gift and in the context of property contributed to a partnership. The inconsistency prevails despite the fact that no greater potential for tax-motivated transactions involving losses exists to potentially justify the disparate treatment. Instead of being based upon a sound policy justification, it is possible that the uneven treatment is merely an artifact of lawmakers crafting an overly narrow response that addressed only the most high-profile threat to the tax base.

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history).

[135] *See supra* note 38.

[136] *See supra* note 97. *See also* JOINT COMM. ON TAXATION, 108TH CONG., REP. OF INVESTIGATION OF ENRON CORP. 18 (Comm. Print 2003) ("[T]he Joint Committee Staff makes the following specific recommendations . . . [t]he duplication of losses should be curtailed so that a single economic loss is not deducted more than once . . . .").