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Mapping the Labyrinth: Partnership Mergers and Divisions[1]

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More than a single beast lurks within the multi-layered maze of rules relating to the tax treatment of partnership mergers and divisions. The author of this paper (no Theseus) strives, not to heroically slay those beasts, but more humbly to map the labyrinthine rules.[2] After surveying the basic merger and division rules and noting where some practitioners have formerly lost their way, the paper proceeds to examine how the new proposed regulations under Sections 704(c)(1)(B)[3] and 737 apply to partnership merger and division transactions. Finally, the paper concludes by discussing some ways in which the Byzantine system can be used to a practitioner's advantage and flagging traps for the unwary.

I. PARTNERSHIP MERGERS AND DIVISIONS: BASIC RULES

Section 708 provides that a partnership is generally considered to be continuing despite a change in ownership. Under the general rule of Section 708(b)(1), a partnership will be considered to terminate only in two circumstances. In the first instance, a partnership will terminate if no part of the business, financial operation or venture of the partnership continues to be carried on by any of the partners in a partnership. Second, a partnership will terminate if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Section 708(b)(2) provides basic rules for determining whether a partnership is considered to continue or terminate in connection with a partnership merger or division.[4]

Both the Code and the regulations use the terms "merger" and "division" to describe certain partnership transactions without defining those terms. In 2000, proposed regulations were issued under Section 708, providing detailed rules on how to treat partnership mergers and divisions, but not providing guidance as to what constitutes a merger or division.[5] In response, some commentators suggested that the IRS and Treasury Department define these terms, while other commentators stated that defining the terms could lead to planning opportunities adverse to the government's interest.[6] Apparently, the government was swayed by the latter position; after noting the arguments made by the commentators, the Preamble to the 2001 final regulations under Section 708 explains that "[t]he IRS and Treasury have decided not to provide comprehensive definitions of what is a partnership merger or division."[7]

A. Defining Partnership Mergers and Determining the Continuing Partnership

The Regulations do not provide an explicit definition of what constitutes a partnership merger, but it becomes apparent from the merger rules that a merger is a transaction in which at least two partnerships combine and no more than one partnership continues.[8] Before applying the rules that determine the tax treatment of a merger transaction, it is necessary to determine which partnership (if any) continues and which partnership goes out of existence. When a partnership merges with another partnership, Section 708(b)(2)(A) provides that the resulting partnership will be considered to be the continuation of the merging partnership whose members receive more than 50% of the capital and profits interest in the resulting partnership. Under this rule, a partnership merger does not necessarily result in the continuation of even a single merging partnership. For example, where three partnerships merge and the partners of none of the merging partnerships receive more than 50% of the interests in the resulting partnership, all of the merging partnerships will terminate and the resulting partnership will be treated as a new partnership. Reg. section 1.708-1(c)(1).

Although not clear from the face of the statute, the regulations under Section 708 provide that, with respect to a partnership merger, there can be no more than one continuing partnership. If the resulting partnership could be considered a continuation of more than one of the merging partnerships (*i.e.*, because the members of more than one of the merging partnerships own interests of more than 50% in the capital and profits of the resulting partnership), then the regulations impose a tie-breaker rule. Under this tie-breaker provision, the resulting partnership is generally considered to be the continuation of the partnership that contributed the assets with the greatest net value to the resulting partnership.[9] The following example illustrates the application of the tie-breaker rule:

> Example 1.
>
> Partnership 1 and Partnership 2 are each owned 75% by A and 25% by B. Partnerships 1 and 2 merge into Partnership 3 with A receiving 75% and B receiving 25% of the Partnership 3 interests. Because A was a member of both Partnership 1 and 2, and because A received more than 50% of the interests of Partnership 3, Partnership 3 could be considered a continuation of either Partnership 1 or 2. However, under the tie-breaker provision in the Regulations, whichever of Partnership 1 or 2 contributed the assets with the greater net value to Partnership 3 will be deemed the continuing partnership.

Since there can be only one continuing partnership in a partnership merger, it is no surprise that the resulting partnership treated as the continuing partnership inherits the employer identification number of the continuing prior partnership and that this resulting partnership continues to file the return for the partnership treated as continuing. Reg. section 1.708-1(c)(2). Although not specified in the regulations, since the resulting partnership treated as continuing is treated as the same entity as one of the pre-merger partnerships, presumably any elections made by the pre-merger partnership treated as continuing will continue to be in effect with respect to that resulting partnership.

B. Defining Partnership Divisions and Determining the Continuing Partnerships

Although the Section 708 regulations do not define a partnership division, the Preamble to those regulations makes it clear that the IRS and Treasury believe that it is necessary for at least two members of the prior partnership to be members of each resulting partnership that exists after the transaction in order for the transaction to constitute a partnership division.[10] This rule is embodied in the regulatory definition of "resulting partnership." Reg. section 1.708-1(d)(4)(iv).[11] In addition, it is clear from the general rule describing which partnership (if any) will be treated as a continuation of the dividing partnership (as well as from the definition of a "divided partnership"),[12] that a partnership division requires there to be at least two resulting partnerships in existence after the transaction.[13] Accordingly, a basic definition of a partnership division cobbled from these pieces is a transaction in which a partnership divides into two or more partnerships, each of which is owned by at least two partners of the former partnership. A transaction that does not constitute a partnership division will not be subject to the partnership division rules set forth in Regulation section 1.708-1(d).

Under the partnership division rules, a partnership may be treated as continuing even though the partnership has terminated under local law. With respect to a transaction qualifying as a partnership division, Section 708(b)(2)(B) provides that if a partnership divides into two or more resulting partnerships, any resulting partnerships the members of which had more than a 50% interest in the capital and profits of the prior partnership will be treated as a continuation of the prior partnership. Any other resulting partnership will be deemed to be a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50% in the capital and profits of the dividing partnership, then all of the resulting partnerships will be treated as new partnerships and the prior partnership will be treated as terminated. If partners of a partnership that has been divided do not become partners in a resulting partnership which is treated as a continuation of the prior partnership, then those partners' interests are treated as having been liquidated on the date of the division. Reg. section 1.708-1(d)(1).

Unlike the partnership merger rules, which allow for only a single continuing partnership, the partnership division rules permit multiple resulting partnerships to be treated as continuing partnerships. Consider the following example:

> Example 2.
>
> Partnership 1 has two 50% partners, A and B. Partnership 1 divides into Partnerships 2 and 3. After the division, A and B each is a 50% partner in each of Partnerships 2 and 3. Accordingly, both Partnerships 2 and 3 would each be treated as a continuing partnership.

Because more than one partnership can be treated as a continuing partnership, rules are needed to determine which of the continuing partnerships will use the prior partnership's employer identification number, which will file the prior partnership's return, and how elections (*e.g.*, a Section 754 election) made by the prior partnership affect the continuing partnerships. The

Regulations largely provide these rules. All continuing partnerships are subject to preexisting elections made by the prior partnership. Reg. section 1.704-1(d)(2)(ii). Any post-division elections made by a resulting partnership will not affect any of the other resulting partnerships. Id. If there is more than one continuing partnership, it is the "divided partnership" that files the partnership return for the prior partnership and retains the employer identification number of the prior partnership. Reg. section 1.708-1(d)(2)(i).

C. Comparison of the Partnership Merger and Division Rules

In essence, the merger rules provide a framework for determining what happens when several partnerships become one, whereas the division rules provide a framework for determining the consequences when one partnership become several. In this sense, the concept of the "continuing partnership" in a merger is the analog of the "divided partnership" concept in a partnership division. In both a merger and a division, if a post-transaction partnership has sufficient similarity of ownership to one of the pre-transaction partnerships, the merger and division rules treat the former as a continuation of the latter.

The partnership merger rules are consistent with the partnership division rules in providing that there may be no continuing partnership after the merger or division. However, whereas the merger rules provide that there can only be a single continuing partnership resulting from a partnership merger, the division rules allow for multiple continuing partnerships. Some of the logic of this discrepant treatment becomes apparent in the context of how the elections of a pre-merger/division partnership affect the post merger/division partnership. With respect to a partnership division, it makes sense that the resulting partnership spawned from the prior partnership should, if it sufficiently resembles the prior partnership, be bound by the elections of the prior partnership. Otherwise, a partnership could terminate the application of otherwise irrevocable elections (at least as to a significant portion of its operations) simply by carrying out a partnership division, even where the partnership divides pro rata, with no material change in economics. With respect to partnership mergers on the other hand, inconsistent elections made by the merging partnerships could create administrative difficulties in determining to which of the inconsistent elections the single resulting partnership is subject.

II. FORM OF PARTNERSHIP MERGERS AND DIVISIONS: ASSETS-UP OR ASSETS-OVER?

On the face of the statute, Section 708 deals only with determining whether a partnership is considered to terminate or continue. However, the regulations under the Section 708 regulations provide guidance as to the form partnership mergers and divisions are considered to take for Federal income tax purposes. In general, these rules, which were added as final regulations in 2001, operate by laying out a complete series of steps that are deemed to have occurred, depending on whether the form of the transaction is "assets-up" or "assets-over."

In an assets-up merger, one partnership is treated as distributing its all of assets in liquidation to its partners, who then contribute those assets to a second partnership in exchange for partnership interests. In an assets-up division, one partnership is treated as distributing some

or all of its assets to its partners who contribute the assets to one or more partnerships in exchange for partnership interests.

In an assets-over merger, one partnership is treated as contributing its assets to a second partnership in exchange for interests in the second partnership and distributing those interests to partners in liquidation. In an assets-over division, one partnership is treated as contributing some or all of its assets to one or more other partnerships in exchange for partnership interests and distributing those interests to its partners.

Prior to the 2001 publication of the final regulations on partnership mergers and divisions, the regulations simply provided rules for determining when a partnership was considered to continue or terminate in a merger or division. The pre-2001 regulations did not address the actual form that the merger or division was considered to take for federal tax purposes.[14] After the 2001 final regulations were promulgated to make it clear that partnership mergers and divisions could be accomplished in either the assets-up or the assets-over form, practitioners questioned how the distributions and contributions transactions treated as occurring as part of the partnership merger or division are treated with respect to the other provisions of the Code and Subchapter K. In particular, confusion arose as to how Sections 704(c)(1)(B) and 737 applied to the transfer of assets treated as occurring under an assets-over or assets-up merger or division. Despite the confusion, the conceptual key to understanding how the distribution and contribution transactions deemed to occur by the regulations as a result of partnership merger or division implicate other provisions of the Code is simply to take the regulations literally. For example, if a partnership merges with another partnership in an assets-over merger, the merging partnership is treated for *all* federal income tax purposes as transferring its assets to the second partnership in exchange for partnership interests and distributing those interests to the partners of the merging partnership in liquidation of their partnership interests.[15] For purposes of determining gain recognized or deferred, basis, basis adjustments, holding period, and application of Sections 704(c)(1)(B) and 737, the normal rules of the Code govern.

A. Form of Partnership Merger

1. Introduction

As a matter of local law, a transaction treated as a partnership merger for federal income tax purposes can be accomplished in one of several ways. A partnership can transfer its assets to its partners who, in turn, transfer those assets to second partnership in exchange for interests in the second partnership (an “assets-up” merger). Alternatively, a partnership can transfer its assets to a second partnership in exchange for interests in the second partnership and then distribute those interests to its partnership in liquidation (an “assets-over” merger). Additionally, partners can transfer their interests in one partnership to a second partnership in exchange for interests in the second partnership.[16] Finally, in certain jurisdictions, merging partnerships may simply file a merger certificate, resulting in a partnership merger for state law purposes without undertaking any particular form. The regulations under Section 708 operate by respecting the form of an assets-up merger, but only in the event the parties actually undertake that form in the specific manner described in the regulations, and by treating all other partnership mergers as having taken the assets-over form.

2. Assets-Up Merger Form

To achieve the assets-up merger form, the parties are required to undertake the necessary steps under applicable local law and convey ownership of the assets that are distributed to the partners. Notwithstanding the fact that the Preamble to the final Section 708 regulations states that the IRS and Treasury believe that this would not require the actual transfer and recording of a deed or certificate of title with respect to most assets,[17] a transfer of real estate will typically necessitate a deed transfer. The Preamble also states that the IRS and Treasury believe that while it should be necessary for a partnership actually to convey ownership of its assets to its partners in order to achieve the assets-up form, it should not be necessary for the partners actually to assume the partnership's liabilities.[18]

3. Assets-Over Merger Form

Under the assets-over form, the terminating partnership is treated as conveying ownership of its assets and transferring its liabilities to the new partnership in exchange for new partnership interests and distributing those interests to its partners in liquidation of their interests in the terminating partnership. The final Regulations select the assets-over form as the default form for partnership mergers; if a merger incorrectly implements the assets-up form, or implements a form other than the assets-up form, the merger will be treated as taking the assets-over form.[19]

4. Assets-Over Merger Buy-Out Rule

The Regulations provide that in the assets-over form only, one or more partners in the terminated partnership may sell all or part of its interest in such partnership for cash to the new partnership and the other partners may receive tax-free treatment. Without this special rule, a sale of a partnership interest in connection with an assets-over merger could be recast as a partial sale of assets by the partnership. Under this recharacterization, the transferring partnership would be treated as contributing a portion of its assets to the transferee partnership on a tax-free basis while selling a portion of its assets to the transferee partnership on a taxable basis. The gain from taxable sale of assets could potentially cause gain to be allocated to all of the partners in the terminating partnership even though only the exiting partner sold for cash.[20]

The regulations contain somewhat inconsistent guidance on how to qualify for the assets-over buy-out rule. Looking at the text of Regulation section 1.708-1(c)(4) (the assets-over buy-out rule), it appears that, in order to qualify for buy-out treatment:

> a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership . . .will be respected as a sale of a partnership interest if the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold, and if the selling partner in the terminated partnership, either prior to or contemporaneously with the

> transaction, consents to treat the transaction as a sale of the partnership interest.

From these words, it appears that to achieve buy-out treatment, sufficient foresight and planning is required to document the buy-out; an eleventh-hour decision by a partner to be bought out would appear not to be feasible in most instances. The language of the regulation seems to require that the resulting partnership actually purchase the partnership interests of the terminating partnership from the exiting partner and that the exiting partner actually assign his interest to the resulting partnership. However, Example 5 of Regulation section 1.708-1(c)(5) (the only example in which the buy-out rule is illustrated) indicates a somewhat looser procedure to qualify for buy-out treatment than indicated in Regulation section 1.708-1(c)(4). In Example 5, the exiting partner, the terminating partnership and the resulting partnership enter into an agreement specifying that the resulting partnership will purchase the exiting partner's interest for $150 before the merger, and as part of the merger, the exiting partner consents to treat the sale of the interest in a manner consistent with such agreement. As part of the merger, the terminating partnership receives $150 from the resulting partnership and distributes this sum to the exiting partner immediately prior to the merger. As illustrated, no actual assignment of the partnership interest from the exiting partner to the resulting partnership is required and the cash can go to the merging partnership, rather than directly to the exiting partner. If, at the last moment before a deal closes, a partner decides that it wishes not to continue as a partner in the resulting partnership, the parties should be able to achieve buy-out treatment, if desired. A side agreement to sell the interest and a consent to buy-out treatment can be drafted with relative ease and speed and executed just prior to closing.

The assets-over buy-out rule is illustrated by the following example:

> Example 3.
>
> A, B and C are equal partners of Partnership 1 (PS-1) which merges into Partnership 2 (PS-2). At the time of the merger, PS-1 owns Asset 1 with a $300 basis and a $600 fair market value. A decides that it does not wish to continue as a partner in PS-2. Accordingly, as part of the merger, PS-2 transfers $200 to PS-1, which PS-1 distributes in liquidation of A's interest, with B and C receiving interests in PS-2. Without the special buy-out rule, PS-1 could be treated as selling 1/3 of Asset 1 for cash and contributing 2/3 of Asset 1 to PS-2. Pursuant to such a recharacterization, the gain from the part-sale would be allocated 1/3 each to A, B and C.

If the requirements of the assets-over buy-out rule are met, the exiting partner is treated as having sold its interest in the terminating partnership. Immediately after the sale, the resulting partnership becomes a momentary partner in the terminating partnership such that the resulting partnership and ultimately its partners (determined prior to the merger), inherit the exiting partner's capital account in the terminating partnership and any Section 704(c) position of the exiting partners.[21] If the terminating partnership had a Section 754 election in effect for the year, the resulting partnership will have a special basis-adjustment with respect to the terminating

partnership's property under Section 743.[22] The assets-over buy-out rule is illustrated in the following example:

> Example 4.
>
> Partnership 1 (PS-1) is owned by partners A, B, and C. Partnership 2 (PS-2) is owned by partners D and E. PS-1 engages in an assets-over merger with PS-2, with PS-2 as the resulting partnership. Partners B and C continue as partners of PS-2 along with D and E, but partner A sells his interest in PS-1 to PS-2 immediately prior to the merger for $100. Partner A's gain or loss on the sale of the partnership interest will be determined under Section 741. PS-2 will inherit partner A's capital account in PS-1 pursuant to Regulation section 1.704-1(b)(2)(iv)(l). PS-2 will have a $100 basis in its partnership interest in PS-1 acquired from A. Section 742.
>
> PS-1 is treated as contributing its assets to PS-2 in exchange for interests in PS-2 and distributing those PS-2 interests to partners B and C.[23] PS-1 is also treated as distributing assets to PS-2 in liquidation of PS-2's partnership interest in PS-1 that PS-2 obtained from partner A. PS-2 will have a $100 basis in the assets deemed received from PS-1 with respect to the PS-1 interest PS-2 acquired from partner A. Section 732(b).

Although the assets-over buy-out rule does not apply with respect to assets-up mergers, the rule may not be necessary in an assets-up merger. In an assets-up merger, the partners of the terminating partnership are deemed to have received the assets of the terminating partnership a moment before they contribute such assets to the resulting partnership. The regulations are explicit that "[d]espite the transitory ownership of the terminated partnership's assets," the form of the merger will be respected provided the requirements of an assets-up merger are met. Accordingly, a partner wishing to exit from an assets-up merger, can simply sell the assets deemed distributed to it from the resulting partnership, and such a sale would not trigger gain to the other partners of the terminating partnership.

The Preamble to the final regulations makes it clear that the assets-over buy-out rule can result in a partnership termination under Section 708(b)(1)(B).[24] Consider the following example.

> Example 5.
>
> A and B each owns 30% of Partnership 1 ("PS-1") and C and D each owns 20% of PS-1. E and F each owns 50% of Partnership 2 ("PS-2"). PS-1 merges with PS-2 in an assets-over merger. As part of the merger, A and B sell their interests in PS-1. After the merger, C and D each owns 30% of PS-2, and E and F each owns 20% of PS-2. Under Reg. section 1.708-1(c)(1), PS-1 is treated as the continuing partnership.[25] However, despite this treatment under the merger rules, Section 708(b)(1)(B) treats PS-1 as

terminating upon the sale of A and B's more than 50% interest in the capital and profits of PS-1.

With respect to the above example, one effect of the Section 708(b)(1)(B) termination will be to terminate any elections that PS-1 had in effect.

5. IRS May Disregard Form of Merger

The Section 708 regulations allow the Service to recast certain merger transactions even if a different form was intended by the parties. If the merger is part of a larger series of transactions, and the substance of the larger series is inconsistent with following the form of the merger chosen by the parties, then the Service may disregard the form of the merger. Reg. section 1.708-1(c)(6). The only example in the Regulations that involves disregarding the purported form of a partnership merger example is one in which the assets-up form is disregarded and the transaction is treated as a taxable exchange of partnership interests.[26] The example is summarized as follows:

> Example 6.
>
> A, B and C are equal partners in the ABC partnership, and D and E are equal partners in the DE partnership. B and C want to exchange their interests in ABC for all of the interests in DE. To achieve this, DE purports to effectuate an assets-up merger with ABC whereby DE transfers all of its assets and liabilities to D and E, who then transfer those assets and liabilities to ABC in exchange for ABC interests. Pursuant to the plan, the assets that ABC acquires from D and E are contributed to a new partnership ("Newco"), and the interests in Newco are distributed to B and C in complete liquidation of their ABC interests. Thus, after the transaction, B and C own Newco which owns all of the historic assets and liabilities of DE, and A, D and E own ABC, which owns all of the historic assets and liabilities of ABC. The regulation concludes that this merger and subsequent division represent transactions that in substance are a taxable exchange of interests in ABC (by B and C) for interests in DE, and accordingly, the transaction is recast to conform with its substance.

The example demonstrates that partnership mergers and divisions, while deemed to consist of certain transactions for tax purposes, are not immune from the application of the step-transaction or substance-over-form doctrines, where part of a larger tax avoidance plan.[27]

B. Form of Partnership Division

1. The Four Possible Forms of Partnership Division

As is the case with partnership mergers, the regulations establish the assets-over form as the default form for partnership divisions unless the formal requirements of the assets-up form are expressly met. The regulations describe four alternative forms that a partnership division can

take: (i) the assets-over form where there is at least one resulting partnership that is a continuation of the prior partnership; (ii) the assets-over form where there is no resulting partnership that is a continuation of the prior partnership; (iii) the assets-up form where the partnership distributing the assets is a continuation of the prior partnership; and (iv) the assets-up form where none of the resulting partnerships is a continuation of the prior partnership.

In the first scenario -- an assets-over division where at least one resulting partnership is a continuation of the prior partnership -- the "divided partnership"[28] is treated as contributing some of its assets and liabilities to a recipient partnership[29] or partnerships in exchange for interests and then immediately distributing those interests to some or all of its partners in partial or complete liquidation of their interests. Reg. section 1.708-1(d)(3)(i)(A).

In the second assets-over scenario -- where no resulting partnerships are a continuation of the prior partnership -- the prior partnership is treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships. Immediately afterward, the prior partnership is treated as liquidating and distributing the interests in the new resulting partnerships to the partners of the prior partnership. Reg. section 1.708-1(d)(3)(i)(B).

In the third scenario, an assets-up division will be respected if the divided partnership distributes certain assets to some or all of its partners in partial or complete liquidation of those partner's interests in the divided partnership and, immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership(s). As assets-up mergers require an actual local-law transfer of ownership of assets, so too does an assets-up division require the divided partnership to actually transfer the assets to its partners in a manner that causes the partners to be treated as the owners of those assets for local law purposes. Moreover, with respect to the assets of the divided partnership that will be owned by a resulting partnership, the assets-up form of division requires that the partners of the divided partnership who received those assets actually transfer ownership to the resulting partnership. Reg. section 1.708-1(d)(3)(ii)(A).

Finally, the Regulations provide rules for achieving the assets-up form of division where no resulting partnership is treated as the continuation of a prior partnership. In this case, the assets-up form will be respected if the prior partnership distributes certain assets (in a manner that causes the partners to be treated as the owners for local law purposes) to some or all of its partners. Immediately thereafter, the partners must transfer the assets they received from the prior partnership to one or more new resulting partnerships in exchange for interests in the resulting partnership(s). All assets transferred by the prior partnership to its partners must subsequently be transferred by those partners to the new resulting partnerships or else the division will be treated as taking the assets-over form. The Regulations further provide that, if the prior partnership does not fully liquidate, the prior partnership is treated as transferring its retained assets and liabilities to a new resulting partnership under the assets-over form. Reg. section 1.708-1(d)(3)(ii)(B). As a result of the preceding sentence, a partnership division with *no continuing partnership* can be treated as part assets-up (to the extent assets are distributed by the prior partnership to its partners and then by those partners to a new resulting partnership) and

part assets-over (to the extent the prior partnership retains assets and liabilities). Id. Consider the following example.

> Example 7.
>
> Partnership 1 has eight equal partners, A through H, and owns Assets 1 through 4. Partnership 1 divides into four partnerships by distributing undivided interests in Asset 2 to partners C and D, undivided interests in Asset 3 to partners E and F, and undivided interest in Asset 4 to partners G and H. C and D contribute Asset 2 to Partnership 2, E and F contribute Asset 3 to Partnership 3, and G and H contribute Asset 4 to Partnership 4. Partnership 1 retains Asset 1. Because there is no continuing partnership, the assets-up transactions are respected, and the retention of assets by Partnership 1 is treated as an assets-over transaction whereby Partnership 1 contributes Asset 1 to a new partnership in exchange for interests in the new partnership and distributes those interests to A and B in liquidation of their interests in Partnership 1.

The results here are surprising; Partnership 1 did not transfer Asset 1 and no other partnership is treated as a continuation of Partnership 1. Nevertheless, there is a deemed transfer of Asset 1 by Partnership 1 to A and B which may have unintended tax consequences.

In contrast to the situation where there is *no* continuing partnership, the partnership division examples in the Regulations make it clear that if a partnership divides, there is *at least one* continuing partnership (thus assuring that there is a "divided partnership"), and one of the resulting partnerships receives assets via both an assets-up route and an assets-over route, the entire division is treated in whole as taking the assets-over form.[30] Consider the following example:[31]

> Example 8.
>
> Partnership ABCD owns properties W, X, Y and Z, and divides into Partnership AB and Partnership CD. Because A and B owned more than 50% of the interests in capital and profits of ABCD, but C and D did not own more than 50%, AB is treated as the continuing partnership and CD is treated as a new partnership. To accomplish the division, ABCD transfers property Y to C and titles property Y in C's name. C then contributes property Y to partnership CD. Simultaneously, ABCD contributes property Z to CD in exchange for a partnership interest in CD, which ABCD distributes to partner D in liquidation of D's interest in ABCD. Because ABCD did not undertake the assets-up form with respect to *all* of the assets transferred to CD, ABCD will be treated as undertaking the assets-over division form. ABCD is deemed to contribute properties Y and Z to CD in exchange for interests in CD and distributing those interests to C and D in liquidation of their interests in ABCD.

2. Which Partnership is the "Divided Partnership?"

As discussed above, in order to analyze the tax consequences of a partnership division, it is necessary to determine which partnership is the "divided partnership," because the "divided partnership" is the partnership that is considered to be the transferor of assets and liabilities to the recipient partnership, either directly (under the assets-over form) or indirectly (under the assets-up form). Reg. section 1.708-1(d)(4)(i) (first sentence). To identify the divided partnership is to determine the direction by which assets and liabilities are deemed to have been transferred. The algorithmic rules for determining the divided partnership are as follows:

- Where there is no continuing partnership:

  → There is no divided partnership.

- Where there is only one continuing partnership:

  → The continuing partnership is the divided partnership. Reg. section 1.708-1(d)(4)(i).

- Where there is more than one continuing partnership:

  → If the partnership that, in form, transferred assets and liabilities in connection with the division is a continuing partnership, such partnership is the divided partnership. Id.

  → In all other cases,[32] the continuing partnership with the greatest net fair market value assets is the divided partnership. Id.

The complexity of applying these rules is illustrated, in part, through the following examples 9 through 12:[33]

<u>Example 9</u>.

Partnership Oldco owns property X with a value of $500, Y with a value of $300, and Z with a value of $200. A and B each owns 40% of the capital and profits of Oldco, and C and D each owns 10%. Oldco contributes property Z to newly formed partnership CD and distributes interests in CD to partners C and D in liquidation of their interest in Oldco. Oldco contributes property X to newly formed partnership AB-1 and distributes interests in AB-1 to partners A and B, but A and B continue to be partners in Oldco, which continues to hold property Y and is subsequently referred to as AB-2. Because the partners of each of AB-1 and AB-2 owned more than 50% of the capital and profits interests in Oldco, both AB-1 and AB-2 are treated as continuing partnerships. Because C and D did not own more than 50% of the capital and profits interests in Oldco, CD is treated as a new partnership. Because AB-2 is a

continuing partnership and because AB-2, in the assets-over form, transferred assets to AB-1 and CD as part of the division, AB-2 will be treated as the divided partnership.

Example 10.

The facts are the same as in Example 9, except that partnership Oldco divides into three partnerships by operation of state law, without undertaking a form. Because the partnership division did not undertake the assets-over or the assets-up form, and because more than one resulting partnership is considered the continuing partnership, the continuing partnership with the greatest net fair market value assets will be treated as the divided partnership. In this case, AB-1 (owning asset X with a value of $500) will be treated as the divided partnership. Accordingly, AB-1 will be treated as having contributed asset Y to AB-2 and asset Z to CD and distributing those partnership interests to its partners.

In Example 9, AB-2 is treated as the transferor partnership (where the transactions undertake the assets-over form), whereas in Example 10, AB-1 is treated as the transferor partnership (where the partnerships undertake neither the assets-over nor the assets-up form). Example 10 demonstrates that the direction of a transfer in a partnership division can be reversed if the partnership undertakes no form for the division as opposed to taking the assets-over form. To the extent local law permits, partners may wish to control the direction of the deemed transfer in the division for many reasons, including to minimize or avoid recognition of gain under Sections 704(c)(1)(B) and 737.[34]

The following Example 11 illustrates how a transaction that, in local law form, occurred as a transfer by CD can be recast for federal tax purposes as a transfer by AB-1.

Example 11.

The facts are the same as in Example 9, except that partnership ABCD divides into three partnerships by contributing property X to newly formed partnership AB-1 and property Y to newly formed partnership AB-2 and distributing all interests in each partnership to A and B in exchange for all of their interests in ABCD. C and D remain partners in ABCD, which retains asset Z and is subsequently referred to as partnership CD. Although CD, in form, transferred assets to AB-1 and AB-2, because CD is not a continuing partnership (*i.e.,* because the partners of CD did not own more than 50% of the capital and profits interests in ABCD), and because more than one resulting partnership is treated as the continuing partnership, the continuing partnership with the greatest net fair market value of assets (*i.e.,* AB-1) is treated as the divided partnership. AB-1 is treated as contributing asset Y to AB-2 and asset Z to CD in exchange for partnership interests and distributing those interests to its partners.

The disparity between the federal tax treatment and the state law treatment can be used to a taxpayer's advantage. Consider a scenario like that in Example 11, where the transfers by CD to AB-1 and AB-2 would not be subject to state real estate transfer tax, but a transfer by AB-1 to CD and AB-2 would. However, for federal tax purposes a transfer by AB-1 to the other partnerships would result in little or no gain recognition to the partners under Section 704(c)(1)(B) and 737, but a transfer by CD to the other partnerships would. [35] In such a scenario, it is to the taxpayer's advantage to have the state treat the division as a transfer from CD to AB-1 and AB-2, but have the division treated as a transfer by AB-1 to CD and AB-2 for federal tax purposes.

The following example illustrates how a partnership division with no continuing partnership can be treated in part as an assets-up division and in part as an assets-over division:

> Example 12.
>
> Partnership ABCDE owns Blackacre, Whiteacre and Redacre, and divides into partnerships AB, CD, and DE. Blackacre is transferred by ABCDE to partners A and B and titled in their names. A and B subsequently contribute Blackacre to partnership AB. ABCDE transfers Whiteacre to partners C and D, titling it in their names. C and D contribute Whiteacre to partnership CD. ABCDE retains Redacre, changing its partnership name to DE. D and E remain partners in partnership DE. Neither the partners of AB, CD nor DE owned more than 50% of the capital and profits of ABCDE. Accordingly, ABCDE is considered to terminate and neither AB, CD, nor DE is considered a continuation of ABCDE. Because there is no continuing partnership, the "divided partnership" rules do not apply; rather the rules set forth in Regulations sections 1.704-1(d)(3)(i)(B) (for assets-over mergers with no continuing partnership) and 1.704-1(d)(3)(ii)(B) (for assets-up mergers with no continuing partnership) apply. Under these rules, the prior partnership (ABCDE) is considered to undertake an assets-up merger with respect to partnership AB and to undertake an assets-up merger with respect to partnership CD. Because partnership ABCDE does not liquidate (*i.e.,* it retains Redacre), it is treated as undertaking an assets-over form with respect to partnership DE, whereby ABCDE contributes Redacre to DE in exchange for partnership interests and distributing those interests in liquidation of D and E's interests in partnership ABCDE.

III. APPLICATION OF SECTIONS 704(c) AND 737 TO PARTNERSHIP MERGERS AND DIVISIONS

A. Section 704(c)

Section 704(c) is designed to prevent the shifting of built-in gain and loss of property contributed to a partnership by one partner (the "contributing partner") to other partners in the partnership. Contributed property that, at the time of the contribution, has a fair market value greater or less than the property's adjusted basis is referred to as "Section 704(c) property."

Generally, Section 704(c)(1)(A) requires income, gain, loss and deduction with respect to Section 704(c) property to be allocated among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution. The basic mechanism of Section 704(c) is demonstrated in the following example:

> Example 13.
>
> A contributes nondepreciable property ("Asset 1") to Partnership 1 with a $100 adjusted basis and a $200 fair market value in exchange for a 50% interest in the partnership. Each of B and C contributes $100 of cash to Partnership 1 in exchange for a 25% interest. Partnership 1 sells Asset 1 at a time when the fair market value is $300. Because Asset 1 is Section 704(c) property with $100 of built-in gain at the time of contribution, $100 of Section 704(c) gain is allocated to A (the contributing partner) and the remaining $100 of gain is allocated 50% A and 25% to each of B and C in accordance with each partner's respective percentage interest.

B. The Anti-Mixing Bowl Rules

Section 704(c)(1)(B) is often referred to as an "anti-mixing bowl rule." This Section was written to ensure that a partner contributing Section 704(c) property does not escape allocation of Section 704(c) gain when the partnership distributes the Section 704(c) property to another partner (instead of disposing of it by sale or exchange). Under Section 704(c)(1)(B), if a partnership distributes Section 704(c) property to a partner other than the contributing partner within seven years of the contribution, such distribution will result in the recognition of Section 704(c) gain or loss and the allocation of that gain or loss to the contributing partner. The amount of gain or loss recognized by the contributing partner is the amount that would have been allocated to the contributing partner had the Section 704(c) property been sold by the partnership for its fair market value.

After 704(c)(1)(B) was added to the Code in 1989, it was still possible for a contributing partner to avoid allocation of Section 704(c) gain by being redeemed from a partnership with a distribution of other assets. Once the partner was redeemed from the partnership, partnership gain could not be allocated to that former partner. Consider the following example:

> Example 14.
>
> The facts are the same as Example 13, except that the partnership purchases Asset 2 for $200. If the partnership were to sell Asset 1 for $200, $100 of Section 704(c) gain would be allocated to A. Instead, the partnership first distributes Asset 2 to A in liquidation of A's partnership interest, and then sells Asset 1 for $200. Under this scenario, A's $100 of precontribution gain was shifted to B and C.[36]

To plug this leak, Section 737 was added to the Code not long after the enactment of Section 704(c)(1)(B).[37] Section 737 patches the hole left by Section 704(c)(1)(B) by ensuring that a contributing partner does not escape allocation of Section 704(c) gain by receiving a distribution of other property from the partnership and exiting the partnership.

Section 737 provides that if a partnership distributes property to a contributing partner within seven years of the contribution (other than the property contributed by such partner), the contributing partner will recognize gain. The amount of the gain is equal to the lesser of (i) the contributing partner's "net precontribution gain" or (ii) the excess of the fair market value of the distributed property over the contributing partner's adjusted basis in its partnership interest. Conceptually, net precontribution gain is the amount of gain that the contributing partner would have recognized under Section 704(c)(1)(B) if all property contributed by the distributee partner to the partnership within seven years of the distribution and held by the partnership immediately before the distribution had been distributed by the partnership to a partner other than the distributee partner. Section 737(b).

C. 1995 Regulations Applying Sections 704(c)(1)(B) and 737 to Certain Partnership Mergers

In 1995, regulations were added under Section 704(c)(1)(B) and 737, which provided guidance as to how those Sections applied to "complete transfers to another partnership." Regulation sections 1.704-4(c)(4) and 1.737-2(b)(1) provide exceptions to Section 704(c)(1)(B) and 737 treatment in the case of a transfer by a partnership (the "transferor partnership") of all of its assets and liabilities to a second partnership (the "transferee partnership") followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. While the 1995 regulations were adopted prior to the final Section 708 regulations describing the assets-up and assets-over form of partnership mergers, the 1995 regulations in effect describe a transaction that would be an assets-over merger under the later Section 708 regulations.

Thus, regulation sections 1.704-4(c)(4) and 1.737-2(b)(1) provide that neither Section 704(c)(1)(B) nor Section 737 are triggered by what is in effect an assets-over merger. For example, if a partner contributed Section 704(c) property to the transferor partnership, and the transferor partnership merged with a second partnership within seven years, the distribution by the transferor partnership of interests in the transferee partnership to the other partners of the transferor partnership will not cause the contributing partner to recognize Section 704(c) gain under Section 704(c)(1)(B). The 1995 regulations also contained the corollary to this exception, whereby Sections 704(c)(1)(B) and 737 would apply to a subsequent distribution by the transferee partnership of property to a partner "to the same extent that a distribution from the transferor partnership would have been subject to section [704(c)(1)(B) or 737]."[38] Essentially, the 1995 regulations exempt certain assets-over partnership mergers from triggering Sections 704(c)(1)(B) and 737, while clarifying that the Section 704(c) contributing partners of the transferor partnership remain subject to those rules to the extent distributions are made by the transferee partnership within seven years of the original contribution. In other words, the transferee partnership steps into the shoes of the transferor partnership with respect to the contributing partners' original Section 704(c) gain.

D. Revenue Ruling 2004-43

1. Description of the Ruling

In Revenue Ruling 2004-43, the IRS explained how Sections 704(c)(1)(B) and 737 apply to assets-over mergers.[39] The Ruling presented the following two scenarios:

> Scenario 1: On January 1, 2004, partner A contributes nondepreciable Asset 1, with a basis of $200 and a fair market value of $300, to partnership AB in exchange for a 50% interest. On the same date, partner B contributes $300 of cash in exchange for a 50% interest. Also on January 1, 2004, C contributes nondepreciable Asset 2, with a basis of $100 and a fair market value of $200, to partnership CD in exchange for a 50% interest, and D contributes $200 of cash to CD in exchange for a 50% interest. On January 1, 2006, AB and CD engage in an assets-over merger whereby AB is the continuing partnership and CD is the terminating partnership. At the time of the merger, AB's only assets are Asset 1, with a value of $900 and $300 of cash and CD's only assets are Asset 2 with a value of $600 and $200 of cash. After the merger, the partners have the following capital and profits interests in AB:
>
> A 30%
> B 30%,
> C 20%
> D 20%.
>
> Neither partnership has a Section 754 election in effect, but both partnerships provide that the partnership will revalue partnership property upon the entry of a new partner. On January 1, 2012, AB has the same assets with the same values as on the date of the merger. On this date, AB distributes Asset 2 to A in liquidation of A's interest in AB.
>
> Scenario 2: The facts are the same as Scenario 1, but on January 1, 2012, Asset 1 has a value of $275 and AB distributes Asset 1 to C in liquidation of C's interest in CD.

The Revenue Ruling notes that on the date of the merger, Asset 2 has a basis of $100 and a value of $600. Of the $500 of built-in gain at this time, $100 consists of C's Section 704(c) gain from his original contribution of Asset 2 to CD, and $400 of the built-in gain consists of new Section 704(c) gain arising from the contribution of assets by CD to AB as part of the merger.[40] When CD enters as a new partner of AB, AB revalues its property. At this time, Asset 1 has a basis of $200 and a value of $900. Of the $700 of built-in gain, $100 is pre-existing built-in gain allocable to A from A's original contribution of Asset 1 to AB. The $600 balance is reverse Section 704(c) gain to be shared equally between A and B.

In the first scenario, the distribution of Asset 2 to A occurs more than seven years after the contribution of Asset 2 to CD. Accordingly, C's original $100 of Section 704(c) gain is not triggered under Section 704(c)(1)(B). However, the contribution of Asset 2 to AB in 2006 resulted in $400 of new Section 704(c) gain shared equally by C and D. When Asset 2 is distributed to A within seven years of the merger, each of C and D recognizes $200 of Section 704(c) gain under Section 704(c)(1)(B). With respect to A, the distribution of Asset 2 occurs more than seven years after A's contribution of Section 704(c) property to AB, so A's $100 of original Section 704(c) gain is not triggered under Section 737. The $600 of reverse Section 704(c) gain is not "net precontribution gain" for Section 737 purposes, so A does not recognize Section 704(c) gain under Section 737 upon the distribution of Asset 2.

In Scenario 2, A does not recognize gain under Section 704(c)(1)(B) because Asset 1 was distributed to C more than seven years after A contributed it to AB. In addition, Section 704(c)(1)(B) does not apply to the reverse Section 704(c) gain arising from the revaluation of AB's assets upon the entry of CD as a new partner. The distribution of Asset 1 to C also occurs more than seven years after C contributed Section 704(c) property to CD, so C does not recognize his original Section 704(c) gain. However, the contribution of Asset 2 by CD to AB resulted in $400 of new Section 704(c) gain, $200 of which is allocable to C. Accordingly, the distribution of Asset 1 to C causes C to recognize $175[41] of gain under Section 737.

2. Response to Revenue Ruling 2004-43

Several commentators argued that Revenue Ruling 2004-43 misapplied the "to the same extent" limitation language of the "subsequent distribution rule"[42] from the Regulations under Section 704(c)(1)(B) and 737. For example, the ABA published commentary in which it stated that nearly all of the practitioners commenting on the subsequent distribution rule of Regulation section 1.704-4(c)(4) and 1.737-2(b)(3) have interpreted the "to the same extent" language to mean that the amount of gain recognized under either Section 704(c)(1)(B) or 737 as a result of a distribution by the transferee partnership should be limited to the amount of gain that would have been recognized under that Section if the property had been distributed by the transferor partnership.[43] Under this interpretation, the "new" Section 704(c) layer of built-in gain created in the merger would not be triggered under either scenario in the Revenue Ruling. Although Revenue Ruling 2004-43 may have run contrary to a common interpretation of the 1995 subsequent distribution rule, such interpretation arguably reads too much into the language of the anti-mixing bowl merger exceptions. As discussed above, in section III.C., the 1995 regulations provided a taxpayer-favorable rule that gain would not be triggered under Sections 704(c)(1)(B) or 737 upon an assets-over merger. The so-called "subsequent distribution rule" is less a special rule than a clarification that partners of the transferor partnership who had contributed Section 704(c) property will continue to be subject to Sections 704(c)(1)(B) and 737 on their respective original Section 704(c) gain with respect to distributions made by the transferee partnership to its partners. This is simply a corollary to the nonrecognition rule of the 1995 Regulations that functions in much the same way as other provisions of the Code that preserve a taxpayer's basis or some special taint or characteristic with respect to property received in a nontaxable exchange. The rule does not address anything beyond the historical Section 704(c) gain.

In addition to this regulatory interpretation argument, the ABA commentary argued that policy also supported its interpretation.[44] It noted that under the Revenue Ruling's approach, a partner contributing cash to the transferor partnership could recognize gain when the transferee partnership distributes property to another partner. The commentary also argued that in the event the IRS did not withdraw the Revenue Ruling, the IRS should at least carve out an exception from the application of Sections 704(c)(1)(B) and 737 to partnership mergers between two partnerships with 80% common ownership.

It is hard, however, to see how the Ruling is wrong on policy grounds. The ABA commentary's point that a partner contributing cash to a transferor partnership could recognize gain when the transferee distributes property received from the transferor partnership to another party is not persuasive. Under basic Section 704(c)(1)(B) rules, a partner who purchases an asset for cash and contributes that asset to a partnership when the asset has appreciated will recognize gain if the partnership distributes that asset to another partner. It is difficult to see then why, when this basic rule is applied to a contribution by one partnership to another (in effect, an indirect contribution of assets by the partners of the terminated partnership), the application of Section 704(c)(1)(B) to a subsequent distribution by the transferee partnership violates equitable tax policy any more than the rigid rule of Section 704(c)(1)(B) does generally.

E. 2007 Proposed Regulations on Application of Section 704(c)(1)(B) and 737 to Assets-Over Mergers.

In response to the criticism received from commentators, the IRS withdrew Revenue Ruling 2004-43 and stated their intent to issue proposed regulations implementing the principles contained in Revenue-Ruling 2004-43.[45] On August 27, 2007, the promised proposed regulations were issued under Sections 704(c)(1)(B) and 737, effective for distributions made after January 19, 2005. The proposed regulations essentially confirm the application of 704(c)(1)(B) and 737 demonstrated by Revenue Ruling 2004-43. Indeed, the proposed Regulations reiterate the position consistently expressed by the IRS – that basic tax rules of Subchapter K and the rest of the Code apply to the transactions deemed to have occurred as part of a partnership merger as if those transaction really occurred. The proposed regulations analyze the consequences of an assets-over merger by bifurcating "original Section 704(c) gain" of a partner contributing 704(c) property prior to the merger from "new Section 704(c) gain" arising from the merger transaction. Subsequent distributions by the transferee partnership more than seven years after the original Section 704(c) gain property was contributed but within seven years of the merger will trigger new Section 704(c) gain only.

In addition, the proposed regulations provide specific rules not addressed in Revenue Ruling 2004-43. They provide an exception for mergers of partnerships where 97% or more of the interests in book capital and in each item of income, gain, loss, deduction and credit and shares of distributions and liabilities are owned by the same owners in the same proportions after the transaction.

The proposed regulations also clarify that, with respect to both original and new Section 704(c) gain or loss, the transferee partnership may continue to use the Section 704(c) method

adopted by the transferor partnership with respect to the original Section 704(c) gain or loss or use another reasonable method.

F. Application of Sections 704(c)(1)(B) and 737 to Partnership Divisions

As is the case with partnership mergers, the transactions deemed to occur as part of a partnership division are subject to Sections 704(c)(1)(B) and 737 as if they actually occurred. However, unlike partnership mergers, there is only one narrow exception to the application of Sections 704(c)(1)(B) and 737 to partnership divisions. The Preamble to the proposed Section 708 partnership merger and division regulations acknowledged that in many situations, Sections 704(c)(1)(B) and 737 will apply to partnership division transactions.[46] If, in an assets-over division, the divided partnership contributes Section 704(c) property to the recipient partnership, the interest in the recipient partnership received in exchange for such Section 704(c) property will be treated as successor Section 704(c) property under Regulation sections 1.704-4(d)(1) and 1.704-3(a)(8). Accordingly, the distribution of the partnership interests in the recipient partnership by the divided partnership will trigger Section 704(c)(1)(B) with respect to the contributing partner where the interests in the recipient partnership are received by a partner other than the partner who contributed the Section 704(c) property to the divided partnership. Consider the following example:

> Example 15.
>
> In 2000, A contributes Blackacre with a value of $300 and a basis of $100 to partnership ABCD in exchange for a 30% partnership interest. At the same time, C contributes $300 of cash to ABCD in exchange for a 30% interest and each of D and E contributes $200 of cash in exchange for a 20% interest. ABCD uses $500 of the cash to purchase Whiteacre. In 2004, when Blackacre is worth $300 and Whiteacre is worth $500, ABCD divides. As part of the division, ABCD transfers Blackacre and $200 of cash to partnership BD, undertaking the assets-over form, and distributes the interests in BD to partners B and D. ABCD changes its partnership name to AC, retains Whiteacre, and A and C continue as partners of AC.[47] Because AC, as successor to ABCD, is treated as transferring Blackacre, which is Section 704(c) property to BD in exchange for interests in BD, the BD interests are treated as replacement Section 704(c) property. Accordingly, upon distribution of the Section 704(c) property (*i.e.*, the BD partnership interests) to partners B and D, partner A will recognize $200 of gain under Section 704(c)(1)(B).

The Preamble to the 2001 proposed partnership merger and division regulations under Section 708 expressed the IRS and the Treasury Department's general belief that it is appropriate to apply sections 704(c)(1)(B) and 737 in the context of partnership divisions, but invited comments on whether it would be appropriate to expand the analogous exceptions to these sections applicable to partnership mergers to certain circumstances involving divisive transactions.[48] The Preamble to the final Section 708 regulations states that, in response, "[m]ost commentators agreed that it would not be wise to expand the current exceptions."[49]

In the Preamble to the 2001 Section 708 final regulations, the IRS stated that, only in the case that a partnership division is strictly pro rata, with no property extraction or infusion and with no new partners will a division not result in new section 704(c) gain or new section 737 precontribution gain.[50] The Preamble noted that the IRS and Treasury would study this issue and request comments, but the author is aware of no such action to date.

Currently, there is only a single narrow exception to the application of Section 737 to an assets-over partnership division. Regulation section 1.737-2(b)(2) provides that if a transferor partnership transfers all of the section 704(c) property contributed by one partner to a transferee partnership and then distributes an interest in the transferee partnership in complete liquidation of that contributing partner's interest in the transferor partnership, section 737 will not apply to the transfer. If the contributing partner retains any interest in the divided partnership, this exception will not apply.

In light of the fact that an assets-over division of a partnership owning Section 704(c) property generally will trigger gain recognition under Section 704(c)(1)(B) and/or 737 with respect to the transferred assets, taxpayers seeking to avoid Section 704(c) gain may in some cases do so by structuring the division in the assets-up form. The Preamble to the 2000 proposed regulations under Section 708 notes that a distribution of assets by a partnership to its partners may or may not trigger Section 704(c)(1)(B) and 737 "depending on the identity of the distributed asset and the distributee partner."[51] In an assets-up partnership division, the divided (or prior, as the case may be) partnership is treated as distributing its assets up to its partners and those partners are then treated as contributing such assets to a new partnership. To the extent the divided partnership is able to distribute Section 704(c) property to the partner who contributed it (*i.e.*, by making a non pro rata distribution of certain partnership assets), the contributing partner can retain an interest in the divided partnership and obtain an interest in the recipient partnership without recognizing gain under Section 704(c)(1)(B) or 737.

Notably, the 2007 proposed regulations on the application of Section 704(c)(1)(B) and 737 to partnership mergers do not address how these sections apply to partnership divisions. As previously discussed in Section III.E., above, with respect to partnership mergers, the 2007 proposed regulations provide an exception whereby the merger itself will not trigger Section 704(c)(1)(B) or 737, but even such a merger can create new Section 704(c) gain and Section 737 net precontribution gain. Because the Preamble to the 2001 Section 708 final regulations on partnership mergers and divisions indicates that the government does not believe that exceptions to the application of Sections 704(c)(1)(B) and 737 to partnership divisions should be broadened, it may be the case that a partnership division can result in both triggering Section 704(c) gain of the partners of the partnership and in creating new Section 704(c) gain and Section 737 net precontribution gain. Example 15, above, illustrates how a partnership division may trigger Section 704(c) gain of a partner in the divided partnership. The creation of new Section 704(c) gain and Section 737 net precontribution gain upon a partnership division can create rather odd results, as illustrated in the following example.

Example 16.

In 2000, A, D and E each contributes $100 to partnership ABCDE in exchange for 10% interests. On the same date, B contributes $400 to the partnership in exchange for a 40% interest, and C contributes $300 in exchange for a 30% interest. Immediately after formation, ABCDE purchases Blackacre for $100. In 2001, when Blackacre has appreciated in value to $300 and ABCDE has $900 of cash, ABCDE divides in an assets-over division. ABCDE, the prior partnership, contributes Blackacre and $300 of cash to partnership CDE in exchange for CDE interests. ABCDE then distributes the CDE interests to partners C, D and E in liquidation of their interests in ABCDE.[52] ABCDE changes its name to partnership AB, retains $600 of cash, and A and B continue as partners of AB. For Section 704(c) purposes, the contribution of Blackacre to partnership CDE creates $200 of Section 704(c) gain (equal to the built-in gain at contribution). This gain is not triggered upon contribution. C, D and E, as transferee to ABCDE's interest in CDE, succeed to ABCDE's $200 of Section 704(c) gain. Two years after the division, CDE distributes Blackacre and $60 cash to partner C in liquidation of his interest in CDE. C is treated as a contributing partner, so the distribution of Blackacre, which is Section 704(c) property, does not trigger Section 704(c)(1)(B) with respect to C.[53] However, D and E are also contributing partners with respect to Blackacre, so the distribution of Blackacre to C, a partner other than D and E, will trigger D and E's respective shares of the Section 704(c) gain under Section 704(c)(1)(B).[54]

The results that flow from Example 16 are surprising. A and B escape any allocation of Section 704(c) gain; apparently, this is because Section 704(c)(1)(B) and 737 do not apply to reverse Section 704(c) gain. However, this produces the odd result that AB will own $600 of cash, and yet A and B's aggregate bases in their AB partnership interests will be only $500. Moreover, there is a conceptual tension between exempting the reverse Section 704(c) gain with respect to A and B, but causing D and E to recognize their shares of the same Section 704(c) gain. If ABCDE had never divided, the distribution of Blackacre would not have resulted in Section 704(c) gain to any partner. Technically, the division rules treat the transaction as a contribution of property, but no partner is any more of a contributor than another. It seems inequitable for only D and E to recognize gain.

IV. TAX PLANNING UNDER THE PARTNERSHIP MERGER AND DIVISION REGULATIONS

A. Partnership Merger Planning

With respect to planning for a partnership merger, in many cases, there will be a distinct advantage to being able to determine which of the entities is deemed to terminate and which is deemed to be continued. Consider the case where Partnership A and Partnership B have agreed to merge. If the parties determine that it is more important to retain the flexibility to distribute Partnership A's assets over the next 7 years than it is to retain such flexibility with respect to Partnership B's assets (either because there is a smaller book-tax difference inherent in Partnership B's assets or for strategic reasons), then the parties should structure the merger such that Partnership B is treated as the terminated partnership and Partnership A is treated as the continuing partnership. Under this structure, there is no contribution of Partnership A's assets, and therefore, those assets are not subject to Sections 704(c)(1)(B) and 737 over the next 7 years. These considerations are relevant whether the merger takes the assets-up or the assets-over form.

Dictating the direction of a partnership merger may prove difficult in certain situations. For example, if the owners of both Partnership A and Partnership B own more than 50% of the resulting entity and the partnerships merge in the assets-over form, the continuing partnership will be determined based on greatest net asset value of the pre-merger partnerships. In the event Partnership B had assets with a greater net asset value than Partnership A, Partnership B, contrary to the preference of the parties, would be treated as the continuing partnership. Selecting the assets-up form may not solve this problem. Because the assets-up format is only respected if the *terminated partnership* distributes its assets-up to its partners, it appears that the parties to a merger cannot control the directionality of the merger by choosing the assets-up form and having Partnership B distribute assets.[55] A potential solution may be for the parties to structure the transaction so that it is not subject to the merger rules at all. For example, Partnership B could contribute its assets to Partnership A, distribute 99% of the interests received to its partners, and retain 1%.

B. Partnership Division Planning

Similar concerns arise in divisions, where the divided partnership is not treated as receiving any contributed assets while the new partnership is treated as if it had received newly contributed assets subject to the 7-year rules of Sections 704(c)(1)(B) and 737 going forward. In addition, the determination as to which partnership is treated as the divided partnership may dictate whether there are consequences under the disguised sale rules of Section 707 (as a result of nonqualified liabilities or transfers within 2 years).

One example of an area in which the treatment of partnership divisions raises real concerns is with respect to divisions of real estate investment trust umbrella partnerships ("UPREITs"). Frequently, partners who contribute Section 704(c) property to an UPREIT on a tax-free basis will negotiate for indemnity payments to compensate those partners in the event the UPREIT causes such partners to recognize any Section 704(c) gain within a certain time period. Accordingly, when an UPREIT divides, determining which resulting partnership is the

divided partnership will control on which properties (and to which partners) existing Section 704(c) gain is triggered.

With respect to structuring partnership divisions, the parties have more ability to structure the direction of the transaction than is the case with respect to partnership mergers. If more than one resulting partnership is owned by partners who owned 50% or more of the capital and profits of the prior partnership, then the partnership that in form transfers assets, either in the assets-up form or the assets-over form, will be treated as the divided partnership. Accordingly, where there are multiple continuing partnerships, the parties can control which is treated as the divided partnership by selecting that partnership to be the transferor of assets.

In other cases, where only one of the resulting partnerships is treated as the continuing partnership, it may be the case that the parties do not wish for that partnership to be treated as the divided partnership. In such a case, the parties may be able to control which partnership is treated as continuing by giving a sliver interest in that partnership to the majority partners of the divided partnership (since the test for determining the continuing partnership looks to what the partners own in the aggregate rather than the overlapping ownership). Consider the following example:

> Example 17.
>
> A and B each owns 20% of Partnership 1 and C owns 60%. The partners wish to divide Partnership 1 into Partnership 1 and 2, with A and B continuing as partners of Partnership 1 and with partners B and C becoming partners of Partnership 2. The partners desire for Partnership 1 to be treated as the divided partnership (and thus, the transferor of assets to Partnership 1). However, under the divided partnership rules, Partnership 2 is treated as the only continuing partnership because only Partnership 2 has partners (B and C) who owned more than 50% of Partnership 1. The parties can make Partnership 1 the divided partnership by giving C a small (e.g. 1%) interest in Partnership 1 and by causing Partnership 1 to, in form, transfer assets (under either the assets-up or the assets-over form). In this case, both Partnership 1 and Partnership 2 are treated as continuing partnerships, so the partnership that, in form, transfers the assets (e.g. Partnership 1) is treated as the divided partnership.

In certain cases, a partnership division can be structured so as to be treated as a transfer in one direction for federal income tax purposes and a transfer in another direction for local law purposes. Consider the following example:

> Example 18.
>
> Partnership 1 is owned 1/3 by each of A, B an C. Partnership 1 owns three real estate assets: (i) Blackacre, located in New Jersey, that Partnership 1 recently acquired for $100, (ii) Whiteacre, located in Montana, with a zero basis and $90 fair market value, and (iii) Redacre, located in Montana, with a zero basis and $90 fair market value. Partnership 1 wishes to divide into

> two or more partnerships to separate the New York assets from the Montana assets.

In a division, Partnership 1 would want to be treated as having transferred Blackacre for federal tax purposes, because this asset has no Section 704(c) gain. However, for local law purposes, Partnership 1 does not want to be treated as having transferred Blackacre, because, unlike a transfer of Whiteacre or Redacre, a transfer of Blackacre will be subject to state and local transfer tax. In this case, if there is more than one continuing partnership, the partnership that in form, transfers the assets, will be treated as the divided partnership. However, in this instance, the transferor partnership will be the same for federal income tax and state law purposes. Accordingly, the parties may cause Partnership 1 to divide "into two or more partnerships without undertaking a form for the division that is recognized under [Regulation section 1.708-1(d)(3)]."[56] In this case, the resulting partnership with the greatest net fair market value assets will be treated as the divided (transferor) partnership for federal income tax purposes. On the facts above, however, a division into two partnerships would result in the partnership owning the Montana assets being treated as the transferor (because these assets have a greater net fair market value than the New York asset). To structure around this impediment, the parties could divide into three partnerships, such that the partnership owning Blackacre (having the greatest net fair market value) would be treated as the transferor for federal income tax purposes, while making no transfer of Blackacre for local law purposes.

C. Unexpected Applications of the Partnership Merger and Division Regulations

Not all assets-up mergers are respected in form; in certain assets-up mergers, the merger rules deem an assets-up transaction to occur, but reverse the direction of merger for tax purposes. Consider the following example: Partnership AB undertakes the assets-up form in merging with partnership CD to form partnership ABCD. Partnership AB transfers its assets to it partners (A and B) who contribute those assets to partnership ABCD in exchange for partnership interests in ABCD. If A and B, together, own more than 50% of the interest in partnership ABCD's capital and profits, the form of the transaction will not be respected.[57] Instead, partnership CD will be treated as merging with partnership AB under the assets-over form by contributing its assets to partnership ABCD in exchange for partnership interests in ABCD and distributing those partnership interests to its partners, C and D, in liquidation of their interests in CD.

In many situations, practitioners may be surprised that the merger and division regulations apply at all. For example, if a partnership distributes a wholly owned limited liability company ("Newco") to two of its partners, most practitioners would assume that Revenue Ruling 99-5 would apply, which would treat the partnership as distributing assets to its partners, and those partners as subsequently contributing the distributed assets to a new partnership.[58] However, since two partners from the distributing partnership will own Newco, presumably the transaction constitutes a division under the regulations.[59] If so, the divided partnership rules may produce counterintuitive results such that Newco may wind up the divided partnership, and the partnership actually distributing assets may be treated as a newly formed entity. Moreover, instead of the distributee partners taking an aggregate basis in Newco equal to the distributing partnership's basis in Newco under Section 732, under the division regulations, the distribution

is treated a distribution of partnership interests, which may result in a basis adjustment to the distributee partnership's assets under Section 743.

V. CONCLUSION

The knotty rules of partnership mergers and divisions can be synthesized in part to a simple principle: take the transactions deemed to occur in a merger or division literally. In other words, we are directed to treat the transfers as having been made as described in the Section 708 regulations and then to apply the normal rules of Subchapter K and the rest of the Code to determine the tax consequences. However, despite the simplicity of this principle, applying it proves to be a challenge. As demonstrated above with respect to the application of Section 704(c) and Section 737 to partnership mergers and especially partnership divisions, both uncertainties and surprising results emanate from these rules.

GLOSSARY OF TERMS

PARTNERSHIP MERGERS:

assets-over merger A merger or consolidation of two or more partnerships under applicable jurisdictional law that either (i) does not undertake a form for the merger or consolidation, or (ii) undertakes a form that is not described by Reg. §1.708-1(c)(3)(ii) (*i.e.*, the assets-up form). In an assets-over merger, the partnership that is considered terminated is treated as having contributed all of its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership, immediately followed by a distribution of the interests in the resulting partnership to the partners of the terminated partnership in liquidation of their interests in the terminated partnership. Reg. §1.708-1(c)(3)(i).

assets-up merger A merger or consolidation of two or more partnerships under applicable jurisdictional law in which the partnership that is considered terminated distributes all of its assets to its partners in liquidation of their interests in the terminated partnership, immediately followed by a contribution by those partners of the assets of the terminated partnership to the resulting partnership in exchange for interests in the resulting partnership. Reg. §1.708-1(c)(3)(ii).

continuing partnership There can be, at most, one continuing partnership in a merger. The resulting partnership will generally be treated as the continuation of the merging partnership, the members of which own more than 50 percent of the capital and profits of the resulting partnership. In the event the partners of more than one merging partnership own more than 50 percent of the capital and profits interests in the resulting partnership, the resulting partnership is treated as the continuation of the merging partnership with the greatest net fair market value assets. Reg. §1.708-1(c)(1).

resulting partnership In a partnership merger, the resulting partnership is the partnership that exists after the merger transaction. There is only one resulting partnership.

terminated partnership All merging partnerships other than the partnership treated as the continuing partnership are treated as terminated partnerships. If members of none of the merging partnership own more than 50 percent of the capital and profits of the resulting partnership, then all of the merging partnerships are treated as terminated partnerships. Reg. §1.708-1(c)(1).

PARTNERSHIP DIVISIONS:

assets-over division A division by a partnership into two or more partnerships under applicable jurisdictional law that either does not undertake a form for the division or that undertakes the assets-over form. Reg. §1.708-1(d)(3)(i).

> With respect to a division where there is *at least one continuing partnership*, the assets-over form consists of a transfer by the divided partnership of certain assets and liabilities to a recipient partnership in exchange for interests in the recipient partnership, immediately followed by a distribution by the divided partnership of interests in the recipient partnership to some or all of the partners of the divided partnership in partial or complete liquidation of their interests in the divided partnership. Reg. §1.708-1(d)(3)(i)(A).
>
> With respect to a division where there is *no continuing partnership*, the assets-over form consists of a transfer by the prior partnership of all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships, immediately followed by a distribution of the interests in the resulting partnership to the partners of the prior partnership in complete liquidation of their interests in the prior partnership. Reg. §1.708-1(d)(3)(i)(B).

assets-up division A division by a partnership into two or more partnerships under applicable jurisdictional law that undertakes one of the following two forms:

> With respect to a division where there is *at least one continuing partnership*, the divided partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of their interests in the divided partnership, and immediately thereafter, those partners transfer the assets of the divided partnership to a recipient partnership in exchange for interests in the recipient partnership. Reg. §1.708-1(d)(3)(ii)(A).
>
> With respect to a division in which there *is no continuing partnership*, the prior partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of their interests in the prior partnership, and immediately thereafter, those partners transfer the assets of the prior partnership to a recipient partnership in exchange for interests in the recipient partnership. Reg. §1.708-1(d)(3)(ii)(B).

continuing partnership The resulting partnership (if any), the members of which had an interest of more than 50 percent in the capital and profits of the prior partnership. Reg. §1.708-1(d)(1).

divided partnership The resulting partnership (if any) existing after the division (if any) that is treated as a continuation of the partnership existing prior to the division. The rules for determining which resulting partnership is the divided partnership are as follows:

- Where there is no continuing partnership:

  → There is no divided partnership.

- Where there is only one continuing partnership:

  → The continuing partnership is the divided partnership. Reg. §1.708- 1(d)(4)(i).

- Where there is more than one continuing partnership:

  → If the partnership, that in form, transferred assets and liabilities in connection with the division is a continuing partnership, such partnership is the divided partnership. Id.

  → In all other cases,[60] the continuing partnership with the greatest net fair market value assets is the divided partnership. Id.

prior partnership The partnership that is subject to division that exists under applicable jurisdictional law prior to the division. Reg. §1.708-1(d)(4)(ii). If a partnership divides and there is no continuing partnership, the partnership that exists prior to the division is a prior partnership, not a divided partnership. If a partnership divides and there is a continuing partnership, the prior partnership is the divided partnership.

recipient partnership A partnership that is treated as receiving, for Federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form). Reg. §1.708-1(d)(4)(iii).

resulting partnership A partnership resulting from a division that exists after the division under applicable jurisdictional law and that has at least two partners who were partners in the prior partnership. Reg. §1.708-1(d)(4)(iv).

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[1] I greatly appreciate the able assistance of Seth Hagen in the preparation of the paper.

[2] As a compass to the reader, a Glossary of Terms is provided at the end of this paper defining the key concepts and terms used in partnership mergers and divisions.

[3] All references to "Section" herein refer to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise noted.

[4] The issue as to whether a partnership is treated as continuing or terminating is relevant to determining whether elections in effect with respect to a partnership remain in effect, whether a method of accounting must be continued, whether a transfer of assets has occurred for Federal income tax purposes, whether an partnership

needs to acquire a new EIN, and whether a private letter ruling issued with respect to one partnership remains in full force and effect. Regarding the last issue, P.L.R. 200806002 recently ruled that a deemed termination of a partnership caused by a more than 50% ownership shift under Section 708(b)(1)(B) did not cause a private letter ruling issued to the terminated partnership to lack full force and effect with respect to the deemed new partnership.

[5] *See* Notice of Proposed Rulemaking, 2000-1 C.B. 455**.**

[6] *See* T.D. 8926, 2001-1 C.B. 496, at 499.

[7] Id. It is not clear whether the IRS and Treasury Department primarily were concerned with taxpayers structuring their way into or out of the partnership merger and division rules. To the extent the IRS and Treasury Department were concerned with the former situation, the current regulations provide an anti-abuse rule allowing the IRS to recast abusive transactions taking advantage of the partnership merger or division forms. *See* Reg. sections 1.708-1(c)(6)(i), 1.708-1(d)(6).

[8] The general partnership merger or consolidation rule describes a transaction in which "two or more partnerships merge or consolidate into one partnership." Reg. section 1.708-1(c)(1).

[9] Reg. section 1.708-1(c)(1). Under the pre-2001 Section 708 regulations, the continuing partnership under the tie-breaker rule was the partnership "which is credited with contribution of the greatest dollar value of assets to the resulting partnership." Prior Reg. section 1.708-1(b)(2)(i). Under the prior regulation it was not clear whether the tie-breaker rule referred to gross or net value of assets. Under the current regulations, the tie goes to the partnership "which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership." Reg. section 1.708-1(c)(1). Under both the prior and the current regulations, the tie-breaker rule applies "unless the Commissioner permits otherwise."

[10] T.D. 8925, 2001-1 C.B. at 499 ("To have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction.")

[11] This section provides that "a resulting partnership is a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership."

[12] This term is defined and explained in both the Glossary of Terms and Section II.B.2, below.

[13] *See* Reg. sections 1.708-1(d)(1) and (d)(4)(i).

[14] With respect to partnership mergers prior to the regulations promulgated in 2001, practitioners drew guidance from several Revenue Rulings in which the IRS indicated that a partnership merger would be treated as taking the assets-over form. *See* Rev. Rul. 68-289, 1968-1 C.B. 314; Rev. Rul. 77-458; 1977-2 C.B. 220; Rev. Rul 90-17, 1990-1 C.B. 314. *Cf.* Rev. Rul. 84-111 (ruling that a partnership *incorporation* transaction would be respected under the assets-over form, the assets-up form or the interests-over form). With respect to partnership divisions, the IRS had issued private letter rulings in which both the assets-over form and the assets-up form were respected. *See, e.g.*, P.L.R. 8852004 (assets-up form); P.L.R. 9015016 (assets-over form); P.L.R. 9108015 (assets-over form); P.L.R. 9350035 (assets-up form); P.L.R. 9437008 (assets-over form).

[15] This understanding is supported by the language of the regulations. Regulation section 1.708-1(c)(3)(i) talks about mergers "undertaking the assets-over form *for Federal income tax purposes*," and Regulation section 1.708-1(c)(3)(ii), dealing with the assets-up form, provides that "[d]espite the partners' transitory ownership of the terminated partnership's assets, the form of partnership merger or consolidation *will be respected for Federal income tax purposes*. . ." (Emphasis added.) Regulation section 1.708-1(d)(3)(i) and (ii) contains similar language with respect to partnership divisions. Moreover, the Preamble to the 2000 proposed regulations implicitly assumes that normal tax rules apply to the transactions deemed to have occurred as part of a partnership merger or division. *See* Notice of Proposed Rulemaking, 2000-1 C.B. 455**.** The Preamble discussed how Sections 752, 731, 721, 707, 704(c)(1)(B), and 737 would apply to mergers and divisions in the ordinary course, providing exception by explicit regulatory direction where appropriate (*e.g.*, Reg. section 1.708-1(c)(4), excepting certain partner buyouts in an assets-over merger from the disguised sale rules). *Id.*

[16] The Preamble to the 2000 proposed regulations under Section 708 refers to this form of transaction as "interests-over" and notes that this form of transaction was respected in Revenue Ruling 84-111 in the context of partnership incorporations. In Revenue Ruling 84-111, the IRS respected only the transferors' conveyances of partnership interests, while treating the receipt of the partnership interest by the transferee corporation as the receipt of the partnership's assets. The theory for the result of the interests-over transaction in Revenue Ruling 84-111 is that the transferee corporation can only receive assets since, as a sole member, it is not possible for it

to receive and hold interests in a partnership. (*See also* Rev. Rul 99-6, 1999-1 C.B. 432, holding that an acquisition of 100% of a partnership is treated as a sale of partnership interests by the selling partners, but a purchase of the partnership assets by the purchaser). With respect to partnership mergers, the IRS and Treasury found the interests-over form problematic and ultimately decided not to respect transactions undertaking that form. Unlike the corporate rules, the partnership rules impose certain tax results (under Sections 704(c) and 737, among other Sections) on the partners based on a concept that matches a contributed asset to the contributing partner. The operation of these matching rules breaks down if the partner is treated as contributing an asset that is different than the partnership is treated as receiving. In comparison, determining how to treat an assets-over transaction is straightforward. Accordingly, the Preamble resolves the problem of how to treat an interests-over transaction by deeming interests-over transactions to be treated as assets-over transactions. *See* Notice of Proposed Rulemaking, 2000-1 C.B. 455-456.

[17] T.D. 8925, 2001-1 C.B. 497.

[18] *Id*.

[19] *See* Reg. section 1.708-1(c)(3)(i).

[20] Many practitioners share an analogous concern regarding partnerships that engage in like-kind exchanges. If a partnership engages in a Section 1031 like-kind exchange and receives cash boot that is distributed in redemption of a partner, many practitioners believe that the gain arising from the receipt of boot must be allocated to all of the partners, not just the redeemed partner. *Cf.* Joint Report on IRC Section 1031 Open Issues Involving Partnerships by the American Bar Association, Section of Taxation to Hon. Charles O. Rossotti, Commissioner of Internal Revenue (Feb. 21, 2001) (arguing that special allocation of such gain should be specially allocable to the exiting partner).

[21] *See* Reg. section 1.708-1(c)(5), Example 5(iii), and T.D. 8925, 2001-1 C.B. at 498-499.

[22] *See* T.D. 8925, 2001-1 C.B. at 498-499.

[23] Reg. section 1.708-1(c)(5) Example 5(iii), Section 704(c) and 1.704-3(a)(7).

[24] T.D. 8925, 2001-1 C.B. at 499. Implicitly, this statement also acknowledges that a sale of substantial portion of the interests in the partnership in connection with an assets-over transaction can still qualify as a partnership merger.

[25] Note that the assets-over buy-out rule of Reg. section 1.708-1(c)(4) applies where there is "a sale of all or part of a partner's interest in the *terminated partnership* to the resulting partnership that occurs as part of a merger or consolidation. . ." Emphasis added. Presumably, the assets-over buy-out rule does not apply to a sale of a partner's interest in the *continuing partnership*, because such a rule is not necessary since the continuing partnership is not transferring assets. An exiting partner of the continuing partnership will be treated as receiving a liquidating distribution of cash from the continuing partnership in redemption of his or interest in the continuing partnership.

[26] *See* Reg. section 1.708-1(d)(6)(ii).

[27] Interestingly, the example simply concludes that the transactions are recast as a taxable exchange of interests in ABC by B and C for interests in DE; the example does not note that the transaction would likely result in tax under Section 704(c)(1)(B) in the event the transactions were respected as structured. Section 704(c)(1)(B) is more fully discussed below in Section III. Presumably, the distribution of interests in Newco by ABC to partners B and C would trigger any original Section 704(c) gain created by the contribution of built-in-gain assets by D and E to DE (if any) as well any new Section 704(c) gain created by the contribution of assets by D and E to ABC as part of the merger transaction under Section 704(c)(1)(B).

[28] This term is defined and explained in both the Glossary of Terms and Section II.B.2, below.

[29] A recipient partnership is defined as a partnership that is treated as receiving, for Federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form). Reg. section 1.708-1(d)(4)(iii)

[30] *See* Reg. section 1.708-1(d)(5), Example 3.

[31] Adapted from Example 3 of Regulation section 1.708-1(d)(5).

[32] Such cases may include partnership divisions in which (i) no partnership, in form, transfers assets and liabilities and (ii) the partnership that, in form, transfers assets and liabilities is not a continuing partnership. *See* Reg. section 1.708-1(d)(4)(i).

[33] Adapted from Examples 4 through 7 of Regulation section 1.708-1(d)(5).

[34] The fuller scope of how these Code section apply to partnership divisions is discussed below in Section III.F.

[35] In other situations, practitioners may also wish to cause a transfer in one direction for FIRPTA purposes and a transfer in a different direction for local law purposes.

[36] This shift of $100 gain may only be a timing difference, because will receive Asset 2 with a fair market value of $200 and a basis of $100. Accordingly, A will ultimately recognize $100 of gain upon a disposition of Asset 2. Nonetheless, Section 704(c) is designed to eliminate such timing differences. If the partnership had a Section 754 election in effect, the partnership would make a $100 upward basis adjustment with respect to Asset 1 (calculated as the excess of the partnership's $200 basis in Asset 2 over A's $100 basis in Asset 2). This basis adjustment would effectively prevent A's share of built-in-gain in Asset 1 from being shifted to B and C.

[37] Section 737 is the other "anti-mixing bowl" rule.

[38] *See* Reg. sections 1.704-4(c)(4) and 1.737-2(b).

[39] 2004-1 C.B. 842.

[40] CD is treated as having contributed Asset 2 and cash to partnership AB in exchange for partnership interests in AB in a nontaxable Section 721 transaction. For a moment in time, CD is a partner of AB that has contributed Section 704(c) property with $400 of Section 704(c) gain. When CD transfers its partnership interest in AB to C and D, C and D step into the shoes of CD with respect to CD's $400 of Section 704(c) gain. *See* Reg. section 1.704-4(d)(2).

[41] $175 is the lesser of (i) C's net precontribution gain ($200), and (ii) the fair market value of the property received ($275) less C's basis in C's interest in AB ($100).

[42] Several commentators, including the ABA, refer to regulatory language stating that a subsequent distribution of Section 704(c) property by the transferee partnership to its partner is subject to Sections 704(c)(1)(B) and 737 to the same extent that a distribution by the transferor partnership would have been, as the "subsequent distribution rule."

[43] Comments Concerning Revenue Ruling 2004-43 by the ABA Section of Taxation (July 13, 2004) at 7-8.

[44] *Id*.

[45] *See* Rev. Rul. 2005-10, 2005-1 C.B. 492, and Notice 2005-15, 2005-1 C.B. 527.

[46] Notice of Proposed Rulemnaking, 2000-1 C.B. at 458.

[47] Because AC is the resulting partnership that, in form, transferred assets, and because AC is a continuing partnership, AC is the divided partnership. Reg. section 1.708-1(d)(4)(i). Under Regulation section 1.708-1(d)(3)(i)(A), AC (as the divided partnership) is treated as the transferor of the assets.

[48] Notice of Proposed Rulemaking, 2000-1 C.B. at 458-459.

[49] T.D. 8925, 2001-1 C.B. at 499.

[50] *Id*, at 498-499. The Preamble states that "[t]o the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the IRS and Treasury agree that a partnership division should not create new section 704(c) property or section 737 net precontribution gain." Despite the IRS and Treasury's agreement that such an exception to Section 704(c)(1)(B) and 737 should apply, the final regulations curiously omit such an exception.

[51] Notice of Proposed Rulemaking, 2000-1 C.B. at 458.

[52] Because the members of neither of the resulting partnership owned more than 50% of the capital and profits of ABCDE, ABCDE is treated as terminated, and AB and CDE are each treated as new partnerships.

[53] Section 737 may also be triggered by the distribution to Blackacre to the extent of the portion of Blackacre distributed to C that C is not deemed to have contributed to CDE. However, in this example, Section 737 does not appear to cause C to recognize gain.

[54] This example implicates a highly complex interaction of adjustments under Sections 743, 734 and 704(c)(1)(B)(iii). The net result of the adjustments, however, should be to cause D and E each to recognize its $20 of gain that each would have recognized had ABCDE sold Blackacre for $300.

[55] Reg. section 1.708-1(c)(3)(ii). Even if the merger is structured so that Partnership B distributes its assets up to its partners, if Partnership B had the greatest net fair market value assets, Partnership A will be treated as having terminated and Partnership B will be treated as continuing. Reg. section 1.708-1(c)(1). In this situation, the assets-up merger with Partnership B distributing its assets is re-characterized as an assets-over merger with Partnership B as the continuing partnership. This scenario is further explored in the following section (IV.C.).

[56] Reg. section 1.708-1(d)(4)(i). Regulation section 1.708-1(d)(3) recognizes four forms of division: (i) the assets-over form where at least one resulting partnership is a continuation of the prior partnership; (ii) the assets-over form where none of the resulting partnerships is a continuation of the prior partnership; (iii) the assets-up form where the partnership distributing assets is a continuation of the prior partnership; and (iv) the assets-up form where none of the resulting partnerships are a continuation of the prior partnership. Avoiding undertaking one of the four forms may prove challenging. Alternatively, "if the resulting partnership that had, in form, transferred assets and liabilities, is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership," the parties may effectuate a transfer in one direction for federal tax purposes and another for local law purposes. Reg. section 1.708-1(d)(4)(i). Note that this alternative solution requires at least three resulting partnerships.

[57] In order for the assets-up merger form to be respected, the *terminated partnership* must distribute its assets to its partners. Reg. section 1.708-1(c)(3)(ii). Here, CD, not AB, is the terminated partnership. Accordingly, the merger is considered to take the assets-over form by default.

[58] Rev. Rul. 99-5, 1999-1 C.B. 434.

[59] The partnership division regulations employ the fiction that the wholly owned entity to which the dividing partnership transfers its assets is a partnership. *See* Reg. section 1.708-1(d)(3)(A). If, on the other hand the assets were previously transferred to a wholly-owned limited liability company in a transaction unrelated to the partnership division, and the interests in the limited liability company were subsequently distributed to the partners of the upper-tier partnership, the transaction would be presumably be treated under Revenue Ruling 99-5 rather than as a partnership division.

[60] Such cases include partnership divisions in which (i) no partnership, in form, transfers assets and liabilities and (ii) the partnership that, in form, transfers assets and liabilities is not a continuing partnership.