Federal Income Tax Consequences of Partnership Mergers

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I. INTRODUCTION

For various business and tax reasons, two or more partnerships may choose to consolidate their operations pursuant to a partnership merger. For example, unrelated partnerships may combine their operations to expand their business, provide better service to their customers, or reduce the aggregate cost of their operations. Similarly, several commonly-owned partnerships may combine into a single partnership to centralize business operations, avoid multiple regulatory requirements, or coordinate financing on a joint basis.

Whatever the reasons for a partnership merger, careful consideration of federal income tax consequences is generally no less important than in the case of corporate merger transactions. In contrast to corporate mergers, where a comprehensive statutory scheme provides for the specific federal income tax consequences to both corporations and their shareholders, there is comparatively little statutory guidance...
regarding the federal income tax consequences of partnership mergers to the merging partnerships and their partners.\(^5\) In fact, the sole statutory guidance in this area is section 708(b)(2)(A) which merely identifies which merging partnerships are considered terminated for tax purposes.

The question of which partnerships are considered terminated (and consequently, which partnership, if any, continues) is important. For instance, because a continuing partnership under section 708(b)(2)(A) retains its former tax characteristics,\(^6\) the parties may be interested in preserving the favorable tax elections of one of the merging partnerships.

While some of the federal income tax consequences of partnership mergers relate specifically to which partnerships terminate for tax purposes, the majority of such consequences reflect the application of the normal federal income tax rules to each of the component steps of a partnership merger. The characterization of the steps of a partnership merger and the resulting federal income tax consequences have

\[^5\] § 368(a) defines the term “reorganization” to include not only transactions which would qualify as mergers or consolidations of corporations for state law purposes, but also certain other corporate business combinations. In the case of a corporate “reorganization,” gain or loss is generally not recognized by either the shareholder or the corporations that are parties to the reorganization. I.R.C. §§ 354, 361. But see, I.R.C. §§ 356, 357 (receipt of boot and assumption of liabilities). Both the participating corporations and shareholders generally obtain a carryover basis in property exchanged in the reorganization. I.R.C. §§ 358, 362(b). Other tax attributes of the participating corporations generally are assumed by the resulting entity. I.R.C. § 381.

While partnership reorganizations may occur on generally a tax-free basis, mergers between corporations and partnerships are not included within the definition of either a tax-free corporate “reorganization” or a partnership “merger.” See Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 Tax L. Rev. 345, 354, 392-93 (1984). The combination of partnerships with other business entities in a statutory merger is possible under state law. See Del. Code Ann. tit. 6, §§ 17-211 (1990 Cumm. Supp.) (permitting the merger of a Delaware limited partnership with a corporation, business trust or association, real estate investment trust, or an unincorporated business). Should Congress or the IRS attempt to bring such mergers within a tax-free reorganization scheme, the corporate merger rules rather than the more limited partnership merger rules would appear to be a more workable mechanism. See Eustice, *supra* at 393-94.

\[^6\] See Eustice, *supra* note 4, at 392. (“The partnership merger and division rules are a pallid and primitive statutory edifice when compared to their corporate counterparts”). It is unclear why Congress failed to provide partnership rules parallel to the corporate merger provisions. It may well be that Congress failed to recognize that the potential tax consequences of partnership reorganizations were every bit as complex for partnerships and partners, focusing instead solely on the issue of the effect of partnership reorganizations on a partnership’s taxable year.


been the subject of only a limited number of Internal Revenue Service ("IRS") revenue rulings and private letter rulings.

These rulings evidence the IRS's position that under section 708(b)(2)(A) terminated partnerships should be treated as: (1) having contributed their assets (and transferred their liabilities) to the resulting partnership in exchange for new partnership interests in the resulting partnership and immediately thereafter, (2) having distributed these interests in liquidation to their partners.7

This Article begins by describing the partnership termination rules, including both the general rule under section 708(b)(1) and the special merger exception under section 708(b)(2)(A). This discussion, combined with the subsequent description of the IRS's characterization of partnership merger transactions in existing rulings, form the basis for analyzing the federal income tax consequences of partnership mergers.

Notwithstanding existing IRS rulings, the limited administrative law in this area is insufficient to plug all of the gaps necessary to provide adequate certainty to taxpayers planning partnership mergers. This Article suggests the means through which the IRS could resolve much of this ambiguity.

Finally, this Article concludes with a discussion of certain issues and suggestions related to further development of the statutory rules applicable to partnership mergers. The suggestions are based upon an underlying policy objective of permitting tax free reorganizations of partnerships, where the economic activities and interests of the partnerships and partners have not changed significantly.

II. PARTNERSHIP TERMINATION UNDER SECTION 708

A. General Termination Rule

The general rule for determining when a partnership terminates for federal income tax purposes does not necessarily reflect the definition of a partnership dissolution or termination for state law purposes.8 Section 708(b)(1) instead provides that a partnership terminates for federal income tax purposes if either: (1) it ceases to conduct a business as a partnership, or (2) there is a sale or exchange of over 50 percent of the interests in the partnership within a 12-

---

month period.  

In the case of a partnership termination due to the sale or exchange of over 50 percent of the interests in the partnership, the IRS applies a constructive liquidation analysis. Under this constructive liquidation analysis, the following steps are deemed to occur:

1. The partnership distributes in liquidation undivided interests in all of its assets to the purchaser and remaining partners in proportion to their respective partnership interests, and

2. The purchaser and remaining partners immediately thereafter contribute the undivided interests in the assets to a new partnership.

The deemed liquidation distribution of partnership assets can result in significant adverse tax consequences to the partners of the terminated partnerships. Absent the statutory exception for partnership mergers discussed below, this constructive liquidation analysis could frequently apply to merging partnerships, even in the case of a partnership that survives the merger.

9. I.R.C. § 708(b)(1) provides:
   
   (1) GENERAL RULE. - For purposes of subsection (a), a partnership shall be considered as terminated only if-

   (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

   (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

   
   Cessation of partnership operations may occur, for instance, where the partners transfer their interests to a single partner (creating a sole proprietorship) or where the partners choose to liquidate the partnership. See Treas. Reg. § 1.708-1(b)(1)(i). In the event of a partnership liquidation, the partnership termination does not occur for federal income tax purposes until the completion of any "winding up period" and the distribution of all remaining partnership assets to the partners. This winding up period has been construed liberally by courts to include periods of time when partnerships maintain even minimal activities and assets. See, e.g., Baker Commodities, Inc. v. Commissioner, 415 F.2d 519 (9th Cir. 1969) (retention of note upon sale of assets); Ginsburg v. United States, 396 F.2d 983 (Ct. Cl. 1968) (mere retention of partnership property); Foxman v. Commissioner, 41 T.C. 535 (1964), acq. 1966-2 C.B. 4, aff'd, 352 F.2d 446 (3d Cir. 1965) (sale of partnership assets for two installment notes maintained by the partnership).


11. For a discussion generally of the tax consequences of constructive liquidations under I.R.C. § 708(b)(1), see Cleveland & Berryman, Tax Treatment Upon Termination of a Partnership May Be Uncertain, But Planning Opportunities Exist, 2 J. PARTNERSHIP TAX'N 35 (1985); Feldman & Cramer, Partnership Terminations Can Provide Substantial Tax Savings Opportunities, 18 TAX'N LAW. 234 (1990); Hammer, Tax Consequences of Partnership Terminations Characterized by Uncertainties, 6 J. PARTNERSHIP TAX'N 327 (1990); Resnick & Sellers, The Termination of a Partnership Can Be Controlled to Meet Needs of the Partners, 41 TAX'N ACCT. 376 (1988);

12. Cf. Rev. Rul. 90-17, 1990-1 C.B. 119 (over 50 percent of the interests in the capital
B. Partnership Merger Exception

Under section 708(b)(2)(A) there is a special partnership termination rule which applies specifically to the "merger or consolidation" of partnerships. For this purpose, the term "partnership merger" has been construed to include "any form of transaction whereby the businesses of two or more partnerships are combined in a single partnership, regardless of the form of the transaction and regardless of whether it happens to be called a 'merger' or 'consolidation' under state law." The partnership merger exception in section 708(b)(2)(A) provides for the deemed continuation of one of the merging partnerships if its partners receive more than a 50 percent interest in the capital and profits of the resulting partnership (the "50 percent test"). By negative implication, partnerships failing to meet the requirements of the 50 percent test are deemed terminated for federal income tax purposes.

In the event that partners of none of the merging partnerships receive more than the required 50 percent interest or partners of more than one of the merging partnerships receive more than the required 50 percent interest, section 708(b)(2)(A) fails to expressly identify the continuing and terminated partnerships. Addressing the first of these two situations, regulations provide that if more than a 50 percent interest in the capital and profits of the resulting partnership is not distributed to the former partners of any one of the merging partnerships, then all the merging partnerships shall be considered terminated. In the second situation, regulations provide that if more
than a 50 percent interest in the capital and profits of the resulting partnership is distributed to the former partners of more than one of the merging partnerships, then unless the Commissioner permits otherwise, the resulting partnership shall be considered the continuation of the merging partnership "which is credited with the contribution of the greatest dollar value of assets to the resulting partnership." These rules can be illustrated by the following examples:

**Example 1:** Partnership AB merges with partnership CD. The pre-merger partnership interests in the merging partnerships (AB and CD) and post-merger interests in the resulting partnership (ABCD) are as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>AB</th>
<th>CD</th>
<th>ABCD</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>0%</td>
<td>40%</td>
</tr>
<tr>
<td>B</td>
<td>50%</td>
<td>0%</td>
<td>40%</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
<td>50%</td>
<td>10%</td>
</tr>
<tr>
<td>D</td>
<td>0%</td>
<td>50%</td>
<td>10%</td>
</tr>
</tbody>
</table>

In this instance, the partners of AB will receive 80 percent of the interests in the resulting partnership, ABCD, whereas the partners of CD will receive only 20 percent of the ABCD interests. The 80 percent aggregate interest in ABCD received by the partners of AB exceeds 50 percent. Therefore, AB will be deemed to be the continuing partnership, and CD will terminate pursuant to section 708(b)(2)(A).

**Example 2:** Partnership AB merges with partnership CD. The pre-merger partnership interests in the merging partnerships (AB and CD) and post-merger interests in the resulting partnership (ABCD) are as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>AB</th>
<th>CD</th>
<th>ABCD</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>0%</td>
<td>25%</td>
</tr>
<tr>
<td>B</td>
<td>50%</td>
<td>0%</td>
<td>25%</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
<td>50%</td>
<td>25%</td>
</tr>
<tr>
<td>D</td>
<td>0%</td>
<td>50%</td>
<td>25%</td>
</tr>
</tbody>
</table>

In this case, the former partners of both partnership AB and CD will receive 50 percent of the interests in ABCD. As a result, the former partners of neither AB nor CD will receive more than a 50 percent interest in ABCD. Both AB and CD will therefore terminate under section 708(b)(2)(A).

**Example 3:** Partnership AB merges with partnership BC and the pre-merger partnership

---

18. *Id.* The distribution of more than a 50 percent interest in the capital and profits of the resulting partnership can occur because of common owners of merging partnerships as illustrated in Example 3.

19. In all examples herein, it is assumed that the interests in both partnership capital and profits are identical.

interests in the merging partnerships (AB and BC) and post-merger interests in the resulting partnership (ABC) are as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>AB</th>
<th>BC</th>
<th>ABC</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>0%</td>
<td>25%</td>
</tr>
<tr>
<td>B</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
<td>50%</td>
<td>25%</td>
</tr>
</tbody>
</table>

In this example, the former partners of both AB and BC will receive a 75 percent interest in resulting partnership ABC. Accordingly, unless otherwise permitted by the Commissioner, whichever of the merging partnerships is credited as having contributed the "greatest dollar value of assets" will be deemed to be the continuing partnership.21

There is considerable ambiguity as to how to compute which of the merging partnerships is credited with contributing the greatest dollar value of assets because the regulations are silent in this regard. Moreover, the IRS has evidenced a reluctance to review taxpayers' methods for such a computation.22 As a result, it has been questioned whether taxpayers may argue that the valuation of the assets may be based upon fair market value, book value, or some other valuation scheme.23 It is also not clear whether the valuation is to be based on the gross value of the assets contributed to the resulting partnership or the value of such assets net of any liabilities transferred to the resulting partnership.24

For a variety of reasons, the "greatest dollar value" test is better construed to mean the greatest fair market value of gross assets contributed to the resulting partnership. Within the regulations, the reference to "dollar value" is unique and literally suggests something different than tax basis, book value, or the equity value contributed by the partnerships. The regulations under section 708 clearly evidence an awareness that the tax basis or book value of the assets transferred (or deemed transferred) by a merging partnership could vary from their fair market value.25 Thus, had the authors of the regulations intended to imply a tax basis or book value test, it seems likely they would have done so expressly.

A similar argument can be made that the term "dollar value of assets" means the fair market value of solely the assets contributed to the continuing partnership, rather than such assets less liabilities transferred, because the authors of the regulations failed to make any reference to netting liabilities. In two revenue rulings, the IRS has

21. Id.
22. See MCKEE, NELSON, & WHITMIRE, supra note 14, at 12-41 n.177, citing, Priv. Ltr. Rul. 86-19-015 (Feb.5, 1986) (Service "expressed no opinion on the method used to determine that P1 has the greatest dollar value of assets.")
23. See McGlinsky & Bolling, supra note 2, at 607.
24. Id.
25. Treas. Reg. § 1.708-1(b)(1)(iv) (cross-reference to I.R.C. § 743(b) and Treas. Reg. § 1.743-1(b)).
expressly distinguished "assets" from "liabilities" in stating the facts of the rulings and held that the greatest dollar value test is to be based on "assets" without any further mention of "liabilities."\textsuperscript{26}

 Nonetheless, some commentators have argued that since the thrust of the partnership merger exception is to measure equity interests (i.e. a more than 50 percent partnership interest in the continuing partnership), some form of net value concept should continue to apply in construing the term "dollar value of assets."\textsuperscript{27} While this view may have some theoretical appeal, it has the potential for substantially increasing the complexity and ambiguity in the application of the 50 percent test and should be rejected by the IRS.

 Netting liabilities would require consideration of a host of valuation and allocation questions not required under a mere gross assets test. For instance, should the amount of a debt obligation be measured by its face amount, the market price of publicly traded debt instruments, the issue price of instruments under the original issue discount provisions, or other methods? Additionally, should there be limitations on the amount of a nonrecourse debt obligation for this purpose where the face amount of the debt exceeds the value of the underlying property? Finally, how should loans be treated for which other parties are jointly liable (either directly or as guarantors), such as other partners of the merging partnerships, other merging partnerships, or other members of a group of tiered partnerships?

 Thus, the application of a gross assets test, without regard to liabilities, is not only consistent with the plain meaning of the regulation, but serves the interests of tax administration by producing a more predictable answer for the IRS and taxpayers with the least administrative burden. Nonetheless where there are other important considerations which support designating a different partnership as the continuing partnership, taxpayers should seek a private letter ruling based upon the facts and circumstances of the case.\textsuperscript{28}

C. Overlap of the Merger Exception with the General Rule

 In a more recent development, the IRS has clarified that there is no overlap between the general partnership termination rule under

\textsuperscript{27} McKee, Nelson & Whittmore, supra note 14, at 12-41 n.177.
\textsuperscript{28} Treas. Reg. § 1.708-1(b)(2)(i) retains discretion with the Commissioner to grant such a ruling. The IRS has not given any indication as to the criteria it would apply in exercising its authority in this area. For instance, if the IRS were to apply a gross asset test as discussed above, one potential area in which to seek a ruling would be where the preferred partnership satisfied a net assets test, but not the gross assets test. It is possible that taxpayers seeking a determination would be required to provide a business purpose for the intended result, aside from the beneficial tax treatment.
section 708(b)(1)(B)(sale or exchange of over 50 percent of the partnership interests within a 12-month period) and the special rule for partnership mergers under section 708(b)(2)(A). Thus, even if pursuant to a partnership merger more than 50 percent of the partnership interests in the surviving partnership are distributed to partners of the terminated partnerships, section 708(b)(1)(B) will not be permitted to cause a termination of the surviving partnership for federal income tax purposes.

III. CHARACTERIZING PARTNERSHIP MERGERS

A. Form vs. Substance

Once the continuing partnership and the terminated partnerships have been identified, the analysis of federal income tax consequences

30. In Rev. Rul. 90-17, 1990-1 C.B. 119, partners A and B each owned a 50% interest in partnership RP (having assets worth $500x). Partners B and C each owned a 50% interest in partnership MP1 (having assets worth $400x). Partners D and E each owned a 50% interest in partnership MP2 (having assets worth $100x). The three partnerships (RP, MP1, and MP2) merged pursuant to a transaction whereby each contributed its assets to a resulting partnership and received in exchange its proportionate interest in the resulting partnership, with such interests subsequently distributed to the partners of the merging partnerships. In summary, the ownership interests were as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>RP ($500x)</th>
<th>MP1 ($400x)</th>
<th>MP2 ($100x)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>50%</td>
<td>50%</td>
<td>0%</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
<td>50%</td>
<td>0%</td>
</tr>
<tr>
<td>D</td>
<td>0%</td>
<td>0%</td>
<td>50%</td>
</tr>
<tr>
<td>E</td>
<td>0%</td>
<td>0%</td>
<td>50%</td>
</tr>
</tbody>
</table>

RP was deemed to be the continuing partnership because its partners received over 50% of the capital and profits interest of the resulting partnership because RP contributed the largest value of assets. Id. Even though the deemed distribution upon liquidation of MP1 and MP2 would literally cause a termination of RP under the general rule of I.R.C. § 708(b)(1), i.e. a transfer of 50% or more of the interests of RP within a twelve month period, the ruling holds that I.R.C. § 708(b)(2)(A) and Treas. Reg. 1.708-1(b)(2)(i) provide the “exclusive means for deciding whether a partnership involved in a merger will terminate” and therefore RP will not be deemed to have terminated under the general partnership termination rules. Id.

Nonetheless, it may be appropriate to apply I.R.C. § 708(b)(1) where the merger results in shifting interests among the partners of the continuing partnership, which prior to the merger would have been sufficient to cause a partnership termination. Postlewaite, Dutton & Magette, A Critique of the ALI’s Federal Income Tax Project - Subchapter K: Proposals on the Taxation of Partners, 75 GEO. L.J. 423, 591 (e.g., A and B’s relative interests in the continuing partnership immediately before and immediately after the partnership merger are 80:20 and 15:60, respectively). Accordingly, if faced with such a fact situation, the IRS or a court may reach a result which is inconsistent with Rev. Rul. 90-17, 1990-1 C.B. 119.
of a partnership merger is further dependent upon the characterization of the steps necessary to accomplish the partnership merger. If the specific form of each partnership merger transaction were respected, the federal income tax consequences of partnership mergers could vary even though they reach the same substantive result. This may be illustrated by the following example:

*Example 4:*
Assume that individuals A and B each own 50 percent interests in three partnerships, P1, P2, and P3. Assume further that partnerships P1 and P2 are merged into P3, with A and B each retaining 50 percent interests in the continuing partnership, P3.

In form, the steps of the above partnership merger could occur in each of the three following manners:

(1) P1 and P2 transfer all their assets and liabilities to P3 in exchange for new interests in P3. P1 and P2 then liquidate, distributing the new interests in P3 to A and B (hereinafter "alternative 1");

(2) A and B transfer their interests in P1 and P2 to P3 in exchange for new interests in P3. P1 and P2 then liquidate, distributing their assets and liabilities to P3 (hereinafter "alternative 2"); or

(3) P1 and P2 liquidate, transferring all their assets and liabilities to A and B. A and B thereafter transfer the assets and liabilities to P3 in exchange for new interests in P3 (hereinafter "alternative 3").

In the case of alternatives 2 and 3, the historic assets of partnerships P1 and P2 would be the subject of liquidation distributions. In contrast, alternative 1 involves a liquidation distribution solely of partnership interests in P3. This distinction is important for the purpose of analyzing the federal income tax consequences of partnership mergers, as discussed below.

Applying the normal partnership tax rules, section 731(a)(1) provides that no gain shall be recognized by a partner pursuant to a liquidation except to the extent that the distribution includes money in excess of the partner's adjusted basis in his partnership interest.\(^\text{31}\) Thus, where a terminated partnership has substantial amounts of money on hand or its partners do not have a significant adjusted basis in their partnership interests, the distributions of partnership assets in alternatives 2 and 3 raise the possibility of gain recognition by the partners of the terminated partnerships.\(^\text{32}\)

---

\(^{31}\) I.R.C. § 731(a)(1) provides:

> (a) PARTNERS. - In the case of a distribution by a partnership to a partner-
>
> (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution . . . .

\(^{32}\) In alternative 2, such gain recognition would occur at P3 and be flowed through
Similarly, it is also possible that alternatives 2 and 3 could result in loss recognition which would not otherwise occur pursuant to the characterization of alternative 1. Section 731(a)(2) provides that loss may be recognized in the event that the liquidation consists solely of money, "unrealized receivables," and "inventory." Thus, where these requirements are met, the characterization under alternative 1 could preclude the recognition of a loss otherwise available under alternatives 2 and 3.

B. IRS Application of Substance over Form

In an initial ruling, the IRS characterized an analogous trust merger as if the liquidating trusts distributed their assets to their beneficiaries and then the beneficiaries recontributed the assets to a new trust (alternative 3). This ruling dealt specifically with the merger of two common trust funds which were treated as partnerships under the Internal Revenue Code of 1939. The participants in the common trust funds did not actually receive any distributions, other than some cash distributions with respect to fractional shares; nonetheless, the IRS treated the assets as constructively distributed. Subsequently, in Rev. Rul. 68-289, the IRS changed its position, characterizing a merger of partnerships consistent with alternative 1 pursuant to the following analysis: "The terminating partnerships . . . are treated as having contributed all of their assets and transferred their liabilities to the continuing partnership in exchange for interests in such partnership that are distributed to the respective partners of the terminating partnerships in liquidation of their interests." While not clear from the face of the ruling, the IRS appeared to be providing for a characterization for tax purposes which was inconsistent with the actual steps of the transaction.

In a subsequent General Counsel Memorandum accompanying

33. The term "unrealized receivables" is defined in I.R.C. § 751(c) and not only includes true receivables, but certain recapture items, including § 1245 and § 1250 property. The term "inventory" is defined in I.R.C. § 751(d)(2) and includes inventory as described in I.R.C. § 1221(1), as well as certain other forms of ordinary income producing assets.

34. Rev. Rul. 55-299, 1955-1 C.B. 402. This analysis is similar to the constructive liquidation analysis applied under I.R.C. § 708(b)(1)(B).

35. In Rev. Rul. 60-240, 1960-2 C.B. 192, the IRS clarified that the distribution of cash or securities in order to eliminate fractional shares in such a merger would constitute a taxable sale or exchange to that extent.


Rev. Rul. 77-458, the IRS expressly concluded that notwithstanding the form in which a partnership merger transaction is actually cast, it should be characterized for tax purposes in a manner similar to alternative 1.\textsuperscript{38} Such a characterization, the IRS concluded, was necessary to provide for a tax-free partnership reorganization scheme. Specifically, the IRS noted:

The provisions of Subchapter K are structured to permit individual taxpayers to use the partnership form of organization without incurring additional tax liability (citation omitted). When partners organize, or reorganize, without changing the economic realities of their businesses, we do not believe, absent contrary enactments, Congress intended to tax or penalize them.\textsuperscript{39}

C. The Continued Vitality of Form

Notwithstanding Rev. Rul. 68-289\textsuperscript{40} and Rev. Rul. 77-458,\textsuperscript{41} it is possible that the IRS will revisit the issue of whether the form in which a partnership merger is cast should determine the tax consequences of the transaction. A very similar change of the IRS's position has already occurred with respect to partnership incorporations. In Rev. Rul. 70-239, the IRS initially held that the incorporation of a partnership, regardless of the actual form of the transaction, should be characterized for tax purposes as if (1) the partnership transferred all of its assets subject to its liabilities to a new corporation in exchange for the outstanding stock of the new corporation, and (2) then liquidated, distributing the stock of the new corporation to the partners of the terminated partnership.\textsuperscript{42} This position of the IRS was revoked in Rev. Rul. 84-111, wherein the IRS chose instead to analyze the tax consequences of a partnership incorporation consistently with the steps actually taken to complete the transaction.\textsuperscript{43} Accordingly, given the symmetry between the issues, the IRS may be tempted to revisit the Rev. Rul. 77-458 characterization of partnership mergers.\textsuperscript{44}


\textsuperscript{39} Id.

\textsuperscript{40} 1968-1 C.B. 314.

\textsuperscript{41} 1977-2 C.B. 220.

\textsuperscript{42} Rev. Rul. 70-239, 1970-1 C.B. 74. The three alternative transaction forms considered in Rev. Rul. 70-239, 1970-1 C.B. 74 were virtually identical to the three possible alternative characterizations of partnership mergers discussed herein.

\textsuperscript{43} Rev. Rul. 84-111, 1984-2 C.B. 88.

\textsuperscript{44} Rev. Rul. 77-458, 1977-2 C.B. 220. Note, since Rev. Rul. 84-111, 1984-2 C.B. 88, the IRS has issued a subsequent ruling on partnership mergers. In Rev. Rul. 90-17, 1990-1 C.B. 119 the IRS again cited and supported the alternative 1 type of characterization provided by Rev. Rul. 77-458, 1977-2 C.B. 220. This ruling, however, involved a transaction where the form of the transaction mirrored the substantive characterization. Thus, the IRS did not have to revisit the substance versus form question.
IV. TAX CONSEQUENCES OF PARTNERSHIP MERGERS

After identifying which merging partnerships are terminated pursuant to section 708(b)(2)(A), the federal income tax consequences of a partnership merger can be determined by applying the normal partnership tax rules to the individual steps of the merger. Rev. Rul. 77-458 provides:

(1) The terminated partnerships will be treated as having contributed their assets (and transferred their liabilities) to the continuing partnership in exchange for new interests in the resulting partnership, and

(2) The terminated partnerships will be treated as subsequently liquidating and distributing the new interests in the resulting partnership to the partners of the terminated partnerships.45

The following discussion addresses the recognition of gain or loss, the treatment of partnership property, and other federal income tax consequences under the framework of Rev. Rul. 77-458. In addition, the tax consequences to both the continuing and the terminated partnerships will be discussed.

A. Gain or Loss

1. Terminated Partnerships

Generally, a partnership merger should not result in gain or loss recognition by a terminated partnership. Section 721(a) should preclude gain recognition upon the deemed contribution of the terminated partnership's assets to the resulting partnership.46 With respect

46. I.R.C. § 721(a) reads as follows:
   (a) GENERAL RULE. - No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Any consideration received by a terminating partnership other than interests in the continuing partnership may result in gain or loss recognition. Although this result is not specifically provided for in the Internal Revenue Code, it follows from either the application of the disguised sale provisions of I.R.C. § 707(a)(2)(B) or the normal distribution rules of I.R.C. § 731(a). McKee, Nelson & Whitmire, supra note 14, at ¶ 4.01[4]. For a discussion of the disguised sale rules generally, see Turlington, Transfers of Encumbered Property to Partnerships: Disguised Sales Under Section 707(a)(2)(B), J. PARTNERSHIP TAX'N 187 (1987).

Because I.R.C. § 721(a) applies only to a contribution of property in exchange for a partnership interest, to the extent any transaction also includes the exchange of a partnership interest for services (whether in substance or form), the transaction will be taxable. See Treas. Reg. § 1.721-1(b). See generally McKee, Nelson & Whitmire, supra note 14, at Chapter 5 (discussion of specific tax treatment of transfers of partnership interests for services). I.R.C. § 721(a) also does not apply to transfers of property to a partnership which would be treated as an "investment company" if it were incorporated. For this purpose, the definition of an "investment company" may be found at Treas. Reg. § 1.351-1(c)(1).
to the deemed distribution of interests in the continuing partnership to the respective partners of the terminated partnerships in liquidation of their interests, section 731(b) provides a flat rule that distributions in liquidation of a partnership shall not cause gain or loss recognition at the partnership level.\footnote{47}

2. Partners of the Terminated Partnerships

Because of the IRS's characterization of partnership mergers, the partners of the terminated partnerships are not deemed to have transferred any property to the continuing partnership, but merely to have received from the terminated partnerships a liquidating distribution which consists solely of interests in the continuing partnership.\footnote{48} Assuming no other assets may be deemed to have been transferred to the partners of the terminated partnerships, partners of the terminated partnerships should generally not recognize gain or loss pursuant to section 731(a).\footnote{49}

A potential exception to this general rule is gain resulting from the constructive distribution of money pursuant to section 752. Under sec-

\footnote{47} I.R.C. § 731(b) provides:

(b) PARTNERSHIPS - No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.


\footnote{49} I.R.C. § 731(a) provides:

(a) PARTNERS - In the case of a distribution by a partnership to a partner -

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of -

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c) and inventory (as defined in section 751(d)(2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

I.R.C. § 707(a)(2)(B) provides the Treasury with the regulatory authority to treat certain disguised sales as taxable sales or exchanges. Under recently proposed regulations, it is possible that the IRS would treat partnership mergers as a disguised sale where the facts and circumstances indicated that the transaction was abusive. For instance, one factor the IRS may consider would be pre-merger partnership borrowing with related pre-merger or post-merger distributions to partners. Prop. Treas. Reg. § 1.707-5, 56 Fed. Reg. 19066 (1991). See Burke, Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations, 63 IND. L. REV. 489, 505-507 (1987-88).
tion 752, any increase in a partner's share of partnership liabilities or increase in individual liabilities because of the partnership's assumption of liabilities, is treated as a contribution of money by the partner to the partnership. Correspondingly, any decrease in a partner's share of partnership liabilities or decrease in individual liabilities because of the partnership's assumption of liabilities, is treated as a distribution of money by the partnership to the partner. Thus, a partner of a terminated partnership who experiences a resulting decrease in liabilities may be deemed to have received a cash distribution which triggers gain recognition under section 731(a).

A particularly troublesome issue in the application of section 752 to partners of the terminated partnership is whether the partners will be permitted to include in the basis of their partnership interest their portion of the liabilities of the continuing partnership. In a private letter ruling, the IRS appears to have taken the position that partners of a terminated partnership will be considered to have received a distribution of money equal to their proportionate share of the liabilities of the terminated partnership, without offset for their proportionate share of the liabilities of the continuing partnership. This result is inconsistent with the ability of taxpayers to engage in tax-free reorganizations of partnerships and runs contrary to the general thrust of section 752 to treat partnerships as an aggregation of individuals and therefore to look through multiple partnerships to account for a partner's share of liabilities.

In contrast, in Rev. Rul. 77-309, the IRS held that for the purpose of determining the deductibility of a partner's distributive share of partnership losses, the adjusted basis of the partnership interest included the partner's allocable share of the liabilities of a second tier partnership. This position has been more recently incorporated in the regulations as a general principle in the application of section

50. I.R.C. § 752(a); Tress. Reg. § 1.752-1T(b).
51. I.R.C. § 752(b); Tress. Reg. § 1.752-1T(c).
52. Priv. Ltr. Rul. 78-05-028 (Nov. 3, 1977) provided the following I.R.C. § 752 holdings in a case where "R" was the terminated partnership:

   (1) For purposes of Code section 752, debts of R secured by its properties will cease to be treated as the liabilities of R and will commence to be treated as the liabilities of the resulting partnership. See section 752(c).

   (2) When the presently-existing liabilities of R cease to be its liabilities and become the liabilities of the resulting partnership, each member of R will be considered to have received a distribution of money from R that is equal to the amount of the member's proportionate share of the liabilities of R immediately prior to the transaction. See section 752(b).

   (3) The amount of money considered to have been distributed to each member of R by reason of section 752(b) will be taken into account in determining the amount of gain (if any) to be recognized by the member under section 731(a)(1).

Thus, given the IRS's characterization of the partnership merger transaction, whereby the terminated partnerships are deemed to hold interests in the resulting partnership the instant before the liquidation distribution, the IRS has adopted an untenable position in the private letter ruling by refusing partners an offset for their share of liabilities in the continuing partnership. The potential tax consequences of this issue can be illustrated by the following example:

**Example 5:**
Assume partnership AB merges with partnership CD and that the pre-merger partnership interests in the merging partnerships (AB and CD) and post-merger interests in the resulting partnership (ABCD) are as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>AB</th>
<th>CD</th>
<th>ABCD</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>0%</td>
<td>40%</td>
</tr>
<tr>
<td>B</td>
<td>50%</td>
<td>0%</td>
<td>40%</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
<td>50%</td>
<td>10%</td>
</tr>
<tr>
<td>D</td>
<td>0%</td>
<td>50%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Immediately prior to the merger, both AB and CD have $100,000 of partnership liabilities allocable to the partners consistent with their partnership interests. Immediately following the merger, the combined liabilities ($200,000) are allocable to the partners consistent with their partnership interests in the resulting partnership. A's basis in AB immediately prior to the merger is $25,000.

In this case, CD will terminate pursuant to section 708(b)(2)(A). If A's gain on the termination of CD is computed consistent with the private letter ruling, the calculation will be as follows:

| Decrease In Share of AB Liabilities | $50,000 |
| Less: Basis in AB                  | (25,000) | Gain |
|                                      | $25,000 |

If A is permitted to offset his share of the liabilities in the continuing partnership, the calculation will be as follows:

54. Temp. Treas. Reg. § 1.752-1T(j) provides:

(j) Special rules - (1) Tiered partnerships. If a partnership (the "upper-tier partnership") is a partner in another partnership (the "subsidiary partnership"), the upper-tier partnership's share of the liabilities of the subsidiary partnership (other than any liability of the subsidiary partnership that is owed to the upper-tier partnership) shall be treated as liabilities of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.


Decrease In Share of AB Liabilities $50,000
Less: Basis in AB (25,000)
Less: Share of Resulting Partnership Liabilities (80,000)
Gain None

This latter treatment is preferable, but until further clarification of these positions is provided by the IRS, taxpayers should consider seeking a determination on the issue as part of a private letter ruling request.

It should be noted that section 731 includes an express exception to nonrecognition treatment for gain which would otherwise be recognized under section 751. Section 751 generally provides for gain recognition on distributions which shift the partners’ proportionate interests in certain unrealized receivables and appreciated inventory of a partnership. Partnership mergers have the potential for such shifting; however, the IRS has taken the position in a revenue ruling that a partnership merger will not be considered a sale or exchange subject to section 751(b).

3. Continuing Partnership

Applying the IRS characterization of the partnership merger transaction (Rev. Rul. 77-458), the continuing partnership is deemed to have received a contribution of property in exchange for partnership interests of the continuing partnership. Again, pursuant to section 721(a), the continuing partnership should not recognize any gain or loss on the receipt of a contribution of property.

4. Partners of the Continuing Partnership

The historic partners of the continuing partnership are generally considered under the IRS’s characterization of partnership mergers neither to have contributed property to the continuing partnership, nor to have received distributions therefrom. Accordingly, gain or loss should not be recognized by the partners of the continuing partner-

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56. A’s new basis in his interest in the resulting partnership would be instead increased to $55,000.
57. I.R.C. § 731(c) provides:
   (c) EXCEPTIONS - This section shall not apply to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner’s successor in interest) and section 751 (relating to unrealized receivables and inventory items).
58. Rev. Rul. 77-458, 1977-2 C.B. 220, 221. Note, however, the facts of this ruling involved a roll-up of partnerships with identical ownership. Query, would the IRS come to a different conclusion if the merging partnerships had different ownership or special allocations and as a result, there was a significant shift in partners’ proportionate share of unrealized receivables or appreciated inventory due to the merger?
59. See note 46.
ship unless some other form of deemed distribution occurs. Similar to the rules discussed above with respect to partners of the terminated partnerships, if a partner in the continuing partnership decreases his share of partnership liabilities pursuant to section 752, there will be a deemed distribution of money which could result in gain recognition under section 731(a).

B. Property Transferred to the Resulting Partnership

1. Basis

As discussed previously, section 721(a) provides generally that no gain or loss will be recognized on the contribution of the property of the terminated partnerships to the resulting partnership. Accordingly, under section 723, the basis of the property in the hands of the resulting partnership should be the same as the terminated partnership's basis in the property immediately prior to the merger. This application of a carryover basis rule should extend also to pre-merger partnership basis adjustments made under section 734(b) pursuant to an earlier election by the terminated partnership under section 754.

To the extent that gain is recognized at the time of the merger by partners of the merging partnerships because of the application of the section 752 constructive distribution rules, the resulting partnership should be able to increase its basis in its post-merger property under section 734(b), provided the necessary section 754 elections have previously been made by the merging partnerships. In the case of gain recognized by the partners of a continuing partnership, a section 754 election will have had to have been made by the resulting partnership. If gain is recognized by the partners of the terminated partnership, both the terminating and continuing partnerships will have had to have made the section 754 election.

60. Id.
61. I.R.C. § 723 provides:
   The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.
62. Cleveland & Berryman, Income Tax Consequences of Service Partnership Mergers, 14 TAX ADVISOR 340, 344 (1983). Pursuant to an election made by a partnership under I.R.C. § 754 and the adjustments prescribed by I.R.C. § 734, a partnership's basis in property is adjusted by the amount of any gain or loss recognized by its partners upon a distribution.
2. Depreciation Methods

Where a terminated partnership transfers depreciable property to the resulting partnership in a partnership merger and no gain or loss recognition occurs pursuant to sections 721 and 731 (thereby resulting in a carryover basis in the property in the hands of the resulting partnership), the resulting partnership steps into the shoes of the terminated partnership and is required to use the same depreciation methods as the transferor. Thus, property depreciated by a terminated partnership under depreciation methods applicable prior to the Tax Reform Act of 1986 would continue to be depreciated under the same methods notwithstanding a transfer of the property in a post-1986 merger. Before 1986, the Internal Revenue Code had similar limitations in place which served to prevent taxpayers from using non-taxable partnership transactions to manipulate depreciation methods or to "churn" depreciable property by the same user.

If the partners of the terminated partnerships recognize gain pursuant to a deemed distribution under sections 752 and 731, and the resulting partnership is permitted a step-up in the basis of its assets pursuant to section 743(b), it would appear that the depreciation methods applicable to transferred property may be applied on a bifurcated basis. Read literally, section 168(i)(7) provides that in the case of a contribution or distribution of property to a partnership, the same depreciation method is to be used by the resulting partnership "with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor." Reflecting this approach, proposed regulations promulgated prior to the Tax Reform Act of 1986 provide that to the extent there exists a step-up in basis of the assets transferred, that portion of the basis which exceeds the carryover basis shall be treated as new property acquired at the time of the transfer and shall be subject to then applicable depreciation methods.

3. Tax Credit Recapture

Transfers of section 38 property by partnerships generally result in

64. See Hammer, supra note 11, at 340-43 for a discussion generally about depreciation methods following I.R.C. § 708 terminations.
66. I.R.C. § 168(i)(7). Note, this rule does not apply in the case of a partnership termination pursuant to I.R.C. § 708(b)(1)(B) (sale or exchange of 50 percent or more of the partnership interests within 12 months) Id.
68. See McKee, Nelson & Whitmire, supra note 14, at 12-43 to 12-44.
69. I.R.C. § 168(i)(7).
tax credit recapture determined at the partner level.\textsuperscript{71} An exception to tax credit recapture is provided under section 50(a)(4) where a transfer of section 38 property is made pursuant to a "mere change in the form of conducting a trade or business" (the "mere change in form" exception).\textsuperscript{72} However, for this exception to apply, regulations require the following conditions be met:

(1) The section 38 property is retained in the trade or business following the transfer;
(2) The relevant partner retains a substantial interest in such trade or business;
(3) Substantially all of the assets (whether or not section 38 property) necessary to operate the trade or business are transferred; and
(4) The transferee assumes a basis in the section 38 property determined in whole or part by reference to the transferor's basis.\textsuperscript{73}

Where the mere change in form exception applies, the holding period, for the purpose of computing recapture upon some subsequent disposition by the transferee of the section 38 property, includes both the transferor's and transferee's holding periods.\textsuperscript{74}

In order to be considered to have maintained a "substantial interest" in the trade or business, partners of terminated partnerships must, after the change in form, retain a partnership interest which (1) "[i]s substantial in relation to the total interest of all persons," or (2) "[i]s equal to or greater than [the partner's] interest prior to the change in form."\textsuperscript{75} Thus, if the partners of the terminated partnerships maintain their same percentage interest in the capital and profits of the continuing partnership, such as in a roll-up of partnerships involving identical partners in each partnership, they should be deemed to have maintained a "substantial interest" in the trade or business.\textsuperscript{76}

Where the partners of the terminated partnership retain a lesser percentage in the continuing partnership, the substantial interest test appears to mean that the partners must maintain a significant percentage interest in capital and profits of the continuing partnership, without reference to the value of that interest.\textsuperscript{77} The regulations do

\textsuperscript{71} See I.R.C. §§ 38, 48; Treas. Reg. § 1.47-3(f)(5)(i).
\textsuperscript{73} Treas. Reg. § 1.47-3(f)(1)(ii).
\textsuperscript{74} Treas. Reg. § 1.47-3(f)(1).
\textsuperscript{75} Treas. Reg. § 1.47-3(f)(2).
\textsuperscript{76} Rev. Rul. 77-458 1977-2 C.B. 220 (10 partnerships rolled up into one and no tax credit recapture because partners retained identical partnership interests in the continuing partnership).
\textsuperscript{77} Soares v. Commissioner, 50 T.C. 909 (1968) (retained interest not substantial
not contain a minimum percentage interest which will qualify, and consequently, there is not much certainty as to what percentage interest will meet the substantial interest test. Apparently, a 45 percent interest in the continuing partnership would satisfy the test, but a 7 percent interest would not.\textsuperscript{78} Between these figures, no line has been drawn. Practitioners and taxpayers should recognize that any percentage interest between 7 and 45 may not satisfy the substantial interest test unless the percentage interest maintained in the continuing partnership equals or exceeds the percentage interest such partner had in the terminated partnership.

For the original partners of the continuing partnership, a dilution of their partnership interest pursuant to a partnership merger could also cause recapture of tax credits. For these partners, tax credits must be recaptured if the admission of new partners to the continuing partnership dilutes the original partners' interest in the continuing partnership to less than two-thirds of their former percentage interest.\textsuperscript{79}

With respect to the requirement that there be a transfer of "substantially all of the assets" of the trade or business, not all of the assets of the terminating partnership need be transferred to the continuing partnership, provided that the assets not transferred are not required for the continued operation of the trade or business or those assets retained are nonetheless made available pursuant to a lease to the continuing partnership.\textsuperscript{80} However, a substantial portion of the assets have to be transferred, and such transferred assets must continue to be used in the same trade or business.\textsuperscript{81}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{78}] Compare Treas. Reg. § 1.47-3(f)(6)(Example 1) with Soares v. Commissioner, 50 T.C. 909, 914 (1968).
\item[\textsuperscript{79}] Treas. Reg. § 1.47-6(a)(2)(ii).
\item[\textsuperscript{81}] Hudspeth v. Commissioner, 51 T.C.M. 175, 184-85 (1985), rev'd, 914 F.2d 1207 (9th Cir. 1990) (retention of approximately 95 percent of the assets and the change in use of transferred equipment from manufacturing to equipment leasing was not a transfer of substantially all of the assets); Treas. Reg. § 1.47-3(f)(1)(ii)(a).
\end{itemize}
\end{footnotesize}
C. Other Federal Income Tax Consequences

1. Partnership Tax Year

The taxable years of the terminated partnerships are closed in accordance with section 706(c). Accordingly, the terminated partnerships are required to file their returns for the taxable year ending on the date of the merger and termination. In the event one of the merging partnerships is deemed to be the continuing partnership under section 708(b)(2)(A), the resulting partnership takes on all the characteristics of the continuing partnership including its taxable year. Consequently, the resulting partnership files a return for the taxable year of the continuing partnership in which it must separately identify "[t]he respective distributive shares of the partners for the periods prior to and subsequent to the date of merger." The regulations also require that this return state that the resulting partnership is a continuation of the merging partnerships and must include the names and addresses of the merged partnerships.

2. Accounting Methods

In cases where the resulting partnership is a continuation of one of the merging partnerships, the resulting partnership also inherits the continuing partnership's tax elections, including its accounting methods. On the other hand, when none of the merging partnerships is deemed to be a continuing partnership, the resulting partnership will be a new partnership and thereby will generally be required to make new tax elections. Because of the existence of favorable or unfavorable accounting methods, tax planning opportunities may be available in a partnership merger to retain a favorable accounting method or terminate partnerships with unfavorable accounting methods.

3. Income Bunching

Partners of the terminated partnerships may be required to report more than twelve months of partnership income ("income bunching") in either one of two instances. First, where the tax years of the merging partnerships differ, the partners of the terminated partnerships may experience a bunching of income solely from the timing of the

84. Id.
85. Id.
87. See Cleveland & Berryman, supra note 62, at 344-45; McGilsky & Bolling, supra note 2, at 606, 608-609; .
partnership year-ends. For instance, consider the following example:

Example 6:
Partnership ABC has a tax year ending June 30 of each year. Partnership DEF has a tax year ending December 31 each year. On July 1, 1992, ABC and DEF merge with DEF being a continuing partnership and retaining its calendar year-end. Partners A and B of partnership ABC have tax years ending on June 30 of each year. C is an individual reporting on a calendar year basis.

In this example, C will report his allocable share of 18 months of partnership income in the year 1992, computed as follows:

<table>
<thead>
<tr>
<th>Partnership</th>
<th>Period</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC</td>
<td>6/30/91 to 6/30/92</td>
<td>12 months</td>
</tr>
<tr>
<td>DEF</td>
<td>7/1/91 to 12/31/92</td>
<td>6 months</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>18 months</strong></td>
</tr>
</tbody>
</table>

Bunching of income can also occur where the merging partnerships employ differing accounting methods. For instance, consider the following example:

Example 7:
Partnership ABC merges with partnership DEF, with DEF being the continuing partnership. ABC reported its income on the cash method of accounting. DEF reports its income on the accrual method. At the time of the merger, ABC has a material amount of trade receivables which it has not taken into income.

At the time of the merger, DEF will generally be required to include in income the receivables transferred from ABC. Under section 704(c), this income will be required to be allocated to the partners of the terminated partnership, ABC. Thus, the partners of the terminated partnership will incur an acceleration in the recognition of income from receivables which would have otherwise generated taxable income only as they were collected. Various alternatives have been suggested to attempt to eliminate or reduce the consequences of such a transfer of receivables, as follows:

1. Notwithstanding the merger, the ABC partnership could retain the receivables and maintain its existence until they were collected and the proceeds distributed to the partners.
2. Prior to the merger, ABC could distribute undivided interests in the receivables to the partners.

88. Because partnership tax years generally reflect the tax year of the majority or principal partners, I.R.C. § 706(b), the existence of a fiscal year partnership is likely to occur most often where there is a corporate partner with a similar fiscal year.

89. However, where the merged partnerships conduct distinct trades or businesses, a different method of accounting arguably may continue to be used for each, providing both methods clearly reflect income. Treas. Reg. § 1.446-1(d)(1). Note, I.R.C. § 448 restricts the use of the cash method of accounting for certain partnerships.

90. See, e.g., Foxman v. Commissioner, 352 F.2d. 466 (3d Cir. 1965).
(3) ABC could sell the receivables for an installment note which is retained by the partnership,

(4) ABC might time the merger in such a way that it occurs immediately after the close of the continuing partnership’s tax year, thereby deferring the income tax consequences for twelve months when the receivables would likely have been collected in any event.91

4. Partnership Allocations

Notwithstanding the actual or deemed distributions of property to partners, Section 704(b) provides for the manner in which income, gains, losses, deductions, and credits at the partnership level are allocated. Absent provisions to the contrary in the partnership agreement, these tax items are allocated in accordance with each partner’s interest in the partnership.92 For a variety of business and economic reasons, partners may wish to allocate certain partnership tax items in proportions differing from their pro rata interests in the partnership (i.e., “special allocations”). In order for a special allocation to be recognized for tax purposes, however, partnership agreements must provide for:

(1) The maintenance of partners’ capital accounts consistent with certain guidelines contained in regulations under Section 704;

(2) Distributions to the partners in accordance with their positive capital balances upon liquidation of the partnership or a partner's interest; and

(3) An unconditional obligation of the partners to restore negative capital balances upon liquidation.93

Where a special allocation provision exists in the partnership agreement of a terminated partnership, it will likely be important to provide equivalent provisions in the partnership agreement of the re-

91. See 3 WILLIS, PENNELL & POSTLEWAITE, PARTNERSHIP TAXATION § 163.02 (4th Ed. 1990); Cleveland & Berryman, supra note 62, at 343-44; McGilsky & Bolling, supra note 2, at 613-14.

92. I.R.C. § 704(b). The IRS may or may not determine a partner's interest in the partnership to be equal to his overall interest in capital and profits. Rather the IRS will seek to make the determination after examining the facts and circumstances, including (1) the partners' respective contributions, (2) the interests of the partners in economic profits and losses, (3) the interests of the partners in "cash flow and other non-liquidating distributions," and (4) the interests of the partners in liquidation distributions. Treas. Reg. § 1.704-1(b)(3)(ii).

93. Treas. Reg. § 1.704-1(b)(2)(ii)(b). If the first two tests are met, but there is no unconditional obligation of the partners to restore negative capital balances upon liquidation, specific special allocations may still be recognized for tax purposes providing they do not cause a deficit or increase a deficit in a partner's capital account and a "qualified income offset" provision is included in the partnership agreement to require the restoration of any negative capital balance as soon as possible. Treas. Reg. § 1.704-1(b)(2)(ii)(d).
sulting partnership in order to continue to provide the intended allo-
cation of tax items. Similarly, to the extent special allocation
provisions exist in a continuing partnership's partnership agreement
prior to a partnership merger, an examination will be necessary to en-
sure that following the merger, these provisions will continue to pro-
vide for the intended allocation of partnership tax items. Care should
be taken in constructing any amendments to the allocation provisions
of the continuing partnership's partnership agreement since the IRS
has taken the position that if a partnership agreement providing for
allocations is subsequently modified, the IRS may redistribute alloca-
tions prior to the modification in accordance with the modified terms
of the partnership agreement.94

As a practical matter, the termination of partnerships in a partner-
ship merger may cause partners of the terminated partnership to be
required to restore negative capital account balances upon the termi-
nation, provided the capital account restoration provision required for
special allocations is included in the partnership agreement of the ter-
minated partnership. Regulations under section 704(b) provide that a
"liquidation" for the purpose of deficit capital account restoration pro-
visions includes the date upon which it ceases to be a going concern.95
This could result in a significant economic cost to partnership mergers
involving terminated partnerships with partners having significant
negative capital account balances, such as burned out tax shelters.

5. Qualified Retirement Plans96

One possible consequence of the termination of a partnership pur-
suant to a partnership merger is the termination of the partnership's
qualified retirement plans.97 The termination of a partnership's qual-
ified retirement plan will cause each employee's accrued benefits to
the date of termination to vest and will normally result in a distribu-

96. The author gratefully acknowledges the assistance of R. Scott Kilgore, an
associate with Wilmer, Cutler & Pickering, in the development of the discussion
herein related to qualified retirement plans.
97. The termination of the partnership's qualified retirement plan will normally fol-
low from a partnership termination unless steps are taken by a surviving partner-
ship or other sponsor to adopt the plan or the plan is merged with a new or
existing plan. Regulations effective before the enactment of the Employee Re-
tirement Income Security Act of 1974 ("ERISA") described a facts and circum-
stances test for when a plan is terminated, but the post-ERISA regulations
provide no real explanation of what constitutes a plan termination. Compare
withdrawn Treas. Reg. § 1.401-6(b)(1) (1963) with current Treas. Reg. § 1.411(d)-
2(c) (1977). Nevertheless, the IRS is likely to take the position that the termina-
tion of all sponsors of a plan terminates the plan, as well, unless steps are taken
to avoid that result.
tion of such benefits to the employees. Distributions from a qualified retirement plan (to the extent not attributable to nondeductible employee contributions) are generally included in taxable income when received by the recipient employee unless rolled over into another qualified retirement plan or an individual retirement account.

In light of the potential tax consequences of a termination of qualified retirement plans, planning for a partnership merger should include a consideration of the following alternatives with respect to any qualified retirement plans of terminated partnerships:

1. Termination of the plans and distribution of the accrued benefits to participants.

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98. Under I.R.C. § 411(d)(3), as a condition to qualified plan status, a plan must provide that the "rights of all affected employees to benefits accrued to the date of [a] termination . . . to the extent funded as of such date, or the amounts credited to the employees' accounts, are nonforfeitable." See also Treas. Reg. § 1.411(d)-2(a)(1). In other words, termination causes all affected employees to become 100 percent vested in what the plan owes them, to the extent then funded.

After termination, benefits will normally be distributed to participants, although the timing can be difficult to predict. Rev. Rul. 89-87, 1989-2 C.B. 81 provides that benefits under terminated plans must be distributed as soon as administratively feasible. How soon that will be depends upon the nature and complexity of the qualified plan, upon whether it is a defined benefit plan, and thus, normally subject to regulation by the Pension Benefit Guaranty Corporation ("PBGC"), and upon whether the sponsor wishes to receive the IRS's assurance through a determination letter that the termination did not disqualify the plan. If the plan is subject to PBGC supervision under ERISA § 4021 (29 U.S.C. § 1321 (1988)), it cannot terminate without being submitted for PBGC review. ERISA § 4041(a) (29 U.S.C. § 1341(a) (1985)). A terminated partnership that maintains a defined benefit plan should therefore give thought to who will be responsible for the necessary filings with the PBGC.

99. I.R.C. § 72(t) may also result in an additional 10% penalty tax on the amount of the distribution which is included in income. Distributions which are rolled over into another qualified retirement plan or an individual retirement account within 60 days are not currently taxable and therefore are not subject to the additional 10 percent tax. See I.R.C. §§ 402(a)(5)(A), (E)(i)(I), 72(t)(1). See also Marcuson, When and How a Distribution From a Qualified Plan Should Be Rolled Over, 15 Tax'n Law. 144 (1986).

100. In addition, partners considering merging with a partnership should consider the kinds of employee benefit-related liabilities which may then attach to the resulting partnership. These liabilities include the possibility of liens because the defined benefit plan maintained by the partnership or even by a related entity may be underfunded. I.R.C. § 412(n). Careful investigation should also be made regarding whether the existing partnership or its related entities have collectively bargained employees who are participants in a multi-employer pension plan. ERISA § 4201 (29 U.S.C. § 1381 (1988); See also United Food & Commercial Workers Union v. Progressive Supermarkets, 644 F. Supp. 633 (D.N.J. 1986) (holding a partnership liable as part of a controlled group). Multi-employer plans can give rise to liabilities on members of controlled groups that are quite disproportionate to the participation of any controlled group members in the plan.

101. Current distribution may not be possible if, for example, the terminating partnership's plan permits pre-tax employee contributions under I.R.C. § 401(k), while...
V. DEVELOPMENT OF STATUTORY RULES

A. Background

Because Congress failed to provide a comprehensive tax-free reorganization scheme for partnerships, there has been an ad hoc evolution of the current set of administrative rules. Notwithstanding the general intent of the IRS under Subchapter K to permit partners to reorganize their partnerships on a tax-free basis, providing they do not change "the economic realities of their businesses,"104 these rules can nonetheless lead to material federal income tax consequences. For instance, consider the following example:

Example 8:
Assume that individuals A, B, C, and D each own 25 percent interests in two partnerships, P1 and P2. Assume further that partnerships P1 and P2 are merged and A, B, C, and D each receive 25 percent interests in the resulting partnership.

In the above example, there is no change whatsoever in the economic realities of the partners' interests in partnership assets and operations. Yet, the current partnership merger rules raise the following potential federal income tax consequences to all of the partners:

(1) The termination of tax elections of the terminated partnership,
(2) Taxable deemed cash distributions under section 752, and
(3) The triggering of capital contribution requirements under section 704 and the partnership agreement.

While the IRS can and should consider the issuance of further administrative guidance to clarify certain ambiguities in the current

102. Continuation of the plans will require consideration of whether, among other things, maintaining a plan for only one portion of the partnership's employees will satisfy the nondiscrimination, minimum participation, and minimum coverage rules of I.R.C. §§ 401(a)(4), 401(a)(26), 410(b) (1990) and regulations promulgated thereunder.

103. The merger would have to consider the forms of benefits and other options provided by the old plan and might have to add forms to the new plan to ensure that forms of benefits previously provided by the old plan were not "cut back" by the merger. I.R.C. § 411(d)(6); Treas. Reg. § 1.411(d)-4 (Q&A-3).

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rules,\textsuperscript{105} it does not have a statutory basis for the development of a comprehensive set of partnership merger rules. Moreover, if the IRS were to revisit and revoke its characterization of partnership mergers in Rev. Rul. 77-458, it is possible that some partnership mergers could be viewed as resulting in a deemed distribution to partners of the terminated partnerships' assets, which to the extent of cash distributions, would be subject to tax under section 731. This event would raise a number of additional tax policy and administrative concerns.\textsuperscript{105}

Accordingly, to the extent that further limiting the tax consequences of partnership reorganizations is a desired tax policy objective under Subchapter K, significant improvements in the current rules may require not only additional administrative guidance, but also additional legislation. If Congress should undertake such an effort, various issues, including those discussed generally below, will need to be addressed.

B. Definition of Partnership Merger

The definition of a partnership merger would need to be described in the statute. It is not clear that analogies to the corporate reorganization definitions contained in sections 368(a)(1)(A) through (E) would be sufficient or appropriate. For instance, while section 368(a)(1)(A) refers to statutory mergers in the corporate context, state law may not be sufficiently developed to adequately provide for a defi-

\textsuperscript{105} Possible areas to be addressed include following items which have been discussed above:

(1) Further definition of the "greatest dollar value of assets" test when determining the continuing partnership in the instance where the partners of two or more of the merging partnerships receive aggregate interests in the resulting partnership greater than 50 percent;

(2) Clarification as to whether Rev. Rul. 90-17, 1990-1 C.B. 119 is to apply in factual situations where there is effectively a significant (in excess of 50 percent) shifting of interests among partners of the continuing partnership pursuant to the merger;

(3) Regulatory guidance on when, if ever, the disguised sales rules under I.R.C. § 707(a)(2)(B) will apply to partnership merger transactions;

(4) Clarification as to whether for the purposes of any deemed distribution under I.R.C. § 752, the partners of the terminated partnership may be permitted to include in the basis of their partnership interest, their portion of the liabilities of the continuing partnership under a tiered partnership analysis; and

(5) Clarification as to how much dilution of a partner's aggregate partnership interest is permissible in a partnership merger pursuant to the mere change in form exception to tax credit recapture.

\textsuperscript{106} A departure to a form over substance methodology would create traps for the unwary, permit sophisticated taxpayers to exploit varying forms of the same economic transaction, and would open the area of partnership mergers to even more complexity and ambiguity.
nition of partnership mergers. Accordingly, enactment of a partnership reorganization scheme may require a more general definition of a partnership merger than its corporate counterpart.

C. Continuity of Interest

A key issue in constructing a statutory scheme for partnership mergers would be the application of a continuity of interest rule. A principal objective of many of today's partnership mergers is to develop a more marketable equity interest for limited partners. Where partnership merger transactions are actually intended to result in the sale or exchange of partnership interests, some limitation would be appropriate given the policy objective of providing tax-free treatment only where the economic interests of the partnerships and partners have not changed.

One approach Congress may wish to consider in this regard is a requirement that no more than 50 percent of the total partnership interests in the resulting partnership could be disposed of by the partners of the merging partnership as part of a preconceived plan. This test would be similar to standards for corporate mergers. This test would also be consistent with the rule in section 708(b)(1) which provides for a partnership termination in the event of a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a twelve-month period.

D. Continuity of Business

Under the corporate merger rules, a tax free reorganization occurs only if there exists a continuity of the business enterprise following the merger. Under regulations, the continuity of business enterprise test requires that:

1. The resulting corporation continue the acquired corporation's historic business; or
2. The resulting corporation uses a significant portion of the acquired corporation's historic business assets.

Similarly, Congress may wish to provide for a continuity of business enterprise test, consistent with the objective of creating a statutory

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107. See Dauber, supra note 5, at 102.
108. See supra text accompanying note 3.
109. Such a rule should be coordinated with the regulations under the disguised sale provision of § 707(a)(2)(B).
111. Treas. Reg. § 1.368-1(d)(2).
scheme for partnership mergers. A failure by the resulting partnership to conduct the same business enterprise of a merging partnership would indicate a significant change in the economic realities of the business owned by the partners.

E. Coordination with Sections 704 and 752

Perhaps the most difficult issues in structuring a statutory scheme for tax-free mergers of partnerships would be those related to coordinating the new rules with the complex rules of sections 704 and 752. While elimination of all potential consequences to partners under these sections is probably unrealistic, new partnership merger rules should be constructed to minimize those consequences and to provide more certainty in their application.

In the case of section 704, procedural rules, whether statutory or regulatory, would be helpful. These rules should permit the carryover of partners’ negative capital account balances to the regulating partnership without triggering capital contribution requirements at the time of the merger. In this context, adequate safeguards would have to be required in the form of necessary amendments to the partnership agreement to maintain the historic capital contribution requirements within the context of the partnership agreement of the resulting partnership.112

With respect to section 752, it may not be possible to eliminate the potential taxation of deemed distributions of cash, where the allocation of liabilities among partners of the merging partnerships is shifted significantly. Any statutory change, however, should ensure that the change in a partner’s share of partnership liabilities is measured by a comparison of the section 752 allocation of liabilities immediately before and immediately after the partnership merger. The IRS should not be permitted to take the position that partners of a terminated partnership will be considered to have received a distribution of money equal to their proportionate share of liabilities of the terminated partnership, without offset for their proportionate share of liabilities of the resulting partnership.113

VI. CONCLUSION

The absence of a sufficient statutory scheme for tax free mergers of partnerships has led to a set of administrative rules which limit, but do not eliminate the potential tax consequences to partners of merging partnerships, even where there is no real change in the economic in-

112. Similarly, procedural rules would be required to ensure that § 704(c) adjustments to basis and related income allocation requirements are also carried over to the resulting partnership.
terests of the partners. Based upon the IRS's characterization of partnership merger transactions, taxpayers are required to divide partnership merger transactions into their component steps and apply the normal tax rules to each step. As discussed in this Article, there are many ambiguities associated with the application of these rules to partnership mergers. Until such time as these ambiguities are resolved in subsequent administrative advice from the IRS or legislative changes, taxpayers would be well advised to seek a private letter ruling from the IRS where the potential tax consequences of a partnership merger are material.