

## ***Should Partnership Tax Define “Merger” and “Division”? (And If So, How?)***

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1. Overview of the Tax Treatment of Partnership<sup>2</sup> Mergers and Divisions
  - a. The Internal Revenue Code of 1986, as amended (the "IRC"), only addresses the question of which entity is treated as continuing after a merger or division. IRC §708(b)(2). This is a substantive determination, depending on the ownership or asset composition of the post-transaction entity (or entities), without regard to what formally happens to the entities under state law.
  - b. Treasury regulations (proposed in 2000 and finalized in 2001) explain the rest of the federal income tax consequences of partnership mergers and divisions.
    - i. Mergers – Treas. Reg. §1.708-1(c)
      1. The regulations treat all partnership mergers as occurring pursuant to one of two constructs, either “assets-up” or “assets-over.”
      2. Assets-Up
        - a. The merger is treated as an assets-up transaction only if the terminated partnership actually transfers its assets up to the partners in liquidation and “in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets” and then the partners immediately contribute the distributed assets to the continuing partnership in exchange for interests in the continuing partnership. Treas. Reg. §1.708-1(c)(3)(ii).
        - b. If the merger is treated as an assets-up transaction, then the tax consequences of the merger follow the merger’s form. *Id.*
      3. Assets-Over
        - a. All partnership mergers that are not structured in a way that qualifies for assets-up treatment are treated as occurring pursuant to an assets-over transaction. Treas. Reg. §1.708-1(c)(3)(i).
        - b. If the assets-over construct applies, the terminated partnership is treated as contributing its assets and liabilities over to the continuing partnership in exchange

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<sup>2</sup> When discussing the tax consequences of partnership transactions, the term “partnership,” as used herein, includes all entities that are treated as partnerships for purposes of the IRC. This includes general partnerships, limited partnerships, limited liability partnerships, limited liability companies, and other economic arrangements that involve joint undertakings to carry on business activity and divide profits therefrom, in each case as long as the entity has more than one member and has not elected to be treated as a corporation for federal income tax purposes. Treas. Reg.. §301.7701-1 to -3.

for interests in the continuing partnership, and then the terminated partnership is treated as making a liquidating distribution to its partners of the interests in the continuing partnership. Id

ii. Divisions – Treas. Reg. §1.708-1(d)

1. The partnership division regulations are similar to the partnership merger regulations. All partnership divisions are treated as occurring pursuant to either an “assets-up” transaction or “assets-over” transaction.

2. Assets-Up

a. A division is only treated as an assets-up transaction if the divided partnership actually transfers its assets up to the partners in a complete or partial liquidation and “in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets” in liquidation, and then the partners immediately contribute all the distributed assets to a recipient partnership in exchange for interests in such partnership. Treas. Reg. §1.708-1(d)(3)(ii).

b. If a division is treated as an assets-up transaction, then the tax consequences of the division follow the division’s form. Id.

3. Assets-Over

a. All partnership divisions that are not structured in a way that qualifies for assets-up treatment are treated as occurring to an assets-over transaction. Treas. Reg. §1.708-1(d)(3)(i).

b. If the assets-over construct applies, the divided partnership is treated as contributing its assets and liabilities over to the recipient partnership in exchange for interests in such partnership, and then the divided partnership is treated as distributing the interests in the recipient partnership to some or all of its partners in partial or complete liquidation of their interests in the divided partnership. Id.

iii. Form vs. Fiction – As a result of these regulations, the tax consequences of mergers and divisions may follow their form, but the tax consequences of the transactions are often determined based on fictional transactions that differ markedly from the actual legal transfers undertaken. This is primarily because assets-over treatment applies to a wide variety of transactions, many of which do not involve the transfer of assets at all. Further, in partnership mergers, the entity that is treated as the continuing partnership for tax purposes in a merger may differ from the entity that continues to exist for state law purposes after the transaction. Similarly, in partnership divisions, the continuing and divided partnerships may not even exist as state law entities prior to the division.

- iv. Tax Consequences of the Different Constructs – Sometimes the assets-up and assets-over treatment could produce the same tax consequences. However, other times, the tax consequences (including basis and potential gain recognition) to partners and partnerships in a merger or division can vary depending on whether the transaction is treated as an assets-up or assets-over transaction.

## 2. The Problem of Definition

- a. Although the regulations provide very detailed guidance on the tax consequences of mergers and divisions, these terms are not defined in the regulations, so there are open questions about which transactions are subject to these regulations. The IRS considered including definitions of “merger” and “divisions” in the final Section 708 regulations, but explicitly decided not to do so. The IRS mentioned concerns that definitions “could lead to planning opportunities that would be adverse to the government’s interest.” T.D. 8925, 2001-1 C.B. 496.
- b. Mergers
  - i. What constitutes a partnership "merger"?
    - 1. The term merger includes more than just partnership mergers that occur pursuant to a state merger statute. As used in the regulations, the term merger appears to include other combinations of partnerships even though such transactions may not be mergers under applicable state law. For example, (a) partnership combinations accomplished via actual assets-up transfers or assets-over transfers, and (b) partnership combinations accomplished via the transfer of all of the interests in one partnership to another partnership in exchange for interests in the latter are all likely “mergers” for purposes of the partnership tax regulations.
    - 2. Per an anti-abuse rule, a transaction that is a merger will not be treated under the Section 708 regulations if the merger is part of a larger series of transactions and the substance of the larger series of transactions is not consistent with the tax treatment described in the regulations. Treas. Reg. §1.708-1(c)(6).
    - 3. Notwithstanding the foregoing, there are many transactions that may or may not be mergers within the meaning of the partnership tax regulations. Two examples: What if some, but not all, of Partnership X’s assets are acquired by Partnership Y? What if only one former partner of Partnership X becomes a partner in Partnership Y?
  - ii. Why does it matter whether a transaction is a "merger"?
    - 1. If the transaction is a merger, then the tax consequences are determined under the partnership merger regulations, and one of two potentially fictional constructs applies. Otherwise, the tax consequences of the transaction are determined based upon how the other applicable provisions of Subchapter K of the IRC apply to the transaction steps that were actually undertaken.

2. In some cases, the results may be the same whether or not the transaction is classified as a merger. However, often the tax consequences (e.g., basis, potential gain recognition, continuation of tax history) can differ markedly depending on whether or not the transaction is subject to the merger regulations. It is not clear whether or not taxpayers will prefer to have the transaction treated as merger; this likely depends on the facts and circumstances.

c. Divisions

i. What constitutes a partnership "division"?

1. In order to be a division, at least two partners from the prior partnership must be partners in each resulting partnership. Treas. Reg. §1.708-1(d)(4)(iv). As used in the regulations, the term division appears to include various transactions pursuant to which one partnership becomes more than one partnership, regardless of the state law nomenclature for such transactions.
2. The partnership division regulations have an anti-abuse rule similar to that in the merger regulations.
3. Notwithstanding the foregoing, there are many transactions that may or may not be divisions within the meaning of the partnership tax regulations. Two examples: What if two former partners of Partnership Z decide to form their own partnership (using former Partnership Z assets) without the knowledge of the remaining partners of Partnership Z? What if Partnership Z (with partners A, B, and C) distributes to C all of the interests in an LLC, and then B contributes cash to the LLC, after which LLC is treated as a tax partnership?

ii. Why does it matter whether a transaction is a "division"?

1. As with mergers, the tax consequences of a transaction can differ markedly depending on whether or not the transaction is subject to the division regulations. It is not clear whether or not taxpayers will prefer to have the transaction treated as division; this likely depends on the facts and circumstances.

d. Policy Considerations

- i. As a result of the uncertainty about the applicability of the regulations, taxpayers could inadvertently participate in a merger or division. This may be particularly unfair to less sophisticated taxpayers.
- ii. Uncertainty about whether a transaction will be subject to the regulations may cause taxpayers to inefficiently restructure transactions in order to gain certainty with respect to the tax consequences.
- iii. The absence of guidance about whether the regulations apply may create tax planning opportunities.
  1. Of course, taxpayers can engage in this behavior even if there is guidance about what transactions constitute mergers and divisions. It was a concern about just this type of planning that caused the IRS not to provide definitions in the first place.

2. However, in the absence of guidance, aggressive taxpayers may be more inclined to try their luck. The only constraint on this is the anti-abuse provision that prevents taxpayers from inappropriately *using* the merger and division regulations as part of a larger transaction.
  3. The regulations do not contain any rule or standard intended to prevent a taxpayer from inappropriately *avoiding* the regulations by taking the position that a transaction is not a merger or division.
- iv. By declining to provide definitions, the regulations rely too much on how a transaction is labeled/categorized (i.e., as a merger, division, or neither), and the Treasury has undermined its attempt to strike a balance between form and substance in the taxation of mergers and divisions.
1. The statute and the regulations use a substance-based inquiry in order to determine which entity is treated as continuing. The regulations enable form to be respected in only limited circumstances; otherwise, the regulations treat all mergers the same way (as assets-over transactions).
  2. Taxpayers may be able to avoid these limitations in situations where they claim there is no merger or division.

### 3. Dealing with the Definition Problem

- a. Comparisons to both tax and non-tax authorities may be useful.
  - i. Questions of definition and classification are prevalent in the tax law. Depending on the circumstance, these questions have been addressed in a variety of different ways (e.g., multi-factored tests, bright-line rules, standards (with and without safe harbors), and elections).
  - ii. The concept of merger and division of businesses has significance not only in tax law but in many other disciplines as well.
- b. Proposal – Amend the partnership merger and division regulations to provide substantive guidance as to which transactions are subject to the regulations and which transactions are not. Balance the need for guidance with the risk of abuse by coupling very few bright-line minimum requirements with broad inclusive language to ensure that taxpayers are not inappropriately avoiding application of the regulations.
  - i. Minimum requirements
    1. Specific provisions can help set minimum thresholds for application of the rules.
      - a. Example: A transaction will only be treated as a merger if at least two partners from each merged partnership are partners of the resulting partnership after the transaction. This clarifies that the partnership merger regulations do not apply where one of the merged entities is effectively a disregarded entity for tax purposes.

2. Compare to other provisions where the term "merger" is clearly defined by statute or regulations.
  - a. Corporate Tax -- The regulations under IRC §368 provide a very specific and narrow definition of merger.
  - b. Mergers under State Partnership Law & State Corporate Law – The most recent revisions to UPA, ULPA, ULLCA, and MBCA provide for mergers of entities,<sup>3</sup> and these acts effectively define the term merger by explaining what requirements must be satisfied in order for there to be a plan of merger and by specifying the effects of a merger.
  - c. Note that these regimes are generally much more form-based than the partnership merger and division rules are intended to be. Caution should be used in using bright line rules as part of the definitions of mergers and divisions.
- ii. Broad inclusive language
  1. Broad inclusive language can enable the Service to ensure that the regulations apply to the variety of transactions that are economically equivalent to mergers and divisions.
    - a. Example: If the substance of a transaction or series of transactions is to merge one partnership with one or more other partnerships (whether that merger is effectuated pursuant to applicable state statutes, by transfers of interests, transfers of assets, both transfers or interests and assets, or otherwise), the Commissioner may disregard the form of such transaction or series of transactions and treat it as subject to these regulations.
  2. Compare to other regimes where the scope of applicability of the relevant statutory provision is determined using broad terms (without regard to whether the label "merger" or "division" would apply to the transaction).
    - a. Antitrust – Very generally, the Clayton Act covers broad range of corporate amalgamations, not just the ones called mergers.
    - b. Securities Regulation – Very generally, the applicability of '33 Act and '34 Act to mergers and divisions depends on whether there is a distribution of securities to the public or whether public shareholders are required to vote on the transaction (and not on whether the transaction is called a merger or division)
    - c. Corporate Tax – Very generally, tax consequences follow from the action of distributing stocks, securities, or assets (and not on whether the transaction is a division)

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<sup>3</sup> Some prior versions of uniform acts did not contain merger provisions. Also, individual state laws vary, and individual partnerships may be able to contract around some of the provisions of the relevant state law.

- d. Note that, even with these examples, there are still definitional problems.
- 3. Articulating broad inclusive language to define the terms is likely better than relying on courts to develop case law (as with de facto mergers of corporations) or relying on the IRS to issue rulings, both of which may be very slow in coming.
- c. Goals – Balance the value of certainty and guidance with the desire to limit the risk of tax planning around bright-line rules. Treat transactions that are economically equivalent to mergers or divisions under the same set of rules. Ensure that the guidance provided accomplishes the objectives behind the promulgation of the regulations.