UNIQUE PLANNING OPPORTUNITIES exist for tax practitioners thanks to the promulgation of regulations under Internal Revenue Code (“Code”) section 708(b)(2). (All section references are to the Code unless otherwise indicated.) Those regulations provide specific rules on how to treat partnership mergers and divisions for tax purposes. Relying on the partnership merger and division rules, practitioners are finding creative solutions to complicated tax problems. Unfortunately, tax planners can misstep when planning a partnership merger or division or overlook the rules entirely and find that their failure undermines other planning objectives.

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Four important points must be considered when structuring partnership mergers or divisions: (1) inside-basis/outside-basis disparity; (2) changes in shares of partnership liabilities; (3) the anti-mixing-bowl rules; and (4) the effect on the participating entities.

OVERVIEW OF PARTNERSHIP Mergers

• The general principle of partnership mergers is that at least one of the merging partnerships terminates. The starting point in determining which partnership terminates is identifying a partnership merger. There is no definition of partnership merger in the Code or the Regulations. It is, however, accepted that partnerships do not have to file articles of merger to be treated as merging under the section 708 regulations. Thus, two general partnerships combining their respective assets and business operations merge under the section 708 regulations. Also, the contribution of all of the assets of one partnership to another partnership could be a partnership merger.

After establishing that two partnerships will merge for tax purposes, the terminating partnership must be identified. A merging partnership terminates at the end of a partnership merger if the members of the merging partnership own less than 50 percent in the capital and profits of the resulting partnership. If, however, the partners of two or more merging partnerships own more than 50 percent of the capital and profits of the resulting partnership, the partnership that is credited with contributing assets with the smallest fair market value (net of liabilities) will be the terminating partnership. Treas. Reg. §1.708-1(c)(1). The form of the partnership merger will determine how the assets flow from the terminating partnership to the resulting partnership.

Assets-Up Merger

All partnership mergers are either assets-up mergers or assets-over mergers. Under the assets-up merger, the terminating partnership distributes all of its assets to its partners in complete liquidation of the partners’ interests, the partners become the owners of the assets under state law, and the partners then contribute those assets to the resulting partnership. The form of this transaction will be respected despite the transitory ownership of the terminating partnership’s assets. Treas. Reg. §1.708-1(c)(3). All other partnership mergers take the assets-over form of merger. Treas. Reg. §1.708-1(c)(3)(i).

Assets-Over Merger

Under the assets-over form, the terminating partnership is deemed to contribute (or actually contributes) all of its assets to the resulting partnership in exchange for an interest in the resulting partnership. The terminating partnership is then deemed to distribute (or actually distributes) the interests in the resulting partnership to its partners in complete liquidation of their interests in the terminating partnership. Treas. Reg. §1.708-1(c)(3)(i).

OVERVIEW OF PARTNERSHIP DIVisions

• In every partnership division, each resulting partnership is either a continuation of the original partnership or a new partnership. In some situations, the original partnership may continue for tax purposes in more than one resulting partnership, but it is not unusual for the original partnership to terminate. If the original partnership terminates, all of the resulting partnerships will be new partnerships. Thus, after determining that a partnership division has occurred, one must determine which, if any, of the resulting partnerships is a continuation of the original partnership and which, if any, of the resulting partnerships is a new partnership.

A resulting partnership will be a new partnership if the members of the resulting partnership had an interest of 50 percent or less in the original partnership. If the members of only one
resulting partnership had an interest of more than 50 percent in the original partnership, that resulting partnership will be a continuation of the original partnership, and all other resulting partnerships will be new partnerships. If the members of none of the resulting partnerships had more than a 50 percent interest in the original partnership, none of the resulting partnerships will be a continuation of the original partnership–instead, all resulting partnerships will be new partnerships. If the members of more than one resulting partnership had more than a 50 percent interest in the original partnership, all such entities shall be a continuation of the original partnership. Treas. Reg. §1.708-1(d)(1).

After identifying any continuing and new partnerships, the focus turns to the flow of assets from the divided partnership to the other partnerships. The focus is placed first on determining which partnership is the divided partnership. Once the divided partnership is identified, one can predict the flow of assets in the division. Assets will flow from the divided partnership to the other partnerships in either an assets-over division or an assets-up division. The divided partnership is the partnership that is deemed to contribute assets to any new partnership (assets-over division) or to distribute them to the partners who will become members of any new partnership (assets-up division). Treas. Reg. §1.708-1(d)(4). The divided partnership is determined in a three-part elimination process:

- First, if the partnership that, in form, transfers the assets is a continuation of the original partnership, that partnership is the divided partnership.
- Second, if the transferring partnership is not a continuing partnership and if there is only one continuing partnership, the continuing partnership is the divided partnership.
- Third, in all other situations, the continuing partnership with assets having the greatest fair market value (net of liabilities) is treated as the divided partnership.

**Assets-Up Division**

Once the divided partnership is identified, one can direct the flow of assets in the division. The division will be an assets-up division only if (1) the divided partnership distributes certain assets to some or all of its partners in partial or complete liquidation of the partners’ interests in the original partnership, and (2) following the distribution, the distributee partners immediately contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partnerships. Treas. Reg. §1.708-1(d)(3)(ii)(A). If there is no continuing partnership for tax purposes, but the original partnership distributes some of its assets to some of the partners, the original partnership will be deemed to distribute all of its assets in complete liquidation of all of the partners’ interests. The partners will then be deemed to contribute the assets to different partnerships. The distribution and contribution will be deemed to occur with respect to all resulting partnerships even though the original partnership does not terminate for legal purposes. Treas. Reg. §1.708-1(d)(3)(ii)(B).

**Assets-Over Division**

All other forms of partnership divisions will be assets-over. Treas. Reg. §1.708-1(d)(3). Under the assets-over form of division, for federal income tax purposes, the divided partnership contributes its assets to one or more other partnerships in exchange for interests in the recipient partnership or partnerships. The divided partnership then distributes the interests in the recipient partnership or partnerships to the partners of the original partnership in complete or partial liquidation of their interests. Treas. Reg. §1.708-1(d)(3)(i)(A). If there is no continuing partnership, the original partnership will be
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