TAX LAW AND ESTATE PLANNING SERIES
Tax Law and Practice
Course Handbook Series
Number D-477

19th Annual
Real Estate Tax Forum

Volume Two

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Is Your Transaction a Partnership Merger or Liquidation and Why You Should Care (January 2015)

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January 2015

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Reprinted from the PLI Course Handbook,
18th Annual Real Estate Tax Forum (Order #144587)

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I. INTRODUCTION

Supreme Court Justice Hugo Black famously stated that "[t]he incidence of taxation depends upon the substance of a transaction."[1] This is unquestionably a true statement, except when it is not. Sometimes a difference in form matters, even when the substance is the same.

For example, a client came into our office recently with an urgent issue related to the tax treatment of a common transaction that arose in the context of a tiered holding partnership structure. The client is a member of a limited liability company ("Holding LLC") whose sole asset is a 70-percent membership interest in another limited liability company ("Property LLC"). The remaining 30-percent membership interest in Property LLC is owned by unrelated third parties. Property LLC owns an office building. Both Holding LLC and Property LLC are treated as partnerships for Federal income tax purposes. In order to simplify the ownership structure of the office building, the client would like to eliminate the current tiered-partnership structure in a manner that will result in the members of Holding LLC owning membership interests directly in Property LLC.

The client is considering two potential transactions to accomplish this goal. First, Holding LLC could liquidate under state law and distribute Holding LLC's membership interest in Property LLC to the members of Holding LLC. Alternatively, Holding LLC could file articles of merger under state law and merge into Property LLC with Property LLC surviving. The client wants to avoid a technical termination of Property LLC under Code Sec. 708(b)(1)(B),[2] which would result if the transaction involves a sale or exchange of 50 percent or more of the total interest in the capital and profits of Property LLC for Federal income tax purposes. A technical termination of Property LLC would require a re-start of the depreciable life of the office building pursuant to Code Sec. 168(i)(7) over a new 39-year recovery period. Does it matter which form of the transaction is undertaken by the client?

Both of the transactions described by the client would result in the consolidation of two tax partnerships into a single partnership for Federal income tax purposes. However, despite the fact that the two proposed transactions are, in substance, identical, whether or not the transaction is treated as a partnership merger will dramatically alter the tax consequences

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1. *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331 (1945).
2. Unless otherwise indicated or clear from context, section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to Treasury regulations promulgated thereunder.

of the transaction.[3] As discussed below, a technical termination under Code Sec. 708(b)(1)(B) would not result if the proposed transaction is treated as a partnership merger for Federal income tax purposes. In contrast, a liquidation of Holding LLC for Federal income tax purposes would result in the distribution of a 70-percent membership interest in Property LLC to the members of Holding LLC and would be treated as an exchange of membership interests in Property LLC for purposes of Code Sec. 708(b)(1)(B).[4] Accordingly, a liquidation of Holding LLC for Federal income tax purposes would result in a technical termination of Property LLC and a re-start of the depreciable life of the office building significantly reducing annual depreciation deductions.

II. PARTNERSHIP MERGERS - GENERALLY

In order for a merger of corporations to be governed by Code Sec. 368(a)(1)(A), the transaction must be a merger or consolidation effected pursuant to the corporation laws of the United States or a State or territory, or the District of Columbia.[5] Moreover, in the case of a corporate merger, a relatively elaborate set of Code provisions specifies the extent to which gain is recognized at the corporate and shareholder level, the effect on stock and asset basis, the extent to which tax attributes carry over and other important tax consequences.

In contrast, Code Sec. 708(b)(2)(A) governing partnership mergers consists of a single sentence, unchanged since its enactment in 1954, that specifies only which partnership, if any, is deemed to continue after the merger. Code Sec. 708(b)(2)(A) provides that in the case of a merger or consolidation of two or more partnerships, the resulting partnership is, for purposes of Code Sec. 708, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. The partnership merger regulations (the “Merger Regulations”) provide that, if the resulting partnership can be considered a continuation of more than one of the merging partnerships, the resulting partnership is the continuation of the partnership that is credited with the contribution of the greatest dollar value of assets to the resulting partnership.[6] Moreover, if

3. We note that if Holding LLC owned assets other than its membership interest in Property LLC, there may be substantive state law creditor rights and other differences between a merger and a liquidation that would need to be taken into account.
4. *See* Code Sec. 761(e).
5. Reg. § 1.368-2(b)(1).
6. Reg. § 1.708-1(c)(1).

none of the members of the merging partnerships own more than a 50-percent interest in the capital and profits of the resulting partnership, all of the merged partnerships are considered terminated, and a new partnership results. Under Code Sec. 706(c), the taxable years of the merging partnerships that are considered terminated are closed.

Partnership Mergers Under State Law

The ability of partnerships and limited liability companies to combine by filing articles or a certificate of merger is a relatively recent feature of state law. For example, Delaware law did not permit limited partnerships to combine by filing articles of merger until 1985 and the Delaware Limited Liability Company Act, which provides for the merger of limited liability companies by filing a certificate of merger, was not enacted until 1992.[7] Thus, Code Sec. 708(b)(2)(A) addressed partnership merger transactions long before state law permitted statutory mergers of partnerships or limited liability companies treated as partnerships for Federal income tax purposes. This fact compelled the conclusion that a partnership merger can take place for Federal income tax purposes without the filing of state law articles or a certificate of merger.

In Revenue Ruling 68-289,[8] the IRS addressed the tax consequences of a partnership merger. The facts of the ruling state that three existing partnerships (P1, P2, and P3) merged into one partnership, with P3 continuing under Code Sec. 708(b)(2)(A). The ruling does not discuss the fact that, at the time of its issuance, no state law permitted a statutory merger of partnerships. Nor does the ruling describe how the "merger" was effectuated as a matter of state law.

Nevertheless, the ruling holds that the two terminating partnerships (P1 and P2) are treated for Federal income tax purposes as having contributed all of their respective assets and liabilities to the resulting partnership (P3), in exchange for a partnership interest in P3. The terminating partnerships (P1 and P2) are then treated as liquidating, with the partners of P1 and P2 receiving interests in P3 in liquidation of P1 and P2 and taking a basis in the P3 interests determined under Code Sec. 732(b). Thus, the ruling applies an "assets-over" form for the merger.[9]

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7. *See* Del. Code Ann. tit. 6 §17-211, adopted by 65 Del. Laws ch. 188, §1 (1985); Del. Code Ann. tit. 6 §18-101, adopted by 68 Del. Laws ch. 434, §1 (1992).
8. 1968-1 C.B. 314.
9. *See* discussion at footnote 13, below.

The Merger Regulations

The Merger Regulations generally provide that the form of a partnership merger accomplished under the laws of the applicable jurisdiction will be respected for Federal income tax purposes if the partnership undertakes the transaction in one of two prescribed forms. The two forms are the "assets-up form" and the "assets-over form."

In the "assets-up form," the merged partnership considered terminated distributes its assets and liabilities to its partners in liquidation of their partnership interests, and immediately thereafter the partners in the terminated partnership contribute the distributed assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership.[10] The "assets-up form" is respected if that is the state law form of the transaction and the distributed assets are actually titled to the distributee or the distributee otherwise acquires state law ownership of the assets.[11]

In the "assets-over form," all of the assets and liabilities of the merged partnership considered terminated are treated as contributed to the resulting partnership, in exchange for an interest in the resulting partnership, and immediately thereafter the terminated partnership is treated as distributing the interests in the resulting partnership to its partners in liquidation.[12] The "assets-over form" is respected for Federal income tax purposes when that state law form is used. It is also the characterization that is adopted when there is no state law form for the merger (e.g., if it is accomplished by filing articles of merger) and when the state law form is the "interests-over form" or a failed "assets-up" transaction.[13]

Notwithstanding the general rules set forth in the Merger Regulations, the doctrine of substance over form and the step transaction doctrine will apply and the Commissioner may disregard form and recast a series of transactions in accordance with their substance.[14]

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10. Reg. §1.708-1(c)(3)(ii).
11. *Id.*
12. Reg. §1.708-1(c)(3)(i).
13. *Id.* The "interests-over" form refers to a transaction in which all of the partnership interests in the merged partnership considered terminated are contributed to the resulting partnership in exchange for partnership interests in the resulting partnership.
14. Reg. §1.708-1(c)(6), §1.708-1(d)(6). In CCA 201315026, an existing partnership merged with a disregarded entity held by a new partnership under state law, and at the same time the partners of the existing partnership contributed their partnership interests in the existing partnership to the new partnership in exchange for all of the interests in the new partnership. As a result, the partners held the same

III. TREATMENT OF STATE LAW MERGER OF HOLDING LLC INTO PROPERTY LLC

If the consolidation of the tiered-partnership ownership structure for the office building is accomplished pursuant to the filing of articles of merger with Property LLC surviving under state law, pursuant to Reg. § 1.708-1(c)(3)(i), the transaction would be treated as an "assets-over" merger of Holding LLC and Property LLC. As a result of the merger, the former members of Holding LLC would own 70 percent of the membership interests in Property LLC. Accordingly, because the former members of Holding LLC would own more than 50 percent of the membership interests in Property LLC, the "direction" of the transaction would be reversed for Federal income tax purposes pursuant to Code Sec. 708(b)(2)(A) and Holding LLC would be treated as the continuing partnership. As a result, for Federal income tax purposes, the transaction would presumably be treated as a contribution of a 30-percent interest in the office building by Property LLC to Holding LLC under Code Sec. 721 in exchange for membership interests in Holding LLC, followed by a distribution of the membership interests in Holding LLC by Property LLC to the members other than Holding LLC in complete liquidation. Further, Property LLC would presumably be deemed to distribute a 70-percent interest in the office building to Holding LLC in liquidation of Holding LLC's membership interest in Property LLC.[15] Neither the deemed contribution of an interest in the office building to Holding LLC, nor the

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interests in the new partnership that they held in the original partnership and the original partnership became a disregarded entity held by the new partnership. The IRS's Chief Counsel's Office concluded that the new partnership should be treated as a continuation of the original partnership and that there was no termination of the original partnership. However, the CCA did not expressly apply the merger regulations to the transaction.

15. The "assets-over" merger would momentarily result in a circular ownership structure in which Holding LLC would own a membership interest in Property LLC and Property LLC would own a membership interest in Holding LLC. The Merger Regulations contain an analysis of the transactions that are deemed to occur in connection with a momentary circular ownership structure resulting from a taxable sale of an interest in the merging or consolidating partnership. The Merger Regulations provide that the continuing partnership is deemed to receive an asset distribution from the merging or consolidating partnership with respect to the portion of such partnership that is purchased by the continuing partnership. *See* Reg. § 1.708-1(b)(5), *Example 5(iv)*. A similar analysis may be applied to a merger of Property LLC into Holding LLC. A liquidating distribution of an interest in the office building under Code Sec. 731(a) would not result in a re-start of the depreciable life of the office building. Code Sec. 168(i)(7)(B)(i).

deemed distribution of a 30-percent membership interest in Holding LLC by Property LLC would result in a re-start of the depreciable life of the office building under Code Sec. 168(i)(7). In addition to avoiding a re-start of depreciation, in some cases it may be important to avoid a liquidation of Holding LLC to prevent a distribution that would trigger gain under the Code Sec. 707(a)(2)(B) partnership disguised sale rules, or the "anti-mixing bowl" rules of Code Secs. 704(c)(1)(B) and 737 to the extent property contributions with built-in gain have been made to Holding LLC. As a result of the treatment of Holding LLC as the continuing partnership, no distributions would be deemed to be made by Holding LLC as a result of the merger.

IV. TREATMENT OF STATE LAW LIQUIDATION OF HOLDING LLC

If the consolidation of the tiered-partnership ownership structure of the office building is accomplished pursuant to a state law liquidation of Holding LLC, it is not clear whether the transaction would be treated as a merger of Holding LLC and Property LLC or as a liquidation of Holding LLC for Federal income tax purposes. Surprisingly, there is no specific guidance as to whether a state law liquidation of an upper-tier partnership may be treated as a merger or as a liquidation for Federal income tax purposes.

The Merger Regulations do not contain a definition of what constitutes a partnership merger. Moreover, as discussed above, Code Sec. 708(b)(2)(A) clearly applies to a combination of two or more partnerships that is not accomplished pursuant to a state law merger. Accordingly, the consolidation of Holding LLC and Property LLC into a single partnership pursuant to a state law liquidation of Holding LLC might be characterized as a merger for Federal income tax purposes. Like the actual state-law merger form of the transaction described above, because the members of Holding LLC would own more than 50 percent of the resulting partnership after the liquidation of Holding LLC, the transaction would be analyzed as an "assets-over" merger and Holding LLC would be treated as the continuing partnership. Although the transaction would involve an actual distribution of Holding LLC's assets to its members, the transaction would not be analyzed as an "assets-up" merger because a transaction can only be treated as an "assets-up" merger if the partnership that is treated as the terminated partnership under Reg. § 1.708-1(c)(1) is the partnership that distributes its assets under state law. In this case, the terminated partnership for Federal income tax purposes would be Property LLC rather than Holding LLC.

If the state law liquidation of Holding LLC is treated as an "assets-over" partnership merger, Property LLC would be deemed to contribute a 30-percent interest in the office building to Holding LLC in exchange for a membership interest in Holding LLC and would then be deemed to distribute its membership interest in Holding LLC to its members in complete liquidation. As noted above, an "assets-over" merger would not result in a re-start of the depreciable life of the office building.

It is possible, however, that the transaction could be analyzed in accordance with its state-law form and treated as an actual liquidation of Holding LLC. We note that a similar transaction in the corporate context would be analyzed in accordance with its state law form. For example, if an individual owns the stock of parent corporation P and P owns the stock of subsidiary corporation S, the consolidation of the tiered-corporate structure with S surviving could be accomplished either by liquidating P or merging P downstream into S. If the transaction is structured as a state law liquidation of P, it would be analyzed as a liquidation of P for Federal income tax purposes despite the fact that the resulting ownership structure could also be accomplished pursuant to a downstream merger.[16] Similarly, if the consolidation of the tiered-corporate structure is accomplished by a state law downstream merger of P into S, the form will generally be respected for Federal income tax purposes.[17]

If the consolidation of Holding LLC and Property LLC is similarly treated as a liquidation of Holding LLC for Federal income tax purposes in accordance with the state law form of the transaction, the distribution of a 70-percent membership interest in Property LLC to the members of Holding LLC would result in a technical termination of Property LLC under Code Sec. 708(b)(1)(B) and a re-start of the depreciable life of the office building under Code Sec. 168(i)(7).

V. CONCLUSION

Whether the consolidation of Holding LLC and Property LLC is treated as a partnership merger for Federal income tax purposes will determine whether the transaction results in a technical termination of Property LLC and a re-start of the depreciable life of the office building owned by Property LLC. As discussed above, a statutory downstream merger of

16. The state law form of the transaction as a liquidation would generally be respected provided the individual stockholder does not plan to cause a reincorporation of P by contributing S to a new corporation, in which case the "liquidation-reincorporation" doctrine may be applied.
17. *See* Rev. Rul. 78-47, 1978-1C.B. 113.

Holding LLC into Property LLC would be treated as an "assets-over" partnership merger and Holding LLC would be treated as the continuing partnership. Property LLC would be deemed to liquidate as a result of the merger and the depreciable life of the office building would not re-start under Code Sec. 168(i)(7). Oddly, it is not clear whether a state law liquidation of Holding LLC would be treated as a partnership merger or liquidation for Federal income tax purposes. Accordingly, although these transactions will result in the same state-law ownership structure for the office building, we would advise the client to engage in a statutory downstream merger in order avoid the uncertainty as to the tax treatment raised by a liquidation of Holding LLC.

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