COMMENTS CONCERNING PROPOSED REGULATIONS 1.708-1, 1.743-1, AND 1.752-1 REGARDING PARTNERSHIP MERGERS AND DIVISIONS

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Partnerships of the Section of Taxation. Principal responsibility was exercised by Mr. Thomas Stephens. Substantive contributions were made by James E. Wregglesworth and Marc Schultz. The comments were reviewed by Thomas Crichton, IV of the Section’s Committee on Government Submissions and by Charlie Egerton, Council Director for the Committee on Partnerships.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: March 28, 2000
Overview

The following are comments regarding the proposed regulations on partnership mergers and divisions (REG-111119-99), published at Fed. Reg. Vol 65, no. 7, p 1572. The regulations provide much needed guidance in this area and we applaud the overall approach of the regulations. The proposed regulations strike a reasonable balance in allowing the tax consequences of the transaction to flow from the form chosen by the taxpayers while avoiding some of the conceptual and practical difficulties that would flow from a “pure” form-driven approach. The following comments are in the nature of suggested clarifications in several areas.

1. Implementation of Assets –Up Form

The acceptance in the proposed regulations of the Assets-Up form in both mergers and divisions, and the attempt to eliminate concerns regarding the transitory ownership of the assets by the partners, is helpful in creating certainty with respect to the tax consequences of these transactions without unnecessarily limiting the options available to taxpayers. However, we believe that it would be helpful if the regulations dealing with the Assets-Up form were further clarified in two respects.

**We recommend that clarification be made that the Assets-Up form may be used whether or not the partners could hold the assets outside of a partnership format.** For example, if two partnerships with operating businesses are merging, it might be impractical, or impossible, to hold the assets of the terminated partnership, including goodwill, as joint owners outside of a partnership form for tax purposes. If the terminated partnership had actually distributed its assets pro rata to its partners, and the partners continued operating the business, the owners of the assets would likely be held to have remained partners for tax purposes. However, since the owners of the terminated partnership do not operate the business outside of partnership form, but contribute it to the resulting partnership, it would be helpful to clarify that the Assets-Up form is permitted even in these cases.

**Further, we recommend that clarification be made that the Assets-Up form will be respected if the partners assign their rights to receive title to the assets in liquidation of the terminated partnership to the resulting partnership or otherwise clearly direct the terminated partnership to transfer title directly to the resulting partnership.** In its current form, we believe the proposed regulation is ambiguous on the point of whether it is necessary for title (as opposed to mere dominion and control) in the assets to pass to the partners in order for the Assets-Up form to be respected. Compare Prop. Reg. §§ 1.708-1(c)(2)(ii) and 1.708-1(d)(2)(ii) (“distribution” required without reference to title) with Prop. Reg. § 1.708-1(d)(4), Ex. 2 (“title” vests in distributee partners). We recognize, of course, that there is no difference in economic substance between the Assets-Over form and the Assets-Up form – in both cases the assets end up owned by the resulting partnership by the end of the closing – so that the form of the transaction must be followed for a distinction to exist. Still, we believe it is an unnecessary, and perhaps expensive, condition to recognition of the Assets-Up form to require that certain types of assets actually be titled in the name of the partners for any period of time.

For example, assume that the terminating partnership owns a parcel of real estate, and the documents provide that the terminating partnership will liquidate and assign a pro rata interest in
the real estate to each partner. At the same time, each partner agrees to assign the interest it receives to the resulting partnership in exchange for an interest in the resulting partnership. If, rather than creating and recording multiple deeds, the terminating partnership places a deed in escrow, and the partners direct that their interests in the property be transferred directly to the resulting partnership, the transactional form appears sufficiently close to an actual titling of the assets in the partners’ hands to merit being respected under the Assets-Up form. An analogy in the case of like-kind exchanges under Section 1031 is consistent with this recommended approach. There, where form is obviously of great importance, it is not required that legal title to either the transferred property or the replacement property be vested momentarily in the qualified intermediary, as long as the real estate sale contracts are in the proper form.

2. Mixing of Forms

We recommend that the regulation clarify that a single merger or division may result in recognition of the Assets-Up form for some partners and the Assets-Over form for others. The proposed regulations (quite appropriately) generally force partnerships mergers and divisions into one of two forms for purposes of testing tax consequences. An underlying premise of this approach may be the assumption that (with exception for the treatment of exiting partners, described below) all partners participate in the merger or division in the same way. We believe, however, that certain partnership mergers or divisions can be envisioned in which a hybrid form is utilized, e.g., where a portion of the assets of a terminated partnership in a merger are distributed to some of the partners and then contributed to the resulting partnership, and the Assets-Over form is used as to the remainder of the partners. In such a case, we suggest that, to the extent that assets are distributed to some (but not all) of the partners and contributed to the resulting partnership (in the case of a merger) or the recipient partnership (in the case of a division), the result to the partnerships and the partners should be based on a combination of the Assets-Up and Assets-Over forms. This suggested result is analogous to the result under the proposed regulations in the case of a division of a partnership where there are no continuing partnerships but the prior partnership does not liquidate. In that event, if the Assets-Up form is used for those assets transferred to new resulting partnerships, the Assets-Over form is still applied to the assets retained by the prior partnership that is, for tax purposes, a new resulting partnership. Prop. Reg. § 1.708-1(d)(ii)(B).

3. Assets-Over Form – Sale of Interest Exception

We understand that the inconsistencies inherent in the Interest-Over form are difficult to reconcile in the context of a partnership merger or division, and agree that that preemptive application of the Assets-Over form is appropriate. We also believe that the rule of Prop. Reg. § 1.708-1(c)(3) (the “sale of interests” rule) addresses directly, and substantially ameliorates, the unfairness and economic difficulties created by partnership allocations where one or more partners (an “exiting partner”) are being cashed-out in a merger or consolidation. However, we suggest one clarification to the sale of interest rule.

We recommend Example 4 of proposed regulations section 1.708-1(c)(4) be clarified to make clear that no actual assignment document is required to be executed by an exiting partner. As currently drafted, the sale of interests rule applies where “a sale of an interest in the terminated partnership” occurs in connection with a merger or consolidation. While the language of the proposed regulation indicates that the exception will apply where the merger
agreement simply provides that the interest will be sold and specifies the consideration, the example includes as a fact that the “selling” partner was a party to the merger agreement in his own capacity. This creates some uncertainty as to whether an assignment or other agreement must be entered into by the “selling” partner. We believe that where the merger agreement or other operative document is clear about the intended treatment and is within the authority of the merging partnerships, the transaction should satisfy the conditions for application of the sale of interest rule whether or not the document is signed by the affected partner. As an example of where this difference may be significant, assume that Partnership X, with 40 partners, is merging into Partnership Y. The general partner of Partnership X sends a letter to the partners requesting their vote on the merger and allowing them the option to be cashed out. The merger agreement then provides that any partner from whom no response was obtained at all will be cashed out and sets the price. (Under the terms of the partnership agreement of Partnership X, the merger agreement is legally binding on the non-cooperative partners.) In cases such as this, we believe it would be helpful to clarify that the treatment of the non-cooperative partners as selling their interests is to be respected without the necessity of obtaining an executed assignment or other instrument from those partners. Otherwise, the partners rolling over their interests into Partnership Y have the same gain allocation problems the sale of interests rule seeks to avoid.

4. Reliance Prior to Enactment

We recommend that the finalized regulations afford elective retroactive application of the proposed regulations to the date of such proposed regulations’ issuance. As currently drafted, the proposed regulations are to be effective with respect to partnership mergers (Prop. Reg. § 1.708-1(c)(6)) and partnership divisions (Prop. Reg. § 1.708-1(d)(6)) occurring on or after the date final regulations are issued in the Federal Register. Because the regulations provide needed clarity in an area that has lacked the benefits of much, if any, clarity in the past, we suggest a statement in the regulations providing for retroactive application, at the election of the affected partnership(s), to partnership merger or division transactions effected on or after January 11, 2000.