February 1, 2006

Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Eric Solomon
Acting Assistant Secretary
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W. Room 3104
Washington, DC 20220

Re: Comments Concerning Notice 2005-15

Dear Gentlemen:

Enclosed are comments concerning Notice 2005-15. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

[Signature]

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, IRS
Heather C. Maloy, Acting Deputy Chief Counsel (Technical), IRS
William P. O’Shea, Deputy Associate Chief Counsel, (Passthroughs & Special Industries), IRS
Christopher Kelley, Special Counsel, IRS
Beverly Katz, Senior Technical Reviewer, IRS
Laura Fields, Attorney, IRS
Michael J. Desmond, Tax Legislative Counsel, Treasury Department
Mark Yecies, Attorney-Advisor, Treasury Department
COMMENTS CONCERNING NOTICE 2005-15

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Christopher McLoon and Howard E. Abrams of the Partnerships and LLCs Committee of the Section of Taxation. Substantive contributions were made by Sandra O’Neill and others. These comments were reviewed by James Wreggelsworth, Committee Vice-Chair, R. Brent Clifton, Committee Vice-Chair, and Steven Frost, Committee Chair. The comments were further reviewed by Richard Levine of the Section’s Committee on Government Submissions and by Charles H. Egerton, Section of Taxation Vice Chair (Committee Operations).

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 income tax rules applicable to the subject matter addressed by these comments, or have advised clients on the application of such rules, 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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February 1, 2006
EXECUTIVE SUMMARY

On April 12, 2004, the Internal Revenue Service issued Revenue Ruling 2004-43 providing that a new layer of 704(c) gain is created when assets are transferred in an “assets-over” partnership merger, as that term is defined in Treasury Regulation section 1.708-1(c)(3)(i). In response to comments that the holding of Revenue Ruling 2004-43 was contrary to the understanding of most tax practitioners, the IRS revoked Revenue Ruling 2004-43 on January 19, 2005. On the same day, the IRS issued Notice 2005-15. Notice 2005-15 stated the Service’s intention to issue proposed regulations that would apply the principles underlying the holding of Revenue Ruling 2004-43 to assets-over partnership mergers. Notice 2005-15 requested comments on this proposal as well as other related matters.

The key points of our comments are as follows:

1. We recommend that the approach of Revenue Ruling 2004-43 not be adopted in proposed regulations and that administrative guidance be provided that reaffirms the plain meaning of existing regulations.

2. In the alternative, if proposed regulations are promulgated that follow the approach of Revenue Ruling 2004-43, we believe it is essential that such regulations be prospective in their application, and in this context prospective application means – and considerations of fairness require – that such regulations apply only to mergers occurring on or after January 19, 2005.

3. If proposed regulations are promulgated that follow the approach of Revenue Ruling 2004-43, they should provide that:
a. Section 704(c)(1)(B) will not apply to, and, for purposes of section 737, net precontribution gain will not include, newly created section 704(c) gain or loss in property contributed by the transferor partnership to the transferee partnership in assets-over partnership mergers involving partnerships in which the same persons own eighty percent (80%) or more of the interests in the capital and profits of each of the merging partnerships (the “Substantially Equal Interests Rule”),

b. As to unrelated partnerships (i.e., partnerships that do not qualify for the Substantially Equal Interests Rule), the proposed regulations should provide that if property that was contributed by a transferor partnership to a transferee partnership in an assets-over merger is distributed by the transferee partnership to a former partner of the transferor partnership, then sections 704(c)(1)(B) and 737 apply as if the transferor partnership had distributed that property to that former partner.

4. If proposed regulations are promulgated that follow the approach of Revenue Ruling 2004-43, guidance should be provided covering a broad range of factual patterns including the application to aged property, the transfer of depreciable property, and the interaction with the ceiling rule limitation.

STATUTORY AND ADMINISTRATIVE BACKGROUND

I. The Anti-Mixing Bowl Rules

A. Pre- Contribution Gain and Loss

Under sections 721 and 722, the contribution of property to a partnership is, in general, a tax-free transaction in which the adjusted basis of the contributed
property carries over into the hands of the transferee partnership. As a result, any unrealized gain or loss in the contributed property will be deferred until that property is sold or exchanged by the partnership. When recognized, such gain or loss is not allocable among the partners under the general rule in section 704(b) (restricting allocations only by the requirement of “substantial economic effect”). Instead, section 704(c)(1)(A) requires that all pre-contribution unrealized gain or loss in contributed property be allocated to the contributing partner when that gain or loss is recognized by the partnership.¹

The nonrecognition treatment offered by sections 721 and 722 thus includes a promise under section 704(c)(1)(A) not only that any unrealized appreciation or loss in contributed property eventually will be recognized but also that it eventually will be recognized by the contributing partner. So long as the contributed property ultimately is disposed of in a taxable transaction by the partnership while the contributing partner remains a partner, this promise will be kept. Section 704(c)(1)(A) will be circumvented, however, if the contributed property is disposed of by the partnership in a tax-free transaction or if the contributing partner exits the partnership before the contributed property is sold or exchanged by the partnership. These possibilities are addressed in three distinct ways.

First, if contributed property is transferred in a tax-free exchange, regulations under section 704(c)(1)(A) treat the replacement property received by the partnership as subject to section 704(c)(1)(A) to the same extent that the transferred

¹ Treas. Reg. § 1.704-3(a)(1).
property was subject to that provision.\(^2\) This tracing-of-the-taint rule ensures that section 704(c)(1)(A) cannot be avoided by laundering property through a like-kind or other tax-free exchange. While the contributed property no longer is owned by the partnership, the substitute-basis property takes its place.

Second, if the contributed property is distributed to another partner, the contributing partner must recognize under section 704(c)(1)(B) any pre-contribution gain or loss in the contributed property as if the contributed property were sold rather than distributed. A distribution of contributed property severs the connection between the contributed property and the contributing partner: the distribution does not trigger recognition of gain or loss to the distributing partnership, yet the partnership does not receive in return any property that can continue the section 704(c)(1)(A) taint. But for the application of section 704(c)(1)(B), the distribution would shift recognition of pre-contribution gain or loss from the contributing partner to the distributee partner, a result inconsistent with section 704(c)(1)(A).

Section 704(c)(1)(B) does not continue the taint but rather accelerates recognition of income to the contributing partner. Under section 704(c)(1)(B) the contributing partner is taxed on any pre-contribution gain or loss in the contributed property in advance of a taxable disposition of the property. To mitigate against this acceleration, section 704(c)(1)(B) applies only to distributions of contributed property that take place within seven years of the contribution of the property to the partnership. Thus, while the taint of section 704(c)(1)(A) lasts indefinitely, it will be avoided if the

\(^2\) Treas. Reg. § 1.704-3(a)(8).
partnership distributes contributed property more than seven years after it was contributed to the partnership.

The third way that the connection between a contributing partner and the contributed property may be severed is by the contributing partner exiting the partnership prior to a taxable disposition of the contributed property. If the contributing partner exits in exchange for a liquidating distribution of cash or marketable securities, the distribution will be taxable to the partner\(^3\) and so the pre-contribution unrealized appreciation or loss is recognized at that time. If the distribution consists of property other than marketable securities, the distribution will be tax-free.\(^4\) When the contributed property eventually is sold or exchanged by the partnership, no part of the pre-contribution unrealized gain or loss can be allocated to the contributing partner because the contributing partner no longer is a member of the venture. To preclude circumvention of section 704(c)(1)(A) in this way, section 737 taxes a contributing partner who receives a distribution of other property within seven years of the contribution. Note that section 737 does not tax any gain or loss in the distributed property itself but rather uses the distribution as a trigger to tax the contributing partner on some or all of the pre-contribution gain in the contributed property. Thus, section 737 – like section 704(c)(1)(B) – backstops section 704(c)(1)(A) by taxing the contributing partner on pre-contribution unrealized appreciation and loss when the connection between the contributing partner and the contributed property is

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\(^3\) I.R.C. §§ 731(a)(1), 731(c).

\(^4\) I.R.C. § 731(a). A distribution that rearranges the partners’ interest in ordinary income assets can be taxable under section 751(b) to the distribute partner, to the partnership, or to both, but the application of section 751(b) is independent of the proper scope of sections 704(c)(1)(B) and 737 and so is ignored in the remainder of these comments.
severed by a distribution.5

Section 737, like 704(c)(1)(B), applies only to distributions made within seven years of the contribution of property to the partnership. The reason for this limitation in section 737, like that for the limitation in section 704(c)(1)(B), is that section 737 accelerates the recognition of 704(c)(1)(A) gain. Accordingly, its application is limited to those distributions which have the hallmark of an inappropriate use of the partnership rules to effect a tax-free mixing bowl transaction; that is, a contribution and distribution closely proximate in time. For this purpose Congress has determined that seven years is the appropriate line separating inappropriate from appropriate use of a partnership.

**B. Post-Contribution Gain and Loss**

Section 704(c)(1)(A) speaks only to the variation between the value of property “contributed to the partnership” and its adjusted basis, measured “at the time of contribution.” Thus, section 704(c)(1)(A) has no application to property that is purchased by a partnership (because such property was not “contributed to the partnership”) nor to any changes in the value of contributed property occurring once the property is in the

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5 Section 737 applies to nonliquidating distributions as well as to liquidating distributions even though a nonliquidating distribution does not sever the connection between the contributing partner and the contributed property. Suppose P contributes appreciated Blackacre to the PQR partnership in exchange for an interest in PQR and then Whiteacre is distributed to P in a nonliquidating distribution. Assume that P’s interest in the venture is worth $1,000 immediately prior to the distribution of Whiteacre, and that Whiteacre has a value of $990 at the time of the distribution. If section 737 did not apply to the distribution of Whiteacre, then this distribution would be tax-free to P and all the unrealized gain in Blackacre would remain unrecognized. But if P then sold its partnership interest, that sale would produce at most a gain of $10 because that would be the amount realized on this final sale. Thus, by receiving a large nonliquidating distribution P is able to exit the venture in exchange for a very small final payment, and receipt of that payment may not support the full recognition by P of the pre-contribution unrealized appreciation in property contributed by P to the partnership. Accordingly, section 737 must – and does – apply to nonliquidating distributions as well as to liquidating distributions.
hands of the partnership (because such changes occur after “the time of contribution”). Because both section 704(c)(1)(B) and section 737 expressly apply only to gain or loss captured by section 704(c)(1)(A), these sections do not speak to gains and losses accruing to property already in the hands of the partnership.6

A partnership may revalue its assets and restate the partners’ capital accounts on the occurrence of certain specific events (including non-pro rata contributions and distributions).7 When this is done, the revaluation creates a variation between the book value and adjusted basis of partnership property that is equivalent to pre-contribution unrealized gain and loss to which section 704(c)(1)(A) speaks. Under existing regulations, such book/tax disparities must be addressed in accordance with the principles underlying section 704(c)(1)(A).8 In particular, if the revaluation of a partnership’s asset increases the partners’ capital accounts to reflect the unrealized appreciation in the asset, then the subsequent recognition of that tax gain must be allocated to the partners as they previously were allocated the unrealized book gain. Such allocations often are called “reverse 704(c)” allocations in contrast to true, or “forward,” 704(c) allocations.

When partnership property having a variation between its adjusted basis and its book value is sold or exchanged by a partnership, any tax gain in excess of book gain must be allocated to the partners as their capital accounts were credited with unrealized book appreciation in the past. This is true whether the variation between basis

6 See generally Treas. Reg. §§ 1.704-4(a) (example 2), 1.737-1(c)(1).
and book value arose when the property was contributed to the partnership (a forward 704(c) allocation) or when the property was revalued (a reverse 704(c) allocation). In this respect there is no difference between a forward 704(c) allocation and a reverse 704(c) allocation. As a technical matter, however, the forward 704(c) allocation is made pursuant to section 704(c)(1)(A) while the reverse 704(c) allocation is made pursuant to section 704(b) (incorporating 704(c)(1)(A) principles).9

The technical distinction between forward and reverse 704(c) allocations is important because sections 704(c)(1)(B) and 737 apply only to forward 704(c) book/tax disparities (that is, to variations between basis and book value that give rise to true 704(c)(1)(A) allocations). Book/tax disparities arising from the revaluation of partnership assets do not implicate section 704(c)(1)(B) if the revalued property is then distributed, nor do book/tax disparities implicate section 737 if other property is distributed to a partner whose capital account was adjusted as a result of the revaluation. To be sure, reverse 704(c) allocations are similar enough to forward 704(c) allocations that Congress reasonably could have extended sections 704(c)(1)(B) and 737 to reverse 704(c) allocations; but Congress has elected not to do so, and the statute is unambiguous that only forward 704(c) book/tax disparities are captured by sections 704(c)(1)(B) and 737.

As a result, reverse 704(c) gain can be shifted from one partner to another. To take the simplest case, suppose Greenacre is distributed to partner X when Greenacre has an adjusted basis and book value of $500. If Greenacre is worth $600 at the time of

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the distribution and X’s share of profits is 25%, then X’s capital account must be increased by $25 of the unrealized appreciation immediately prior to the distribution and the capital accounts of the other partners must be increased by an aggregate amount of $75.\textsuperscript{10} Even though X’s capital account was credited with only one-quarter of the unrealized appreciation in Greenacre, X ultimately will include 100% of that appreciation because Greenacre is now owed by X in X’s individual capacity.

Reverse 704(c) gain can be shifted in various other ways. If a liquidating distribution of property is made to a partner whose capital account has been increased to reflect the revaluation of partnership assets, the exiting partner’s share of the reverse 704(c) gain in undistributed assets will be shifted to other partners because the exiting partner cannot be allocated gain recognized by the partnership in a taxable year after the partner has left the venture. Also, if a new partner joins the venture in exchange for a contribution of cash or property, that admission can trigger an optional revaluation of the partnership’s assets. A subsequent distribution of any revalued assets to the incoming partner will cause a shift of the reverse 704(c) gain from the continuing partner to the new partner. Application of sections 704(c)(1)(B) and 737 to these transactions would eliminate the shifts, but those sections simply do not apply to reverse 704(c) gains and losses.

II. \textbf{An Assets-Over Partnership Merger Under Existing Law and Regulations}

In an assets-over merger, the transferor partnership transfers all of its assets to the transferee partnership in exchange for interests in the transferee partnership,\textsuperscript{10}

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\textsuperscript{10} Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1).
\end{flushright}
and then the transferor partnership liquidates.\footnote{11} For example, suppose the XYZ partnership owns three nondepreciable assets, Blackacre, Whiteacre and Greenacre. Suppose that X had contributed Blackacre to the XYZ partnership with an adjusted basis of $100 and a fair market value of $500. Suppose that Whiteacre had been contributed to the XYZ partnership with an adjusted basis of $200 and a fair market value of $320. Suppose also that the partnership had purchased Greenacre with cash of $470. Finally, assume that each of the assets of XYZ is worth $500 at the time that XYZ merges into the P partnership and that XYZ properly is treated as the transferor partnership in the merger.

To what extent should section 704(c)(1)(A) apply to the three assets of XYZ now owned by P? No regulation speaks to this issue directly, but regulations promulgated under sections 704(c)(1)(B) and 737 provide that these two provisions will apply to distributions to X, Y and Z “to the same extent” that a distribution by the XYZ partnership would have subjected them to taxation under those provisions (the “Subsequent Distribution Rule”).\footnote{12} If there had been no merger but instead XYZ had distributed one of its assets to either of the two non-contributing partners within seven years after the date such asset was contributed to XYZ, how would section 704(c)(1)(B) have applied to the distribution? The answer is clear: section 704(c)(1)(B) would have no application to a distribution of Greenacre (because it was purchased by XYZ rather than contributed to XYZ), it would apply to only $120 of the gain in Whiteacre (with the remaining $180 of the gain arising after Whiteacre was contributed to the partnership), and it would apply to the entire $400 unrealized appreciation in Blackacre (because all of

\footnote{11} Treas. Reg. § 1.708-1(c)(3)(i).

\footnote{12} Treas. Reg. §§ 1.704-(c)(4), 1.737-2(b)(3).
that gain arose prior to the contribution of Blackacre to the partnership). Thus, if section 704(c)(1)(B) would apply to these assets after the merger “to the same extent,” then the 704(c) gain in the assets cannot change as a result of the merger. That is, the 704(c) gain in the assets must remain unchanged by reason of the assets-over merger.

Note that this does not speak to the proper allocation of any post-contribution unrealized appreciation or loss in property of the transferor partnership as of the time of the merger. Such unrealized appreciation or loss should be allocated among the members of the transferor partnership as they have agreed to share gain or loss from such property. This result could arise from treating the assets-over merger as subject to section 704(c)(1)(A) for all purposes other than subsequent applications of sections 704(c)(1)(B) and 737. Equivalently, the merger could be treated as an opportunity for a mandatory revaluation of the transferor partnership’s assets (immediately prior to the merger, just as assets of a partnership may be revalued immediately prior to a tax-free contribution or distribution of property), and then the merger itself could be treated as being beyond the proper scope of section 704(c)(1)(A), and thus outside the scope of sections 704(c)(1)(B) and 737 (the “Anti-Mixing Bowl Rules”).


On April 12, 2004, the IRS issued Revenue Ruling 2004-4313, which adopted a very different interpretation of the “to the same extent” language. In Revenue Ruling 2004-43, the Service concluded that an asset contributed to a partnership and then

13 2004-1 C.B. 842.
transferred from the first partnership to a second partnership in an assets-over merger has two distinct layers of 704(c)(1)(A) gain: the 704(c) Pre-Merger Layer (the variation between fair market value and basis at the time the property was contributed to the first partnership) and the 704(c) Merger Layer (the variation between fair market value and book value as recorded on the books of the transferor partnership as of the date of the merger). Surprisingly, Revenue Ruling 2004-43 made no attempt to square its conclusion with the “to the same extent” language in the existing regulations.

Revenue Ruling 2004-43 also made no attempt to explain why it rejected a literal interpretation of the relevant statutory language in section 704(c)(1)(A). Under section 704(c)(1)(A), the partners must properly account for the variation between the fair market value of contributed property and its adjusted basis at the time of contribution. Under section 704(c)(1)(B), this variation is allocated to the contributing partner if the contributed property is distributed to another partner within seven years of the contribution. If an assets-over merger is treated as the contribution of assets from the transferor partnership to the transferee partnership, then a literal application of the statute would create a new, single layer of section 704(c) gain with a fresh, seven-year window for the application of sections 704(c)(1)(B) and 737. If an assets-over merger is not treated as an asset transfer, then there is no statutory basis for creating any section 704(c) gain on the transaction. Revenue Ruling 2004-43 treats some but not all of the variation

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15 Without any further elaboration, Revenue Ruling 2004-43 concluded that “[Regulations s]ection 1.704-4(c)(4) does not prevent the creation of new section 704(c) gain or loss when assets are contributed by one partnership to another partnership in an assets-over merger.”
between book value and adjusted basis as a fresh layer of section 704(c) gain, a result seemingly inconsistent with the statutory language. If the drafters of Revenue Ruling 2004-43 did not feel constrained by the “to the same extent” language of existing regulations to conclude that no new 704(e) gain was created by the merger, it is hard to understand how the precise conclusion of Revenue Ruling 2004-43 was reached.

The outcry over Revenue Ruling 2004-43 was immediate. Two points were almost universally accepted by practitioners and academics alike: (1) the conclusions reached in Revenue Ruling 2004-43 were inconsistent with existing regulatory authority; and (2) application of Revenue Ruling 2004-43 to existing transactions was inappropriate.

In response, the IRS issued Revenue Ruling 2005-10 on January 19, 2005, declaring its intent to issue proposed regulations (as described in Notice 2005-15) and revoking Revenue Ruling 2004-43. On the same day, the IRS issued Notice 2005-

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18 2005-1 C.B. 492.
Notice 2005-15 states that the proposed regulations referenced in Revenue Ruling 2005-10 will be issued under sections 704 and 737 and will apply the principles of Ruling 2004-43 to distributions of property following assets-over partnership mergers. Notice 2005-15 provides that the new regulations will be effective for distributions occurring after January 19, 2005.

Notice 2005-15 also announces that the new regulations will provide a related party exception. Under this exception, section 704(c)(1)(B) will not apply to, and section 737(b) net precontribution gain will not include, newly created section 704(c) gain or loss in property contributed by the transferor partnership to the transferee partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In order for merging partnerships to qualify for this exception, each partner’s percentage interest in the transferor partnership’s capital, profits, losses, distributions, liabilities, and all other items must be the same as the partner’s percentage interest in those items of the continuing partnerships.

PROPOSALS AND ANALYSIS

I. The Approach of Revenue Ruling 2004–43 Should Be Rejected

Sections 704(c)(1)(A), 704(c)(1)(B) and 737 work together to ensure a single goal: pre-contribution unrealized gain and loss in contributed property ultimately should be taxed to the contributing partner. Revenue Ruling 2004-43 would have extended the reach of these sections to encompass post-contribution unrealized gain and

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19 2005-1 C.B. 527.
A. No New Section 704(c) Gain Should Be Created in an Assets-Over Merger

When two partnerships merge in an assets-over merger, any section 704(c) Pre-Merger Layer should continue after the merger. This occurs automatically with respect to assets held prior to the merger by the transferee partnership, and the same rule should apply to assets held by the transferor partnership immediately prior to the merger. Because the existing step-into-the-shoes rule preserves the connection between pre-contribution unrealized gain (or loss) and the contributing partner, no new rule is needed.

Section 704(c)(1)(A) ensures that gains and losses accruing outside of a partnership cannot be shifted to another taxpayer by contributing appreciated or loss property to a partnership in anticipation of sale. Sections 704(c)(1)(B) and 737 backstop section 704(c)(1)(A) by taxing the contributing partner on pre-contribution gain if the link between the contributing partner and the contributed property is broken by distribution of the contributed property to another partner or by distribution of other property to the contributing partner. None of these provisions, however, speaks to the
allocation of post-contribution appreciation or loss among the partners. Indeed, such
post-contribution appreciation may even be allocated to a partner who joined the venture
after the post-contribution appreciation accrued.

Consider the case of property purchased by the transferor partnership for
cash prior to the merger. Such property could be distributed to any partner of the
transferor partnership prior to the merger without implicating section 704(c)(1)(B). But
if that property were distributed in the same transaction (that is, to a prior member of the
transferor partnership) after the merger, the transaction would become taxable to the
other members of the transferor partnership. Such a rule would discourage the
combination of business activities through the form of partnership mergers for no
discernable reason.

If property held by the transferor partnership were distributed to a new
partner (that is, to a member of the transferee partnership only), the distribution still
should not trigger taxation under section 704(c)(1)(B). Section 704(c)(1)(B) backstops
section 704(c)(1)(A) to ensure that pre-contribution gain is taxed to the contributing
partner if contributed property is distributed within seven years of contribution. A
distribution that breaks the connection between the contributing partner and the
contributed property is subject to taxation under section 704(c)(1)(B) without regard to
how long the distributee partner has been invested in the venture. That is, it is the timing
of the distribution and not the length of time over which the distributee has held its
interest in the partnership that triggers taxation under section 704(c)(1)(B). Accordingly,
if a distribution to a former partner of the transferor partnership should not be subject to
section 704(c)(1)(B), then a distribution to any other partner also should escape the reach
of section 704(c)(1)(A). In the case of property purchased directly by the transferor partnership, there simply is no pre-contribution gain to which section 704(c)(1)(B) should attach.

To be sure, in an assets-over partnership merger there is a nominal transfer of assets from the transferor partnership to the transferee partnership, and a literal application of section 704(c)(1)(B) could therefore capture the entire variation between adjusted basis and fair market value existing at the time of the merger. Even Revenue Ruling 2004-43 does not go this far, and with good reason. Because the transferor partnership disappears as a result of the merger, the transferee partnership essentially steps into the shoes of the transferor partnership. This ensures that the connection between any property contributed to the transferor partnership and the partner who contributed it remains unbroken; thus a step-into-the-shoes rule for section 704(c)(1)(B) is all that is needed to protect the integrity of section 704(c)(1)(A). Such a rule already exists in the plain meaning of the “to the same extent” language in the existing regulations.

Notice 2005-15 includes a statement that forthcoming regulations following the approach of Revenue Ruling 2004-43 will include an exception for a merger in which the transferor and transferee partnerships are owned by the same partners in the same proportions. This exception plainly is based on the notion that if

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20 The provisions in existing regulations providing that no new 704(c) gain is created on an assets-over merger, Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(3), plainly fall within the broad grant of administrative authority found in the express introductory language of section 704(c)(1) providing that the application of section 704(c)(1) shall be determined “[u]nder regulations prescribed by the Secretary.” This grant of regulatory authority applies equally to the application of section 737 because that section expressly incorporates section 704(c)(1)(B) in the definition of “net precontribution gain” in section 737(b).
there is identical ownership of both partnerships, the merger represents a mere change in
form and should have no substantive implications. Such an exception makes sense, but its
underlying reasoning demonstrates the weakness in the approach of Revenue Ruling
2004-43. The justification for section 704(c)(1)(B) was to prevent (within seven years)
the separation of pre-contribution unrealized gain or loss in contributed property from the
contributing partner prior to recognition of that gain or loss.

If the contributed property is distributed to any partner other than the
contributing partner, the distribution causes a separation of the pre-contribution gain or
loss from the contributing partner. *This is true without regard to the profit and loss
percentages of the distributee partner, the contributing partner, or any other partner.* A
partnership merger is properly considered a mere change in form for purposes of section
704(c)(1)(B) because one partnership is substituted for another without regard to the
partners’ shares of profits, loss or capital (shares which, after all, can change on a daily
basis).

**B. Creating New 704(c) Gain in An Assets-Over Merger Will Introduce
Inappropriate Complexity into an Already Overly-Complex Area**

As indicated below, if new 704(c) gain is created by the transfer of assets
in an assets-over merger, then subsidiary rules must be created to take account of
depreciable property, the ceiling rule limitation, and long-aged property. 21 Additional
problems likely will arise if such property has been revalued by the partnership prior to

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21 See part III below.
the merger. Because the existence of section 704(c) gain affects so many other rules (including, for example, the allocation of nonrecourse debt and the amortization of intangible property), resolution of these problems likely will lead to additional and unforeseen complexities. Indeed, creation of new forward 704(c) gain will have a particularly dramatic impact on partnerships having exempt organizations as partners.

The rules governing section 704(c) are complex enough. Creating yet another layer of section 704(c) gain – part new forward gain, part old forward gain – adds complexity to an area that cries out for simplification. This complexity would not respond to any perceived tax abuse or partnership loophole. On the contrary, reaffirming the plain meaning of the “to the same extent” language in existing regulations would do no more than permit partnerships to merge without adversely affecting their partners. Taxpayers can avoid the creation of fresh 704(c) gain by eschewing partnership mergers; rejecting Revenue Ruling 2004-43 will permit taxpayers to repackage their business ventures as business needs dictate in a tax-neutral way. There is no reason to add complex new rules to disadvantage taxpayers who engage in common business transactions for legitimate business reasons. Sections 704(c)(1)(A), 704(c)(1)(B) and 737 will apply to such taxpayers after an assets-over merger precisely as they would have applied before the merger. In this context, simplicity and tax policy coincide.

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22 Revenue Ruling 2004-43 does not address the extent to which reverse 704(c) gain arising from a pre-merger asset revaluation (the “Reverse 704(c) Layer”) is converted into forward 704(c) gain if the revalued asset is transferred as part of an assets-over merger.


24 See Treas. Reg. § 1.514-2(c)(1)(i) (ignoring 704(c) gain for fraction rule computations).
II. **If New Regulations Will Follow the Approach of Revenue Ruling 2004-43, Such Regulations Should Apply Only to Mergers On or After the Announcement of Notice 2005-15**

Notice 2005-15 (the “Notice”) indicates that any regulations promulgated to implement the approach of Revenue Ruling 2004-43 will be effective “for distributions from partnerships made after January 19, 2005,” the date on which Notice 2005-15 was issued. Adopting this effective date is presumably intended to avoid a retroactive effect to regulations which adopt a position that is inconsistent with the prevailing interpretation among practitioners and academics of the “to the same extent” language of the Subsequent Distribution Rule. Regulations generally must be prospective in their application under the general rule of section 7805(b)(1).

Tying the effective date to “distributions” is unfortunate and unfair. Rather, the new regulations, if finalized, should not apply to mergers taking place prior to January 19, 2005. Such regulations will adopt a rule inconsistent with current law as understood by virtually all practitioners. Based on the prevailing understanding of the Subsequent Distribution Rule, partnership mergers were executed without any awareness that significant adverse tax consequences might follow from the transaction. The precise point of such new regulations, after all, is to establish a regime in which post-merger distributions of property will be subjected to the Anti-Mixing Bowl Rules even though the same distributions would escape those provisions if the merger did not occur. Given this radical change in the tax landscape, it is inappropriate to apply the new regime to mergers which were consummated without knowledge that adverse tax consequences would result from the merger.
Existing regulations speak directly to the issue that will be addressed by these new regulations. These existing regulations provide that a distribution of property made by the transferee partnership subsequent to an assets-over merger will be subject to section 704(c)(1)(B) and 737 “to the same extent” as a distribution made by the transferor partnership prior to the merger. Thus, the new regulations will not clarify an existing area of the law in which guidance was lacking but rather will reverse the law in which guidance seemingly was clear. Taxpayers who consummated transactions in reliance on such specific guidance should not be prejudiced by the government’s reversal of position. Taxpayers made their decisions to merge partnerships based on the tax consequences of the merger as specified in final, effective regulations. Changing those tax consequences after the merger has occurred is not fair.

III. **If New Regulations Will Follow the Approach of Revenue Ruling 2004-43, They Should Be Narrowly-Tailored to Meet The Objectives of Revenue Ruling 2004-43**

A. **Exceptions Where Same Persons Own Interests In Each Merging Partnership**

The Notice provides that any new regulations will provide that section 704(c)(1)(B) does not apply to, and, for purposes of section 737, net precontribution gain does not include, newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. The Notice further provides that, for merging partnerships to qualify for the exceptions described in this paragraph (the “Equal Interests Exception”), each partner’s percentage interest in the transferor partnership’s capital, profits, losses, distributions, liabilities, and all other items
must be the same as the partner’s percentage interest in those items of the continuing partnership. We believe that the Equal Interests Exception will apply in very few situations.

**Example 1 – Equal Interests Exception under the Notice – Requirements Satisfied.** Same facts as Situation 1 of Revenue Ruling 2004-43, except that C and D own both AB and CD in the same proportions. Because (i) C and D were partners in both AB and CD, (ii) C owned AB in the same proportion C owned CD, (iii) D owned AB in the same proportion D owned CD, and (iv) C’s and D’s percentage interest in CD’s items is the same as C’s and D’s percentage interest in those items of AB after the Merger, the Anti-Mixing Bowl Rules will not apply to any 704(c) Merger Layer created in the AB Merger. So, for example, if AB distributes Asset 2 to D six years after the Merger, C will not recognize gain under the Anti-Mixing Bowl Rules with respect to the 704(c) Pre-Merger Layer because the distribution occurs more than seven years after C’s contribution of Asset 2 to CD. In addition, the Reverse 704(c) Layer is not included in determining D’s net precontribution gain because reverse section 704(c) gain is excluded from net precontribution gain. Accordingly, the distribution will not cause D to recognize gain under section 737. Finally, because C and D satisfy the requirements of Treasury’s Equal Interests Exception, the Anti-Mixing Bowl Rules will not apply to the 704(c) Merger Layer.

**Example 2 – Equal Interests Exception under the Notice – Requirements Not Satisfied.** Same facts as Situation 1 of Revenue Ruling 2004-43, except that C and D each own a fifty percent interest AB. Further, on the date of formation, D contributed $202 of cash to CD.

Although C and D were partners in both AB and CD, C and D did not own AB in the same proportion C and D owned CD. That is, C and D each owned a fifty percent interest in AB, but C owned a 49.75 percent interest, and D owned a 50.25 percent interest, in CD. Accordingly, under a plain reading of the Equal Interests Exception provided in the Notice, the Anti-Mixing Bowl Rules would apply to the 704(c) Merger Layer created in the Merger.
Thus, after the Merger, because C and D shared CD profits 49.75/50.25, respectively, C and D share the 704(c) Merger Layer 49.75/50.25, respectively. As a result, six years later, when AB distributes Asset 2 to D, both C and D will recognize gain in connection with the distribution of Asset 2. More specifically, C will recognize $199\text{25}$ under section 704(c)(1)(B) because the distribution of Asset 2 occurs within seven years of the Merger and because C and D did not satisfy the requirement of the Equal Interests Exception contained in the Notice.

As Examples 1 and 2 illustrate, the exception provided in the Notice provides little flexibility and will find little application in practice. We find the disparate treatment to C and D in Examples 1 and 2 to be incongruous. In our view, there is no policy reason for the different results. We submit that there are policy reasons justifying more or less equal treatment.

If Treasury and the IRS adopt a Substantially Equal Interests Exception, as opposed to the Equal Interests Exception, the inequities demonstrated in Example 2 will be remedied in a significant number of cases. Under the “Substantially Equal Interests Rule,” Section 704(c)(1)(B) would not apply to, and, for purposes of section 737, net precontribution gain would not include, newly created section 704(c) gain or loss in property contributed by the transferor partnership to the transferee partnership in assets-over partnership mergers involving partnerships in which the same persons own eighty percent (80%) or more of the interests in the capital and profits of each of the merging partnerships.

Though the Substantially Equal Interests Rule is administratively better and more equitable than the Equal Interests Exception, there would still be cases in which

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25 49.75% of the $400 704(c) Merger Layer.
differences between taxpayers would be based upon an arbitrary cut-off, rather than a solid policy-based approach. For that reason, we recommend that, in addition to the Substantially Equal Interests Rule, the Treasury and the IRS adopt the Continuity Rule. This rule, which is described in the following paragraphs, is a policy-based exception to the general application of the principles of Revenue Ruling 2004-43.

B. Continuity Rule

We believe that the application of Revenue Ruling 2004-43’s principles, even as limited by the Substantially Equal Interests Rule, unduly restrict transactions the Subchapter K rules are designed to accommodate. For this reason, we propose that, in addition to the Substantially Equal Interests Exception, the proposed regulations include the Continuity Rule. While the Continuity Rule is more complex than either the Equal Interests Exception or the Substantially Equal Interests Rule, if the principles of Revenue Ruling 2004-43 are incorporated into proposed regulations we believe the additional complexity that would be required to implement the Continuity Rule is warranted to advance significant purposes of Subchapter K.

The Continuity Rule is, in a nutshell, the Subsequent Distribution Rule applied to the Pre-Merger 704(c) Layer and the 704(c) Merger Layer, but only as to certain distributions. These are distributions of property contributed by a terminated partnership to one or more former partners of such partnership.

Mechanically, the Continuity Rule works as follows: if property that was contributed by a terminated partnership to the resulting partnership is distributed by the resulting partnership to a former partner of the terminated partnership, then section 704(c)(1)(B) and 737 apply as if the terminated partnership had distributed that property
to that former partner. The Continuity Rule as applied is illustrated in the following example:

**Example 3 – Continuity Rule.** Same facts as Situation 1 of Revenue Ruling 2004-43, except that AB distributes Asset 2 to D. Immediately prior to the distribution, AB held Asset 1 with a fair market value of $1900 (i.e., since the Merger, Asset 1 has appreciated $1000). Immediately before AB distributes Asset 2 to D, AB revalues its property and adjusts the capital accounts of the partners accordingly. (D’s capital account is increased to $600.)

Under the Continuity Rule, the tax consequences to C and D under the Anti-Mixing Bowl Rules resulting from AB’s distribution of Asset 2 to D will be determined as if CD distributed Asset 2 to D. If the Merger had not occurred and CD distributed Asset 2 to D, neither C nor D would have recognized gain under the Anti-Mixing Bowl Rules. C would not have recognized any gain under section 704(c)(1)(B) because C contributed Asset 2 to CD more than seven years before the distribution of Asset 1. Further, section 704(c)(1)(B) would not have applied to the CD 704(c) Merger Layer (i.e., the 704(b) gain in CD) if Asset 2 had been distributed to D. D would not have recognized gain under section 737 because D did not have any net precontribution gain with respect to CD; D did not contribute section 704(c) property to CD.

Without this rule, both C and D would recognize $200 of gain – the same amount of gain C and D recognized in Situation 1 of Revenue Ruling 2004-43. The gain realized relates solely to the 704(c) Merger Layer (formerly, the 704(b) gain in CD). C’s gain is realized under section 704(c)(1)(B): $200 equal to C’s share of section 704(c) gain created on the Merger. D realizes $200 under section 737 on account of precontribution gain equal to D’s share of the section 704(c) gain created in connection with the Merger.

Adopting the Continuity Rule permits certain distributions of a terminated partnership’s property without undermining the aims of Revenue Ruling 2004-43. In addition, adopting the Continuity Rule would serve to minimize the disparate treatment
of partners of the transferor partnership and partners of the transferee partnership (assuming, as we believe should be the case, that the principles of Revenue Ruling 2004-43 should not be applied to the partners of the transferee partnership). Accordingly, we recommend that the proposed regulations, if issued, provide that if property that was contributed by a terminated partnership to the resulting partnership is distributed by the resulting partnership to a former partner of that terminated partnership, then the distribution is treated, for Anti-Mixing Bowl Rules purposes, as if the terminated partnership had distributed that property to that former partner.

If only a portion of section 704(c) property is distributed, it becomes necessary to determine the order in which the section 704(c) layers comprising such property are distributed. Accordingly, we believe that a rule (the “Ordering Rule”) must apply to the Continuity Rule in order to determine how the Anti-Mixing Bowl Rules should apply to such a distribution. The Ordering Rule is designed to produce the same tax results as would occur under the Undivided Interests Rules.\(^{26}\) Accordingly, the Ordering Rule will first take into account all section 704(c) layers attributable to property actually or constructively contributed by the distributee partner. First, the distributing partnership will be treated as distributing property with the 704(c) Merger Layers deemed contributed to such partnership by the distributee partner. Once that layer is exhausted, the distributing partnership will be treated as distributing any property with section 704(c) Pre-Merger Layers contributed by the distributee partner more than seven years

\(^{26}\) Treas. Reg. §§ 1.704-4(c)(6),and 1.737-2(d)(4). The Undivided Interest Rules provide that the Anti-Mixing Bowl Rules do not apply to the distribution of an undivided interest in property to the extent that the undivided interest distributed does not exceed the undivided interest, if any, contributed by the distributee partner in the same property.
before the distribution. After this layer is exhausted, the distributing partnership is
treated as distributing property with 704(c) Merger Layers actually or constructively
contributed by non-distributee partners. Finally, after this layer is exhausted, the
distributing partnership is deemed to distribute property relating to all other section
704(c) layers actually or constructively contributed by non-distributee partners.²⁷

The operation of the Ordering Rule as applied to the Continuity Rule can
be illustrated by the following two examples.

**Example 4 – Ordering Rule.** Same facts as Situation 1 of
Revenue Ruling 2004-43, except that AB distributes $400
of Asset 2 to D.

The Continuity Rule will first test the distribution as if it
had been made by CD in absence of the Merger. Because
AB’s distribution of Asset 2 to D was made eight years
after C contributed Asset 2 to CD, C will not realize any
gain under section 704(c)(1)(B) attributable to the 704(c)
Pre-Merger Layer of the distributed property.

Under the Ordering Rule, AB will be treated as first
distributing the amount of Asset 2 that relates to the 704(c)
Merger Layer deemed contributed by D. Consequently, D
will be deemed to receive an amount of Asset 2 attributable
to its $200 share of the 704(c) Merger Layer. Under the
Continuity Rule, D should not recognize gain on such
distribution under the Anti-Mixing Bowl Rules because D
did not contribute section 704(c) property to CD.²⁸

The Ordering Rule would then take into account any 704(c)
Layers relating to property contributed by D more than

²⁷ We acknowledge that there may be more than one distributee partner. In such a case, a partner
may be both a distributee partner and a non-distributee partner for purposes of the Ordering Rule. We
believe the Ordering Rule should be applied in such cases so that each distributee partner receives a pro
rata share of each 704(c) layer.

²⁸ Note that if D had contributed 704(c) property to CD, D would have recognized gain under section
737 despite the application of the Continuity Rule because the exception would test the distribution as if
made by CD in absence of the Merger.
seven years before the distribution. There are no such Section 704(c) Layers in Asset 2.

The Ordering Rule would then provide that an amount of Asset 2 that relates to C’s share of the 704(c) Merger Layer should be taken into account. Consequently, D will then be deemed to receive an amount of Asset 2 attributable to C’s $200 share of the 704(c) Merger Layer.

The $200 of Asset 2 remaining in AB should be that part of Asset 2 that relates to C’s 704(c) Pre-Merger Layer, which, as noted above, is no longer within the seven-year period.

Example 5 – Ordering Rule. Same facts as Situation 1 of Revenue Ruling 2004-43, except that AB distributes $400 of Asset 2 to D four years after the Merger.

The Continuity Rule will first test the distribution as if it had been made by CD in absence of the Merger. In this example, the distribution was made six years after the contribution of Asset 2 to CD. Thus, C’s $100 704(c) Pre-Merger Layer is subject to the seven-year period of section 704(c)(1)(B). Accordingly, the Continuity Rule should first treat AB’s distribution of Asset 2 as causing $66 of C’s 704(c) Pre-Merger Layer to be recognized.29 Under the Ordering Rule, as in Example 9, D will be deemed to first receive an amount of Asset 2 that relates to its $200 share of the 704(c) Merger Layer. Finally, the remaining $200 of Asset 2 distributed to D should be an amount of Asset 2 that relates to C’s share of the 704(c) Merger Layer.

The $200 of Asset 2 remaining in AB should include that part of Asset 2 that relates to C’s original contribution to CD with a remaining section 704(c) amount equal to $34.

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29 D should be deemed to receive $66 of C’s $100 704(c) Pre-Merger Layer, equal to the proportionate two-thirds of Asset 2 distributed ($400/$600).
IV. If New Regulations Will Follow the Approach of Revenue Ruling 2004-43, Additional Guidance Must Be Provided to Address Aged Property, Depreciable Property, and the Ceiling Rule Limitation

Revenue Ruling 2004-43 considered only the case of nondepreciable, appreciated property that was held by the transferor partnership less than seven years. If proposed regulations continue the approach of Revenue Ruling 2004-43, they should provide guidance in a broader range of circumstances.

A. Aged Property

Suppose nondepreciable Blackacre is contributed to the P partnership. At the time of the contribution, Blackacre has an adjusted basis of $4,000 and a fair market value of $10,000. More than seven years later, Blackacre is transferred as part of an assets-over merger. At the time of the merger, Blackacre has an adjusted basis in the hands of the partnership of $4,000 and a fair market value of $12,000. The regulations, if issued, should provide that if Blackacre subsequently is distributed in a transaction implicating section 704(c)(1)(B) or 737, the 704(c) Merger Layer gain should equal $2,000, the spread between the property’s book value at the time of the merger ($12,000) and its book value at the time of contribution ($10,000).

B. Depreciable Property

If depreciable property is contributed to a partnership, any section 704(c) gain will be reduced over time as the property is depreciated differently for book and tax purposes.\(^{30}\) For example, suppose property with fair market value of $10,000 and

\(^{30}\) See, e.g., Treas. Reg. § 1.704-3(b)(2) (example 1).
adjusted basis of $4,000 is contributed to the P partnership in exchange for a partnership interest. Assume that the partnership will depreciate the property using the “traditional” section 704(c) recovery method, and that for tax purposes the property is depreciable over 10 years using the straight-line method. Accordingly, after one year the property will have a book value of $9,000 and an adjusted basis in the hands of the partnership of $3,600. Assume that the property continues to be worth $10,000.

If the property is now transferred as part of an assets-over merger, the book/tax disparity equals $6,400 while the remaining, pre-merger 704(c) gain in the property equals $5,400. Is there a new, post-merger layer of 704(c) gain equal to $1,000 (that being the excess of fair market value of the property over the book value at the time of the merger), or is it equal to $0 (because the property has not appreciated in the hands of the partnership)? If the post-merger layer is $1,000, then contributed property will be treated more harshly the longer it is held by the partnership (since pre-merger 704(c) gain will be converted into post-merger 704(c) gain, restarting the seven-year windows of sections 704(c)(1)(B) and 737).

C. The Ceiling Rule Limitation

Suppose nondepreciable Blackacre is contributed to the P partnership with an adjusted basis of $4,000 and a fair market value of $10,000. When Blackacre is worth only $9,000, it is transferred as part of an assets-over merger. If Blackacre is subsequently distributed in a transaction implicating section 704(c)(1)(B), and if Blackacre is worth $10,000 at the time of this distribution, is the 704(c) gain on the distribution equal to $6,000 (the pre-merger amount) or $5,000 (the post-merger amount).
Is the property treated as having both a built-in gain and a built-in loss for purposes of sections 704(c)(1)(A) and 737?