Intersecting Corporate and Partnership Tax Techniques

By Robert W. Wood • Wood LLP • San Francisco

Old timers like me will remember Internal Revenue Code Section ("Code Sec.") 337 which, before 1986, provided a sleek 12-month corporate liquidation rule. It was easy, it was incredibly useful, and it was even relatively free of traps that could trip you up. You could sell assets and liquidate and avoid corporate-level tax within the confines of a manageable time period and with nearly certain results both from a corporate and tax perspective.

Curiously, it was even somewhat related (*via* its former colleague Code Sec. 334(b)(2)) to the enactment of Code Sec. 338 (still with us), so that companies would not necessarily have to actually liquidate to get a basis step-up after a purchase. All that has changed of course. With the repeal of the *General Utilities* doctrine that previously shielded corporations from entity-level tax on a liquidation done correctly, Code Sec. 337 was consigned to tax history.

Now, Code Sec. 337(d) gives authority for regulations to prevent appreciated property from leaving corporations in a way that would achieve a basis step-up without the collection of

a corporate-level tax on the appreciation. Way back in 1989, the IRS invoked Code Sec. 337(d). The May Department Stores Company and investors used a partnership to redeem company stock with appreciated property, hoping to avoid recognizing corporate level gain. The IRS response was Notice 89-37, 1989-1 CB 679.

In that notice, the IRS warned that regulations would be issued calling for gain recognition by corporate partners under described circumstances. The notice included a deemed redemption rule and a distribution rule. In the first, appreciated property would be contributed by a corporate partner to a partnership.

Another partner would contribute the corporate partner's stock. The distribution rule covered partnership distributions of a corporate partner's stock. Proposed regulations came along in late 1992 and are often labeled the May Company Regulations.

If a partnership directly or indirectly owns, acquires or distributes the stock of a partner, beware of their application. If the transaction has the economic effect of an exchange by a partner of its interest in appreciated property for an interest in that partner's stock, it is treated as a taxable exchange. Moreover, if a partnership distributes stock of a partner to that partner, it is a taxable redemption. It may be complete or partial, but it is a redemption and therefore taxable.

Amazingly, 20 years after the May Company Regulations were proposed, they remain just that. They are still only proposed. With a kind of *in terrorem* overlook, corporate taxpayers are not supposed to be able to use partnerships to avoid gain that is required to be recognized under Code Sec. 311 or 337(d). That sounds, and is, pretty broad.

With a little more specificity, Reg. §1.337(d)-3(a) states that a partner must recognize gain when the partner is treated as increasing its interest in its own stock (or an affiliate's stock) in exchange for appreciated property. Again, that is broad.

Of course, the partnership tax rules are notoriously complex, far more nuanced to most eyes than corporate tax rules. It is why so many putative tax shelters and so many other putatively aggressive transactions involve partnerships. In fact, it is hard to think of one that does not.

In an upcoming issue of the M&A TAX REPORT we'll examine what remains of the post-*General Utilities* partnership tax planning in the area of corporate acquisitions. Stay tuned.

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