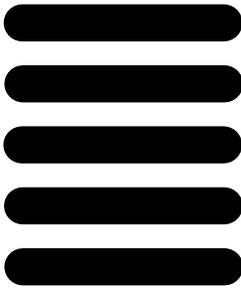




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## Built-in Gain Rules and Partnership Mergers

By Robert W. Wood • Wood & Porter • San Francisco

M&A TAX REPORT readers know that corporate tax rules are not the only weapon M&A tax practitioners need these days. Partnerships aren't just for real estate deals, after all. Nor are partnerships only of interest to the current target du jour, private equity.

Thus, M&A TAX REPORT readers should take note of the IRS's release of proposed regulations dealing with how the built-in gain rules of Code Sec. 704(c) and Code Sec. 737 apply to distributions of property pursuant to certain partnership mergers.

Partnerships can merge in several different ways. One common method is where two partnerships engage in an "assets-over" merger. What is an assets-over merger, you might well ask?

### New Nomenclature

Basically, in an assets-over partnership merger, the terminating partnership will contribute (or be deemed to contribute) all its assets to the resulting (surviving) partnership in exchange for an interest in the resulting partnership. The terminating partnership then distributes (or is deemed to distribute) the interests in the resulting partnership to its partners in complete liquidation of their interests in the terminating partnership. The basis of the assets transferred from a merging partnership to the resulting post-merger partnership is not re-computed.

Instead, the basis is carried over to the resulting partnership post-merger. The partners in the merging partnership receive an interest in the post-merger partnership (in a liquidating distribution). That means the partners' bases in their old partnership interest will become their basis in their post-merger partnership interest.

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## Statutory Scheme

Where the basis of property that is contributed to a partnership by a partner is different from the fair market value of the property as of the date of contribution (in other words, where there is a built-in gain or a built-in loss on the asset), there are certain consequences. The concern, of course, is that taxpayers might manipulate who gets taxed on this inherent built-in gain, and/or who gets the benefit of a built-in loss.

As a result, if the partnership distributes the contributed property to a partner other than the contributing partner within seven years of the contribution of that property to the partnership, the distributed property will be treated as sold.

It will be treated as sold for the property's fair market value on the date of the distribution. The contributing partner will have to recognize any gain (or loss) from this constructive sale

in an amount equal to the gain (or loss) that would have been allocated to him had the property *actually* been sold. [See Code Sec. 704(c)(1)(B).]

However, if property is distributed to the partner who contributed it, he will recognize gain in an amount equal to the lesser of:

- the excess of the fair market value of the property over the adjusted basis of that partner's interest in the partnership immediately before the distribution (but reduced by money and marketable securities received); or
- the partner's net pre-contribution gain under Code Sec. 737(b). [See Code Sec. 737(a).]

## Old Guidance

There are a couple of rulings that are helpful in figuring out how this works. Rev. Rul. 2004-43, 2004-1 CB 842, explains how the built-in gain rules of Code Sec. 704 and Code Sec. 737 apply in assets-over partnership mergers. Commentators in 2004 quickly noted that this ruling seemed to be inconsistent with the regulations under Code Sec. 704(c)(1)(B) and Code Sec. 737. Plus, the observers argued that Rev. Rul. 2004-43 should in any case not be applied retroactively.

Thereafter, the IRS revoked Rev. Rul. 2004-43. Now, the proverbial other shoe has fallen, but this time the guidance is in the form of proposed regulations. Still, the preamble to the new proposed regulations notes that the IRS is implementing the principles originally enunciated in Rev. Rul. 2004-43.

## New Proposed Regs

The proposed regulations provide that following an assets-over merger, Code Sec. 704(c)(1)(B) and Code Sec. 737 will not apply to the transfer by a partnership of all of its assets and liabilities to another partnership, followed by a distribution of the interests in the transferee partnership in liquidation of the transferor partnership, as part of the same plan or arrangement. However, Code Sec. 704(c)(1)(B) does apply in the case of a subsequent distribution by the transferee partnership of Code Sec. 704(c) property that is contributed in the assets-over merger by the transferor partnership to the transferee partnership. The proposed regulations also



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say that Code Sec. 737 when a partner of the transferor partnership receives a subsequent distribution of property from the transferee partnership.

Note that the seven-year period will not restart with respect to the *original* Code Sec. 704(c) gain or loss as a result of a merger. However, with respect to any *new* Code Sec. 704(c) gain or loss, the proposed regulations provide that the seven-year period begins with the date of the merger. That means subsequent distributions of property (that have new Code Sec. 704(c) gain or loss) are subject to tax under Code Sec. 704(c)(1)(B) and 737, assuming such distributions occur within seven years of the merger.

### Original Contributor

Of course, no Code Sec. 704(c) gain or loss is recognized if property that was originally contributed to the transferor partnership is distributed to the original contributor of the property. However, if property has new Code Sec. 704(c) gain or loss, then a subsequent distribution of that property within seven years of the merger to one of the former partners of the transferor partnership (a former partner, let's say) would be subject to Code Sec. 704(c)(1)(B). Of course, that would be limited, applying only to the extent of the former partners' shares of such gain or loss.

There's also a proportionality principle here. If less than all of a Code Sec. 704(c) property is distributed, a proportionate amount of the original and new Code Sec. 704(c) gain or loss would be recognized. Likewise, if gain must be recognized under Code Sec. 737, a proportionate amount of original and new Code Sec. 704(c) gain would be recognized under Code Sec. 737.

The proposed regulations include a subsequent merger rule. Under it, if a transferee is subsequently merged, the new Code Sec. 704(c) gain or loss resulting from the *original* merger would be subject to Code Sec. 704(c)(1)(B) for seven years from the time of the original merger. Plus, the new Code Sec. 704(c) gain or loss that resulted from the subsequent merger would be subject to Code Sec. 704(c)(1)(B) for seven years from the time of the subsequent merger.

### De Minimis Rule

The proposed regulations would provide an identical ownership and a *de minimis* change in ownership exception to the Code Sec. 704(c) and Code Sec. 737 rules with respect to assets-over partnership mergers. A difference in ownership is *de minimis* if 97 percent of the interests in bank capital, items of income, gain, loss, deduction and credit, and share of distributions and liabilities of the transferor partnership and transferee partnership are owned by the same partners in the same proportions.

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**The overall caveat is that all methods must be consistent with the purposes of Code Sec. 704(b) and (c).**

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Keeping track of old and new Code Sec. 704(c) gain is clearly indicated. The proposed regulations permit taxpayers to distinguish between the two categories, and transferee partnerships may continue to use the Code Sec. 704(c) allocation method adopted by the transferor partnership, or may adopt another reasonable method. Any reasonable method can be adopted for the new Code Sec. 704(c) gain or loss. The overall caveat is that all methods must be consistent with the purposes of Code Sec. 704(b) and (c).

### Effective Date

These proposed regulations are set to apply for any distributions of property after January 19, 2005, if that property was contributed in an assets-over merger after May 3, 2004. Although these effective dates may seem awfully retroactive in scope, as noted above, bear in mind that there was 2004 and 2005 guidance on this issue. The provisions relating to the change in regulations to reflect the current seven-year (rather than five-year) rule are effective August 22, 2007.