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The M&A Tax Report

AUGUST 2013 VOLUME 22, NUMBER 1

The Monthly Review of Taxes, Trends & Techniques

IRS Takes Odd Stance on Entity Liquidations

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M&A practice often requires balancing several different legal regimes. This jack-of-all-trades triage can get particularly tricky when tax law comes into play. First, there is state corporate law, which provides the basic legal framework for corporate formation and organization.

Then, there are the federal laws regarding corporate governance, including securities regulation, which can provide an additional layer of legal and reporting requirements. Finally, there are the state and federal tax rules, which are often the most important considerations in M&A planning. Of course, tax law is famously complex.

It is made more so by the fact that the tax rules don't always follow the corporate law rules. For example, take the federal "check-the-box" tax rules. An entity might be a corporation for state law purposes, but be a partnership for federal tax purposes or *vice versa.* And states can have their own versions of the check-the-box rules. Sometimes the tax rules don't even follow the *tax rules themselves*.

The IRS has recently taken the surprising position that a liquidation for one tax law purpose may not be a liquidation for other tax law purposes. Specifically, the IRS has said that a liquidation for purposes of the Treasury Regulations regarding the selection of a tax matters partner (TMP) does *not mean* a liquidation under the Internal Revenue Code. Instead, the IRS claims that it means a liquidation under state law.

Of course, tax advisors all know—or thought they knew—that a liquidation for federal tax purposes controls. When a partnership converts to a single-member LLC, it terminates for federal tax purposes and is deemed to have liquidated. Nevertheless, the IRS argues that this does not count as a "liquidation" under its own TMP regulations in some cases.

When does this odd situation apply? If state law recognizes the entity's continued existence, the IRS claims that normal rules

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don't apply. The IRS's position shows how treacherous it can be to navigate simultaneously through several different legal regimes.

IRS Schizophrenia?

There is a dizzying array of IRS guidance, much of it labeled with acronyms or abbreviations. One of the most obscure is the NSAR, or Non-Docketed Service Advice Review. But like many other pieces of internal IRS guidance on technical issues, tax advisors read them and are pleased to have the IRS position.

Here, although it is better to know of an IRS position than to be caught unaware, the position seems gerrymandered. In 2011, the IRS issued NSAR 20111701F, which addressed, among other issues, whether the conversion of a TMP from a partnership to a single-member LLC terminated the TMP's ability to act on behalf of the partnership under the applicable regulations.

The M&A Tax Report
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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

The IRS concluded that it should not. However, the NSAR acknowledged that taxpayers may disagree. Plainly, the IRS knows that taxpayers argue with some force that such a conversion does result in a termination of the TMP's status. Indeed, the IRS recognized that under Internal Revenue Code Section ("Code Sec.") 708(b)(1)(A), a partnership is *terminated* if it is not carried on as a partnership by the partners.

Therefore, what must occur when a multiple-member LLC that is treated as a partnership for tax purposes becomes a single-member LLC? The partnership is surely terminated for tax purposes. But read on.

The NSAR scurries to get around this seemingly immutable conclusion by distinguishing between a *termination for tax purposes* and a *liquidation or dissolution for state law purposes*. The NSAR takes the position that the phrase "liquidation or dissolution" is referring to the latter. According to the IRS, a technical termination for federal tax purposes shouldn't terminate a TMP's authority.

Rev. Rul. 99-6

Perhaps there is a surface appeal to this. But the fresh paint peels away easily, such that the IRS may have trouble defending its distinction between a tax "termination" and a "liquidation."

After all, the IRS's own rulings reveal that there is no such distinction. In Rev. Rul. 99-6, IRB 1999-6, 6, the IRS considered the tax consequences of a partnership's conversion to a single-member LLC. The IRS concluded that when one partner purchases all the partnership interests, the partnership terminates and is deemed to make a "liquidating distribution of all of its assets" to the former partners.

The surviving partner is treated as acquiring the assets deemed to have been distributed to the exiting partners "in liquidation of" the exiting partners' interests. The ruling shows that there is no distinction for federal tax purposes between a partnership "termination" and a partnership "liquidation" in the context of the conversion of the entity into a single-member LLC. That unequivocal statement makes it difficult for the IRS to defend its position that a partnership termination does not constitute a "liquidation" for purposes of the TMP regulations.

Moreover, *G.A. Rauenhorst*, 119 TC 157, Dec. 54,899 (2002), holds flatly that the IRS *cannot* litigate positions that are contrary to its own revenue rulings. How, then, could the IRS argue that a partnership's conversion to a single-member LLC was not a liquidation? The IRS is hoist by its own petard.

Cablevision of Connecticut

Of course, where there's a will, there's a way. Despite the edict of Rev. Rul. 99-6, the IRS might take the position that not all liquidations are alike. A deemed liquidation for federal tax purposes, the IRS might theorize, is not the same as the real liquidation referred to in the TMP regulations.

On the surface, this argument might seem to have legs. In *Cablevision of Connecticut*, 65 TCM 2147, TC Memo. 1993-106 (1993), the Tax Court agreed with the IRS (albeit in a memorandum opinion) that an entity undergoing a deemed liquidation under the tax rules does not liquidate for purposes of the TMP rules. Therefore, the Tax Court said, it does not lose its TMP status.

However, the issue in *Cablevision of Connecticut* was whether a Code Sec. 338(h)(10) election caused a termination of TMP status. The taxpayer argued that the TMP's status had terminated because the effect of the election was to cause a deemed liquidation of the TMP under Code Sec. 332. The Tax Court noted that the relevant regulations provide that the new entity is treated as a continuation of the old because it is liable for the old entity's tax liabilities.

Accordingly, the Tax Court agreed with the IRS that a deemed liquidation does not cause a termination of the corporation's TMP status. In that sense, this could provide a reed of potential support for distinguishing between a "deemed" liquidation and a liquidation under the TMP regulations. On the other hand, it seems clear that a deemed liquidation under Code Sec. 338 is not remotely similar to a termination of a partnership for federal tax purposes.

In any case, it is interesting that the IRS does not refer to *Cablevision of Connecticut* in NSAR 20111701F. Perhaps it is because of the dramatically different context and business entities. In any event, a close inspection reveals that the decision does not offer the IRS any support in the partnership context. Again, *Cablevision of Connecticut* concerned a deemed liquidation of a *corporation*.

This is quite a different animal from a deemed liquidation of a partnership. For federal tax purposes, a partnership cannot exist without more than one partner—a point that is fundamental to the partnership provisions of the Internal Revenue Code. Moreover, the Tax Court's rationale that the new entity retains liability for the old tax liabilities and therefore its status as TMP is not terminated simply cannot apply to a partnership. Axiomatically, partnerships are not taxable entities.

In fact, this is explained in the very first section of Subchapter K of the Code. [*See* Code Sec. 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.")] As a result, a single-member LLC that resulted from the dissolution of a partnership could not retain the partnership's old tax liabilities.

There would simply be no continuing tax liabilities to retain. The basis for the Tax Court's holding in *Cablevision of Connecticut* is wholly inapplicable to partnership terminations under Code Sec. 708(b)(1)(A).

Federal vs. State Law

The IRS's principal argument in NSAR 20111701F is that state law—not federal law—controls TMP designations. Sure, a partnership dissolves or liquidates for federal tax purposes upon conversion to a single-member LLC, the IRS theorizes. Yet as long as state law recognizes that the entity continues, the IRS claims, its status as a TMP should continue.

The IRS points to Rev. Rul. 2004-88, 2004-2 CB 165, which provides that eligibility to be a TMP is determined under *state* law. Courts have generally looked to state law in questions regarding a TMP's authority. This makes sense because concepts of agency and contract law are clearly relevant. However, the courts have not looked to state law regarding TMP authority when it conflicts with federal tax law. [*Transpac Drilling Venture 1983-63*, ClsCt, 92-2 USTC ¶50,486, 26 ClsCt 1245, 1247 (1992); *Barbados #7*, 92 TC 804, 810–12, Dec. 45,612 (1989) (bankruptcy terminated TMP's authority under state law).]

This might be perceived as a tricky issue. Indeed, there does not appear to be any authority under the TMP regulations for *ignoring* a liquidation that occurs by operation of federal tax law. As such, when the TMP regulations refer to a "liquidation," one might ask whether they are referring to a liquidation for federal tax purposes, or to one under state law. The regulations do not expressly refer to state law.

However, without such an express reference, it is difficult to justify inferring one. This seems especially true in this context. It is generally accepted that a liquidation for federal tax purposes may not correspond to a liquidation for state law purposes. In *FEC Liquidating Corp.*, 77-1 USTC ¶9160, 212 CtCls 345 (1977), the Claims Court noted that certain terms such as "reorganization" can have a particular meaning in the tax context.

No matter how clear that meaning may be, they may have an entirely different meaning in a general sense. The Claims Court in *FEC* even discussed dissolution.

The court said that "nor does every corporate dissolution under state law qualify as a complete liquidation for tax purposes; conversely, the tax law may recognize a liquidation even though the corporate form survives under state law."

Depending on the context, the same term may contain two entirely different meanings. Not surprisingly, courts typically apply tax rules by referencing tax rules, not state law. [*See West Shore Fuel, Inc.*, CA-2, 79-1 USTC ¶9357, 598 F2d 1236 (1979): "But the proper tax treatment to be accorded this transaction depends upon how it should be characterized for purposes of I.R.C. §453, not upon how it may be characterized for state law merger purposes." (Citing authorities.)]

In *Community Bank*, CA-9, 87-2 USTC ¶9379, 819 F2d 940 (1987), the Ninth Circuit applied this same principle to interpreting Treasury Regulations. Indeed, the court noted that unless there is an *express* reference to state law, federal tax law should control. It is therefore difficult to see how a liquidation of a partnership for federal tax purposes would not qualify as a liquidation under the TMP regulations.

Moreover, whether a partnership exists for federal tax purposes is a matter of *federal law*, not state law. [*F.E. Tower*, SCt, 46-1 USTC ¶9189, 327 US 280, 287–88 (1946).] The Code takes precedence over local law and provides its own standards for determining whether a partnership exists. There is certainly no suggestion in the TMP regulations that the phrase "liquidation or dissolution" is meant to direct courts to *ignore* federal tax law on entity classification.

In fact, a review of the Treasury Regulations on partnership classification strongly suggests that federal law should control. For example, Reg. §301.7701-1(a)(1) states that an entity's separate status from its owners for federal tax purposes is a matter of federal tax law. It is *not dependent* upon whether the organization is recognized as an entity under local law.

Moreover, Reg. §1.704-1(b)(2)(ii)(g) specifically defines what constitutes a "liquidation" of a partnership, and does not reference state law. Rather, it refers to Code Sec. 708(b)(1). Under that provision, a partnership that becomes a single-member LLC is deemed to have liquidated. In short, the case for looking to federal tax law in interpreting the TMP regulations is compelling. The IRS's own regulations provide a definition for the term "liquidation," and there is no suggestion in the TMP regulations that any other dictionary should be used.

Delaware Law

Of course, the IRS's position in NSAR 20111701F assumes that state law controls. Yet it also goes a key step further. It assumes that state law would not recognize a partnership's conversion to a single-member LLC as a liquidation or dissolution.

This key IRS assumption itself has problems. In many states, tax rules follow federal rules. In that sense, state law is of little help to the IRS. For example, the NSAR itself uses the example of a Delaware LLC.

Delaware is an important and even omnipresent state given the number of business entities of nearly every variety that are formed under Delaware law. Delaware generally follows federal tax law on entity classification. The statute (30 Del. C. §1601(6)) defines a "pass-through entity" as any person "that is classified as a partnership under the Internal Revenue Code."

Delaware has a "check-the-box" regime modeled after the federal one. What's more, Delaware even issued a Technical Information Memorandum (TIM 98-1) clarifying that a single-member LLC *cannot* elect to be treated as a partnership. Therefore, a partnership that converts to a single-member LLC should be considered to have liquidated or dissolved. This is so under both federal and Delaware tax law, whether or not it follows as a matter of Delaware corporate law.

Conclusion

The IRS's position in the NSAR highlights the difficulty of balancing several different legal regimes when confronting choice of entity questions. The TMP regulations refer to "liquidations or dissolutions" but do not specify what law is to be consulted. Is it state tax law, federal tax law or state corporate law?

As courts have noted, a liquidation for federal tax purposes may not qualify as a liquidation for state law purposes, and *vice versa*. So how should the phrase be interpreted? And how should similar conflicts be resolved in the future?

Given this milieu, some of the IRS's confusion is understandable. Even so, the position it arrives at is awfully difficult to defend. It does not even correspond with the U.S. Supreme Court's instructions on interpreting tax rules: "State law controls, however, only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." [*Burnet v. Harmel*, SCt, 3 USTC ¶990, 287 US 103 (1932).]

Admittedly, the Supreme Court did not address what to do when state *tax* law says one thing and state *corporate* law says another. Nevertheless, the TMP regulations do not expressly or necessarily depend upon state law in this instance. Plainly, therefore, federal law should control.

In federal tax law (and even in Delaware tax law), a partnership's conversion to a single-member LLC constitutes a change in entity status and a dissolution and liquidation of the partnership. As a consequence, the partnership's TMP status should be recognized as having terminated. Strangely, the IRS does not agree.

M&A practitioners should stay on their toes when interpreting phrases in tax rules in this area and in others. There are many different legal regimes that can and do come into play. Sometimes the IRS would rather look to state law than its own tax rules. Sometimes the reverse. Be careful out there.