When the IRS Says a Liquidation Is Not a Liquidation

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In this article, the authors discuss the recent confusion over terminology in the regulations regarding the selection of tax matters partners and what constitutes a liquidation or dissolution.

Groucho: Now it says, the party of the second part of this contract shall be known in this contract as the party of the second part.

Chico: Well I don't know about that.

Groucho: Now what's the matter?

Chico: I no like the second party either.

Groucho: Well you should have come to the first party. We didn't get home 'til around four in the morning. I was blind for three days.

Chico: Hey, look! Why can't the first part of the second party be the second part of the first party? Then you got something.

— from *A Night at the Opera*

As almost everyone knows, ordinary English language and legal terminology are often significantly different. For example, the word "boot" means something different to a cobbler or computer user than to a tax lawyer. Even business people can be confused at times — a reorganization of a corporation means something distinct from a reorganization for tax purposes.

And when it comes to taxes, even the IRS can be unsure when a word or phrase in the tax rules deserves to be defined. For example, the term "physical injury" is not defined in the IRC or regulations, and litigation has been fulsome since the term was added to section 104 in 1996.[1]

Then there is the recent confusion over terminology employed in the byzantine regulations regarding the selection of tax matters partners (TMPs).[2] The regulations provide that in addition to other triggering events, the designation of a TMP terminates upon the "liquidation or dissolution of the tax matters partner, if the tax matters partner is an entity."[3]

This sounds straightforward, yet confusion arises over what constitutes a liquidation or dissolution. Is it an event that occurs by operation of state law? Or is it a liquidation or dissolution for federal tax purposes, which might include a deemed liquidation? This issue touches on broader questions of how to interpret tax regulations and statutes because courts generally require references to state or local law to be expressly stated in the tax rules.[4]

The IRS has recently taken the position that a termination of a partnership for federal tax purposes is not a liquidation or dissolution under the TMP regulations unless the entity also dissolves as a matter of state law. Given Delaware law on entity classification, it seems doubtful that the IRS is

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[1]Nina Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," at 356 (Dec. 31, 2009) ("Since the amendment of IRC section 104(a)(2) in 1996, the scientific and medical community has demonstrated that mental illnesses can have associated physical symptoms. Accordingly, conditions like depression or anxiety are a physical injury or sickness and damages and payments received on account of this sickness should be excluded from income. Including these damages in gross income ignores the physical manifestations of mental anguish, emotional distress, and pain and suffering").

[2]Reg. section 301.6231(a)(7)-1.

[3]Reg. section 301.6231(a)(7)-1(l)(1)(iii).

[4]*Burnet v. Harmel*, 287 U.S. 103 (1932).

correct to suggest that state law would produce a different outcome than federal law, at least for a Delaware limited liability company. Moreover, case law, IRS rulings, and federal tax regulations suggest that a termination of a partnership for federal tax purposes should qualify as a liquidation or dissolution. Thus, we believe it is clear that a termination of a partnership for federal tax purposes should terminate the partnership's TMP designation under the applicable regulations.

NSAR 20111701F

There is a dizzying array of IRS guidance on the subject, including the non-docketed service advice review (NSAR). In 2011 the IRS issued NSAR 20111701F, which addresses whether the conversion of a TMP from a partnership to a single-member LLC terminates the TMP's ability to act for the partnership under the applicable regulations.[5] The IRS concluded that it does not.

NSAR 20111701F acknowledges that taxpayers may argue that that type of conversion does result in a termination of the TMP's status. Indeed, under section 708(b)(1)(A), a partnership terminates if it is not carried on as a partnership by the partners. Therefore, when a multiple-member LLC that is treated as a partnership becomes a single-member LLC, the partnership terminates for tax purposes.

The guidance scurries to get around that problem 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'' refers to the latter. The IRS postulates that a technical termination for tax purposes shouldn't terminate a TMP's authority. But making that distinction is trickier than the IRS lets on.

Rev. Rul. 99-6

The IRS may have trouble defending its distinction between a tax termination and a liquidation because its own revenue rulings make clear that there is no such distinction. In Rev. Rul. 99-6, the IRS considered the tax consequences of a partnership's conversion to a single-member LLC.[6] The IRS concludes that with only two partners, when one partner purchases the other's interest, the partnership terminates and is deemed to make a liquidating distribution of all its assets to the former partners.[7] The surviving partner is treated as acquiring the assets deemed to have been distributed to the exiting partner in liquidation of the exiting partner's interest.

The revenue ruling suggests that there is no distinction for tax purposes between a partnership termination and a partnership liquidation in the context of a conversion to a single-member LLC. Therefore, it seems difficult for the IRS to defend its position that a partnership termination does not constitute a liquidation for purposes of the TMP regulations. Moreover, because the IRS cannot litigate contrary to its own revenue rulings, it would be hard-pressed to argue that a partnership's conversion to a single-member LLC is not a liquidation.[8]

Cablevision of Connecticut

Despite the edict of Rev. Rul. 99-6, the IRS might contend that a deemed liquidation for tax purposes is not the same as the liquidation referred to in the TMP regulations. In *Cablevision of Connecticut v. Commissioner*,[9] at the urging of the IRS, the Tax Court held in a memorandum opinion that an entity that has a deemed liquidation under the tax rules does not lose its TMP status.

Here, the issue was whether a section 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 section 338(h)(10) election was to cause a deemed liquidation of the TMP under section 332. The Tax Court, however, noted that the regulations provide that the new

[5]NSAR 20111701F.

[6]Rev. Rul. 99-6, 1999-1 C.B. 432 (''What are the federal income tax consequences if one person purchases all of the ownership interests in a domestic limited liability company (LLC) that is classified as a partnership under section 301.7701-3 of the Procedure and Administration Regulations, causing the LLC's status as a partnership to terminate under section 708(b)(1)(A) of the Internal Revenue Code?'').

[7]Rev. Rul. 99-6 (''Under the analysis of *McCaulsen* and Rev. Rul. 67-65, for purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest'').

[8]*Rauenhorst v. Commissioner*, 119 T.C. 157 (2002) (''To that end, the IRS has committed itself 'to increased and more timely published guidance,' in the form of revenue rulings and revenue procedures, in the hopes of achieving increased taxpayer compliance and resolving 'frequently disputed tax issues.' These stated goals will not be achieved if the Commissioner refuses to follow his own published guidance and argues in court proceedings that revenue rulings do not bind him or that his rulings are incorrect. Certainly, the Commissioner's failure to follow his own rulings would be unfair to those taxpayers, such as petitioners herein, who have relied on revenue rulings to structure their transactions. Moreover, it is highly inequitable to impose penalties, which respondent has done in this case. Accordingly, in this case, we shall not permit respondent to argue against his revenue ruling, and we shall treat his revenue ruling as a concession''). *See also* Internal Revenue Manual section 31.1.1.1.3 (''In contrast, litigation should be used as an enforcement tool to advance and defend established positions, not as a vehicle for making policy'').

[9]T.C. Memo. 1993-106 (1993).

entity is treated as a continuation of the old because it is liable for the old entity's tax liabilities.[10]

The Tax Court therefore agreed with the IRS that a deemed liquidation does not cause a termination of the corporation's TMP status. In that sense, there appears to be some general support for distinguishing between a deemed liquidation and a liquidation under the TMP regulations. The IRS does not refer to *Cablevision of Connecticut* in NSAR 20111701F, but the case does appear to support the position the IRS takes, at least at first glance.

On closer inspection, however, the decision does not offer the IRS any support in the partnership context. *Cablevision of Connecticut* concerned a section 332 deemed liquidation of a corporation, quite a different animal from a deemed liquidation of a partnership. Section 338(h)(10) is an elective allocation of tax liabilities for the purpose of matching inside and outside basis in a stock acquisition. Unlike the conversion of a partnership into a single-member LLC, the form of entity is not altered in a section 338(h)(10) election. The Tax Court's rationale, that the new entity retains liability for the old entity's tax liabilities and thus its status as a TMP is not terminated, simply does not translate to a partnership's conversion to a single-member LLC.

Axiomatically, partnerships are not taxable entities.[11] Accordingly, 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 none to retain.[12] The basis for the Tax Court's holding in *Cablevision of Connecticut* is therefore inapplicable to partnership terminations under section 708(b)(1)(A).

Federal Versus State Law

The IRS's principal argument in the NSAR is that state law — not federal law — controls TMP designations. Even if a partnership dissolves or liquidates for federal tax purposes upon conversion to a single-member LLC, as long as state law recognizes that the entity continues, its status as a TMP might continue, the IRS theorizes. In fairness, the IRS is not without support for this distinction.

The IRS points to Rev. Rul. 2004-88,[13] which provides that eligibility to be a TMP is determined under state law. Also, some courts have looked to state law in questions regarding a TMP's authority, although not when doing so conflicts with federal tax law.[14] However, this is a tricky issue because there does not appear to be any authority under the TMP regulations for ignoring a liquidation that occurs by operation of federal tax law. And it is generally accepted that a liquidation for tax purposes may not correspond to a liquidation for state law purposes.

In *FEC Liquidating Corp. v. United States*,[15] the Claims Court noted that terms such as "reorganization" can have a particular meaning in the tax context, yet an entirely different meaning in a general sense.[16] The court discussed dissolution, stating 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."[17] The court thus maintained that depending on the context, the same term may contain two different meanings.

When the TMP regulations refer to a liquidation, are they referring to a liquidation for federal tax purposes or one under state law? The regulations do not expressly refer to state law. Without such an express reference, it is difficult to justify inferring one. It is even more difficult to justify ignoring the impact of a liquidation that occurs by operation of the federal tax rules.

Not surprisingly, courts generally apply tax rules by referencing federal tax law, not state law.[18] The Ninth Circuit, in *Community Bank v. Commissioner*,[19] 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.[20]

It is therefore difficult to see how a liquidation of a partnership for federal tax purposes would not

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[10]Reg. sections 1.338-4T(l)(1) and 1.338(h)(10)-1T(e)(8)(ii).

[11]Section 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").

[12]*See, e.g.*, *Simmons v. Commissioner*, 164 F.2d 220, 224 (5th Cir. 1947) ("Only partners incur income tax liability for partnership income"). For purposes of "simplicity," Rev. Rul. 99-6 assumed that the partnership had no indebtedness.

[13]2004-2 C.B. 165.

[14]*Transpac Drilling Venture, 1983-63 v. United States*, 26 Cl. Ct. 1245, 1247 (1992); *Barbados #7 v. Commissioner*, 92 T.C. 804, 810-812 (1989) (holding that a bankrupt entity could not act as a TMP because "under Utah law, the dissolution of a partnership is caused by the bankruptcy of any partner or the partnership").

[15]212 Ct. Cl. 345 (1977).

[16]*Id.* at 352-353 ("The same is true of the term 'reorganization,' defined for tax purposes in section 368. Not every change in corporate form that might fall within the generic meaning of reorganization qualifies for tax treatment as such").

[17]*Id.* at 353.

[18]*See West Shore Fuel Inc. v. United States*, 598 F.2d 1236 (2d Cir. 1979) ("But the proper tax treatment to be accorded this transaction depends upon how it should be characterized for purposes of I.R.C. section 453, not upon how it may be characterized for state law merger purposes").

[19]819 F.2d 940 (9th Cir. 1987).

[20]*Id.* at 942 ("State law controls, however, 'only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law.' . . . Here,

(Footnote continued on next page.)

qualify as a liquidation under the TMP regulations. Plainly, the regulations contain no reference to state law liquidations. Of course, whether a partnership exists for federal tax purposes is a matter of federal law, not state law.[21]

An entity's status under local law is not determinative for federal tax purposes.[22] The IRC 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, Treasury regulations on partnership classification suggest that federal law controls. For example, reg. section 301.7701-1(a)(1) describes the classification of various entities for federal tax purposes. It states that an entity's separate status from its owners for federal tax purposes is a matter of federal tax law and is not dependent on whether the organization is recognized as an entity under local law.

Moreover, reg. section 1.704-1(b)(2)(ii)(g) defines what constitutes a liquidation of a partnership. It refers to section 708(b)(1), not to state law. Under section 708(b)(1), a partnership that becomes a single-member LLC is deemed to have liquidated. In short, the case for looking to federal tax law alone in interpreting the TMP regulations is compelling. Federal tax law provides a definition for the term "liquidation," and there is no suggestion in the TMP regulations that any other dictionary should be used.

Delaware Law

The IRS's position in NSAR 20111701F not only assumes that state law controls, but also that state law would not recognize a partnership's conversion to a single-member LLC as a liquidation or dissolution. But in many states, local tax rules follow federal rules. In that sense, state law may be of no help to the IRS.

For example, NSAR 20111701F uses the example of a Delaware LLC. Delaware generally follows federal tax law on entity classification.[23] Delaware has a check-the-box regime modeled after the federal one.

What's more, Delaware issued a technical information memorandum clarifying that a single-member LLC cannot elect to be treated as a partnership.[24] Therefore, a partnership that converts to a single-member LLC should be considered to have liquidated or dissolved. That is the case under both federal and Delaware tax law, even if not for purposes of Delaware corporate law.

Conclusion

The IRS's position in NSAR 20111701F reflects the long-standing tension between tax terms and everyday English. Significantly, the TMP regulations do not expressly state whether they intend the phrase "liquidation or dissolution" to refer to federal tax law, state tax law, or general 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? It is difficult to defend the IRS's position which seems untenable.

In fact, the Supreme Court takes this approach to 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."[25] It seems plain that the TMP regulations do not expressly or necessarily depend on state law. Federal tax law should therefore 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 of this conversion, the partnership's TMP status should be recognized as having terminated. Sometimes, a liquidation is a liquidation. As Chico would say, "Then you got something!"

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nothing in Treasury Regulation 1.166-6 makes its operation depend upon state law" (quoting from *Burnet*, 287 U.S. 103, at 110)).

[21]*Commissioner v. Tower*, 327 U.S. 280, 287-288 (1946).

[22]*Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964).

[23]30 Del. C. section 1601(6) (defining the term "pass-through entity" as any person "which is classified as a partnership under the Internal Revenue Code").

[24]TIM 98-1 Addendum (June 1, 1998) ("Addendum to 'Check the Box' Regulations").

[25]*Burnet*, 287 U.S. 103.