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TAX STRATEGIES FOR CORPORATE ACQUISITIONS,  
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# Partnership Mixing-Bowl Issues

June 2011

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Mark J. Silverman is a partner in the Washington office of Steptoe & Johnson LLP. Mr. Silverman was named one of the top ten tax lawyers in Washington in 2005 by Legal Times. He is a member of The American Law Institute, Tax Advisory Group for the Study of Subchapter C of the Internal Revenue Code. He was formerly an advisor to the Committee on Ways and Means during their consideration of revisions to the corporate tax provisions of the Internal Revenue Code. He is a Fellow of the American College of Tax Counsel. Mr. Silverman was formerly a Council member of the American Bar Association, Section of Taxation and was formerly Chair of the Corporate Tax Committee. He chaired the Tax Section Task Force on Leveraged Buyouts. Mr. Silverman co-authored the Tax Advisors Planning Series on Financially Troubled Businesses. Mr. Silverman is currently a member of the advisory boards of BNA Tax Management, Consolidated Returns Tax Report, M&A Tax Report, and Corporate Taxation magazines. Mr. Silverman is on the Editorial Board of The American Journal of Tax Policy, and is on the Board of Trustees of the Southern Federal Tax Institute. Mr. Silverman chairs the ALI-ABA annual consolidated returns program. He was formerly Corporate Tax Editor of The Journal of Taxation, and a member of the advisory boards of NYU Institute on Federal Taxation. Mr. Silverman was formerly a member of the Executive Committee of the New York State Bar Association. In addition, he is an Adjunct Professor of Law at Georgetown University Law Center and was formerly attorney-advisor to Judge Samuel B. Sterrett of the United States Tax Court. Mr. Silverman is a frequent speaker on tax matters and has published numerous articles on the subject.



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Former advisor to Committee on Ways & Means Counsel, ABA, Tax Section

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Former attorney-advisor to Judge Samuel B. Sterrett of US Tax Court

### Planning and Transactional Practice

Mr. Silverman focuses on planning and transactional matters. He has extensive experience in structuring acquisitions, mergers, and spin-off transactions for large public corporations, as well as closely held businesses. He has authored a book on the tax consequences of financially troubled businesses and advises corporations on consolidated return issues. Mr. Silverman advises leverage buyout groups, venture capitalists and privately held commercial real estate developers with respect to various transactional matters. He is often called upon to advise the Internal Revenue Service, Treasury Department and the staffs of the Congressional tax writing committees with respect to corporate tax issues.

### Tax Policy Practice

A significant part of Mr. Silverman's practice involves the resolution of tax policy issues before Congress and the Treasury Department. These issues arise in the context of pending or proposed legislation and proposed Treasury Department regulations. Mr. Silverman is currently meeting with members of Congress and their staffs on many of the corporate tax provisions proposed by the Administration and by members of Congress (including corporate spin-offs, financial product provisions, and corporate capital gains).

### Audit and Controversy

Mr. Silverman also handles audit and controversy matters. He has extensive experience negotiating with field agents, appeals officers and district counsel in settling significant audit issues. Mr. Silverman frequently prepares technical advice requests and often meets with National Office officials with respect to audit and tax litigation matters.

Recently, Mr. Silverman was successful in negotiating global tax shelter settlements with the IRS.



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Aaron P. Nocjar is a partner in the Washington office of Steptoe & Johnson LLP, where he is a member of the Tax group. He focuses on federal income taxation issues, with particular emphasis on the taxation of pass-through entities. Mr. Nocjar advises clients in structuring transactions involving partnerships, limited liability companies, S corporations, and disregarded entities. In addition to providing tax planning advice, Mr. Nocjar assists clients throughout the Internal Revenue Service administrative process. Mr. Nocjar also has experience addressing tax policy issues before Congress and the Treasury Department.

Prior to joining Steptoe, Mr. Nocjar earned his LL.M. in Taxation from Georgetown University Law Center, where he received the Thomas Bradbury Chetwood, S.J. Prize for attaining the highest academic average in his graduating class.

### PUBLICATIONS

Co-author, The S Corporation Rules and the Use of S Corporations as Acquisition Vehicles, Practising Law Institute (2011)

Co-author, Partnership Disguised Sale Rules, Practising Law Institute (2011)

Co-author, Section 197 and Partnership Transactions, Practising Law Institute (2011)

Author, Using Tax Partnerships to Trigger Tax Loss in the Commercial Real Estate Market, Tax Management Real Estate Journal (May 2010)

Author, Closely Held Companies: Now Might be the Best Time to Convert to Tax Partnership Status, Journal of Taxation (Oct. 2009)

Author, The Sliver Investor: May We Disregard You for Tax Purposes?, Tax Management Real Estate Journal (Apr. 1, 2009)

Author, Section 470 and Partnerships Left Outside Future Congressional Relief, Tax Management Memorandum (2007)

Co-author, Establishing Business Purpose in a Transparent World, 2004 USC Tax Institute

Author, The 2000 Proposed Regulations on Corporate Sponsorship Payments: A Step Toward Restoring the Public's Trust in Charitable Organizations, 54 Tax Law. 357 (Winter 2001)



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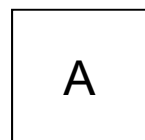
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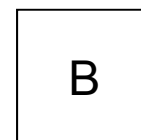
## Overview

- Mixing-Bowl Transactions and Issues
- Leveraged Mixing-Bowl Transactions and Additional Issues
- Other Strategies to Keep in Mind with Mixing-Bowl Transactions
- Other Partnership Structuring Issues
- Common Business Considerations in Mixing-Bowl Transactions
- Partnership Merger Proposed Regulations

## Mixing-Bowl Transactions and Issues



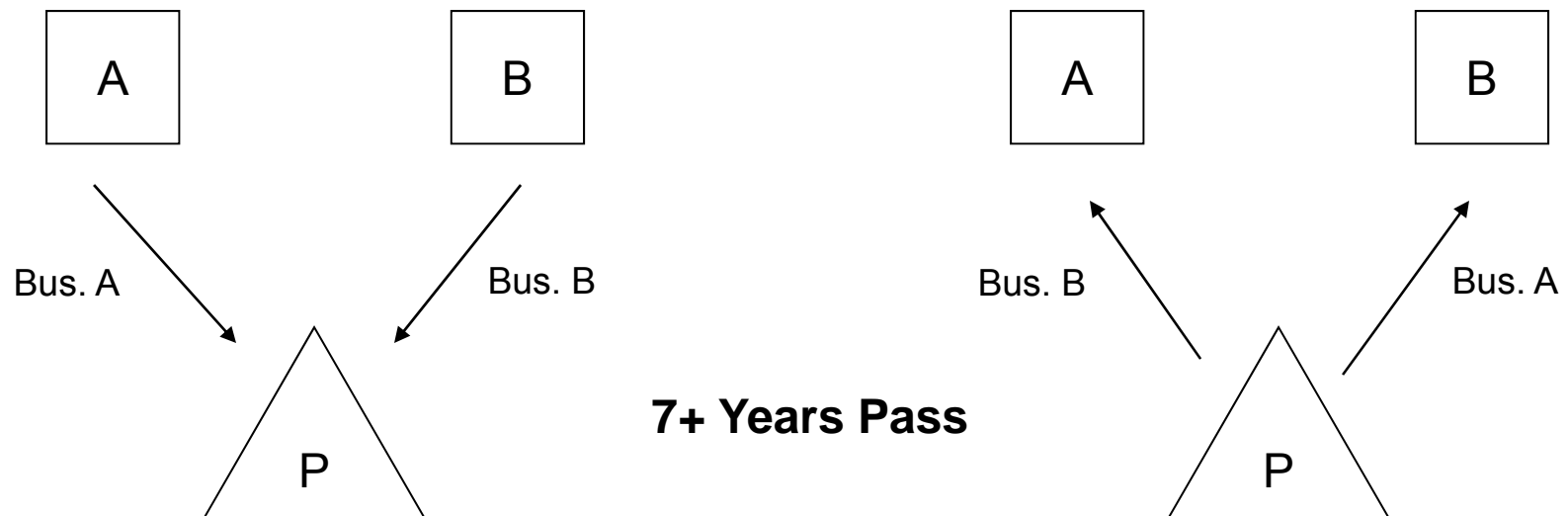
Bus. A



Bus. B

- A would like to dispose of Bus. A, which is appreciated
- A wants to acquire Bus. B (or cash)
- B would like to dispose of Bus. B, which may or may not be appreciated
- B wants to acquire Bus. A
- A and B wish to defer any built-in gain in their businesses as long as possible
- Section 1031 is not available since Bus. A and Bus. B assets are not “like-kind”
- Combining the businesses in corporate form would introduce an additional layer of tax since no party will have an 80%+ interest in the corporate joint venture

## Mixing-Bowl Transactions and Issues



- Bus. A profits, losses, and cash flow: A:25% B:75%
- Bus. B profits, losses, and cash flow: A:75% B:25%
- Daily operations of Bus. A managed by B/Daily operations of Bus. B managed by A
- Liquidate in accordance with capital accounts
  - To extent available, A receives Bus. B assets/B receives Bus. A assets

## Mixing-Bowl Transactions and Issues

- Typical Issues
  - Section 704(c)(1)(A) – built-in gain or loss in section 704(c) property taken into account by contributing partner via allocation of depreciation/amortization or disposition gain or loss at partnership level
  - Section 704(c)(1)(B) – distribution of section 704(c) property to noncontributing partner w/in 7 years
    - ◆ Mechanical provision
  - Section 737 – distribution of property to partner who contributed other section 704(c) property w/in 7 years
    - ◆ Mechanical provision
    - ◆ Applies to nonliquidating distributions as well, but may be overkill since section 704(c) continues to apply

# Mixing-Bowl Transactions and Issues

- Typical Issues
  - Section 707
    - ♦ Disguised sale of property between partner and partnership – final regulations
    - ♦ Disguised sale of partnership interest between partners – proposed regulations recently withdrawn
  - General rules to treat as disguised sale:
    - ♦ Simultaneous transfers: second transfer would not have been made “but for” first transfer
    - ♦ Nonsimultaneous transfers: same “but for” test + subsequent transfer not dependent on “entrepreneurial risks of partnership operations”
  - Presumptions:
    - ♦ Transfers w/in 2 years presumed disguised sales unless facts “clearly establish” otherwise
    - ♦ Transfers not w/in 2 years presumed not disguised sales unless facts “clearly establish” otherwise
  - “Clearly establish” appears to be high standard – can help & hinder partners
  - Illustration of mixing-bowl transaction involving disguised sale of property – Treas. Reg. 1.707-3(f) ex. 8
  - Although no regulations for disguised sales of partnership interests, section 707 should be viewed as self-enforcing in this regard

## Mixing-Bowl Transactions and Issues

- Interaction of disguised sale of property and interest rules
  - Both sets of rules potentially could apply to a mixing-bowl transaction
    - ◆ Withdrawn proposed interest rules said that property rules take precedence over interest rules – Prop. Treas. Reg. 1.707-7(a)(6)
  - However, proposed interest rules would not have applied to transactions “incident to the formation of a partnership” – Prop. Treas. Reg. 1.707-7(a)(8)
    - ◆ Seems appropriate since transactions at formation already covered by property rules
  - Withdrawn interest rules contained reporting requirements for transfers that might be disguised sales of property or interests
    - ◆ Very broad: would have required reporting of any transfer of encumbered property to or from a partnership

## Mixing-Bowl Transactions and Issues

- Interaction of disguised sale of property and interest rules (cont.)
  - Both rules treat disguised sale as occurring at the time of the earliest transfer
    - ♦ For disguised sale of property, seems to make sense, since sale deemed to occur between same parties that did the transactions that caused disguised sale treatment
    - ♦ For disguised sale of partnership interest, generally did not make sense, since sale deemed to occur between partners that actually did not engage in transactions between each other
      - Rule could have created nonsensical results:
        - » A and B in old and cold partnership
        - » Jan. 2005: A receives nonliquidating cash distribution
        - » Dec. 2006: Unrelated new partner C enters partnership with cash contribution
        - » C presumed to be a partner since Jan. 2005 for all purposes of Code! Prop. Treas. Reg. 1.707-7(a)(2)(ii)(E), (l) exs. 2, 5

## Mixing-Bowl Transactions and Issues

- Keep an eye on liabilities of Bus. A and Bus. B
  - Could create disguised sale of property at contribution
    - ♦ Is transferred liability a “qualified liability” of partner?
      - Includes unsecured ordinary business liabilities where all material assets of business contributed
      - If Bus. A is only a line of overall business conducted by A, have all material assets been transferred? -- Could section 355 guidance provide comfort?
      - If B wants only a portion of Bus. A assets, then ordinary business liabilities of Bus. A transferred to P will not be “qualified liabilities”
    - ♦ If not, does the contributing partner retain a large enough share of the liability after the contribution?
      - Every dollar of non-“qualified liability” of partner for which partner does not remain on the hook treated as disguised sale consideration
      - Normal recourse liability rules apply
      - Only profit-sharing rule of nonrecourse liability rules apply
      - Consider guarantees, indemnifications, etc. to preserve risk of loss

## Mixing-Bowl Transactions and Issues

- Keep an eye on liabilities of Bus. A and Bus. B (cont.)
  - Even if no disguised sale, could recognize gain at contribution under section 731
  - Particularly if businesses disproportionately leveraged
  - Consider guarantees, indemnifications, etc. to prevent shift of liabilities and resulting deemed distribution of cash in excess of outside basis
    - ◆ No nontax business purpose needed – Treas. Reg. 1.752-2(b), 1.737-4(b) ex. 2
  - Relying on nonrecourse rules may provide only temporary comfort
    - ◆ Outside basis from Tier 1 (p/s min. gain) rule decreases as P pays debt
    - ◆ Outside basis from Tier 2 (section 704(c) min. gain) rule decreases as P depreciates assets
  - Consider paying down portion of debt prior to transfers to P so as to eliminate disproportionate leverage

## Mixing-Bowl Transactions and Issues

- Keep an eye on liabilities of Bus. A and Bus. B (cont.)
  - Could recognize gain as debt is paid down over time under section 731
  - Income of partnership increases outside basis of partners at end of partnership year only
  - Deemed distribution of cash due to debt payment taken into account immediately
  - Gain recognition under section 731 if deemed distribution of cash exceeds outside basis (unadjusted for current year income)
  - Exception: treat deemed distribution of cash as “draw” against partner’s distributive share of income and take into account at end of partnership year
    - ♦ Allows income to increase outside basis before testing for gain recognition under section 731
    - ♦ However, rule seems to apply only if partnership has income and only to the extent of partner’s distributive share thereof
    - ♦ See Treas. Reg. 1.731-1(a)(1)(ii); Rev. Rul. 94-4

## Mixing-Bowl Transactions and Issues

- Watch out for section 721(b)
  - Section 721 nonrecognition rule overridden if P viewed as “investment company” under section 351(e) rules
  - TRA of 1997 significantly broadened rules
  - Two requirements for “investment company” status:
    - ◆ 1. Diversification of A’s and B’s interests in transferred assets
      - Generally need transfer of non-identical assets
    - ◆ 2. >80% of gross value of assets of P are (i) “bad assets” and (ii) held for investment
      - “Held for investment” broadly defined: all assets other than inventory and assets used in financial services businesses

## Mixing-Bowl Transactions and Issues

- Watch out for section 721(b) (cont.)
  - Could have section 721(b) issue when
    - ♦ B is contributing cash or other financial assets (rather than Bus. B)
      - Such contribution apparently disregarded if plan for P to use such assets to acquire Bus. B assets
    - ♦ Business contributed consists of large amount of working capital for future expansion
    - ♦ Business contributed includes interests in other entities where other entities essentially hold cash or cash-equivalents equal to proceeds of sales of valuable assets
    - ♦ B contributes a personal note
    - ♦ Any combination of the above circumstances

## Mixing-Bowl Transactions and Issues

- Watch out for section 721(b) (cont.)
  - “Bad assets” include
    - ♦ Money and foreign currency
    - ♦ All forms of equity in corporations (no active trade req’t)
    - ♦ All forms of indebtedness in corporations (no active trade req’t)
    - ♦ All other equity interests if can convert or exchange into any other “bad asset”
    - ♦ Any interest in any entity if “substantially all” assets of entity are “bad assets”
      - “Substantially all” not defined – but see Treas. Reg. 1.731-2(c)(3) (adopts 90% gross value test for similar purpose)
    - ♦ Any interest in any entity if not “substantially all” assets of entity are bad assets, but only to extent value of interest attributable to “bad assets” of entity
      - No floor – but see Treas. Reg. 1.731-2(c)(3) (adopts a 20% gross value floor for similar purpose)

## Mixing-Bowl Transactions and Issues

- Section 731(c)
  - “Marketable securities” treated as cash to extent of FMV
  - Could cause gain recognition upon distribution if exceed outside basis
  - “Marketable security” has broad meaning
    - ◆ Unlike section 721(b), no >80% gross value requirement
    - ◆ Actively traded financial instruments and currencies (broadly defined)
    - ◆ Interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both
      - “Substantially all” means “90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.” Treas. Reg. 1.731-2(c)(3)(i)

## Mixing-Bowl Transactions and Issues

- Section 731(c)
  - “Marketable security” has broad meaning (cont.)
    - ♦ Any interest in an entity not described above but only to the extent of the value of such interest which is attributable to marketable securities, money, or both.”
      - Exception: “[A]n interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.” Treas. Reg. 1.731-2(c)(3)(ii).
  - Section 731(c)(6) could convert resulting capital gain under section 731 into ordinary income if “marketable security” is “unrealized receivable” or “inventory” item
    - ♦ Unlike section 751(b), inventory need not be “substantially appreciated” to convert capital gain to ordinary income

## Mixing-Bowl Transactions and Issues

- Other section 704(c) considerations
  - Section 704(c) method should not be overlooked when negotiating terms of partnership agreement
  - Instead of economically owning 75% of Bus. A through P, B could have purchased 75% of Bus. A assets from A
    - ♦ Direct purchase would have given B a full cost basis from which to generate depreciation deductions
    - ♦ Generally, section 704(c) attempts to preserve the amount of depreciation deductions that noncontributing partners would have taken into account if the property had a cost basis
    - ♦ However, “ceiling rule” under section 704(c) may limit amount of depreciation deductions allocable to B from Bus. A assets if inside basis of Bus. A is low enough
    - ♦ Can remedy with curative allocations or remedial allocations
      - Curative allocations helpful only if expect to have other similar property generating depreciation deductions
      - If no similar property, use remedial allocations (creating tax items)
      - Curative or remedial allocations of additional depreciation to B will cause additional income to be allocated to A
        - » Traditional method would not have allocated additional income to A

## Mixing-Bowl Transactions and Issues

- Section 751(b)
  - Section 751(b) – overrides section 731 nonrecognition rule upon distribution if shift in partner's share of “hot assets”
    - ♦ Section 751(b) could apply since not making liquidating distributions consisting of pro rata portion of value of each asset of P
    - ♦ “Hot assets” include assets generally not considered “substantially appreciated inventory” or “unrealized receivables,” such as depreciation recapture
    - ♦ Even though accounts receivable may not qualify as “unrealized receivables,” can be treated as “inventory”
      - If included, reduces likelihood that inventory will be “substantially appreciated” as long as P on accrual method
  - Reduce section 751(b) exposure
    - ♦ Do not contribute “hot assets” (e.g., A/R and inventory) to extent possible (depreciation recapture cannot be separated from its underlying property)
    - ♦ Enter into agreement stating which “cold assets” deemed exchanged for disproportionate distribution of “hot assets” – cannot do reverse agreement
  - Watch out: Must test for section 751(b) when have deemed distributions of cash due to debt shifts under section 752 as well

## Mixing-Bowl Transactions and Issues

### ■ Anti-Abuse Rules

- Treas. Reg. 1.701-2 (general anti-abuse rule), 1.704-4(f) (section 704(c)(1)(B) anti-abuse rule), 1.737-4 (section 737 anti-abuse rule)
  - ♦ Would not seem to apply since
    - 75:25 disproportionate allocations do not seem inconsistent with the intent of subchapter K – still significant joint investment and entrepreneurial risk sharing
      - » 90:10 may be too aggressive – Treas. Reg. 1.707-3(f) ex. 8
      - » “Substantially all” may be too aggressive – Treas. Reg. 1.704-4(f)(2) ex. 1
    - A and B have continuing interest in assets for significant period of time (7+ years)
    - Congress already has addressed any perceived abuse by enacting section 704(c)(1)(B) and 737, which has clear 7-year cut-off
      - » Treas. Reg. 1.704-4(f)(2) ex. 1 blesses delay of distribution to period outside 7-year period for “principal purpose of avoiding” section 704(c)(1)(B)

## Mixing-Bowl Transactions and Issues

- Anti-Abuse Rules (cont.)
  - Unhelpful circumstances to avoid
    - ♦ 90:10 allocations
    - ♦ Investment banking and in-house materials giving the appearance that the parties intended from the start to liquidate the partnership immediately after 7 years
      - Partnership agreement should not require liquidation after 7 years – rather, agreement should provide that partnership shall not be liquidated within 7 years without consent of A and B
    - ♦ Lack of any discussion/substantiation of the potential synergistic effects of combining Bus. A with Bus. B
    - ♦ Mechanisms designed to undo the apparent economic deal between the parties (e.g., fixed price call option on certain partnership property or long-term leases of certain partnership property)

## Mixing-Bowl Transactions and Issues

### ■ Preferred Interests

- Structure could be modified so that A receives 25% preferred interest with respect to Bus. A assets and B receives 25% preferred interest with respect to Bus. B assets
  - ♦ Technique used to substantially freeze A's continuing interest in Bus. A to 25% of its FMV at contribution and B's continuing interest in Bus. B to 25% of its FMV at contribution
- Risk is that preferred interest will be treated as debt of P
  - ♦ If treated as debt of P, portion (or all) of contributed property could be viewed as being sold to P
  - ♦ Dearth of authority on treating preferred interests as debt
  - ♦ Commonplace for preferred stock to be treated as equity
- Risk might be reduced by combining preferred interest with common interest – “participating preferred interest”

## Mixing-Bowl Transactions and Issues

- Preferred Interests (cont.)
  - Partners may wish to monetize their preferred interests as well
  - A could borrow 90% of value of its 25% preferred interest
  - Monetizing creates risks
    - ◆ Preferred interest sold to lender
    - ◆ Preferred interest disregarded and treated as sale of assets to lender
  - How reduce risk?
    - ◆ Involve third-party lender with arm's-length lending terms
      - Since preferred interest non-marketable, likely lender is B
    - ◆ Secure the note with unrelated substantial assets of A
    - ◆ Make repayment terms of note and terms of preferred interest materially different

## Mixing-Bowl Transactions and Issues

- Puts and Calls on Interests in P
  - Circumstance: Usually when B has contributed non-business assets
  - Purposes:
    - ♦ Liquidation of P can be vetoed by either partner
    - ♦ A's put option on its interest gives A some unilateral power to force exit from partnership under certain conditions
      - May further insulate A from downside of Bus. A in P
    - ♦ B's call option on A's interest gives B some unilateral power to remove A from partnership under certain conditions
      - May further transfer to B upside of Bus. A in P
    - ♦ Options also can be viewed as injecting liquidity into an otherwise non-marketable interest

## Mixing-Bowl Transactions and Issues

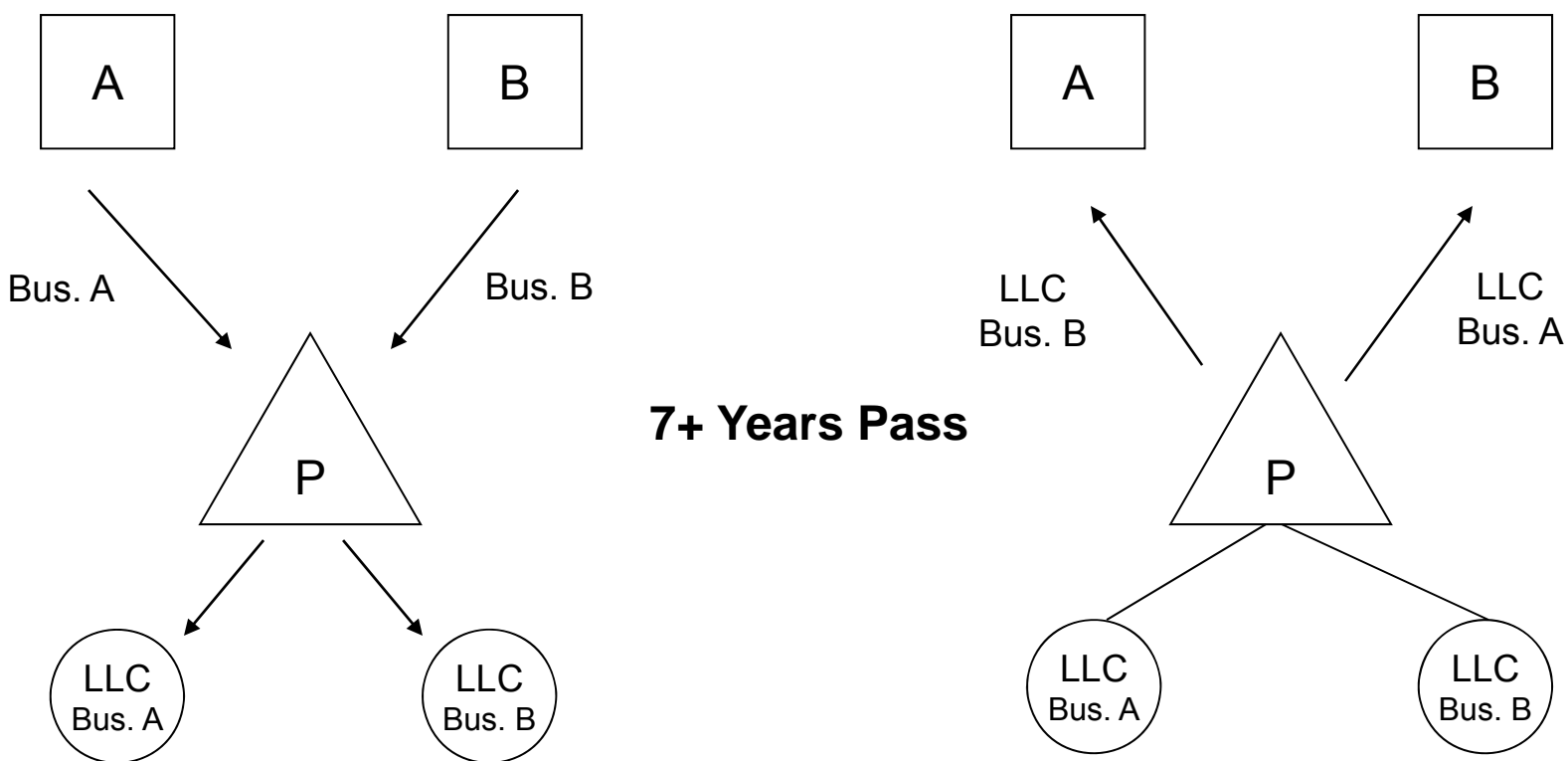
- Puts and Calls on Interests in P (cont.)
  - Risks:
    - ♦ Cause current sale of interest in P
    - ♦ Increase risk of disguised sale of property since could evidence intent of parties that A not share in entrepreneurial risks of Bus. A from formation date of P
    - ♦ Increase risk of anti-abuse rules applying

## Mixing-Bowl Transactions and Issues

- Puts and Calls on Interests in P (cont.)
  - How reduce risks?
    - ♦ Overall guiding principle: make sure that, at time of entering into options, “more than remote possibility” that options will not be exercised during relevant exercise periods
      - See Penn-Dixie, 69 T.C. 837 (1978), Kwiat, 64 T.C.M. 327 (1992), Griffin Paper, 74 T.C.M. 559 (1997), Rev. Rul. 72-543, F.S.A. 1998 WL 1984538
      - Function of volatility of price of businesses within P -- Penn-Dixie (steel business, very volatile – no sale), Kwiat (industrial metal shelving not as volatile -- sale)
      - Function of expected financial ability of optionholder to exercise in future - Griffin
    - ♦ Delay exercise periods until period of years after grant
      - Penn-Dixie (3 & 4 years after grant), Griffin (8 years after grant)
    - ♦ Vary exercise periods of put and call
      - Coinciding exercise dates fatal in Rev. Rul. 72-543, 1 day gap o.k. in Penn-Dixie, complete overlap of exercise period o.k. in Griffin but court focused more on potential financial inability of optionholder to exercise
    - ♦ Exercise prices=FMV of interest at time of exercise
      - Exercise prices not tied to FMV was one of fatal facts in Kwiat

# Mixing-Bowl Transactions and Issues

Variant: Place businesses in separate disregarded LLCs to shield assets of one business from the liabilities of the other business in a tax transparent manner

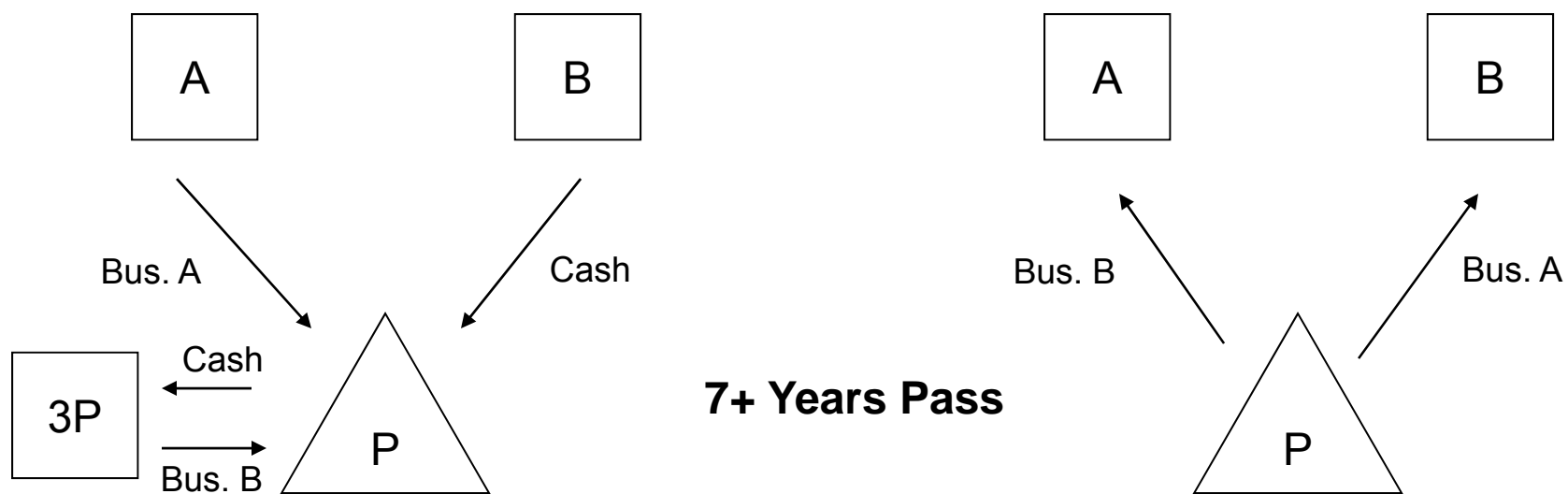


## Mixing-Bowl Transactions and Issues

- Could the transfer of Bus. A and Bus. B into separate disregarded LLCs impact the disguised sale analysis?
  - Disguised sale analysis focuses on whether subsequent transfer of property is dependent on entrepreneurial risks of partnership operations
    - ♦ More likely that subsequent distribution is not dependent on risks of partnership operations, more likely a disguised sale
    - ♦ Placing businesses in separate LLCs effectively insulates assets of each segment of partnership operations from liabilities of the other
    - ♦ However, the separate income and loss of each business are still shared between the parties
      - See also Treas. Reg. 1.707-3(b)(2)(viii) (fact that may prove existence of sale):  
“That partnership distributions, allocations, or control of partnership operations is designed to effect an exchange of the burdens and benefits of property.”

# Mixing-Bowl Transactions and Issues

Variant: B contributes cash, and P acquires Bus. B from a third party with such cash

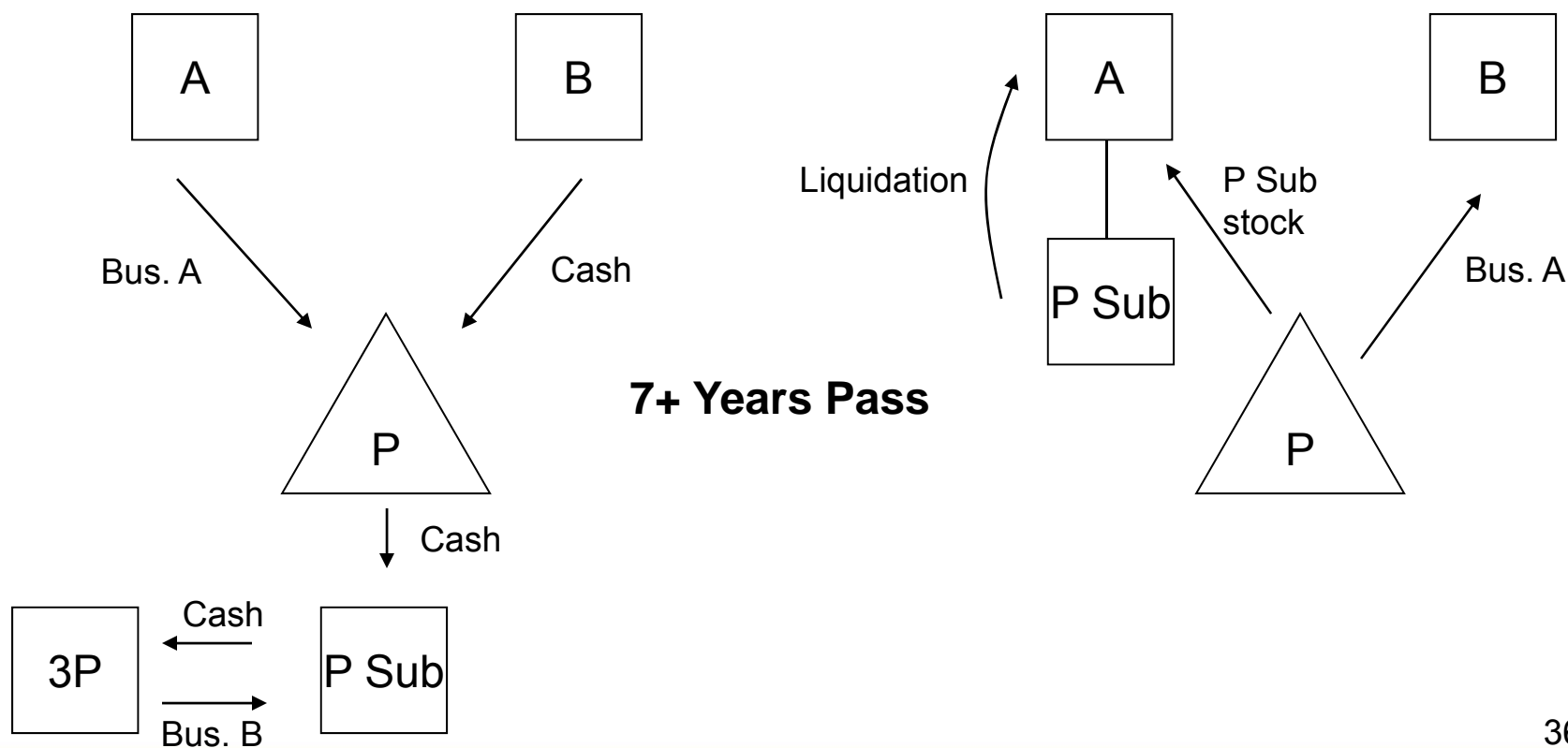


## Mixing-Bowl Transactions and Issues

- Bus. B assets are not subject to section 704(c), section 707, or section 737
- Bus. A assets are subject to such provisions
- If distribute Bus. B to A during 7-year period, section 737 issue for A?
  - A nonliquidating distribution of Bus. B to A could avoid section 737 if A's outside basis equals or exceeds FMV of Bus. B
    - ◆ Can accomplish via A's guarantee of sufficient amount of P debt
    - ◆ See Treas. Reg. 1.737-4(b) ex. 2
  - A liquidating distribution of Bus. B to A could avoid section 737 if A's outside basis equals or exceeds FMV of Bus. B
    - ◆ Apparently could accomplish by A assuming or taking subject to a sufficient amount of P debt
- As discussed above, section 721(b) apparently should not be issue since plan is for cash to be used to acquire Bus. B assets

# Mixing-Bowl Transactions and Issues

Variant: B contributes cash, P contributes cash to P Sub, P Sub acquires Bus. B, A receives P Sub stock, A liquidates P Sub

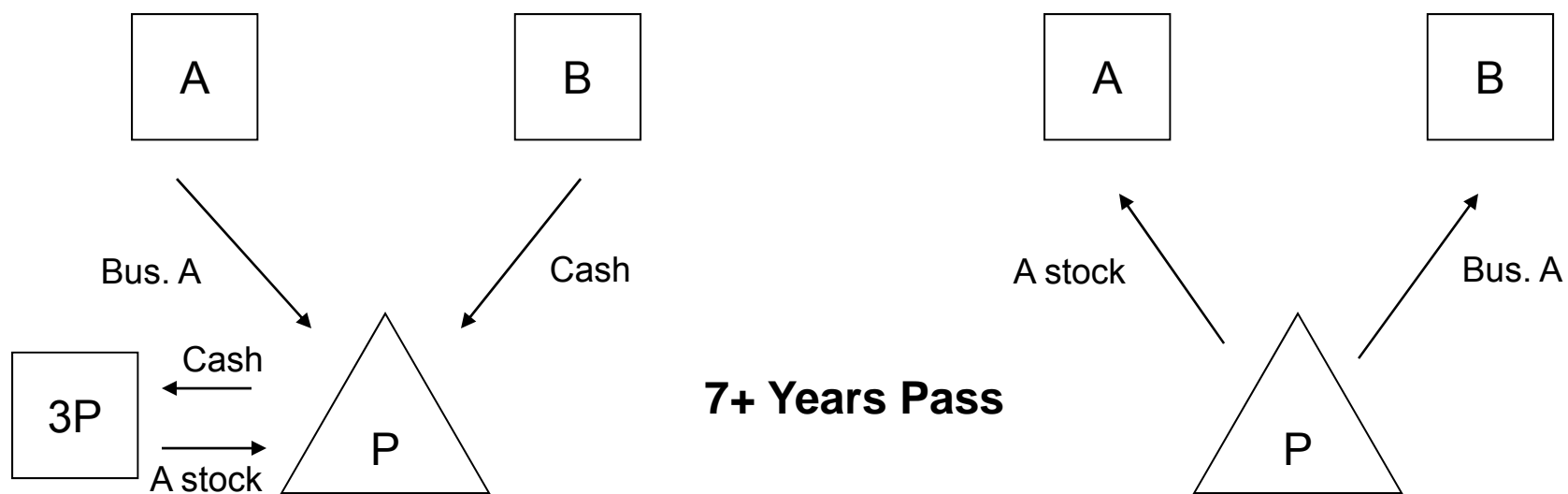


## Mixing-Bowl Transactions and Issues

- P Sub stock not subject to section 704(c), section 707, or section 737
- Bus. A assets are subject to such provisions
- Under section 334(b), A takes basis in Bus. B assets equal to inside cost basis of Bus. B assets rather than outside low basis of P Sub stock
  - Apparently eliminating A's built-in gain from Bus. A assets via tax-free liquidation of P Sub
- However, section 732(f) requires a basis step-down of P Sub assets (or gain recognition) upon P's distribution of P Sub stock to A
  - Reduction amount = lower of (i) actual basis step-down of P Sub stock upon distribution to A and (ii) aggregate basis of P Sub assets over A's basis in P Sub stock
  - If required basis reduction > basis of P Sub property, excess = capital gain to A
  - Thus, A's built-in gain from Bus. A assets continues in Bus. B assets to extent Bus. B assets have sufficient initial basis to reflect such built-in gain; A recognizes capital gain otherwise
- As discussed above, section 721(b) apparently should not be issue since plan is for cash to be used to acquire Bus. B assets

# Mixing-Bowl Transactions and Issues

Variant: B contributes cash, and P acquires A stock from a third party with such cash

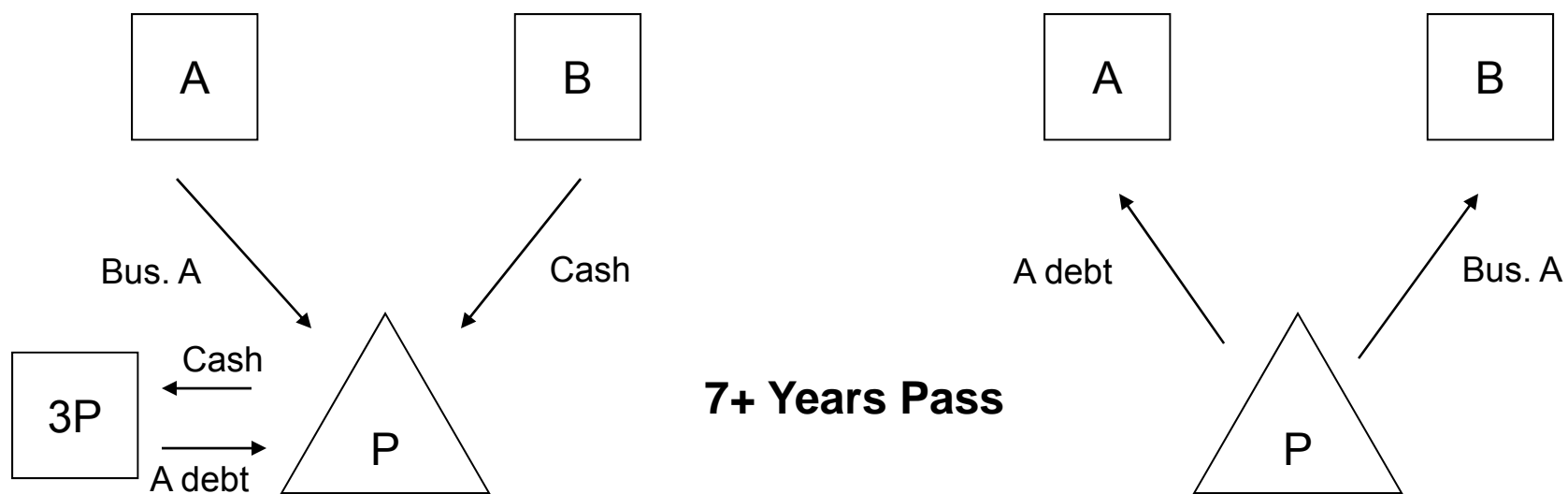


## Mixing-Bowl Transactions and Issues

- Current Law Treatment
  - Effectively, A disposed of its appreciated business assets in exchange for its own stock in a manner that permanently eliminates the built-in gain in its business assets
  - Upon liquidation, A's low outside basis transfers to its stock
  - Subsequently, built-in gain in the stock should not be recognized under section 1032
  - But see section 721(b) – cash contributed to acquire A stock still “bad asset”
  - But see section 731(c) – stock could be “marketable security”
- Prop. Treas. Reg. 1.337(d)-3
  - Would treat the liquidating distribution to A as a redemption of A's stock with A's interest in P under section 311, rather than section 731 (i.e., built-in gain in A's interest in P would be recognized)
    - ◆ Would apply to stock of A and A's affiliates
    - ◆ Would apply to options, warrants, and similar interests as well
  - Proposed in 1992, but not finalized yet
  - When finalized, could have retroactive effective date back to 1989

# Mixing-Bowl Transactions and Issues

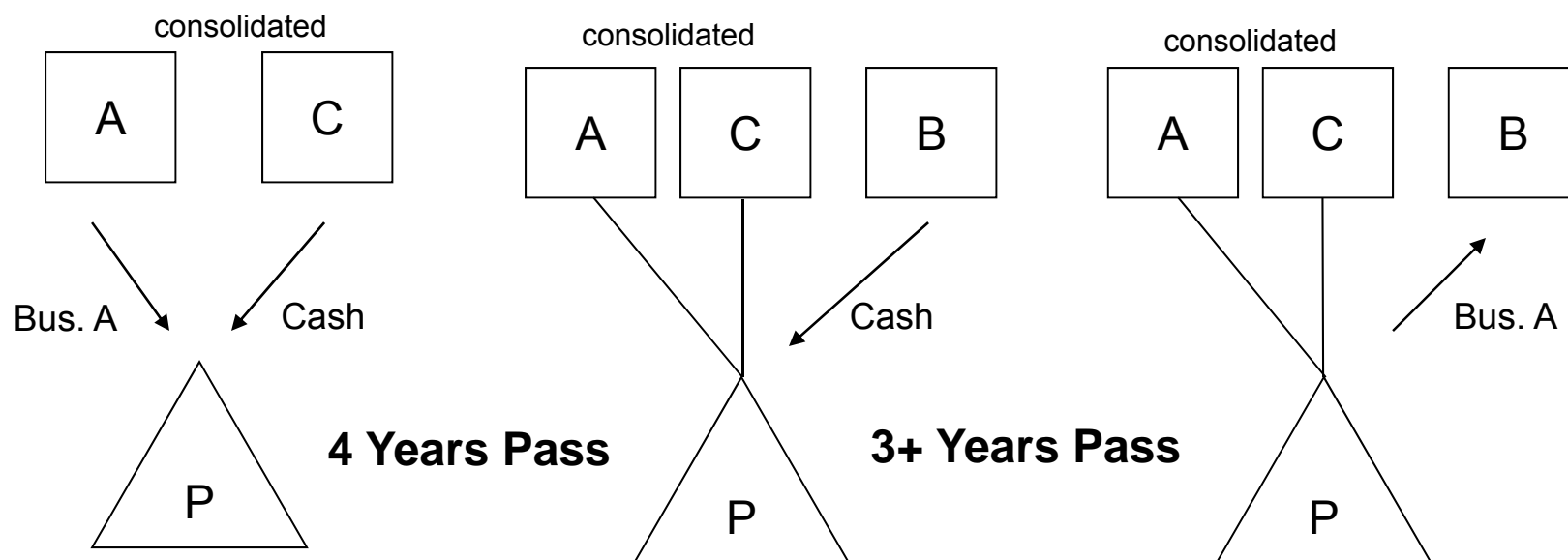
Variant: B contributes cash, and P acquires A debt from a third party with such cash



## Mixing-Bowl Transactions and Issues

- Proposed Treas. Reg. 1.337(d)-3 does not apply to debt instruments
- Effectively, A disposed of its appreciated business assets in exchange for its debt in a manner that permanently eliminates the built-in gain in its business assets
  - Upon liquidation, A's outside basis transfers to its debt if section 731 applies
    - ◆ Section 731 may not apply if do not view debt as "property"
  - Debtor position and creditor position merge
  - But see section 731(c) – debt could be "marketable security"
- However, Rev. Rul. 93-7: A must recognize gain to extent FMV of debt exceeds basis of debt following distribution
- A also could recognize COD income to extent adjusted issue price > FMV
- Do not overlook section 721(b) – cash contributed to acquire A debt still "bad asset"

## Mixing-Bowl Transactions and Issues

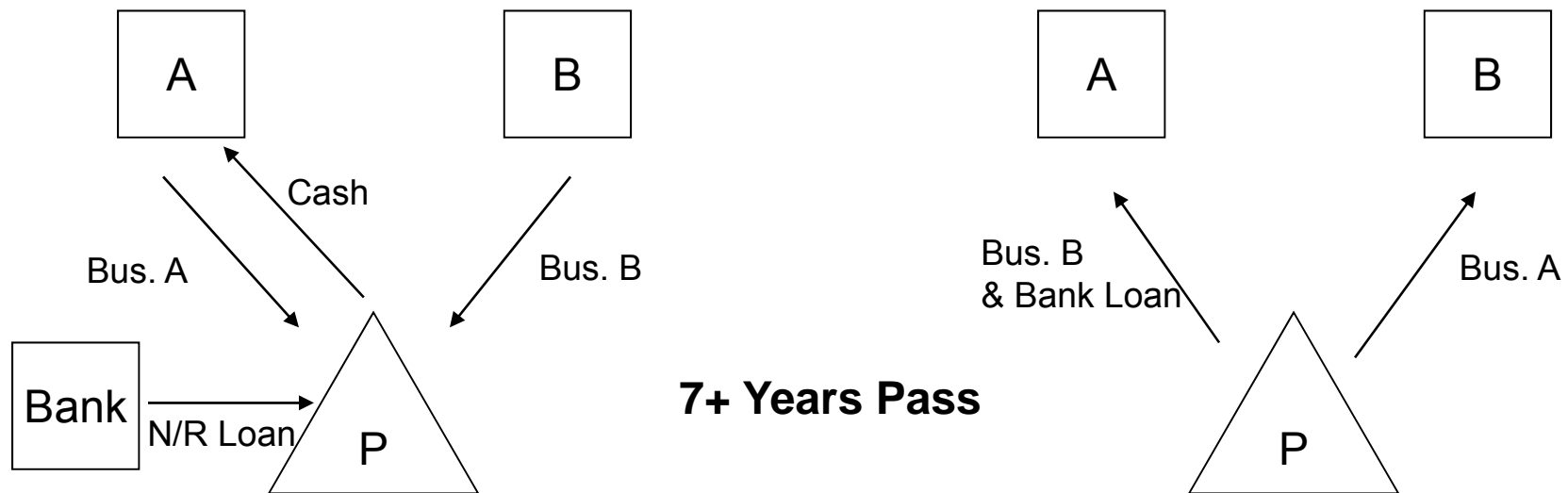


- A and C are members of consolidated group
- A wants to dispose of Bus. A but wants to minimize time that it has to remain a partner with potential acquirer (B)

## Mixing-Bowl Transactions and Issues

- Does acquirer partner have to be a partner with selling partner for at least 7 years in order to avoid section 704(c)(1)(B)?
  - Although the statute does not impose such a requirement, it appears that Service would challenge such a transaction if P “formed pursuant to a plan the principal purpose of which is to minimize period of time that A would have to remain a partner with a potential acquirer” of Bus. A
  - See Treas. Reg. 1.704-4(f)(2) ex. 2
  - However, such a transaction should work if P is formed for other non-tax business reasons

## Leveraged Mixing-Bowl Transactions and Additional Issues



- A wants to reduce its ownership in Bus. A in exchange for cash immediately but defer gain recognition
- Bus. A profits, losses, and cash flow: A:25% B:75%
- Bus. B profits, losses, and cash flow: A:75% B:25%
- Bus. A managed by B/Bus. B managed by A
- Nonliquidating distribution of loan proceeds to A=90% FMV of Bus. A assets
- Liquidate in accordance with capital accounts
  - To extent available, A receives Bus. B assets/B receives Bus. A assets

## Leveraged Mixing-Bowl Transactions and Additional Issues

- Section 707 – Treas. Reg. 1.707-5(b)
  - A must receive distribution of loan proceeds (or other consideration traceable to loan proceeds) w/in 90 days of P incurring bank loan to avoid disguised sale
    - ♦ If (i) cash also contributed by B or (ii) P already has other cash from operations or unrelated borrowings, how avoid argument that cash distribution did not come from bank loan proceeds? – cash is fungible
    - ♦ P should (i) direct Bank to transfer loan proceeds to A, (ii) receive loan proceeds and immediately transfer to A, or (iii) deposit into new bank account and distribute to A w/in 90 days
    - ♦ See Treas. Reg. 1.163-8T(c)
      - If receive loan proceeds in cash and transfer any cash w/in 15 days of receipt of loan proceeds, then P can treat the transfer of cash as allocable to such loan proceeds
      - If receive and deposit loan proceeds in bank account, P may treat any transfer of cash out of account w/in 15 days of deposit of loan proceeds as transfer of loan proceeds
      - Otherwise, if receive and deposit loan proceeds in bank account, any transfer of cash out of account treated as such loan proceeds before treated as (i) any unborrowed amounts deposited at time loan proceeds deposited or (ii) any amounts deposited after loan proceeds deposited
      - Rules applied separately to separate bank accounts of P

## Leveraged Mixing-Bowl Transactions and Additional Issues

- Section 707 – Treas. Reg. 1.707-5(b) (cont.)
  - A also must have sufficient share of loan under section 752 to avoid disguised sale
    - ♦ Sufficient share=(modified section 752 share x percentage of total liability proceeds distributed to A)
      - Tier 1 (p/s min. gain) and Tier 2 (section 704(c) min. gain) rules of nonrecourse liability rules do not apply for this purpose
      - Must rely on recourse liability rules and general Tier 3 rule (profit-sharing ratios) of nonrecourse liability rules
      - Since profit-sharing ratios usually not enough, focus falls on recourse liability rules
        - » In this example, A could have only a 75% share of bank loan under Tier 3 rule (and it might be lower)
    - ♦ Thus, A having share of bank loan merely equal to amount distributed to A may not be sufficient if P retains some loan proceeds

## Leveraged Mixing-Bowl Transactions and Additional Issues

- Section 731
  - Even if avoid disguised sale, A must have enough share of bank loan under normal section 752 rules to avoid distribution of loan proceeds in excess of outside basis

## Leveraged Mixing-Bowl Transactions and Additional Issues

- For purposes of section 707 and 731 issues, how make otherwise non-recourse liability a recourse liability allocable to A? Treas. Reg. 1.752-2
  - A guarantees portion (or all of) bank loan
    - ♦ Guarantee of portion of bank loan can be “bottom-dollar” – Treas. Reg. 1.704-2(m) ex. 1(vii), 1.752-2(b)
    - ♦ Guarantee must be enforceable under state law
      - Notice of guarantee to creditor
    - ♦ Guarantee with amount guaranteed floating from year-to-year appears to be valid – Treas. Reg. 1.705-1(a), 1.752-4(d)
    - ♦ Guarantee with limited term appears to be valid
  - All of A’s rights of contribution, reimbursement, and subrogation from B, P, and all related parties must be waived

## Leveraged Mixing-Bowl Transactions and Additional Issues

- Necessary capitalization of A to support guarantee obligation
  - Presumption that A will satisfy guarantee regardless of net worth
    - ♦ Treas. Reg. 1.752-2(b)(6)
  - However, anti-abuse rules could apply to disregard A's guarantee
    - ♦ Treas. Reg. 1.752-2(j)
  - No bright-line rule for appropriate level of net worth
    - ♦ Do not need net worth equal to debt guaranteed
    - ♦ 50%?
    - ♦ 21%? Canal Corp. v. Comm'r, 135 T.C. 199 (2010) (net worth of 21 percent of maximum exposure on indemnity cited as factor in court disregarding indemnity pursuant to Treas. Reg. 1.752-2(j))
    - ♦ 10%? Rev. Proc. 89-12 (former entity classification ruling guideline)
    - ♦ 0%?
  - Rules suggest that lack of net worth alone is not sufficient to disregard guarantee – Treas. Reg. 1.752-2(j) ex.; CCA 200246014
- Types of assets to create net worth
  - Liquid assets v. illiquid assets
  - Business assets v. investment assets
  - Note receivable from affiliate that has deep pocket (not sufficient in Canal)
  - Not interest in the relevant partnership

## Leveraged Mixing-Bowl Transactions and Additional Issues

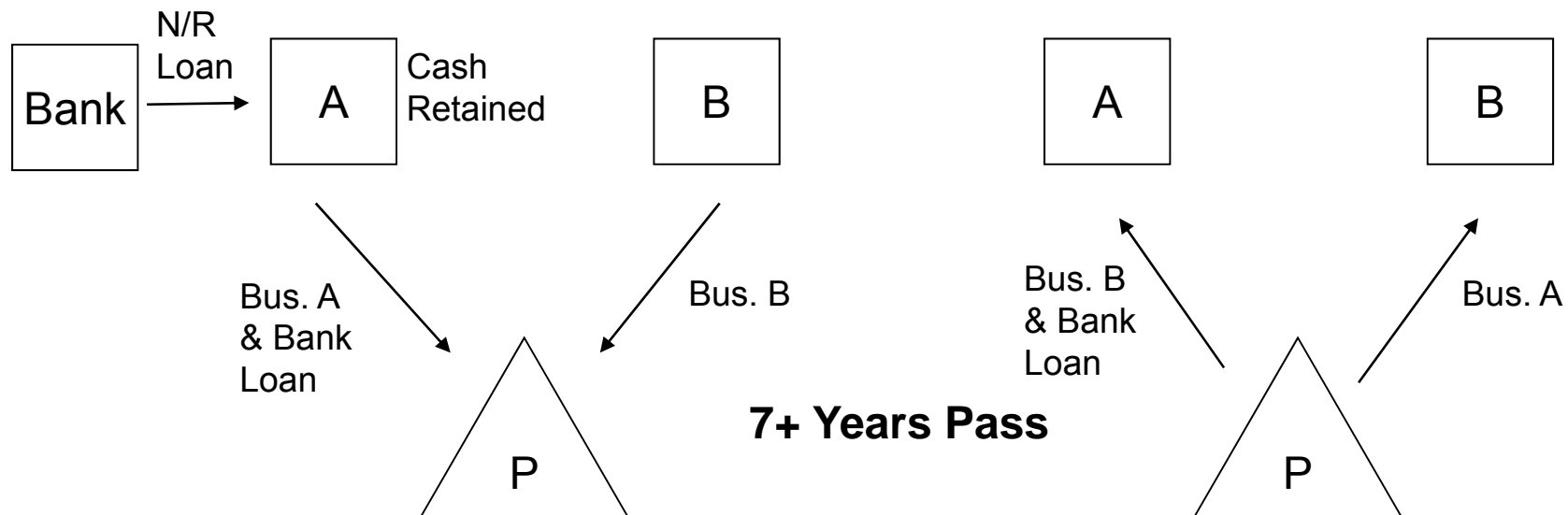
- Use of interposed shell entities
  - Same net worth considerations apply if A interposes a shell corporate subsidiary
  - If A interposes a shell disregarded LLC, lose presumption of satisfaction under Treas. Reg. 1.752-2(b)(6)
    - ◆ Under Treas. Reg. 1.752-2(k), payment obligation of a disregarded LLC is treated as a payment obligation of its owner only to the extent of the net worth of the LLC
  - Regulations did not extend net worth limit to shell corporate subsidiaries
  - Interposing shell corporate subsidiaries seems preferable to shell disregarded LLCs

## Leveraged Mixing-Bowl Transactions and Additional Issues

- Appears that A could vary the level of its net worth as the required level of guarantee varied over time – Treas. Reg. 1.705-1(a), 1.752-4(d)
- As bank loan is paid down, A will recognize the gain that it deferred by reason of the guarantee at contribution
  - Structure bank loan as balloon payment debt so as to push this event far into the future
- Partnership could retain profits in special debt amortization fund so as to insure that funds would be available to pay down debt when it became due
- Use of contribution agreements to force B to make cash contributions to P in case P lacks funds to service bank loan creates risk that A's guarantee would be disregarded – Treas. Reg. 1.752-2(j)
  - Such contribution agreements could be viewed as insulating A from having to pay under its guarantee
- Existence of other senior guarantees or pledged assets increases risk that A's guarantee will be disregarded -- Treas. Reg. 1.752-2(j); CCA 200246014
- Drafting guarantee to limit potential liability of A and to reduce likelihood of payment could result in finding that guarantee should be disregarded. See Treas. Reg. 1.752-2(j); Canal Corp. v. Comm'r, 135 T.C. 199 (2010)

# Leveraged Mixing-Bowl Transactions and Additional Issues

Variant: A borrows against Bus. A assets and contributes assets



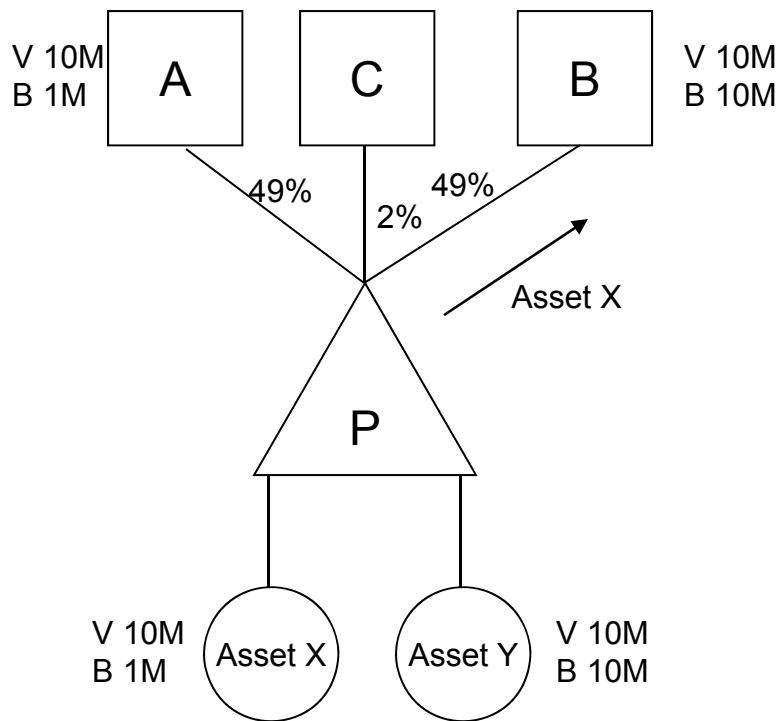
## Leveraged Mixing-Bowl Transactions and Additional Issues

- Issues regarding incurrence of bank loan at P level exist in this structure as well
- However, there are certain disguised sale rules that could eliminate the need for A to guarantee the bank loan when it is transferred to P
  - If bank loan is treated as “qualified liability,” then the deemed distribution of cash to A upon the loan’s transfer from A to P is disregarded for disguised sale of property rules
  - No exception for “qualified liabilities” was contained in the now-withdrawn proposed disguised sale of interest regulations
    - ♦ Even with no exception, still would not have been issue for transfers incident to formation of P
  - “Qualified liability” includes
    - ♦ Liability incurred more than 2 years prior to contribution that has encumbered contributed property for 2-year period leading up to contribution
    - ♦ Liability the proceeds from which are allocable to capital expenditures with respect to contributed property
    - ♦ Ordinary business liabilities where all material business assets contributed
    - ♦ Liability incurred within 2 years prior to contribution but not incurred in anticipation of contribution of property – must “clearly establish”

## Leveraged Mixing-Bowl Transactions and Additional Issues

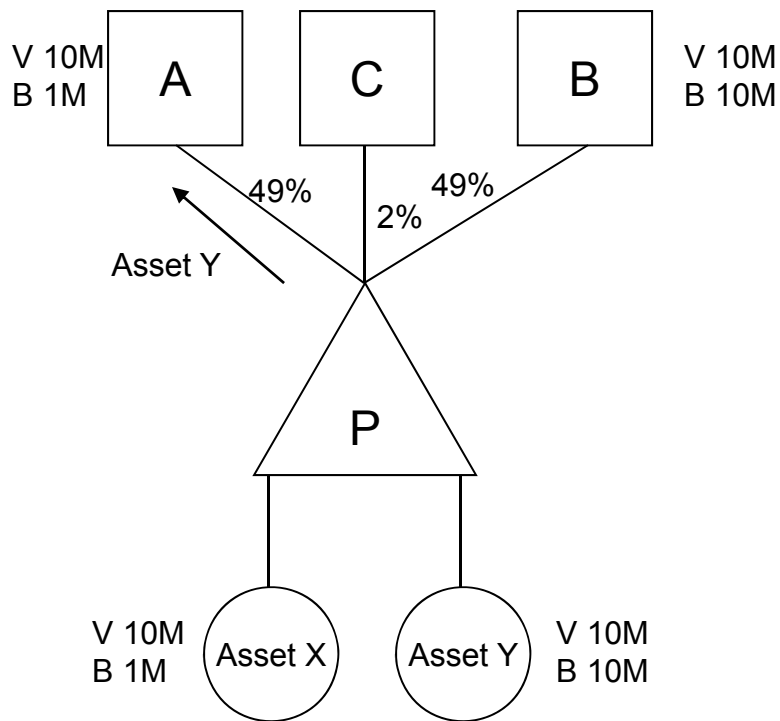
- Even if bank loan is “qualified liability,” guarantee of bank loan may be needed to avoid gain recognition under section 731
- However, may not need to guarantee as much to avoid section 731 risk as would have had to guarantee to avoid section 707 risk if bank loan incurred at P level
  - Section 707: Every dollar of bank loan distributed to A that A does not bear under modified section 752 rules is treated as disguised sale consideration to A
  - Section 731: Only need to guarantee enough to avoid a deemed distribution of cash in excess of outside basis

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



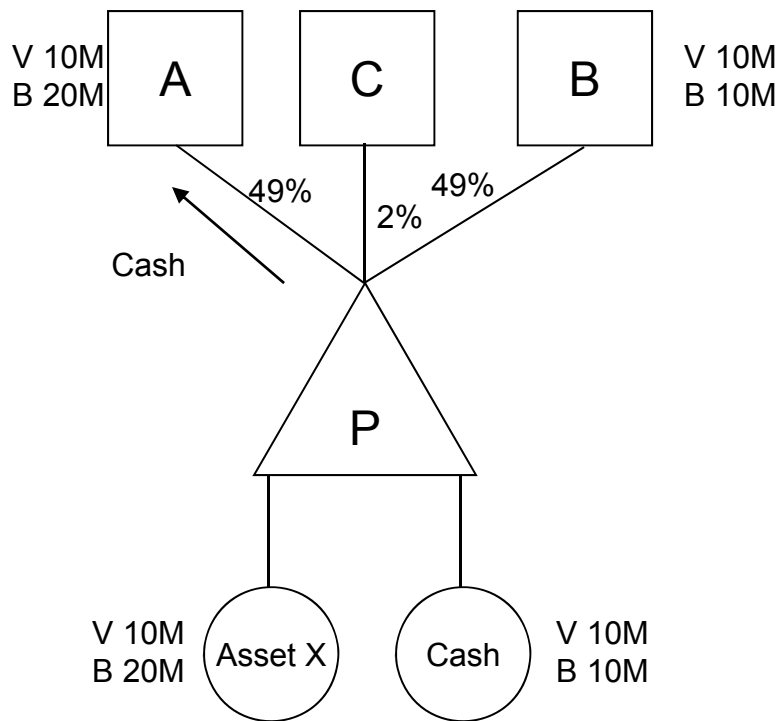
- Prior to AJCA, Asset X takes stepped-up basis in B's hands of 10M, and, if no section 754 election, basis of Asset Y is not reduced.
  - Basis "stripped" from B's interest in P and transferred to Asset X
  - P's sale of Asset Y later yields no gain, but distribution of sale proceeds would trigger gain to A of 9M
  
- After AJCA, Asset X still takes a stepped-up basis in B's hands, but, even if no section 754 election, Asset Y must be stepped down by 9M.
  - no mandatory step down if Asset X's basis step-up  $\leq$  250,000
  - may be able to stagger distributions of property to avoid 250,000 threshold
  
- See amended section 734 ("substantial basis reduction"  $>$  250,000).

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



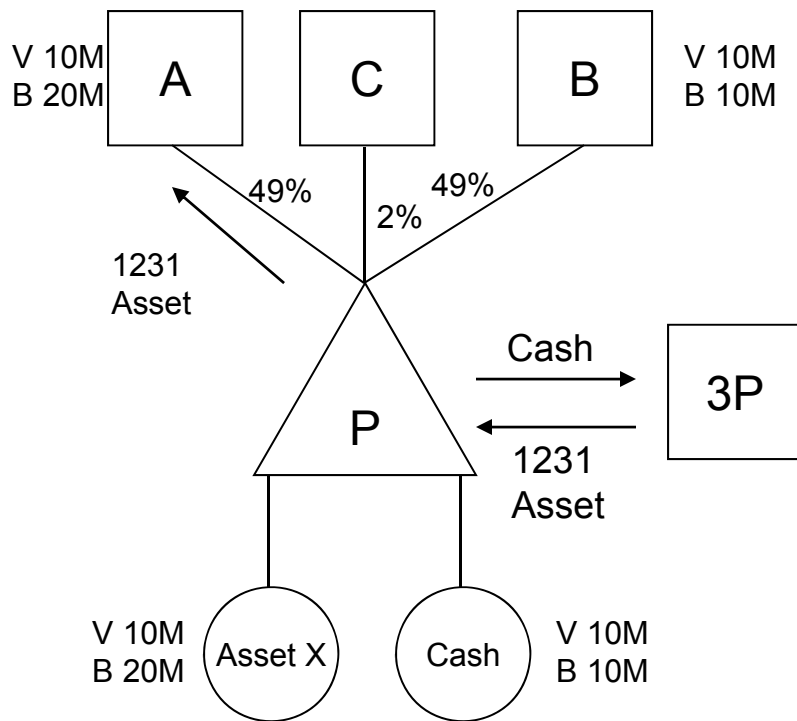
- Prior to AJCA, Asset Y takes stepped-down basis in A's hands of 1M, and, if section 754 election, basis of Asset X is increased by 9M.
  - Basis "stripped" from Asset Y and transferred to Asset X
  - A has gained control of when to recognize its built-in 9M gain
    - prior to distribution, A may not have had control over P's sales of assets
  - Advantageous to A if Asset Y is nondepreciable
  - P's sale of Asset X later yields no gain and distribution of sale proceeds to B should trigger no gain
  
- After AJCA, no apparent change.

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



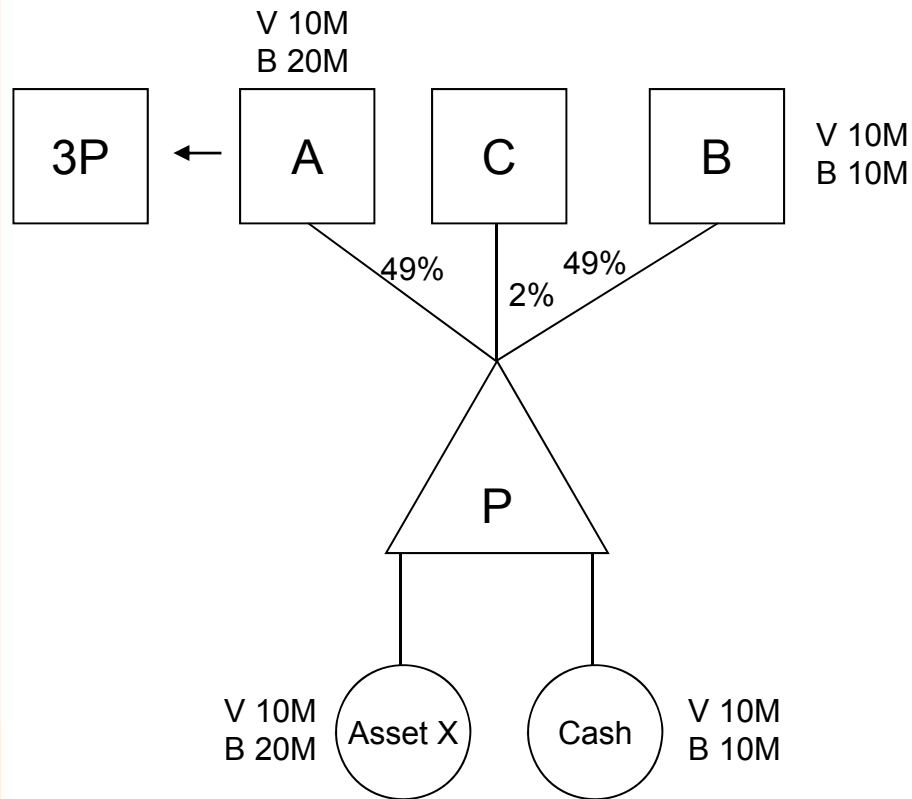
- Prior to AJCA, A recognizes 10M loss, and, if no section 754 election, basis of Asset X remains 20M.
  - P's sale of Asset X later yields another 10M loss, but any distribution of sale proceeds would trigger offsetting gain to B
- After AJCA, A still recognizes 10M loss, and, even if no section 754 election, basis of Asset X reduced by 10M. See amended section 734(b).
  - P's sale of Asset X later yields no gain or loss, and distribution of sale proceeds would yield no gain or loss to B
- Amended section 704(c)(1)(C) overkill?
  - Assuming Asset X was contributed by A with the 10M built-in loss, amended section 704(c)(1)(C) would have prohibited B from taking into account the second 10M loss in the absence of amended section 734(b)
  - But what about loss arising after contribution?

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



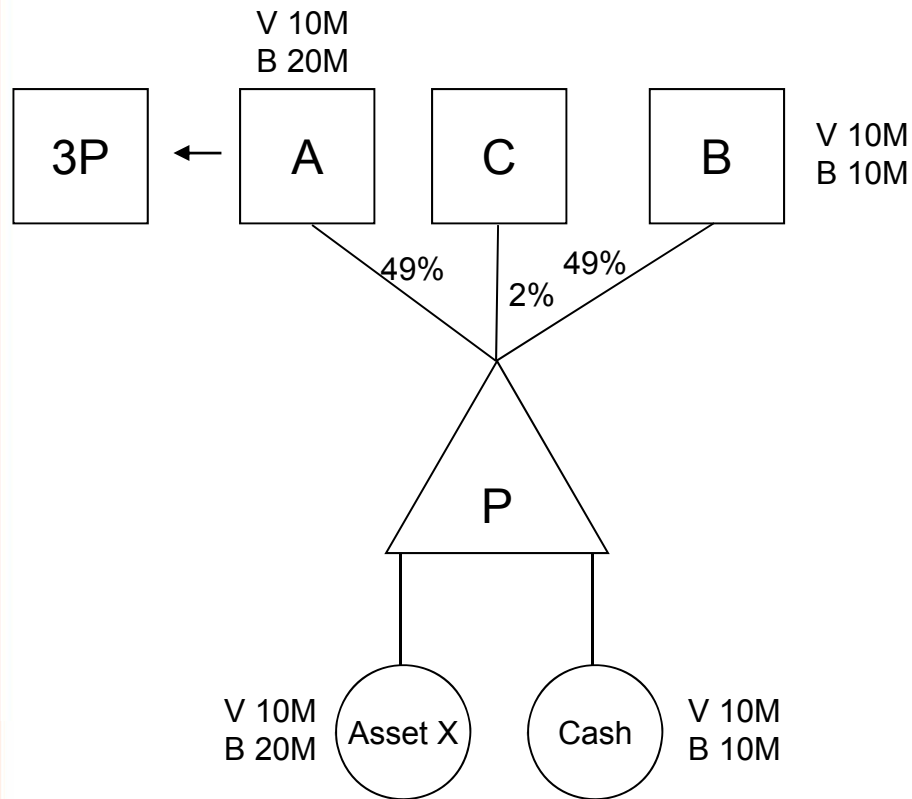
- Instead of P distributing cash to A, P uses the cash to acquire an asset that is used in P's trade or business for more than one year
- P later distributes that asset to A
- A uses that asset in its trade or business for more than one year
- A sells that asset when A does not recognize any gain from other section 1231 property
- If A would have received a cash distribution or sold its interest in P, it would have recognized a 10M capital loss
- However, since A received a section 1231 asset, A can recognize an ordinary loss under section 1231(a) – but see section 1231(c) (5-year recapture period)

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



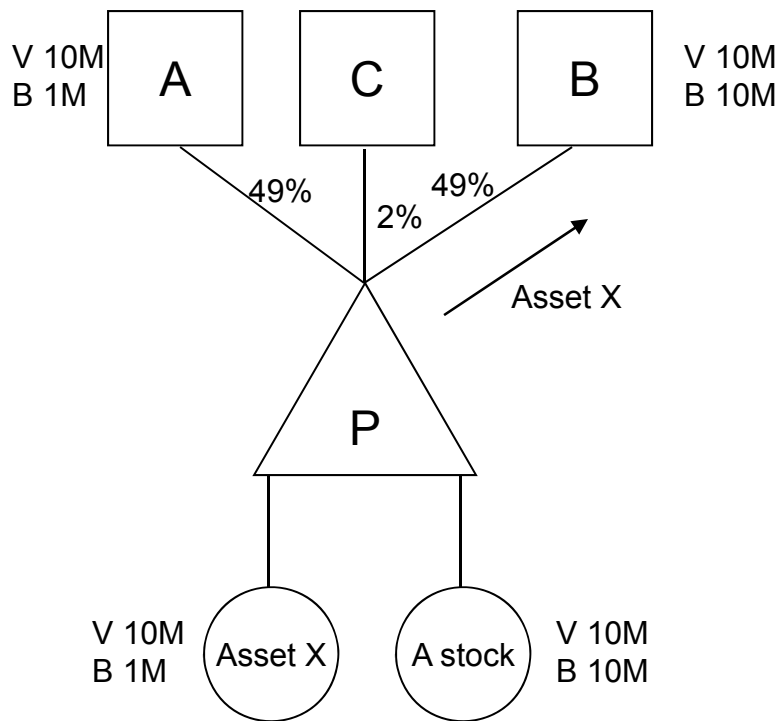
- Prior to AJCA, A recognizes 10M loss, and, if no section 754 election, basis of Asset X unchanged.
  - P's sale of Asset X later yields another 10M loss, but any distribution of sale proceeds would trigger offsetting gain to 3P
- After AJCA, A still recognizes 10M loss, and, even if no section 754 election, basis of Asset X reduced by 10M. See amended section 743(b) ("substantial built-in loss" > 250,000).
  - P's sale of Asset X later yields no gain or loss, and distribution of sale proceeds would yield no gain or loss to 3P
  - "Substantial built-in loss" determined on aggregate basis – avoid with built-in gain property

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



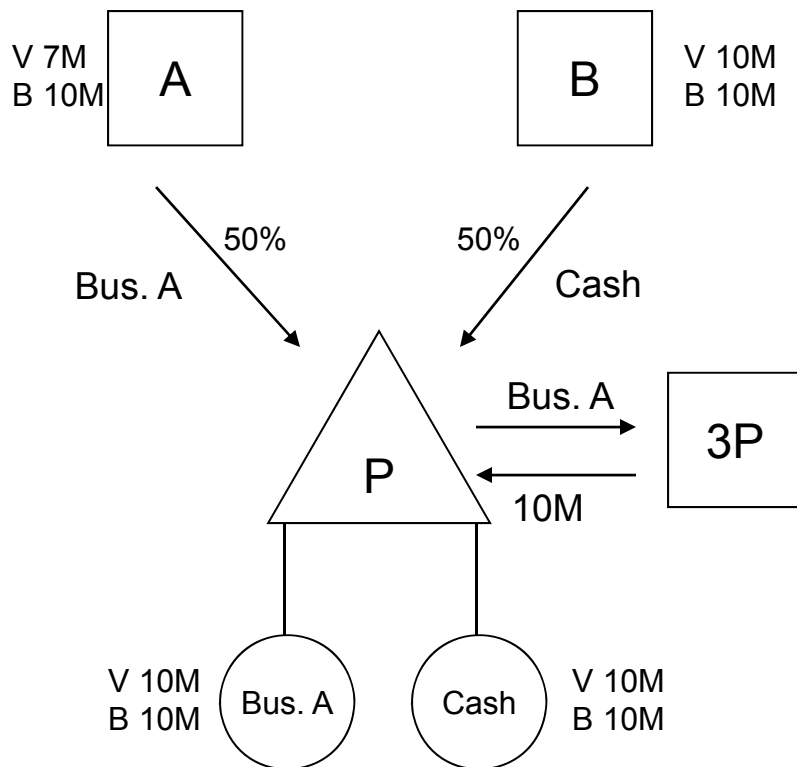
- Amended section 704(c)(1)(C) overkill?
  - Assuming Asset X was contributed by A with the 10M built-in loss, amended section 704(c)(1)(C) would have prohibited 3P from taking into account the second 10M loss in the absence of amended section 743(b)
  - But what about loss arising after A's contribution of Asset X?

## Other Strategies to Keep in Mind with Mixing-Bowl Transactions



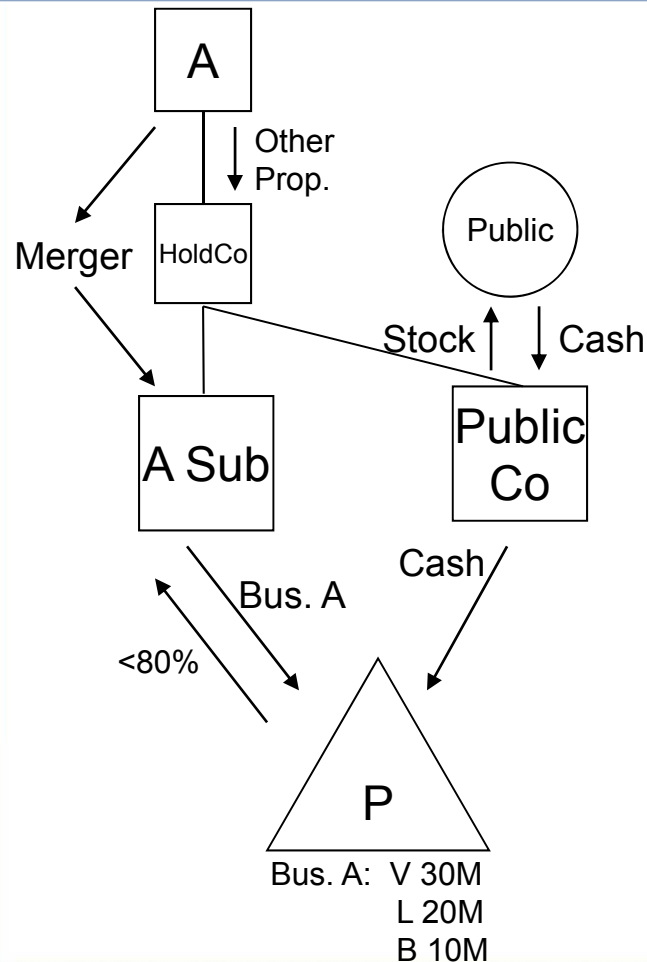
- Prior to AJCA, Asset X takes stepped-up basis in B's hands of 10M, and, if no section 754 election, basis of A stock is not reduced
  - Basis "stripped" from B's interest in P and transferred to Asset X
  - P's sale of A stock later yields no gain, but distribution of sale proceeds would trigger gain to A of 9M
- After AJCA, Asset X still takes a stepped-up basis in B's hands, but, even if no section 754 election, A stock must be stepped down by 9M
  - But irrelevant since section 1032 protects A from gain recognition
- However, after AJCA, since basis step down normally would be made to A stock, amended section 755(c) requires that basis step down be made to "other property" instead
  - If no "other property," P recognizes 9M gain

## Other Partnership Structuring Issues



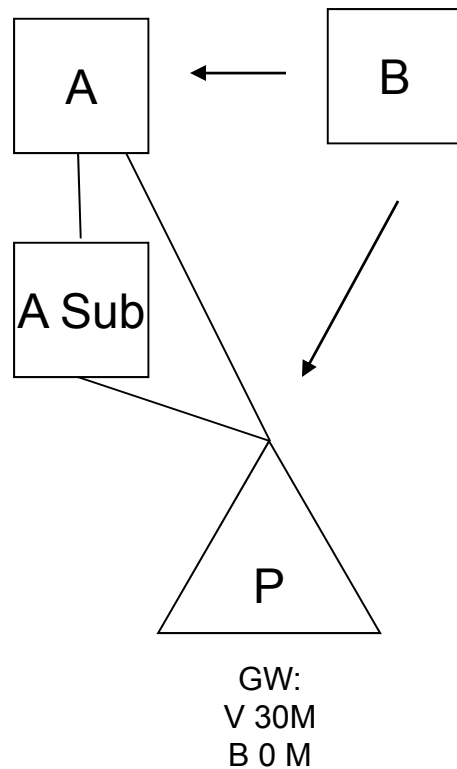
- Bus. A appreciates in P from 7M to 10M, then P sells Bus. A to 3P for 10M
- For purposes of determining A's tax consequences, the basis of Bus. A is 10M – so no gain or loss
- For purposes of determining B's tax consequences, appears that the basis of Bus. A is 7M -- see amended section 704(c)(1)(C).
  - B may have 50% of 3M gain allocated to it – is this right?
- Since there was no economic/book gain or loss, should there be an offsetting 1.5M tax loss allocated to A?

## Other Partnership Structuring Issues



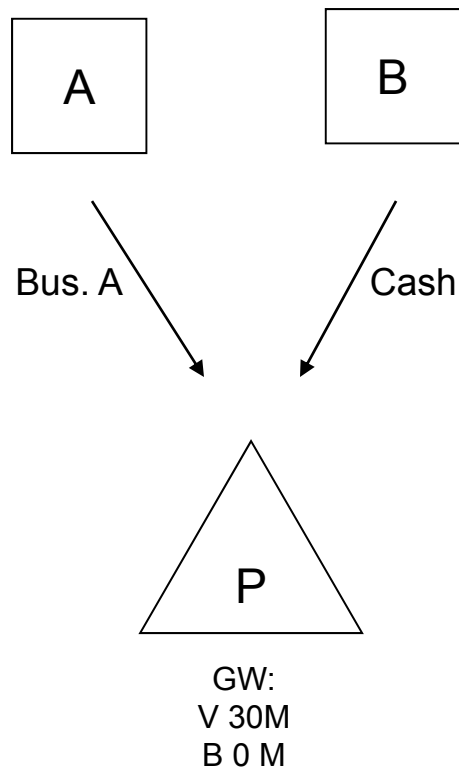
- A wants to take Bus. A public but realizes that it will not be able to retain an 80%+ interest in the business after the IPO and it also does not want to trigger section 357(c) gain
  - A forms HoldCo, A Sub, and Public Co.
  - A transfers Bus. A to A Sub via merger, A Sub contributes Bus. A to P.
  - Public Co contributes cash raised in the IPO to P
- All transactions should be tax-free (but see section 721(b))
- Permits A/HoldCo to retain significant portion of upside without an additional level of tax
- If A/HoldCo wants to exchange its indirect interest in P in tax-free transaction, A Sub can merge with Public Co
- If A/HoldCo wants to exchange its indirect interest in P in taxable transaction, A Sub can exchange its interest in P for Public Co stock
- Public Co can contribute additional assets to P later tax-free since no 80% control requirement
- Structure similar to UPREIT -- Treas. Reg. 1.701-2(d) ex. 4

## Other Partnership Structuring Issues



- A has operated Bus. A since 1990 and has built up a substantial amount of goodwill
- How should B acquire a portion of Bus. A?
  - Alt. 1: If B purchases a portion of Bus. A and then contributes it to P, the anti-churning rules of section 197 will preclude B from taking amortization deductions for its portion of the Bus. A goodwill.
  - Alt. 2: If A (and A Sub.) form P with Bus. A first, B purchases an interest in P from A, and P has a section 754 election, the anti-churning rules of section 197 will not apply to B's portion of the Bus. A goodwill that is stepped-up via section 743(b)
    - How much time should pass between formation of P and sale of interest to B? Cf. Rev. Rul. 70-140
    - B cannot be otherwise related to P or A
- See section 197(f)(9); Treas. Reg. 1.197-2(k) exs. 18, 19

## Other Partnership Structuring Issues



- How should B acquire a portion of Bus. A? (cont.)
  - Alt. 3: If A contributes Bus. A and B contributes other property to P, P can make remedial allocations of amortization to B
  - However, if P distributes B's assets to A shortly after formation of P, could have disguised sale of property between A and P
  - See Treas. Reg. 1.197-2(g)(4), (h)(12)(vii), (k) ex. 17

## Common Business Considerations in Mixing-Bowl Transactions

- Generally, as business risk decreases, tax risk increases
  - 99:1 sharing of interests in income, loss, and cash-flow
  - Preferred Interests
  - Puts and Calls
  - Obligating one party to contribute cash to P to ensure enough cash flow to meet current distribution requirements
  - Insulating Bus. A assets from liabilities of Bus. B
  - Retaining operational control over contributed business
- Note that, if B contributes only cash or cost-basis assets, B may not care about tax risks
  - Recast as sale of Bus. A to B may not hurt (may even help) B from tax perspective
  - Consider using Tax Indemnity Agreement in favor of A to make B care about tax risks

## Common Business Considerations in Mixing-Bowl Transactions

- Possible techniques to reduce business risk without increasing tax risk
  - Restrict B's right to manage Bus. A
  - Permit A to take over management of Bus. A if financial distress
  - Require P to hire trusted third-party managers for Bus. A
  - Give A control (or veto right) over P's tax returns and audits – control tax treatment (particularly in first year)
  - Give A control (or veto right) over selection of P tax elections
    - ◆ E.g., section 704(c) allocation method, section 754 election
  - Provide stated mechanism for determining FMV of contributed assets for capital account and section 704(c) purposes
  - Prohibit P from disposing of Bus. A assets outside ordinary course of business without approval of A (section 704(c)(1)(B))
  - Provide for tax liability distribution provision

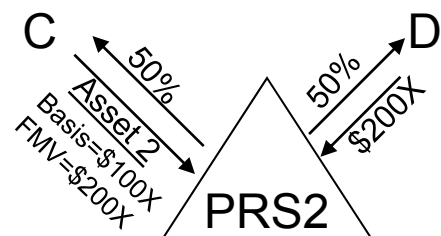
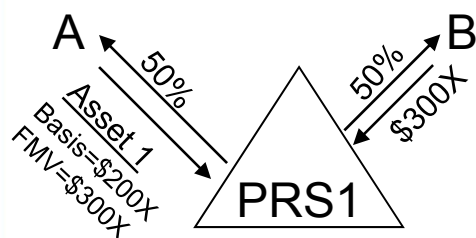
## Proposed Regulations – Partnership Mergers

- Proposed regulations concerning the application of sections 704(c)(1)(B) and 737 to distributions of property after two partnerships engage in an assets-over merger
  - Some commentators argued that Rev. Rul. 2004-43 was not consistent with the existing regulations under sections 704(c)(1)(B) and 737
- Proposed regulations implement principles articulated in Rev. Rul. 2004-43.
  - §1.704-4(c)(4) and §1.737-2(b) provide that in an assets-over merger, sections 704(c)(1)(B) and 737 do not apply to the transfer by a partnership (the transferor partnership) of all of its assets and liabilities to another partnership (the transferee 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.
  - Proposed regulations, however, provide that section 704(c)(1)(B) applies to a subsequent distribution by the transferee partnership of section 704(c) property contributed in the assets-over merger by the transferor partnership to the transferee partnership
  - Proposed regulations also provide that section 737 applies when a partner of the transferor partnership receives a subsequent distribution of property (other than money) from the transferee partnership.

# Proposed §704(c) & §737 Regulations – Partnership Mergers

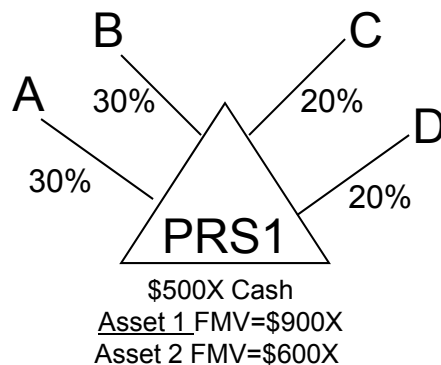
## Example 1

January 1, 2005

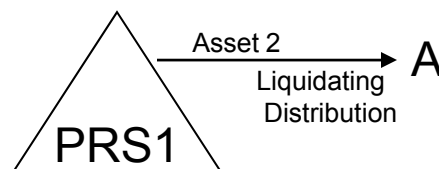


January 1, 2008

PRS2 merges into PRS1



January 1, 2013



### 1.704-4 Example (1)

- On 1/1/08, Asset 2 has \$500X §704(c) gain (\$600X FMV - \$100X inside basis)
  - \$100X of original §704(c) gain (\$200X FMV (1/1/05) - \$100X inside basis)
  - \$400X of new §704(c) gain (\$500X total §704(c) gain - \$100X of original §704(c) gain)
- On 1/1/13 liquidating distribution
  - C and D required to recognize \$200X of §704(c) gain each
    - C and D split \$400X of new §704(c) gain
    - \$100X of original §704(c) gain excluded

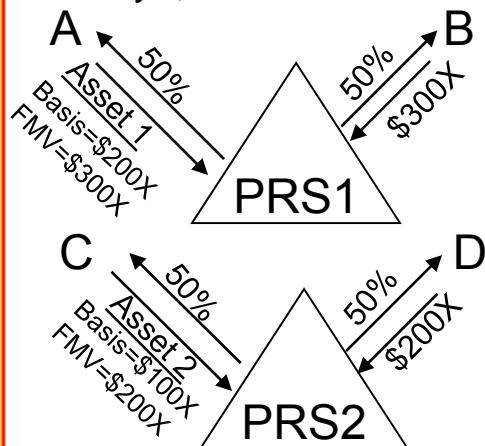
### 1.737-2 Example (1)

- A will not recognize gain on the distribution
  - Distribution of Asset 2 results in a \$400X excess distribution (FMV \$600X - \$200X outside basis)
  - However, because distribution occurred 7+ years after A's contribution of Asset 1, A's net precontribution gain for purposes of §737 is zero
    - \$600X of reverse §704(c) gain in Asset 1 not considered precontribution gain

# Proposed §704(c) & §737 Regulations – Partnership Mergers

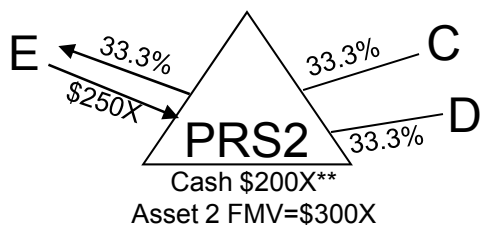
## Example 2

January 1, 2005



Sometime in 2005

(January 1, 2007 in §1.737-2 Example)

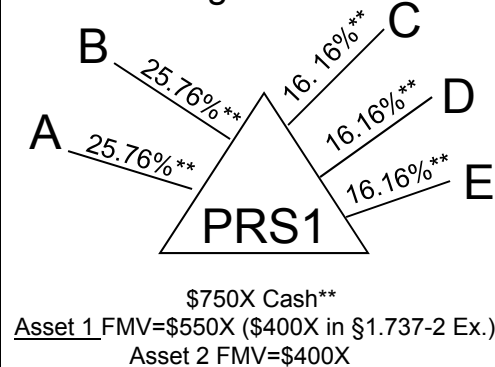


- Partnership revalues assets at E admission under §1.704-1(b)(2)(iv)(f)
- Unrealized gain of \$100X attributable to Asset 2 allocated equally between C and D, or \$50X each

\*\* Detail omitted in §1.737-2 Example, but would not change result

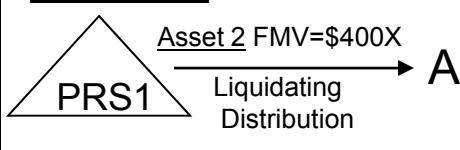
January 1, 2008

PRS2 merges into PRS1

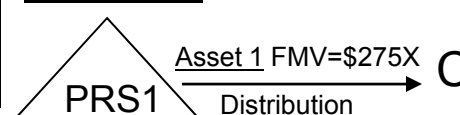


January 1, 2011

§1.704-4 Example



§1.737-2 Example



### §1.704-4 Example (2)

- On 1/1/08, Asset 2 has \$300X §704(c) gain (\$400X FMV - \$100X inside basis)
  - \$100X of original §704(c) gain (\$200X FMV (1/1/05) - \$100X inside basis)
  - \$200X of new §704(c) gain (\$300X total §704(c) gain - \$100X of original §704(c) gain)
- On 1/1/11 liquidating distribution, C, D and E recognize gain
  - C will recognize \$183.33X of gain (\$100X of original §704(c) gain + \$50X of new §704(c) gain as a result of the revaluation + \$33X of new §704(c) gain as a result of the merger)
  - D will recognize \$83.33X of gain (\$50X of new §704(c) gain as a result of the revaluation + \$33X of new §704(c) gain as a result of the merger)
  - E will recognize \$33.33X of gain (all new §704(c) gain as a result of the merger)

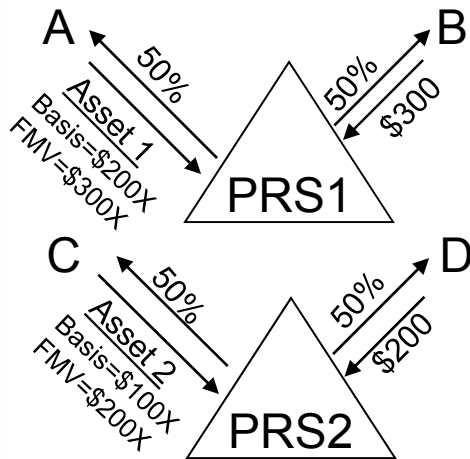
### §1.737-2 Example (2)

- Distribution of Asset 1 to C results in \$175X excess distribution (\$275X FMV - \$100X adjusted outside basis)
- C's pre-contribution gain at distribution is \$183.33X (\$100X original §704(c) gain + \$50X reverse §704(c) gain on admission of E + \$33.33X §704(c) gain upon merger)
- C recognizes \$175X gain upon receipt of Asset 1, because C's excess distribution is less than C's net pre-contribution gain

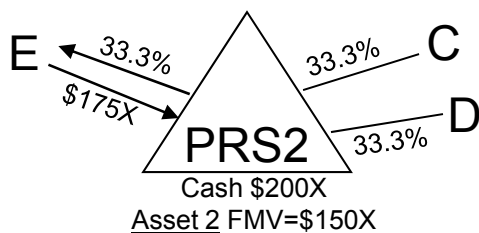
# Proposed §704(c) Regulations – Partnership Mergers

## Example 3

January 1, 2005

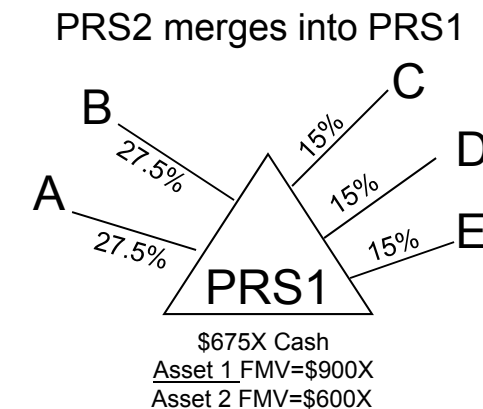


Sometime in 2005

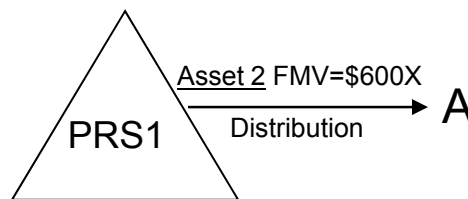


- Partnership revalues assets at E admission under §1.704-1(b)(2)(iv)(f)
- Unrealized loss of \$50X attributable to Asset 2 allocated equally between C and D, or \$25X each

January 1, 2008



January 1, 2013



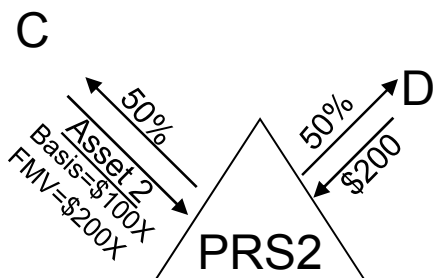
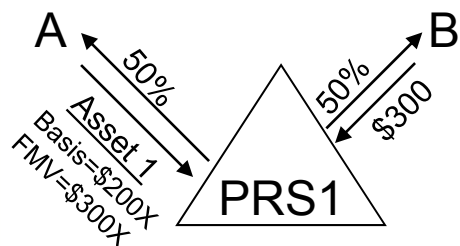
### § 1.704-4 Example (3)

- On 1/1/08, Asset 2 has \$500X §704(c) gain (\$600X FMV - \$100X inside basis)
  - ♦ \$50X original §704(c) gain (\$200X FMV - \$100 adjusted inside basis - \$50X unrealized loss attributable to 2005 revaluation)
  - ♦ \$450X new §704(c) gain (\$500X §704(c) gain - original \$50X §704(c) gain)
- On 1/1/13 distribution, C, D and E each recognize \$150X gain (1/3 each of \$450X new §704(c) gain)
  - ♦ Because distribution of Asset 2 occurs 7+ years after contribution by C, §704(c)(1)(B) does not apply to original §704(c) gain
  - ♦ However, because distribution occurs within 7 years of merger, §704(c)(1)(B) applies to new §704(c) gain

# Proposed §737 Regulations – Partnership Mergers

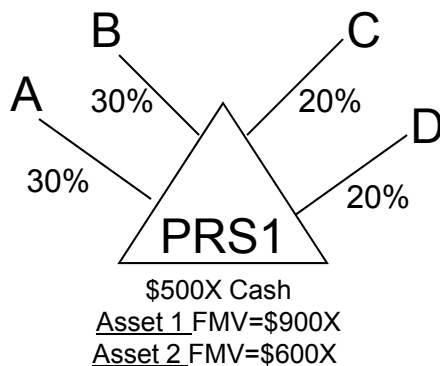
## Example 3

January 1, 2005

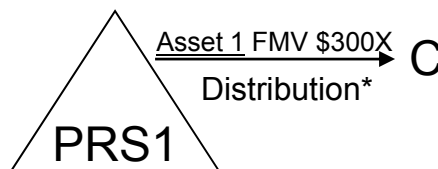


January 1, 2008

PRS2 merges into PRS1



January 1, 2011



\* Immediately prior to distribution, PRS1 revalues its property in accordance with §1.704-1(b)(2)(iv)(f)

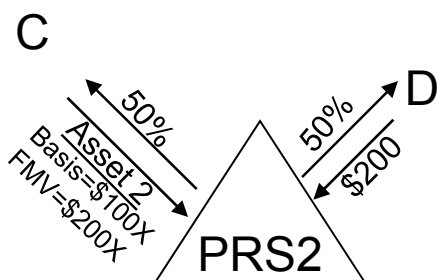
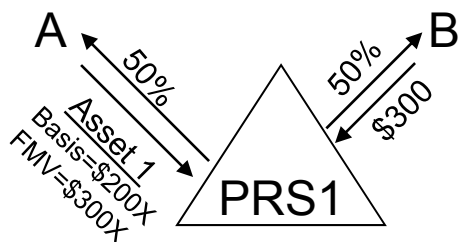
### 1.737-2 Example (3)

- C's net precontribution gain at distribution is \$300X (\$100X original §704(c) gain + \$200X new §704(c) gain)
  - ♦ Distribution results in excess distribution of \$200X (\$300X FMV - \$100X outside basis)
  - ♦ C recognizes \$200X of gain upon receipt of Asset 1

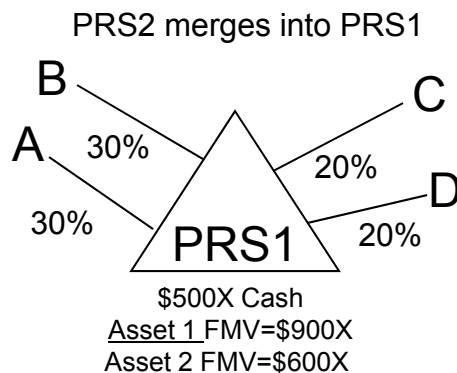
# Proposed §704(c) & §737 Regulations – Partnership Mergers

## Example 4

January 1, 2005

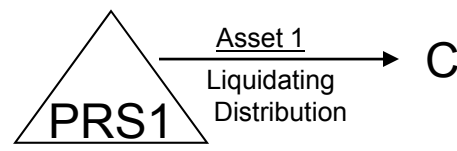


January 1, 2008



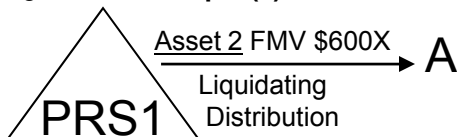
January 1, 2013

### §1.704-4 Example (4)



January 1, 2011

### §1.737-2 Example (4)



### §1.704-4 Example (4)

- Neither A nor B recognize gain under §704(c)(1)(B) as a result of the distribution of Asset 1 to C
  - No original §704(c) gain pursuant to §1.704-4(c)(4)(ii)(A) (distribution 7+ years after contribution)
  - No reverse §704(c) gain pursuant to §1.704-4(c)(7) (reverse gain or loss excluded)

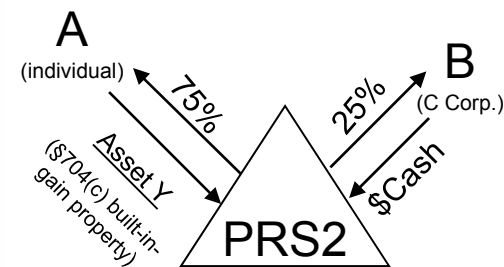
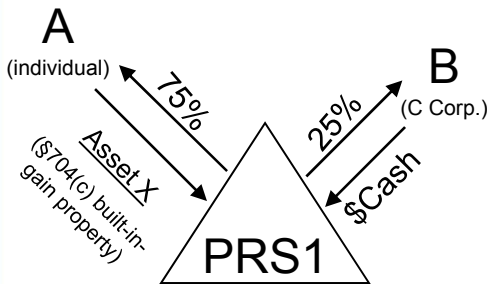
### §1.737-2 Example (4)

- Distribution of Asset 2 results in \$400X excess distribution (\$600X FMV - \$200X adjusted basis)
- \$100X §737(b) pre-contribution gain at distribution (A's original §704(c) gain from contribution to Asset 1) because distribution occurs within 7 years of contribution
  - Under §1.737-2(e), A's net pre-contribution gain excludes A's reverse §704(c) gain upon revaluation of Assets of PRS1 prior to merger
- A recognizes \$100X of gain (lesser of excess distribution or net pre-contribution gain) under §737

# Proposed §704(c) & §737 Regulations – Partnership Mergers

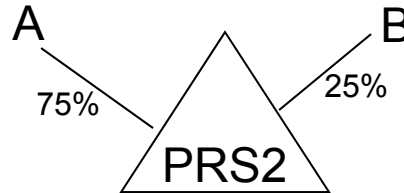
## Example 5

1990



January 2005

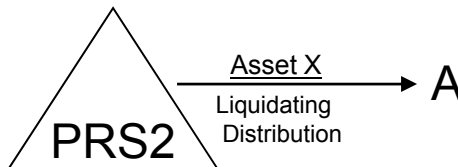
PRS1 merges into PRS2



Asset X and Asset Y have increased in value

- New §704(c) gain in Asset X
- Reverse §704(c) gain in Asset Y

2006



### 1.704-4 Example (5)

- Original built-in gain on original Asset X contribution to PRS1 not taken into account in applying §704(c)(1)(B) because distribution occurs 7+ years after formation of PRS1 and original contribution of Assets X to PRS1
- New built-in gain upon contribution of Asset X in connection with the partnership merger not taken into account in applying section 704(c)(1)(B) to the proposed distribution
  - §1.704-4(c)(4)(ii)(E) provides that §704(c)(1)(B) and paragraph §1.704-4(c)(4)(ii)(B) do not apply to new §704(c) gain or loss in property transferred by the transferor partnership to transferee partnership if both the transferor and transferee partnerships owned by same owners in same proportions

### 1.737-2 Example (5)

- Original built-in gain on original contribution of Asset Y excluded in applying §737 because distribution occurs 7+ years after PRS2 formation and original contribution of Asset Y
- New built-in gain created upon revaluation of Asset Y in connection with the partnership merger will not be taken into account in applying §737 to the proposed distribution