What You Should Know About Mergers and Divisions of Partnerships

Brad Borden
The partnership merger and division rules have potential as planning tools – and as tax disasters

Table of Contents

I. Overview of Partnership Mergers ........................................... 2
   A. Assets-Up Merger ........................................................... 2
   B. Assets-Over Merger ......................................................... 2

II. Overview of Partnership Divisions ................................. 3
   A. Assets-Up Division .......................................................... 4
   B. Assets-Over Division ........................................................ 4

III. Inside-Basis/Outside-Basis Disparity .............................. 4
    A. Assets-Over Form ............................................................ 5
    B. Assets-Up Form ............................................................ 6

IV. Change in Share of Partnership Liabilities ...................... 7

V. The Anti-Mixing Bowl and Disguised Sale Rules .............. 9
   A. Anti-Mixing-Bowl ............................................................ 9
   B. Disguised Sale ............................................................... 10

VI. The Effect on the Participating Entities ......................... 12

VII. Anti-Abuse Rules .......................................................... 13

VIII. Conclusion ................................................................. 13

Practice Checklist ............................................................ 14

Unique planning opportunities exist for tax practitioners thanks to the promulgation of regulations under Internal Revenue Code (“Code”) section 708(b)(2). (All section references are to the Code unless otherwise indicated.) Those regulations provide specific rules on how to treat partnership mergers and divisions for tax purposes. Relying on the partnership merger and division rules, practitioners are finding creative solutions to complicated tax problems. Unfortunately, tax planners can misstep when planning a partnership merger or division or overlook the rules entirely and find that their failure undermines other planning objectives.

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Four important points must be considered when structuring partnership mergers or divisions: (1) inside-basis/outside-basis disparity; (2) changes in shares of partnership liabilities; (3) the anti-mixing bowl rules; and (4) the effect on the participating entities.

I. OVERVIEW OF PARTNERSHIP MERGERS

The general principle of partnership mergers is that at least one of the merging partnerships terminates. The starting point in determining which partnership terminates is identifying a partnership merger. There is no definition of partnership merger in the Code or the Regulations. It is, however, accepted that partnerships do not have to file articles of merger to be treated as merging under the Section 708 regulations. Thus, two general partnerships combining their respective assets and business operations merge under the Section 708 regulations. Also, the contribution of all of the assets of one partnership to another partnership could be a partnership merger.

After establishing that two partnerships will merge for tax purposes, the terminating partnership must be identified. A merging partnership terminates at the end of a partnership merger if the members of the merging partnership own less than 50 percent in the capital and profits of the resulting partnership. If, however, the partners of two or more merging partnerships own more than 50 percent of the capital and profits of the resulting partnership, the partnership that is credited with contributing assets with the smallest fair market value (net of liabilities) will be the terminating partnership. Treas. Reg. § 1.708-1(c)(1). The form of the partnership merger will determine how the assets flow from the terminating partnership to the resulting partnership.

A. Assets-Up Merger

All partnership mergers are either assets-up mergers or assets-over mergers. Under the assets-up merger, the terminating partnership distributes all of its assets to its partners in complete liquidation of the partners’ interests, the partners become the owners of the assets under state law, and the partners then contribute those assets to the resulting partnership. The form of this transaction will be respected despite the transitory ownership of the terminating partnership’s assets. Treas. Reg. §1.708-1(c)(3). All other partnership mergers take the assets-over form of merger. Treas. Reg. §1.708-1(c)(3)(i).

B. Assets-Over Merger

Under the assets-over form, the terminating partnership is deemed to contribute (or actually contributes) all of its assets to the resulting...
partnership in exchange for an interest in the resulting partnership. The terminating partnership is then deemed to distribute (or actually distributes) the interests in the resulting partnership to its partners in complete liquidation of their interests in the terminating partnership. Treas. Reg. §1.708-1(c)(3)(i).

II. OVERVIEW OF PARTNERSHIP DIVISIONS

In every partnership division, each resulting partnership is either a continuation of the original partnership or a new partnership. In some situations, the original partnership may continue for tax purposes in more than one resulting partnership, but it is not unusual for the original partnership to terminate. If the original partnership terminates, all of the resulting partnerships will be new partnerships. Thus, after determining that a partnership division has occurred, one must determine which, if any, of the resulting partnerships is a continuation of the original partnership and which, if any, of the resulting partnerships is a new partnership.

A resulting partnership will be a new partnership if the members of the resulting partnership had an interest of 50 percent or less in the original partnership. If the members of only one resulting partnership had an interest of 50 percent in the original partnership, that resulting partnership will be a continuation of the original partnership, and all other resulting partnerships will be new partnerships. If the members of none of the resulting partnerships had more than a fifty percent interest in the original partnership, none of the resulting partnerships will be a continuation of the original partnership – instead, all resulting partnerships will be new partnerships. If the members of more than one resulting partnership had more than a 50 percent interest in the original partnership, all such entities shall be a continuation of the original partnership. Treas. Reg. §1.708-1(d)(1).

After identifying any continuing and new partnerships, the focus turns to the flow of assets from the divided partnership to the other partnerships. The focus is placed first on determining which partnership is the divided partnership. Once the divided partnership is identified, one can predict the flow of assets in the division. Assets will flow from the divided partnership to the other partnerships in either an assets-over division or an assets-up division. The divided partnership is the partnership that is deemed to contribute assets to any new partnership (assets-over division) or to distribute them to the partners who will become members of any new partnership (assets-up division). Treas. Reg. §1.708-1(d)(4). The divided partnership is determined in a three-part elimination process.

- First, if the partnership that, in form, transfers the assets is a continuation of the original partnership, that partnership is the divided partnership.
• Second, if the transferring partnership is not a continuing partnership and if there is only one continuing partnership, the continuing partnership is the divided partnership.
• Third, in all other situations, the continuing partnership with assets having the greatest fair market value (net of liabilities) is treated as the divided partnership.

A. **Assets-Up Division**

Once the divided partnership is identified, one can direct the flow of assets in the division. The division will be an assets-up division only if (1) the divided partnership distributes certain assets to some or all of its partners in partial or complete liquidation of the partners' interests in the original partnership, and, (2) following the distribution, the distributee partners immediately contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partnerships. Treas. Reg. §1.708-1(d)(3)(ii)(A). If there is no continuing partnership for tax purposes, but the original partnership distributes some of its assets to some of the partners, the original partnership will be deemed to distribute all of its assets in complete liquidation of all of the partners' interests. The partners will then be deemed to contribute the assets to different partnerships. The distribution and contribution will be deemed to occur with respect to all resulting partnerships even though the original partnership does not terminate for legal purposes. Treas. Reg. §1.708-1(d)(3)(ii)(B).

B. **Assets-Over Division**

All other forms of partnership divisions will be assets-over. Treas. Reg. §1.708-1(d)(3)(i). Under the assets-over form of division, for federal income tax purposes, the divided partnership contributes its assets to one or more other partnerships in exchange for interests in the recipient partnership or partnerships. The divided partnership then distributes the interests in the recipient partnership or partnerships to the partners of the original partnership in complete or partial liquidation of their interests. Treas. Reg. §1.708-1(d)(3)(i)(A). If there is no continuing partnership, the original partnership will be deemed to contribute all of its assets to new partnerships in exchange for partnership interests. The original partnership will then be deemed to distribute the interests in the new partnerships to the partners in complete liquidation of their interests in the original partnership. Treas. Reg. §1.708-1(d)(3)(i)(B).

III. **INSIDE-BASIS/OUTSIDE-BASIS DISPARITY**
Drawing upon the principles of partnership mergers and divisions, tax advisors may help partners and partnerships obtain favorable tax results in mergers or divisions. Failure to consider these principles can result in unfavorable tax consequences. Tax advisors must be particularly aware of pitfalls when partnerships have inside-basis/outside-basis disparity. The following example demonstrates this point in the partnership division context.

**Example: Division of Partnership and Properties**

A, B, and C are equal partners in ABC Partnership. A has an outside basis in ABC Partnership of $200,000 and B and C have outside bases of $100,000. ABC Partnership has two properties: Property 1, with a basis of $300,000 and a fair market value of $900,000 and Property 2, with a basis of $600,000 and fair market value of $900,000. B and C have had a falling out and wish to terminate their relationship. A would like to remain partners with each of B and C. The partners are considering dividing the partnership with A and B becoming partners in AB Partnership, which will own Property 1, and A and C becoming partners in AC Partnership, which will own Property 2. ABC Partnership will transfer Property 2 to AC Partnership and then become AC Partnership. Not surprisingly, the different forms of partnership division create different results when there is an inside-basis/outside-basis disparity.

**A. Assets-Over Form**

Because the members of both AB Partnership and AC Partnership had a greater than 50 percent ownership in ABC Partnership, both resulting partnerships will be a continuation of ABC Partnership. Under the assets-over form, AB Partnership will be the divided partnership because it will transfer Property 2 to AC Partnership in exchange for all of the interests in AC Partnership. AB Partnership will then distribute one third of the AC Partnership interests to A in partial liquidation of A’s interest in AB Partnership and will distribute two thirds of the AC Partnership interests to C in complete liquidation of C’s interest in AB Partnership.

Under Section 721, no gain or loss will be recognized on the contribution to AC Partnership. AC Partnership will take a $600,000 basis in Property 2 under Section 723, and AB Partnership will take a $600,000 basis in its AC Partnership interests under Section 722.

Under Section 731(a)(1) and (b), no gain or loss will be recognized by the partners or the partnerships on the distribution of the AC Partnership interests to A and C. A, receiving a non-liquidating distribution, will take a basis in the AC Partnership interest equal to the basis AB Partnership had in the interest, or $200,000 (one third of $600,000). §732(a)(1). A’s interest in AB Partnership will be reduced to
zero. §§ 705(2) and 733(2). C, receiving a liquidating distribution, will take a basis in the AC Partnership interests of $100,000 (C's outside basis in ABC Partnership). § 732(b). Thus, the division results in the following bases:

<table>
<thead>
<tr>
<th>AB Partnership</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property 1</td>
<td>$300,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>A's Outside Basis</td>
<td>-0-</td>
<td>300,000</td>
</tr>
<tr>
<td>B's Outside Basis</td>
<td>100,000</td>
<td>600,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>AC Partnership</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property 2</td>
<td>$600,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>A's Outside Basis</td>
<td>200,000</td>
<td>300,000</td>
</tr>
<tr>
<td>C's Outside Basis</td>
<td>100,000</td>
<td>600,000</td>
</tr>
</tbody>
</table>

B. Assets-Up Form

AB Partnership distributes Property 2 to A and C in partial liquidation of A's interest and in complete liquidation of C's interest. Again, AB Partnership as the distributing partnership and as a continuing partnership will be the divided partnership. A takes a one-third undivided interest and C takes a two-thirds undivided interest in Property 2. A takes a basis in the one-third undivided interest equal to ABC Partnership's basis in the interest, or $200,000, and C takes a basis in the two-thirds interest equal to C's basis in ABC Partnership, or $100,000. §732(a)(1), (b). A and C then contribute their interests in Property 2 to AC Partnership. AC Partnership takes a $300,000 basis in Property 2 (A's $200,000 basis and C's $100,000 basis). § 723. A's outside basis in AC Partnership is $200,000 and C's outside basis is $100,000. § 722. A's outside basis in AB Partnership is reduced to zero on the distribution of Property 2. I.R.C. §§ 705(2) and 733(2). Thus, the assets-up division results in the following bases:
This example demonstrates that by using the assets-up form, instead of the assets-over form, AC Partnership loses basis. Under the assets-over form, AC Partnership takes a basis of $600,000 in Property 2 but, under the assets-up form, takes a basis in Property 2 of only $300,000. If Property 2 were sold immediately following the division, AC Partnership would have $300,000 more of gain to allocate to the partners if the assets-up form is used. Also, if Property 2 is a depreciable asset, the assets-up form will cause AC Partnership to pass lower depreciation deductions on to the partners. Thus, the assets-over form produces the most favorable tax result. The unwary tax advisor, failing to consider both forms, could inadvertently choose the assets-up form, causing AC Partnership to lose basis.

If the opposite situation occurs, however, the assets-up form is preferable. For example, if the partners' outside bases exceed the terminating partnership's inside basis, the assets-up form would result in the assets being contributed to the new partnership with a larger basis. This would create larger depreciation deductions and give the property larger basis to reduce gain recognition on the subsequent disposition of the property.

IV. CHANGE IN SHARE OF PARTNERSHIP LIABILITIES

Section 1.752-1(f) of the regulations provides that when two or more partnerships merge or consolidate under Section 708(b)(2)(A), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under Section 752. Although this rule can create problems if not considered in partnership mergers, it also creates planning opportunities. Consider the Section 752 deemed contribution and distribution rules and then consider
Bradley T. Borden

the potential for using partnership mergers to improve the tax position of the partners.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of such partnership liabilities, shall be considered a contribution of money by such partner to the partnership. This deemed cash contribution increases a partner's basis in the partnership. §722.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered a distribution of money by the partnership to the partner. This deemed distribution shall reduce the partner's basis in the partnership and, to the extent the deemed distribution exceeds the partner's outside basis in the partnership, the partner shall recognize gain on the deemed distribution. §§ 705(2), 731(a), and 733.

Consider the possible negative Section 752 results of a partnership merger. B owns a 70 percent interest in Partnership T. Partnership T's sole asset is Property X which is encumbered by a $1,000 liability. Partnership T's adjusted basis in Property X is $600, and the value of Property X is $1,000. B's adjusted basis in its Partnership T interest is $420. B also owns a 20 percent interest in Partnership S. Partnership S's sole asset is Property Y, which is encumbered by a $100 liability. Partnership S's adjusted basis in Property Y is $200, the value of Property Y is $1,000, and B's adjusted basis in its Partnership S interest is $40.

Partnership T and Partnership S merge under Section 708(b)(2)(A). Under Section 708(b)(2)(A) and Treas. Reg. §1.708-1(c)(1), Partnership T is considered terminated and the resulting partnership is considered a continuation of Partnership S. Partnerships T and S undertake the assets-over merger. Partnership T contributes Property X subsequent to the $1,000 liability to Partnership S in exchange for an interest in Partnership S. Immediately thereafter, Partnership T distributes the interests in Partnership S to its partners in liquidation of their interests in Partnership T. B owns a twenty-five percent interest in Partnership S after Partnership T distributes the interests in Partnership S to B.

Under Treas. Reg. §1.752-1(f), B nets the increases and decreases in its share of partnership liabilities associated with the merger of Partnership T and Partnership S. Before the merger, B's share of partnership liabilities was $720 (B had a $700 share of partnership liabilities in Partnership T and a $20 share of partnership liabilities in Partnership S immediately before the merger). B's share of Partnership S's partnership liabilities after the merger is $275 (25 percent of S's total partnership liabilities of $1,100). Accordingly, B has a $445 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a
$445 distribution from Partnership S under Section 752(b). Because B's adjusted basis in its Partnership S interest before the deemed distribution under Section 752(b) is $460 ($420 + $40), B will not recognize gain under Section 731. After the merger, B's adjusted basis in its Partnership S interest is $15. If Partnership S subsequently allocates more than $15 of loss and no gain to B, B will not be able to recognize the entire portion of loss because of the reduced outside basis.

Section 752 also creates planning opportunities under the merger rules. Assume A and B are partners in AB Partnership. A has an outside basis of $10 and B has an outside basis of $50 in AB Partnership. AB Partnership will recognize a loss this year of $40, which will be allocated equally to each of A and B. B will be able to recognize the entire loss, but A will recognize the loss only to the extent of its $10 basis in AB Partnership. The remaining $10 of loss allocated to A will be suspended under Section 705(a)(2). B is also a partner in BC Partnership with C. B and C have outside bases in BC Partnership of $30. BC Partnership has a $30 liability and no gains or losses for the year. If AB Partnership and BC Partnership merge with AB Partnership being the surviving partnership, following which A takes a one-third interest, B takes a one-half interest, and C takes a one-sixth interest in ABC Partnership. Of ABC Partnership's $30 liabilities, $10 will be allocated to A, increasing A's basis to $10. With the increased basis, A will be able to recognize the $10 suspended loss. Thus, the partnership merger rules create planning opportunities using the Section 752 partnership liability rules.

V. THE ANTI-MIXING BOWL AND DISGUISED SALE RULES

Devastating tax consequences may result if partnerships are merged or a partnership is divided and the anti-mixing bowl rules are neglected. Two sections of the Code contain anti-mixing bowl rules (§§ 704(c)(1)(B) and 737(a)), and Section 707(a)(2)(B) contains the disguised sale rule. After reviewing these rules, consider their application in the partnership merger context.

A. Anti-Mixing-Bowl

Section 704(c)(1)(B) provides that if, within seven years from the date of its being contributed, Section 704(c) property is distributed to a partner other than the contributing partner, the contributing partner shall recognize the property's Section 704(c) built-in gain or loss. The amount of gain or loss shall be equal to the amount of Section 704(c) built-in gain or loss that the contributing partner would have recognized had the property been sold for its fair market value at the time of the distribution. This rule is intended to prevent a high-tax-bracket partner from transferring built-in gain property through a partnership to a low-tax-bracket partner. It also is
intended to prevent the tax-free transfer of built-in losses to a partner who has offsetting gains.

Section 737(a) provides that a distributee partner shall recognize gain on the distribution of property if (1) the fair market value of the distributed property exceeds the distributee partner's outside basis in the partnership and (2) within the past seven years, the distributee partner had contributed property with a Section 704(c) built-in gain, which the partnership holds on the day of the distribution. This rule is intended to prevent a person from contributing built-in gain property to a partnership and receiving a liquidating distribution of other property, after which the partnership sells the asset and allocates gain to the remaining partners.

B. Disguised Sale

A Section 707(a)(2)(B) disguised sale occurs when a partner contributes property to a partnership and within two years receives a distribution from the partnership. Such transaction shall be presumed to be a sale to the partnership, but the presumption may be overcome with appropriate facts. Treas. Reg. §1.707-3(c). The following example demonstrates a practical use of the partnership merger rules and identifies ways to avoid the fatal anti-mixing bowl and disguised sale rules.

Example: The Office Building with Built-In Gain

B is a 50-percent partner in two partnerships: AB Partnership and BC Partnership. B's partner in AB Partnership is A. AB Partnership's sole asset is Office Building. Office Building has a basis to AB Partnership of $450,000 and is worth $900,000. One year ago, B contributed Office Building to AB Partnership when it had a basis to B of $450,000 and was worth $900,000. Thus, Office Building has a Section 704(c) built-in gain of $450,000 that would be allocated to B if Office Building were sold. A contributed cash of $900,000, which has been used to operate and manage Office Building.

B's partner in BC Partnership is C. BC Partnership owns two pieces of raw land. Raw Land 1 has a basis of $300,000 and a value of $600,000. Raw Land 2 has a basis of $300,000 and a value of $350,000. Neither property has any Section 704(c) built-in gain. The properties were acquired by BC Partnership several years ago with cash contributed equally by B and C. Raw Land 1 and Raw Land 2 are adjacent to Office Building. Buyer has offered to buy Office Building, Raw Land 1, and Raw Land 2 from both partnerships for a total of $1.95 million. A, B, and C believe this is an offer they should accept, but each would like to reinvest the sale proceeds in other real property in a transaction that qualifies for Section 1031 treatment. Specifically, A, B, and C decide to combine the proceeds from the sale of Office Building, Raw Land 1, and Raw Land 2 for $2.1
11 million. B has agreed to contribute any cash needed to complete the transaction.

Instead of maintaining both partnerships following the disposition and having each partnership acquire an undivided interest in Apartment Complex, A, B, and C decide to merge AB Partnership and BC Partnership before acquiring Apartment Complex. To avoid the possibility of triggering the mixed-person rules and destroying the intended Section 1031 exchange (see Bradley T. Borden, Section 1031 Exchanges and Proximate and Midstream Business Transactions (Part 1), THE REAL ESTATE TAX DIGEST, at 10 (Dec. 2001) for a discussion of the mixed-person rule), A, B, and C decide to merge AB Partnership and BC Partnership, to form ABC Partnership; cause ABC Partnership to enter into the contract and sell Office Building, Raw Land 1, and Raw Land 2; and cause ABC Partnership to acquire Apartment Complex. A, B, and C rely on Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985), and Magneson v. Commissioner, 753 F.2d 1490 (9th Cir. 1985) for their position that ABC Partnership satisfies the holding and use requirements for all of the properties following the merger. (See Bradley T. Borden, Section 1031 Exchanges and Proximate and Midstream Business Transactions (Part 2), THE REAL ESTATE TAX DIGEST, at 17-21 (Jan 2002) (discussion of the section 1031 holding and use requirement in the context of partnership mergers and divisions.) They must choose the best method of merging the two partnerships.

If the partnerships merge as they now stand, both partnerships will be a continuation of the prior partnership under the 50-percent ownership test. Thus, the asset-value test must be used to determine which partnership terminates. Because BC Partnership has assets worth $50,000 more than the assets of AB Partnership, AB Partnership will be the terminating partnership and BC Partnership will be the continuing partnership. Consider the consequences to A under both merger forms if the merger occurs under these circumstances.

The partners must consider Office Building's Section 704(c) built-in gain. If this gain is triggered, a portion of the Section 1031 planning will be lost. Under Section 704(c)(1)(B), the Section 704(c) built-in gain will be triggered, at least in part, if AB Partnership distributes Office Building to A and B as part of an assets-up merger (i.e., the distribution of an interest of Office Building to B will be a prohibited distribution of Section 704(c) property). Thus, the distribution of Office Building to A and B in complete liquidation of their interests in AB Partnership will fall within the definition of taxable transactions under Section 704(c).

If, on the other hand, the transaction is structured as an assets-over transaction, AB Partnership will contribute Office Building to ABC Partnership in exchange for an ABC Partnership interest. ABC Partnership will take a basis of $450,000 in Office Building under Section 723. Office
Building will have a Section 704(c) built-in gain allocable to AB Partnership. Under Treas. Reg. §1.704-4(c)(4), the ABC Partnership interests will inherit Office Building’s Section 704(c) built-in gain. The subsequent liquidating distribution of the ABC Partnership interest will not trigger gain recognition under Section 704(c)(1)(B). A will, however, remain the contributing partner of an interest in Apartment Complex for Section 704(c) purposes. Treas. Reg. §1.704-4(c)(4) and (d)(1). Therefore, if AB Partnership is terminated as part of an assets-over merger, A will not recognize the Section 704(c) built-in gain on the transaction. Thus, structuring the merger as an assets-over merger avoids the built-in gain pitfall that would occur under an assets-up merger.

In this example, it appears there is no inside-basis/outside-basis disparity, so the assets-over merger is preferable. If, however, A's and B's aggregate outside bases exceeded the basis AB Partnership had in Office Building, the distribution in an assets-up merger would have ultimately given Office Building a larger basis in ABC Partnership. The tax effects of this result must be compared to the tax results of doing an assets-over merger to determine which method is preferable.

VI. THE EFFECT ON THE PARTICIPATING ENTITIES

Each partnership merger or division affects the participating entities. The consequences affecting each partnership’s existence may convince the alert tax planner to alter the structure of the merger or division. Furthermore, realizing the distinction between the legal form of the transaction and the tax result is key to properly structuring a merger or division.

As stated above, in a partnership merger, at least one partnership will be terminated. Thus, for each partnership merger the effect of terminating a partnership must be considered. The terminating partnership will file a final tax return for the taxable year ended on the date of the termination. Treas. Reg. §1.708-1(c)(2). As a consequence, all of the elections of the terminating partnership will be lost, unless made by the continuing partnership. The tax identification number of the terminating partnerships will also be forfeited, and the tax identification number of the continuing partnership will be used after the merger. Id.

Unlike a technical termination under Section 708(b)(1)(B), a termination under a partnership merger does not restart depreciation. Section 168(i)(7)(B) specifically provides for depreciation restart under a technical termination. The rules of Sections 721 and 731, however, govern partnership mergers. Therefore, there is no depreciation restart in partnership mergers. §168(i)(7)(B).

The partnership that terminates for legal purposes may not be the same partnership that is deemed to terminate for tax purposes. For example, assume that for legal reasons, the partners of AB Partnership and
BC Partnership decide that BC Partnership will be merged into AB Partnership under state law. The 50-percent ownership rule does not designate the continuing partnership, so the asset-value test must be used. Under the asset-value test, BC Partnership is the continuing partnership and AB Partnership is the terminating partnership. Since this merger did not follow an assets-up form, it will be treated as an assets-over form under the default rules of Treas. Reg. §1.707-1(c)(3)(i). Failing to consider this point could produce negative tax results (e.g., thinking that BC Partnership is the terminating entity because its legal existence terminates, when AB Partnership terminates for tax purposes, could result in unintended Section 704(c) built-in gain being triggered).

In partnership divisions, the divided partnership files a return for the taxable year of the partnership that has been divided and retains the identification number of the prior partnership. Treas. Reg. §1.707-1(d)(2)(i). The return must provide information about the other continuing partnerships. Id. All other resulting partnerships and new partnerships are required to file separate returns for the taxable year beginning the day after the division. Id. All such partnerships must obtain new tax identification numbers. Id. All continuing partnerships are subjected to the preexisting elections that were made by the prior partnership. Treas. Reg. §1.707-1(d)(2)(ii). As with partnership mergers, partnership divisions must be carefully planned because the form of the transaction under state law may not dictate the federal income tax form of the transaction.

VII. ANTI-ABUSE RULES

Both the partnership merger and the partnership division regulations contain anti-abuse rules. Treas. Reg. §§1.708-1(c)(6)(i) and -1(d)(6). Under both provisions, the form of a transaction may be disregarded if the transaction is part of a larger series of transactions, and the substance of the larger series of transaction is inconsistent with following the form of the transaction. Thus, while partners may choose between the forms of partnership mergers and divisions, planning transactions that abuse the rules could result in the transaction being disregarded.

VIII. CONCLUSION

This brief look at the partnership merger and division rules demonstrates their potential as planning tools as well as their potential for tax disasters. Tax practitioners must be familiar with the merger and division rules to recognize situations that may be improved by using a partnership merger or division. Also, once the decision is made to do either a partnership merger or partnership division, care must be taken to ensure
that adverse tax consequences do not arise as a result of using the less favorable form of merger or division.

**PRACTICE CHECKLIST**

What You Should Know About Mergers and Divisions of Partnerships

Relying on the partnership merger and division rules, practitioners are finding creative solutions to complicated tax problems. Unfortunately, tax planners can misstep when planning a partnership merger or division or overlook the rules entirely and find that their failure undermines other planning objectives.

- Four important points must be considered when structuring partnership mergers or divisions.
  - Inside-basis/inside-basis disparity;
  - Changes in shares of partnership liabilities;
  - The anti-mixing-bowl rules; and
  - The effect on the participating entities.

- For partnership mergers, consider the effects of assets-up mergers and assets-over mergers.
  - In an assets-up merger, the terminating partnership distributes all its property to its partners, who in turn contribute those assets to the resulting partnership.
  - In an assets-over merger, the terminating partnership contributes all its assets to the resulting partnership in exchange for an interest in the resulting partnership. It then distributes that interest to its original partners.

- Partnership divisions similarly are divided into assets-up and assets-over.

- Other points to consider:
  - In a partnership merger, at least one partnership will be terminated. The terminating partnership will file a final tax return for the taxable year ended on the date of the termination. As a consequence, all of the elections of the terminating partnership will be lose, unless made by the continuing partnership.
  - The tax identification number of the terminating partnerships will also be forfeited, and the tax identification number of the continuing partnership will be used after the merger.
Unlike a technical termination under section 708(b)(1)(B), a termination under a partnership merger does not restart depreciation.

The partnership that terminates for legal purposes may not be the same partnership that is deemed to terminate for tax purposes. Failing to consider this point could produce negative tax results.

In partnership divisions, only the divided partnership retains the identification number. All other partnerships must obtain new identification numbers and file returns for the taxable year beginning the day following the division.