Garvey Schubert Barer Tax Roundtable

Tax and Legal Aspects of Merging LLCs

Seattle: November 15, 2011
Portland: November 16, 2011

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BEIJING NEW YORK PORTLAND SEATTLE WASHINGTON, D.C.

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I. Treatment of LLCs for Federal Income Tax Purposes

A Limited Liability Company ("LLC") is an entity created under state law that is neither a partnership nor corporation from a state business law perspective. In Washington, LLCs are governed by RCW 25.15. In Oregon, LLCs are governed by ORS Chapter 63. Under state law, an LLC offers its owners (generally referred to as "members") protection from personal liability for the debts and obligations of the LLC's business much like the liability protection that a corporation offers to its shareholders.[1] As in the case of a partnership, members have the option of participating directly in the management of the business.[2] Most importantly, the LLC does not require a general partner with associated personal liability to manage the affairs of the LLC.

An LLC is governed by an operating agreement which sets forth the management, rights and obligations of the members. In the absence of an operating agreement, or where an operating agreement is silent, the state statute governing LLCs[3] serves to provide default rules or to fill

[1] *See* e.g., RCW 25.15.125 and ORS 63.165.
[2] *See* e.g., RCW 25.15.150 and ORS 63.130.
[3] All 50 states and the District of Columbia have authorized the organization of LLCs under state law.

gaps. Because an LLC is governed by its operating agreement, there are virtually unlimited ways to structure management, ownership and rights and restrictions among members.

An LLC may be either member-managed or manager managed.[4] In a member-managed LLC, each member has the right to bind the LLC, and the members make the decisions – usually on a majority basis. In a manager-managed LLC, the management is centralized in one or more managers – who need not be members – who make day-to-day and operating decisions for the LLC. Also, in a manager-managed LLC, non-manager members do not have the authority to bind the LLC.

A. Check-the-Box Regulations

The Internal Revenue Code (the "Code") does not recognize an LLC as an entity classification for federal tax purposes. The tax status of LLCs is determined by the entity classification rules of section 7701.[5] From a federal tax standpoint, an LLC will be treated as a corporation, partnership, or sole proprietorship.

In December 1996, the Internal Revenue Service (the "Service") issued final regulations under the entity classification rules—referred to as the "check the box regulations"[6]—that allow

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[4] Under both Washington and Oregon law, an LLC defaults to member management unless the certificate of formation or articles of organization vests management in a manager. *See* RCW 25.15.150 and ORS 63.130(i).
[5] All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder unless otherwise indicated.
[6] Regs. sections 301.7701-1 through 301.7701-3.

certain business entities to choose their entity classification for federal tax purposes. Under the check the box regulations, all business entities other than those classified as trusts or corporations for federal tax purposes (referred to as "eligible entities"), may choose their entity classification for federal tax purposes. An eligible entity may elect to be classified as a corporation, partnership, or an entity disregarded as separate from its owner.

The Service treats an LLC as an eligible entity under the check-the-box rules.[7] Therefore, the flexibility exists to classify an LLC as a partnership, a corporation, or a disregarded entity. An eligible entity with at least two members can elect to be classified as a partnership or as a corporation for federal tax purposes.[8] An eligible entity with a single owner can elect to be classified as a corporation or an entity disregarded as separate from its owner.[9]

B. LLCs Treated as Partnerships

If an LLC does not choose its federal tax classification it will be classified under default rules set forth in the check the box regulations.[10] Under the default classification rules, an LLC with at least two members is classified as a partnership for federal income tax purposes.[11] An LLC with

[7] Reg. section 301.7701-3(a).
[8] Reg. section 301.7701-3(a).
[9] Reg. section 301.7701-3(a).
[10] Reg. section 301.7701-3.
[11] Reg. section 301.7701-3(b)(1)(i).

only one member is treated as an entity disregarded as separate from its owner for income tax purposes.[12]

The following analysis of LLC mergers discusses the federal tax issues related to LLCs classified as partnerships for federal tax purposes. Unless otherwise stated herein, the following discussion assumes that no LLC that is a party to the merger has elected to be treated as a disregarded entity or corporation for federal tax purposes.

II. Overview of Federal Tax Consequences of Mergers and Combinations of LLCs

A. Tax Consequences to the LLC(s)

1. Nontaxable

A partnership generally is not a taxable entity.[13] If the merger or combination is a nontaxable event, then no gain or loss is triggered on the transfer of assets and liabilities. Consequently, no items of gain or loss are passed through the partnership to its partners. Basis adjustments may be required with respect to assets transferred to a partnership as part of a merger.

[12] Reg. section 301.7701-3(b)(1)(ii). An entity owned by a husband and wife who reside in a community property state and own their ownership interests in the entity as community property may treat the entity as owned by one member. *See* Revenue Procedure 2002-69, 2002-2 CB831 (10/9/2002).
[13] Section 701.

2. Taxable

Partnership mergers result in the transfer of assets and liabilities between partnerships. As a result of how such assets and liabilities flow from one partnership to another partnership gain or loss may result. Although a partnership is not a taxable entity, it must compute and characterize the amount of income that passes through it to be reported on its partners' returns. These gains and losses are included in each partner's distributive share and each partner reports his distributive share of partnership gain or loss on his or her tax return for the year in which, or with which, the partnership's year ends.

B. Tax Consequences to the Member(s)

1. Nontaxable

The general rule of contributions and distributions to and from a partnership is that a partner does not recognize gain or loss. This general rule of nonrecognition is also applicable in the context of partnership mergers. However, as discussed in more detail below, both the form of the merger and the tax characteristics of a partner's interest can result in recognition of gain or loss by a partner.

2. Taxable

Gain recognition in a partnership merger is most likely to result where one or both of the merging partnerships have built-in gain or loss property ("section 704(c)" property). Another attribute of merging partnerships that can result in gain recognition to a partner is the shifting of liabilities between partners and the partnership. Lastly, gain (or loss) recognition is the general rule where a partner sells his or her interest in the partnership as part of the merger.

III. Mergers and Combinations of LLCs with Partnerships

A. Overview of LLC Mergers

Section 708(b)(2)(A)of the Code governs the federal income tax treatment of partnership mergers. The statutory rule consists of a single sentence, enacted in 1954, and specifies only which partnership, if any, is deemed to continue after the merger for federal income tax purposes. The partnership merger regulations[14] (hereinafter referred to as the "Merger Regulations") provide the specific rules as to how partnership mergers are treated for tax purposes.[15]

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[14] Reg. section 1.708-1(c), (d).

[15] The Merger Regulations were proposed on January 11, 2000 (Notice of proposed rulemaking and notice of public hearing (REG-111119-99, 2000-5 I.R.B. 455) published in the Federal Register at 65 FR 1572) and finalized on January 3, 2001 (T.D. 8925).

1. General Rules

The general principle of a partnership merger is that one of the merging partnerships survives and the other merging partnership(s) terminate. Under section 708(b)(2)(A), when two or more partnerships merge or consolidate into a single partnership, the combined partnership (the "resulting partnership") is a continuation of one of the merging partnerships or all of the merging partnerships are terminated and a new partnership results. Any partnership that is not treated as "continuing" is considered to be terminated.[16]

The resulting partnership is considered a continuation of any merging partnership whose members own more than 50 percent of the capital and profits of the resulting partnership.[17] If the partners of more than one of the merging partnerships own more than 50% of the capital and profits of the resulting partnership, then the resulting partnership is "considered [a] continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership."[18] If members of a merging partnership do not own more than 50% of the capital and profits of the resulting partnership, the resulting partnership is not a continuation of any prior partnership and is treated as a new partnership.[19]

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[16] Reg. section 1.708-1(c)(1).
[17] *See* Reg. section 1.708-1(c)(1).
[18] Reg. section 1.708-1(c)(1).
[19] Reg. section 1.708-1(c)(1).

Once it has been determined which merging partnership is treated as continuing and which merging partnership is treated as terminated, the form of the partnership merger prescribed by the Merger Regulations will determine how the assets and liabilities flow from the terminating partnership to the resulting partnership.

2. Formulations of Merger for Tax Purposes

Partnership mergers can be effectuated through various forms prescribed by applicable state law. The Service has treated section 708(b)(2)(A) as widely applicable to any form prescribed by state statute for a transaction whereby the businesses of two or more partnerships are combined in a single partnership, regardless of the form of the transaction and regardless of whether it happens to be called a "merger" or "consolidation" under state law.[20]

Prior to 2001, the Service took the position that the form of a merger or consolidation of partnerships was disregarded in determining the tax consequences of the transaction. Regardless of the form, each terminating partnership was treated as contributing its assets to the resulting partnership and then liquidating by distributing interests in the resulting partnership to its partners.[21] Section 708(b)(2)(A) and the Merger Regulations now clarify the categorization and taxation of partnership mergers and, to a limited extent, respect the form

[20] *See* Rev. Rul. 90-17, 1990-1 CB 119 (merger of three partnerships into one existing partnership); Rev. Rul. 77-458, 1977-2 CB 220 (merger of nine partnerships into one existing partnership); Rev. Rul. 68-289, 1968-1 CB 314 (merger of three partnerships).

[21] *See* Rev. Rul. 68-289, 1968-1 CB 314.

selected by the partners, giving planners the opportunity for some measure of control over tax consequences.

Under the Merger Regulations, partnership mergers are treated under one of two constructs: (a) the Assets-Over form, or (b) the Assets-Up form. If a merger involves multiple terminating partnerships, each terminating partnership is analyzed separately, so that the Assets-Over form may apply to some transfers and the Assets-Up form to others.[22]

a. Asset Transfers

(i) Assets-Up

In an Assets-Up merger, the terminating partnership is considered to have distributed all of its assets and liabilities to its partners in complete liquidation of the partners' interests and the partners become the owners of the assets under state law. The partners are then considered to contribute those assets to the resulting partnership in exchange for interests in the resulting partnership.[23]

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[22] Reg. section 1.708-1(c)(3)(i).

[23] Reg. section 1.708-1(c)(3)(ii). The form of this transaction will be respected despite the transitory ownership of the terminating partnership's assets. Reg. section1.708-1(c)(3).

The Assets-Up construct generally adheres to form, in that it only applies if the terminated partnership actually transfers its assets up to the partners "in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets."[24]

(ii) Assets-Over

All mergers and consolidations that are not cast in the Assets-Up form are treated as Assets-Over transactions, regardless of their form (or lack of form) under local law.[25] In an Assets-Over form of merger, a 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.[26]

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[24] TD 8925, 2001-1 C.B. 496,497.

[25] Reg. section 1.708-1(c)(3)(ii) (Assets-Up form respected only if "merged or consolidated partnership that is considered terminated under [Reg. section 1.708-1(c)(1)] ... distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interest in the terminated partnership."

[26] Reg. section 1.708-1(c)(3)(i).

b. Formless Mergers and "Disrespected" Forms of Merger

Sometimes the form of the transaction attempted is neither the Assets-Up nor the Assets-Over form. For example, in what is sometimes called an interests-over merger form,[27] the partners in a terminating partnership transfer their partnership interests to the resulting partnership in exchange for interests in the resulting partnership. The interests-over construct is not respected under the Merger Regulations.[28]

The Merger Regulations recognize only the Assets-Up and Assets-Over merger forms. Any partnership merger that is not constructed in a way that qualifies for Assets-Up treatment will be treated as an Assets-Over transaction. Hence, the Assets-Over construct will apply not only to transactions actually taken in an Assets-Over form, but also to any formless partnership merger that occurs under a state statute, any partnership merger that is effectuated as an interests-over form and any partnership merger that otherwise fails to qualify as an Assets-Up transaction.

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[27] The interests-over form is one of the three permitted structures for converting a partnership to a corporation. *See* Rev. Rul. 84-111, 1984-2 C.B. 88.

[28] Reg. section 1.708-1(c)(4). If the interests-over construct was respected, the partners of the terminated partnership would be treated for tax purposes as transferring interests in the terminated partnership to the resulting partnership, and the resulting partnership would be treated as receiving assets. Partnership Mergers and Divisions, 65 Fed. Reg. 1572 (proposed Jan. 11, 2000); Rev. Rul. 84-111, 1984-2 C.B. 88; *McCauslen v. Comm'r*, 45 T.C. 588 (1966); *see* infra note 51.

3. Acquisition Transactions Involving LLCs

In some cases, parties may wish to merge a target partnership into an existing, or newly formed, partnership subsidiary. There are two primary approaches for the acquisition of a target partnership into an acquiring subsidiary partnership : the forward triangular merger and reverse triangular merger. The form of merger applicable to the two acquisition structures are discussed below.

a. Forward Triangular Merger

In a forward triangular merger, an acquiring partnership creates a wholly owned acquisition subsidiary partnership into which the target partnership will merge. The wholly owned partnership that survives the merger will generally be treated as a disregarded entity under Reg. section 301.7701-3. As a result, the acquiring partnership will be treated as acquiring the assets of target partnership for tax purposes. If the target partnership transfers all its assets to acquiring partnership and terminates for tax purposes, the transaction will be treated as a merger of the acquiring partnership and target partnership. As such, a forward triangular merger will be treated as an Assets-Over form of merger for federal tax purposes.

b. Reverse Triangular Merger

In a reverse triangular merger, the acquiring partnership creates a wholly owned acquisition subsidiary partnership which will merge into the target partnership. Target partnership survives as a wholly owned subsidiary partnership treated as a disregarded for tax purposes under Reg. section 301.7701-3. As a result, acquiring partnership will be treated as acquiring the assets of target partnership for tax purposes. If all of the interests of target partnership are transferred, the transaction will be treated as a merger of acquiring partnership and target partnership. Although structurally the transaction looks like an interest-over transaction, a reverse triangular merger will be treated as an Assets-Over form of merger for federal tax purposes.

B. Federal Income Tax Consequences of Merger Formulations

The choice between the Assets-Up and Assets-Over forms controls for all federal income tax purposes[29] and may have significant tax repercussions. Depending on the form of merger, a resulting partnership's basis and holding period in its assets and a partner's basis and holding period in its interest in the resulting partnership can vary. The form of a merger can also affect the likelihood and extent of gain recognition, including gain recognition resulting from the

[29] *See* Reg. sections 1.708-1(c)(3)(i) ("treated as taking the Assets-Over form for Federal income tax purposes"), 1.708-1(c)(3)(ii) (Assets-Up form "respected for Federal income tax purposes").

shifting of liabilities, and gain recognition with respect to appreciated properties pursuant to section 704(c) and section 737. These and other considerations are discussed below.

1. Assets-Over Formulation

An Assets-Over transaction is the transfer of assets from one partnership to another in exchange for one or more interests in the transferee partnership followed by a distribution of the interests received to partners of the transferor partnership.

a. **Recognition of Gain or Loss**

(i) Contribution to Resulting Partnership

Section 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to a partnership in exchange for an interest in the partnership. If a merger is treated (or deemed) an Assets-Over merger, the normal rules of section 721, relating to the contribution of assets to a partnership in exchange for a partnership interest, would apply to the deemed contribution by any terminating partnership.

(ii) Distribution by Terminating Partnership

Section 731(a)(1) provides that in the case of a distribution by a partnership to a partner gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. In an Assets-Over merger, the partners receive only interests in the resulting partnership (but see sale within a merger below) and therefore no gain should be recognized by the partners.

b. Tax Basis and Holding Period

(i) Inside (i.e., Partnership) Tax Basis

Under the Assets-Over form, the tax basis of assets contributed to the resulting partnership is determined under section 723. Section 723 provides, in relevant part, that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution. Thus, in an Assets-Over merger, the terminated partnership's basis in the assets carries over to the resulting partnership and the tax basis of assets contributed to the resulting partnership should be generally unaltered by the transaction under section 723.

Since the property has the same basis in the hands of the resulting partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner.[30]

(ii) Outside (i.e., Partner) Tax Basis

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. Thus, in an Assets-Over merger, the partner's basis in terminating partnership interest carries over to the resulting partnership interests.[31]

In determining the holding period of a taxpayer who received property in exchange, there is included the period for which the taxpayer held the property exchanged if the property has the same basis in whole or in part in the taxpayer's hands as the property exchanged an the

[30] Reg. section 1.723-1.

[31] If the resulting partnership has a section 754 election in effect, the distribution of resulting partnership interests in liquidation of each terminated partnership apparently triggers section 743(b) basis adjustments to the partners of the terminated partnership. Reg. section 1.761-1(e) (deemed distribution of partnership interest in section 708(b)(1)(B) termination triggers section 743(b) basis adjustments if new partnership has a section 754 election in effect). If the partners in the terminated partnership had previous section 743(b) basis adjustments that were deemed contributed to the resulting partnership, matters become more uncertain. Under the common basis approach (adding or subtracting the contributed section 743(b) adjustment to the common basis of the lower-tier partnership's assets), the section 755 basis calculations would presumably be made with reference to the resulting partnership's new common basis. Although the distribution of resulting partnership interests by each terminating partnership under the Assets-Over form apparently is treated as a transfer for purposes of making section 743(b) adjustments, it should not be treated as a transfer of interests in the resulting partnership for purposes of applying section 708(b)(1)(B). *See* Rev. Rul. 90-17, 1990-1 CB 119 (merger rules of section 708(b)(2)(A) take precedence over section 708(b)(1)(B) termination rules). The logic of this ruling seems equally valid under the 2001 Regulations.

property exchanged at the time of the exchange was a capital asset.[32] Generally, an interest in a partnership is treated as a capital asset. Thus, the holding period of the resulting partnership received in exchange should include such partner's holding period for the property transferred to the partnership.[33]

c. Changes in Share of Liabilities

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 as a distribution of money to the partner by the partnership. Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is considered a contribution of money by that partner to the partnership.[34] This deemed cash contribution increases a partner's basis in the partnership.[35]

If a partner's share of partnership liabilities is treated as decreasing in a merger, the partner is treated as receiving a deemed distribution under section 752, which could result in gain recognition by the partner pursuant to section 731. Prior to the Merger Regulations, the risk of gain recognition was particularly acute in the context of Assets-Over mergers because the

[32] Section 1223(1).
[33] Section 1223(1).
[34] Section 752(a).
[35] Section 722.

terminated partnership could be treated as if it received a deemed distribution in the first step of the Assets-Over transaction, and the consequences of that gain recognition would flow through to the partners of the terminated partnership. In order to address this risk, the Merger Regulations incorporate a "netting" concept for purposes of determining whether a partner has a decrease in its share of partnership liabilities as a result of a merger.[36]

Reg. section 1.752-1(f) 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.

d. Built-in Gains

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.[37] A corollary rule under section 737 prevents the partner

[36] *See* Reg. section 1.752-1(f).
[37] Section 704(c)(1)(B).

who contributed section 704(c) property from receiving distributions of other property within seven years after the partner contributed the section 704(c) property.[38]

In 2007, the Treasury promulgated proposed regulations regarding treatment of built-in gain in a partnership merger.[39] Pursuant to the proposed regulations, neither section 704(c)(1)(B) nor section 737 applies to a merger transaction in the Assets-Over form.[40] However, the deemed contribution of assets from a terminating partnership to the resulting partnership may create a new layer of built-in gain for purposes of those rules.[41] Further, the proposed regulations do provide, however, that section 704(c)(1)(B) will apply to a subsequent distribution by the resulting partnership of section 704(c) property contributed in the Assets-Over merger by the terminating partnership to the resulting partnership.[42] The proposed regulations also provide

[38] Section 737.
[39] 2007-41 I.R.B. 790 (72 FR 46932). The proposed regulations incorporate some of the principles originally set forth in Rev. Rul. 2004-43, 2004-18 I.R.B. 842, revoked by Rev. Rul. 2005-10, 2005-7 I.R.B. 492.
[40] Reg. section 1.704-4(c)(4), 1.737-2(b).
[41] In Revenue Ruling 2004-43, 2004-1 CB 842, the Service ruled that a new layer of section 704(c) gain was created for the partners of the terminating partnership in an Assets-Over merger, thus bringing into play both section 704(c)(1)(B) and section 737 during the seven-year period following the merger. This ruling was promptly revoked when the Service realized that it might be in conflict with the Regulations under both of these Code sections. Rev. Rul. 2005-10, 2005-1 CB 492. However, the Service, unrepentant, simultaneously announced plans to amend the Regulations to produce the results articulated in Revenue Ruling 2004-43, such amendments to be effective for distributions after January 19, 2005. *See* Notice 2005-15, 2005-1 CB 527. Because the proposed effective date is tied to the date of the distribution triggering the gain rather than the contribution creating it, the new Regulations may be applicable to contributions that occurred well before the publication of any of these pronouncements. The merger of two partnerships with identical ownership does not create built-in gain regardless of the date of the distribution. Notice 2005-15, 2005-1 CB 527; Priv. Ltr. Rul. 200631014, (May 1, 2006). The Service subsequently issued proposed regulations largely following Revenue Ruling 2004-43, 2004-18 IRB 842 (Apr. 12, 2004), revoked by Rev. Rul. 2005-10, 2005-1 CB 492. Prop. Reg. sections 1.704-4(c)(4), 1.737-2(b)(2007). In Notice 2009-70, 2009-34 IRB 255 (Aug. 12, 2009), the Service asked for comments on certain section 704(c) issues raised by the proposed regulations.
[42] Prop. Reg. section1.704-4(c)(4)(ii).

that section 737 will apply when a member of the terminating partnership receives a subsequent distribution of property (other than money) from the resulting partnership.[43]

e. Sale Within a Merger Transaction

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. Generally, such transactions are presumed to be a sale to the partnership, although the presumption may be overcome with appropriate facts.[44]

Within the Assets-Over form, a special rule (i.e., the "sale-within-a-merger" rule) applies to the situation where some partners want to sell all or part of their interests. Under this variation of the Assets-Over approach a partner in the terminated partnership can sell its interest in the terminated partnership to the continuing partnership immediately before the Assets-Over transaction.[45]

If as part of the merger or consolidation transaction, a partner sells their interests to the resulting partnership pursuant to a merger agreement (or other document) that (1) identifies the transaction as sales of interests for tax purposes and (2) quantifies the consideration for

[43] Prop. Reg. section1.737–2(b).
[44] Reg. section1.707-3(c).
[45] Reg. section 1.708-1(c)(4).

each interest sold, the Service will respect this transfer as a sale of interests governed by section 741.[46] Although the overall transaction is characterized as taking the Assets-Over form, the selling partners are treated as selling their interests to the resulting partnership.[47] The result is capital gain treatment to the selling partners pursuant to section 741.

2. Assets-Up Formulation

An Assets-Up transaction is the distribution of assets from a terminating partnership to a partner and then the contribution of those assets by the distributee partner to the resulting partnership.

a. Recognition of Gain or Loss

(i) Distribution by Terminating Partnership

Section 731(a)(1) provides that in the case of a distribution by a partnership to a partner gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Provided no distributee partner receives cash in excess of his outside basis in the

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[46] Id. Reg. section 1.708-1(c)(4), -(1)(c)(5) ex. 5.

[47] Reg. section 1.708-1(c)(4). The sales of partnership interests under this rule may themselves trigger a section 708(b)(1)(B) termination of the partnership immediately prior to the merger. *See* Supplementary Information in TD 8925, 2001-1 CB 496, 499.

partnership, no gain or loss should be recognized on the distribution of assets from the terminating partnership. However, because assets are in fact being distributed, special attention needs to be paid to sections 704 and 737, discussed below.

(ii) Contribution to Resulting Partnership

In the Assets-Up form of merger, section 721 will apply to the contribution of the assets received by the members from the terminating partnership to the resulting partnership such that no gain or loss should be recognized on the contribution.

b. Tax Basis and Holding Period

Under the Assets-Up form of merger, the basis of the assets of a terminating partnership are first determined under sections 732(b) and 732(c) upon distribution to the partners, and then under section 723 upon contribution to the continuing partnership.

(i) Outside (i.e., Partner) Tax Basis

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in

the same transaction. Specific rules apply in allocating that basis over the distributed assets under section 732(c). These rules can lead to significant basis changes, particularly if the terminating partnership has inside-outside basis differences.

(ii) Inside (i.e., Partnership) Tax Basis

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution. Thus, as with an Assets-Over merger, the partner's basis in the assets carries over and the tax basis of assets contributed to the resulting partnership should be unaltered by the transaction under section 723.

In an Assets-Up merger, the basis in the assets is stepped up or down to the partners' outside basis in their partnership interests pursuant to section 732(b), and this stepped up or down basis carries over to the resulting partnership. This difference may be ameliorated if the resulting partnership makes an election under section 754; not all partnerships will have a section 754 election in effect, and even if such election is in effect, the allocation of the basis step-up may be different in the Assets-Over and Assets-Up scenarios.

c. Changes in Share of Liabilities

If in connection with the contribution of property to the resulting partnership, a partner's share of liabilities is increased or reduced, basis adjustments or gain may result.

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.[48]

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.[49]

[48] Section 722.

[49] Sections 705(2), 731(a), and 733.

d. Built-in Gains

Under the Assets-Up form of merger, both sections 704(c)(1)(B) and 737 are applicable if any assets distributed to the partners were previously contributed to the distributing partnership within seven years of the distribution. 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.

e. Sale Within a Merger Transaction

The special rule discussed above is needed only in the case of an Assets-Over merger. The mechanics of the Assets-Up merger already yield this result. In the Assets-Up merger, each partner of the terminated partnership is treated as contributing its share of assets to the surviving partnership, so the receipt of cash by one of those partners will generally result in gain only to that partner.[50] The gain recognized will be treated as capital gain.[51]

C. Anti Abuse Rule

All of the above rules and constructs operate against the backdrop of an anti-abuse rule. Pursuant to the anti-abuse rule, if a merger is part of a larger series of transactions, the Service can disregard the form of the merger altogether and "recast the larger series of transactions in accordance with their substance."[52]

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. The Regulations provide an example that considers an exchange of partnership interests with a

[50] *See* section 731.
[51] Section 731. Gain recognized considered gain from the sale or exchange of the partnership interest.
[52] Reg. section 1.708-1(c)(6).

merger in the middle. The form of the merger is not respected, and the transaction is recast as a taxable exchange.[53]

D. Continuity of Tax Characteristics

The parties to a partnership merger may select one entity to be the survivor based on state-law governed issues of liability and change-of-control provisions that may be contained in the parties' existing contracts. They may also factor in federal income tax consequences, including consideration of which partnership's tax elections and method of accounting will remain in effect, and which partnership must file a final tax return following the merger. The determination of which of the partnerships continues for tax purposes however, is made without regard to which partnership is treated as continuing for state law purposes.[54]

The partnership that is deemed to be the continuing entity under the Merger Regulations will be treated by the Service in the same manner as the old entity. This means that the resulting partnership's taxable year does not close and the resulting partnership files a return for the taxable year of the merging partnership that is continuing.[55] The resulting partnership retains the accounting methods and elections of the old entity, it retains the same employer identification number, and the assets will have a carry-over basis and holding period that can

[53] Reg. section 1.708-1(c)(6)(ii) Example.
[54] Reg. section1.708-1(c)(5) ex 2.
[55] Reg. section1.708-1(c)(2).

be tacked (except in the case where an Assets-Up form of merger was employed, in which case the substituted basis rules in section 732 may apply instead).[56]

The terminating partnership will file a final partnership tax return for the taxable year ending on the date of the termination.[57] 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.[58]

E. Conclusion

None of the merger form constructs is certain to produce the most tax favorable result for every taxpayer. Although the Service has indicated that it believes the Assets-Over construct will generally be preferable for taxpayers,[59] the tax consequences of applying a particular construct to a transaction may be more or less favorable depending on the specific facts and circumstances of the taxpayer's situation.

Because the Assets-Over construct applies to a wide variety of transactions, many of which do not involve the transfer of assets at all, the transfers that are deemed to occur in a partnership

[56] Reg. section1.708-1(c)(2).
[57] Reg. section1.708-1(c)(2).
[58] Reg. section1.708-1(c)(2).
[59] *See*, e.g., Partnership Mergers and Divisions, 65 Fed. Reg. 1572 (proposed Jan. 11, 2000).

merger may be entirely fictional and markedly different from the transfers that actually occur. This possible fictional result is magnified because the partnership that is treated as continuing for tax purposes, and thus treated as receiving the transferred assets, may cease to exist for state law purposes.

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 partnership that terminates for legal purposes may not be the same partnership that is deemed to terminate for tax purposes. The consequences affecting each partnership's existence may convince the alert tax planner to alter the structure of the merger. Furthermore, realizing the distinction between the legal form of the transaction and the tax result is key to properly structuring a merger of LLCs.

IV. Mergers and Combinations of LLCs with Corporations

A. Merger of a Corporation into an LLC

The merger of a C corporation into an LLC, in which the LLC survives, may result in double taxation for federal income tax purposes. For purposes of determining the tax consequences, the merger will be bifurcated into two steps.[60] First, the corporation will be deemed to transfer

[60] PLR 9701029 (Oct. 2, 1996).

all of its assets and liabilities to the LLC in exchange for ownership interests in the LLC. Second, the corporation will be deemed to be liquidated.[61]

1. Step One

Considering the first step, the transfer of the corporation's assets and liabilities to the LLC will generally be a tax-free contribution pursuant to section 721.[62] The corporation's basis in the LLC's interests will equal the adjusted basis of the assets the corporation held at the time of the deemed contribution of its assets to the LLC.[63]

2. Step Two

The liquidation of the corporation in the second step, however, may result in gain (or loss) pursuant to both sections 331 and 336.[64] The corporation will recognize gain (or loss) on the distribution of the LLC interests to its shareholders as if the corporation had sold the LLC ownership interests to its shareholders at fair market value at the time of the distribution.[65] The shareholders will be treated as having received full payment in exchange for their stock and will recognize gain or loss equal to the difference between the fair market value of the LLC

[61] A merger that does not qualify under section 368(a)(1)(A) is treated as a transfer of assets followed by a liquidation of the target. Rev. Rul. 69-6.
[62] *See infra*, note 60.
[63] *Id. See* section 721.
[64] If the corporation is a subsidiary of a parent corporation, the liquidation may be tax-free pursuant to sections 332 and 337.
[65] Section 336(a). If the corporation's basis in the LLC's ownership interests equal the fair market value of the LLC ownership interests at the time of the corporate liquidation, the corporation should not recognize any gain or loss.

interests received by each shareholder and the shareholder's adjusted basis in his or her stock.[66]

The corporation's distribution of the LLC's interests may affect other aspects of the surviving LLC. If the LLC has a section 754 election in place, the corporation's distribution of the LLC's ownership interests to its shareholders will constitute a transfer pursuant to section 743 and the LLC will be required to adjust the basis of its assets pursuant to sections 743 and 755. The corporation's distribution of the LLC's ownership interests to its shareholders will also constitute an exchange that will cause the LLC to terminate pursuant to section 708(b)(1)(B) if the corporation receives 50 percent or more of the LLC's outstanding ownership interests. A termination of the LLC will result in a deemed transfer of all of the LLC's assets and liabilities to a "new" LLC in exchange for an ownership interest in the new LLC. Immediately thereafter, the "old" LLC will be deemed to distribute the ownership interests in the new LLC to the members.[67] The members' capital accounts will carry over from the old LLC.[68]

If the LLC held unrealized receivables or inventory ("hot assets"), the deemed liquidation of the LLC may also trigger gain or loss under section 751. Section 751 provides that to the extent that money or property received by a partner in exchange for all or part of the partner's interest

[66] Section 331(a).
[67] Reg. section 1.708-1(b)(4).
[68] Reg. section 1.704-1(b)(2)(iv)(l).

attributable to the partner's share of partnership hot assets gain or loss will be ordinary income or loss.

The tax consequences of the merger of an S corporation into an LLC are generally the same as the tax consequences described above for the merger of a C corporation into an LLC. The S corporation, however, will not generally owe an entity-level tax on any gain recognized because it is a pass-through entity, unless the gain is subject to built-in gains tax under section 1374. Otherwise, any gain caused by the distribution of the LLC's ownership interests in the deemed liquidation will be passed through to the S corporation's shareholders, increasing the shareholders' stock bases. The increase in the shareholders' stock bases will generally prevent the shareholders from recognizing further gain on the deemed exchange of the LLC ownership interests for their stock. As a result, the merger an S corporation into an LLC will generally result in one as opposed to two levels of tax.

B. Merger of an LLC into a Corporation

The tax consequences of the merger of an LLC into a corporation, in which LLC members receive corporate stock in exchange for the merged LLC's assets and liabilities and the corporation survives, will generally be more favorable than the tax consequences of the merger of a corporation into an LLC. The merger of an LLC into a corporation will generally be characterized as an "asset-over" transaction. As discussed in section III. A. 2. A. ii above, the LLC will first be

deemed to transfer all of its assets and liabilities to the corporation in exchange for stock in the corporation. If the LLC will control the corporation following the contribution of the LLC's assets, the exchange will likely qualify as a tax-free contribution pursuant to section 351.

The LLC will then be deemed to distribute the stock of the corporation to its members in complete liquidation of their LLC interests and will dissolve pursuant to the plan of merger. Pursuant to section 731, an LLC member will not recognize gain on the distribution of the corporate stock, except to the extent that the stock is treated as "money" and the money exceeds the adjusted basis of the member's interests in the LLC. "Marketable securities" are treated as money for purposes of section 731. Thus, if the stock qualifies as marketable securities, then the LLC member may recognize gain if the value of the stock received by the member exceed the member's basis in his or her LLC interests. If the stock does not qualify as marketable securities, then the LLC member should not recognize any gain and the member's basis in the stock received will be equal to the adjusted basis of the member's interest in the LLC.[69]

C. Forward Triangular Merger with a Corporation

In a forward triangular merger, a corporation will be merged into a subsidiary of the LLC with the subsidiary surviving. The federal tax consequences in a forward triangular merger will vary

[69] Section 732(b).

slightly depending on whether the LLC's subsidiary will be classified as a partnership, disregarded entity or corporation.

If the LLC's subsidiary will be classified as a partnership, the merger of a corporation into the subsidiary may result in double taxation if the corporate target is a C corporation and a single level of tax may be imposed if the corporate target is an S corporation. As described in section III.A.3 above, this transaction will be bifurcated and the corporation will be deemed to transfer all of its assets and liabilities to the LLC in exchange for ownership interests in the LLC and the corporation will be deemed to be liquidated.[70] The tax consequences of these two steps will be the same as those described in the discussion of "Merger of a Corporation into an LLC" above. This would be true regardless of whether the interests of the subsidiary or the parent LLC were exchanged in the transaction.

If the LLC's subsidiary will be classified as a disregarded entity, the corporation will be treated as merging directly into the LLC. The tax consequences of this transaction will be the same as those described in the discussion of "Merger of a Corporation into an LLC" above.

If the LLC's subsidiary will be classified as a corporation, the transaction may qualify as a tax-free merger pursuant to section 368(a). If the LLC's interests are used as consideration in the merger, however, the transaction will not qualify as a tax-free merger under section 368(a) and

[70] PLR 9701029.

will be subject to tax as described above in the discussion of "Merger of a Corporation into an LLC."

D. Reverse Triangular Merger with a Corporation

In a reverse triangular merger, the LLC's subsidiary will be merged into a corporate target with the corporate target surviving. As with a forward triangular merger, the federal tax consequences in a forward triangular merger will vary slightly depending on whether the LLC's subsidiary will be classified as a partnership, disregarded entity or corporation.

If the LLC's subsidiary will be classified as a partnership, the merger of the subsidiary into a corporation will generally be characterized as an "asset-over" transaction. As described above, the LLC will be deemed to transfer all of its assets and liabilities to the corporation in exchange for stock in the corporation and the subsidiary will distribute the stock of the corporation to its members in complete liquidation. The tax consequences will be the same as those described in the discussion of "Merger of an LLC into a Corporation" above. This would be true regardless of whether the interests of the subsidiary or the parent LLC were exchanged in the transaction.

If the LLC's subsidiary will be classified as a disregarded entity, the LLC will be treated as merging directly into the corporation. The tax consequences of this transaction will be the same as those described in the discussion of "Merger of an LLC into a Corporation" above.

If the LLC's subsidiary will be classified as a corporation, the transaction may qualify as a tax-free merger pursuant to section 368(a). If the LLC's interests are used as consideration in the merger, however, the transaction will not qualify as a tax-free merger under section 368(a) and will be subject to tax as described above in the discussion of "Merger of an LLC into a Corporation."

Following the merger, the corporation will be a wholly owned subsidiary of the LLC and will continue to be subject to a double tax regime.

V. Check and Merge

As discussed above, most mergers involving corporations and LLCs will result in taxation at some level. Nonrecognition treatment may be possible if the LLC makes an election to be taxed as a corporation and, then, the LLC, which is treated as a corporation, merges with another corporate entity. Considering the first step, the change in federal income tax designation by the LLC from a partnership to a corporation, the LLC will be deemed to contribute all of its assets to a new corporation in exchange for stock in the new corporation, followed by a deemed liquidation of the LLC, distributing the stock of the corporation to its members. This deemed transaction will generally be tax-free pursuant to section 351. The merger of the newly

created corporation into another corporation will qualify for a tax-free merger pursuant to section 368, assuming the merger otherwise qualifies.

Taxpayers that engage in this two-step process will not be required to recognize gain or loss provided the form of the transaction is respected by the IRS. There is a risk, however, that the IRS will apply the "step transaction" doctrine and collapse the two steps together. If these steps are collapsed, the conversion of the LLC to a corporation will be ignored and the corporation will be treated as being merged directly with the LLC.

VI. Conclusion.

The tax and legal aspects of merging LLCs are complex. Careful planning and guidance in effectuating the transaction are necessary.

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