

*Fiction, Form and Substance in Subchapter K –
Approaching Partnership Mergers, Divisions and Incorporations*

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ABSTRACT

The tax consequences of substantively equivalent partnership mergers, divisions and incorporations can vary dramatically depending on the form of the transaction. This disparate treatment arises because the tax analysis of these partnership transactions inconsistently adheres to the “form” of the transaction and limits the use of legal “fictions”. This part-form, part-fiction approach distorts parties’ incentives about whether and how to undertake such transactions and can make the transactions less efficient, all without materially advancing other policy goals. This result is exacerbated by non-tax business exigencies that restrict parties’ abilities to implement certain transaction forms and by the increase in “formless” transactions. In order to treat substantively equivalent transactions similarly, this article proposes the adoption of a uniform regime in which the tax consequences of partnership mergers, divisions and incorporations are determined based on the legal “fiction” elected (from up to three choices) by the parties, regardless of the “form” in which the transaction is implemented. The proposed approach not only remedies the problem of disparate treatment and addresses the policy concerns raised by existing part-form, part-fiction regime, but also rationalizes the use of “form” and “fiction” in the tax analysis of substantively equivalent partnership transactions.

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I. INTRODUCTION

Most corporate and tax lawyers know that a single economic transaction often can be effectuated through a variety of different structures. Once a structure is selected, query how the tax consequences of the economic transaction should be determined -- should the tax consequences be determined based on the formal legal steps chosen to accomplish the transaction (the “form” of the transaction), based on a recast of the transaction reflecting the “non-tax economic relationships between the parties created, and commercial goals achieved, by virtue of the transaction”¹ (the “substance” of the transaction), or based on a set of hypothetical steps that is deemed to, but does not actually, occur, and that is not merely a substantive recast of the transaction (a “fiction”).² Whether to choose form or substance is a common question in the tax law,³ but rarely does the question offer a third possible answer – “fiction”. Perhaps this reflects a desire for tax analysis to be grounded in “reality,” either economic reality, in the case of substance, or legal reality, in the case of form. Or perhaps fiction might be viewed merely as

¹ Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457 (1999).

² In an attempt to define “legal fiction”, one commentator has explained,

[Fiction’s] true nature remains difficult to state with clarity. The legal fiction is an elusive concept because by design it must blend into its surroundings; it must adapt to changing circumstances. On a philosophical level, the legal fiction is the expression of a relation. In legal theory it may also be described as a metaphor. On a more pragmatic level, it is a falsehood deemed to be true for limited purpose. But none of these phrases convey a concrete image. The legal fiction is a form that draws its substance from the body of law in which it is employed.”

John A. Miller, *Liars Should Have Good Memories: Legal Fictions and the Tax Code*, 64 U. Colo. L. Rev. 2 (1993).

³ The existing discussions in the literature about substance and form serve as a backdrop for this paper’s discussion about formulating a coherent approach to the application of form and fictions. *See generally, e.g.*, Steinberg, *supra* note 1; Sheldon I. Banoff, *Mr. Popeil Gets ‘Reel’ About Conversions of Legal Entities: The Pocket Fisherman Flycasts for “Form” but Snags on “Substance”*, 75 TAXES 887 (Dec. 1997); William F. Nelson, *The Limits of Literalism: The Effects of Substance Over Form, Clear Reflection and Business Purpose Considerations on the Proper Interpretation of Subchapter K*, 73 TAXES 641 (Dec. 1995); Stephen G. Utz, *Partnership Taxation In Transition: Of Form, Substance, And Economic Risk*, 43 TAX LAW. 693; Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982). However, a detailed discussion of substance over form principles is outside the scope of this paper. This paper’s focus is not on whether and when to use substance rather than form or form rather than substance, largely because, as discussed in greater detail below, the varieties of each transaction discussed herein are substantively equivalent. Hence, trying to analyze such a transaction in accordance with its substance is insufficient to determine how it should be taxed.

a subset of substance, in that, analyzing a transaction in accordance with its substance requires that the tax consequences be determined on the basis of hypothetical steps that reflect the true substance of the transaction and that are deemed to occur. However, a fiction-based analysis can be legitimate and can be more than just a mechanism of a substantive analysis.⁴ In fact, the use of fiction pervades the tax law. One commentator explained that

Tax law is riddled with legal fictions. For example, the law “attributes” ownership of property to one person when it is actually owned by another. It “constructs” non-existent transfers of money between persons. It “deems” property held for a different period of time from that for which it was actually held. And tax law treats transfers of property “as if” they never occurred.⁵

Fictions can be used in many ways, from implementing analogies that apply the existing law to new facts to making incremental changes in the law over time,⁶ and moreover, as this paper will demonstrate, fictions⁷ can be quite helpful, particularly if a transaction can be taken without a clear form, if the substance of a transaction can be effectuated through multiple, equally plausible, structures or if there is a desire to permit flexibility in the tax characterization of a particular entity or event.

⁴ For a theoretical discussion of legal fiction as a phenomenon of the tax law, *see* Miller, *supra* note 2 (providing, among other things, a review of some of the relevant literature on the role of fictions in legal analysis). This paper, while informed by such theoretical discussions, takes a more application-oriented approach and discusses fiction as it is used and as it should be used in the analysis of partnership mergers, divisions and incorporations.

⁵ Miller, *supra* note 2 (citations omitted).

⁶ *See id.*

⁷ In an effort to distinguish between hypothetical steps invented solely to most accurately reflect the substance of a transaction (i.e., as a substantive recast) from hypothetical steps that are pure fabrication, the remainder of this paper’s use of the term “fiction” will refer only to the latter unless specifically stated. The former will be referred to as “substance.”

However, throughout the Code,⁸ and in Subchapter K⁹ in particular, balancing the use of fictions with the use of substance and form in the tax analysis of transactions remains difficult.¹⁰ This paper focuses on how substance, form and fiction are, and should be, used in the analysis of the tax consequences of partnership mergers, divisions and incorporations. Part II of this paper discusses various forms of partnership mergers, divisions and incorporations, explains the tax “constructs”¹¹ that are used for analyzing these forms, and demonstrates that this analysis can lead to disparate tax treatment of substantively equivalent forms of transactions. The constructs, as currently applied, incorporate an inconsistent adherence to form and a limited use of fictions, and Part III analyzes the policy implications of this part-form, part-fiction approach. Specifically, Part III concludes that the existing tax rules for the analysis of partnership mergers, divisions and incorporations distort parties’ incentives about whether and how to undertake transactions, thereby undermining several well-accepted tax policy goals, including neutrality and efficiency, without materially advancing other considerations, such as simplicity and administrability, among others. To address these policy concerns and to rationalize the use of “form” and “fiction” in the analysis of these transactions, Part IV proposes that, regardless of the actual form of transaction, parties be able to elect which fiction (from up to three choices) will

⁸ Unless otherwise stated, all “Section” references and references to the “Code” herein refer to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

⁹ Subchapter K is comprised of Sections 701 through 777 of the Code and generally sets forth the rules dealing with the federal income taxation of partners and partnerships.

¹⁰ See, e.g., Joseph A. Snoe, *Economic Reality or Regulatory Game Playing?: The Too Many Fictions of the § 752 Liability Allocation Regulations*, 24 SETON HALL L. REV. 1887 (1993-94) (discussing the use of fictions in the analysis of the rules regarding the treatment of partnership liabilities); John S. Pennell & Philip F. Postlewaite, *When Hypothetical Transactions Have Real Results – New Prop. Regs. for Subchapter K*, 88 J. TAX. 262 (May 1998) (discussing the rules regarding special adjustments to basis).

¹¹ By “construct”, I mean the set of transactional steps, whether actual or hypothetical, that are respected for purposes of determining the tax consequences of a transaction. As used herein, the use of the term “construct” does not indicate a judgment about whether the tax analysis is based on the actual “form” of the transaction or whether the tax analysis is based on a “fiction.”

apply for purposes of analyzing the tax consequences of partnership mergers, divisions and incorporations.

II. ANALYZING THE TAX CONSEQUENCES OF PARTNERSHIP MERGERS, DIVISIONS AND INCORPORATIONS

As with many transactions, partnership mergers, divisions and incorporations can be effectuated through various forms under the applicable state law.¹² The IRS generally uses some or all of the following constructs – “assets-up”, “assets-over” and “interests-over” – in order to determine the tax consequences of these transactions. The details of how these constructs apply to partnership mergers, divisions and incorporations are set forth in Treasury Regulation section 1.708-1(c), Treasury Regulation 1.708-1(d)¹³ and Revenue Ruling 84-111,¹⁴ respectively, and are discussed below.¹⁵

¹² For example, in order to “merge”, (a) the merged partnership and the surviving partnership can undertake a statutory merger, (b) the merged partnership can transfer its assets to the surviving partnership in exchange for interests in the surviving partnership and then liquidate, (c) the merged partnership can transfer its assets up to its partners and then the partners can contribute the assets to the surviving partnership in exchange for interests in the surviving partnership, (d) the partners in the merged partnership can transfer all of their interests in the merged partnership to the surviving partnership, or (e) some combination of the foregoing could be undertaken (e.g., transferring some assets directly from the merged partnership to the surviving partnership and transferring some assets up to the partners of the merged partnership).

¹³ The current versions of Treas. Reg. 1.708-1(c) and -1(d) were proposed in 2000 by 65 Fed. Reg. 1572 (Jan. 11, 2000) (the “Proposed Section 708 Regulations”) and finalized in 2001 by Treas. Dec. 8925, 2001-1 C.B. 496 (the “Final Section 708 Regulations”) and together with the Proposed Section 708 Regulations, the “Section 708 Regulations”). Prior to the promulgation of the Section 708 Regulations, partnership mergers were generally analyzed under the “assets-over” construct. *See, e.g.*, Rev. Rul. 68-289, 1968-1 C.B. 314. However, the Service did not employ a consistent approach to partnership divisions prior to the promulgation of Section 708 Regulations; the IRS respected the “assets-up” approach taken in Priv. Ltr. Rul. 89-45-069 (Aug. 17, 1989), respected the “assets-over” approach taken in Priv. Ltr. Rul. 94-37-007 (June 10, 1994), and recast an attempted “assets-over” transaction as an “assets-up” division in Priv. Ltr. Rul. 93-50-035 (Sept. 22, 1993), in each case without articulating a clear rationale for the choice of construct.

¹⁴ 1984-2 C.B. 88. Before Revenue Ruling 84-111, Revenue Ruling 70-239 provided that all forms of incorporations were treated pursuant to the “assets-over” construct. 1970 C.B. 74.

¹⁵ This paper assumes that the Section 707 regulations regarding disguised sales do not change the analysis set forth herein for mergers and divisions and assumes that the final regulations regarding disguised sales will coordinate with the application of the Final Section 708 Regulations. *See generally* Richard M. Lipton, *Controversial Prop. Regs. on Disguised Sales of Partnership Interests – IRS Jumps Into the Deep End*, J. TAX’N (Feb. 2005), at note 28

A. *Partnership Mergers*¹⁶

1. General Rules

In order to understand how the various constructs apply to a partnership merger, one must first determine whether the combined partnership (the “resulting partnership”) is a continuation of either of the merging partnerships.¹⁷ The Code and regulations answer this question by looking at the substance of the transaction, looking specifically at the ownership or asset composition of the resulting partnership, without regard to which partnership is formally the surviving partnership under state law. The resulting partnership is considered a continuation of the merging partnership “the [partners] of which own more than 50 percent of the capital and profits of the resulting partnership”, and if the partners of more than one of the merging partnerships own more than 50% of the capital and profits of the resulting partnership,¹⁸ the resulting partnership “is considered a continuation solely of that partnership which is credited

and accompanying text (discussing the possibility of interaction between the regulations regarding partnership mergers and divisions and the proposed regulations regarding disguised sales).

¹⁶ Neither the Code nor the Treasury Regulations actually defines whether a transaction constitutes a “merger” of partnerships. Section 708(b)(2)(A); Treas. Reg. section 1.7081-1(c). In connection with the promulgation of the Final Section 708 Regulations, the IRS considered including, but explicitly decided not to provide, a definition of the term “merger”. Treas. Dec. 8925, 2001-1 C.B. 496. However, the IRS has generally treated the combination of two or more partnerships (or the businesses of such partnerships) into a single partnership as a “merger” for purposes of Section 708, regardless of the form of or state-law nomenclature for the transaction. *See, e.g.*, Priv. Ltr. Rul. 2003-29-039 (Sept. 26, 2003) (applying the partnership merger rules to the consolidation of six partnerships into a single LLC); *see also, e.g.*, WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS (hereinafter “MCKEE”) ¶ 12.06[1] n. 199 (3d ed.) (collecting examples of transactions that the IRS treated as mergers prior to the promulgation of the Final Section 708 Regulations). This paper adopts this approach. Further, although a merger can involve many partnerships, for simplicity, all partnership mergers discussed in this paper are assumed to be mergers of only two partnerships, unless otherwise stated.

As an aside, the failure of the IRS to provide a definition has raised the ire of some commentators, who argue that this omission results in an unfair and unnecessary uncertainty. *See, e.g.*, Barksdale Hortenstine et al., *Final Partnership Merger and Division Regulations – Analysis, Commentary and Examples*, 568 PRACTISING LAW INSTITUTE TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES (hereinafter “PLI”) 998, 1010-11 (2003).

¹⁷ Section 708(b)(2)(A); Treas. Reg. section 1.708-1(c)(1).

¹⁸ This could occur, for example, if some partners own interests in both merging partnerships.

with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership.”¹⁹

Once it has been determined which merging partnership is treated as continuing and which merging partnership is treated as terminated,²⁰ the partnership merger constructs are applied. The Treasury Regulations provide two basic constructs for partnership mergers – “assets-up” and “assets-over”.

- Under the “assets-up” construct, the terminated partnership is treated as distributing its assets up to its partners in liquidation, and then the partners of the terminated partnership are treated as contributing the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.²¹
- Under the “assets-over” construct, the terminated partnership is treated as contributing its assets and liabilities over to the resulting partnership in exchange for interests in the resulting partnership, and then, the terminated partnership is treated as making a liquidating distribution to its partners of the interests in the resulting partnership.²²

¹⁹ Treas. Reg. section 1.708-1(c)(1). If members of no merging partnership own more than 50 percent of the capital and profits of the resulting partnership, the resulting partnership is treated as a new partnership and not as a continuation of any prior partnership. *Id.*

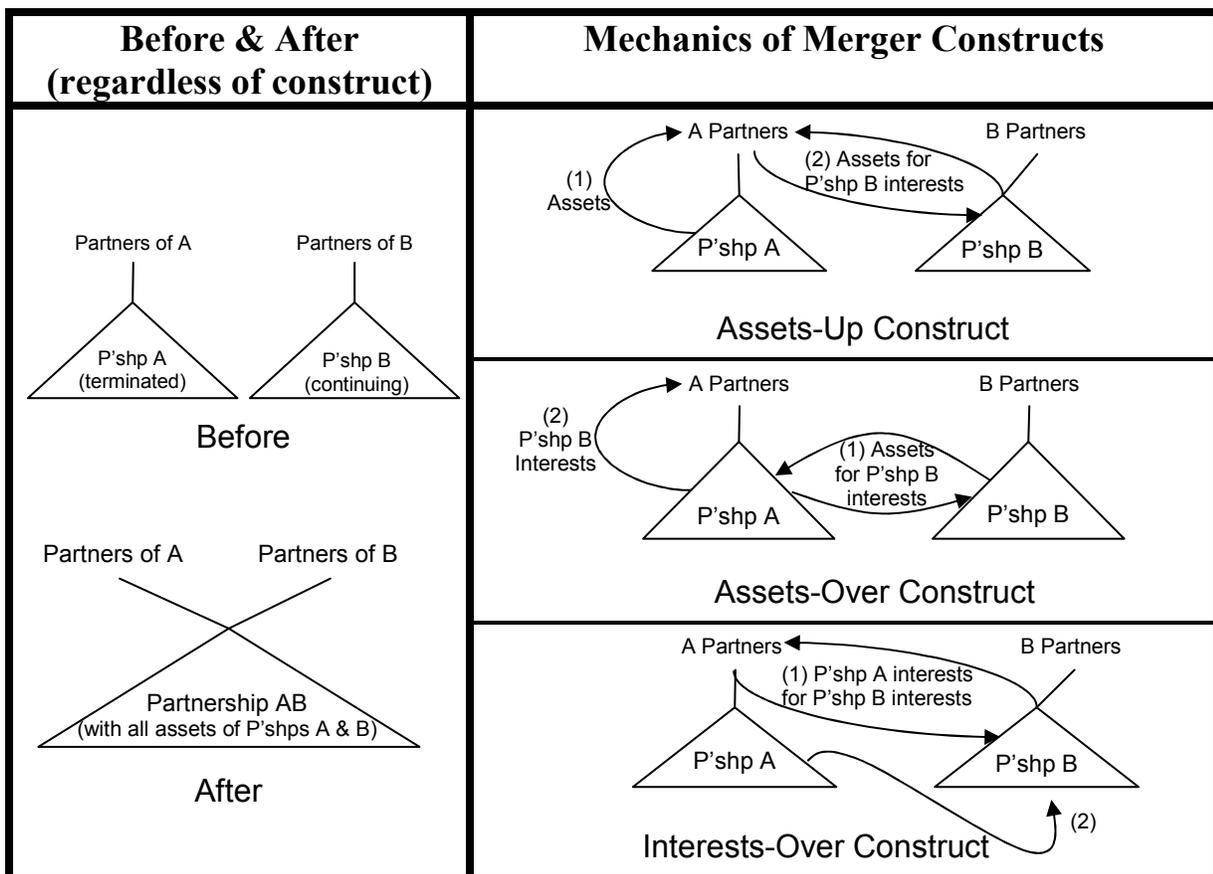
²⁰ Any partnership that is not treated as “continuing” is considered to be terminated. *Id.*

²¹ *Id.* at 1.708-1(c)(3)(ii).

²² *Id.* at 1.708-1(c)(3)(i).

The “interests-over” construct, in which the partners in the terminated partnership contribute all of their interests in the terminated partnership over to the resulting partnership in exchange for interests in the resulting partnership, is not respected under the Treasury Regulations.²³

Note that all three constructs lead to the same substantive result:



²³ *Id.* at 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*. Preamble to 65 Fed. Reg. 1572 (Jan. 11, 2000); Rev. Rul. 84-111, 1984-2 C.B. 88; *McCaulesen v. Commissioner*, 45 T.C. 588 (1966). See *infra* note 48.

The Treasury Regulations also provide for a variation on the “assets-over” approach to address the situation where some partners want to sell all or part of their interests. Under the “buy-out” rule, a partner (or partners) in the terminated partnership can sell its (or their) interest in the terminated partnership to the continuing partnership immediately before the “assets-over” transaction; subject to the satisfaction of certain conditions, the Service will respect this transfer as a sale of interests governed by Section 741 of the Code.²⁴

All of these rules operate against the backdrop of an anti-abuse rule pursuant to which, if the merger is part of a larger series of transactions, the Service can disregard the form of the merger “and recast the larger series of transactions in accordance with their substance.”²⁵

2. Application of the “Assets-Up” Construct

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.”²⁶ The preamble to the Final Section 708 Regulations explains that, in order to accomplish this transfer, it is insufficient for partners merely to “assign their rights to receive title to the assets in liquidation of the partnership, or direct the partnership to transfer title to the assets to the resulting partnership.”²⁷ Moreover, although the preamble to the Final Section 708 Regulations states that “[f]or most types of assets, this [transfer of assets] will not require the

²⁴ Treas. Reg. section 1.708-1(c)(4), -1(c)(5)(ex. 5). Although the merger regulations do not respect the “interests-over” construct, the buy-out rule is an “interests-over”-type transaction in that the transfer is respected as a transfer of interests.

²⁵ *Id.* at 1.708-1(c)(6).

²⁶ *Id.* at 1.708-1(c)(3)(i).

²⁷ Treas. Dec. 8925, 2001-1 C.B. 496.

actual transfer and recording of a deed or certificate of title”,²⁸ it is clear that the transfer of title and recording of a deed will, in fact, be required in order to transfer certain assets.

In addition, notwithstanding the regulations’ general adherence to form and applicable local law, the “assets-up” construct contains fictional elements as well. For example, the preamble to the Final Section 708 Regulations and the regulations themselves indicate that the transfer of an asset to the partners will be respected even if the partners generally could not own the asset outside the partnership.²⁹ Further, despite the requirement that the terminated partnership actually transfer the assets to the partners, the partners are not actually required to assume the liabilities of the partnership in order for the “assets-up” form to be respected.³⁰

3. Application of the “Assets-Over” Construct

Any partnership merger that is not structured so as to qualify for “assets-up” treatment will be treated as an “assets-over” transaction.³¹ 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 is undertaken under a state statute, any partnership merger that is effectuated in an “interests-over” form, and any partnership merger that otherwise fails to qualify as an “assets-up” transaction.

²⁸ *Id.*

²⁹ *Id.*; Treas. Reg. section 1.708-1(c)(5)(ex. 3). To illustrate this point, the Service specifically cites goodwill (and specifically, the undivided interest in business goodwill that a partner might receive as part of an “assets-up” transaction) as the type of asset that might raise this problem.

³⁰ Treas. Dec. 8925, 2001-1 C.B. 496. See *infra* notes 76-77 and accompanying text (discussing the Service’s explanation for this treatment of liabilities).

³¹ Treas. Reg. section 1.708-1(c)(3)(i).

Given that the “assets-over” construct applies to such 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 merger may be entirely fictional and markedly different from the actual transfers that occur. This possible fictional result is magnified because, as discussed above in Part II.A.1., 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.

B. *Partnership Divisions*³²

1. General Rules

The tax treatment of partnership divisions is quite similar to the tax treatment of partnership mergers. In order to understand how the various constructs apply to a partnership merger, one must first determine whether any of the post-division local law partnerships (each, a “resulting partnership”) is a continuation of the pre-division local law partnership (the “prior partnership”) and, if so, which continuing partnership (if any) is treated, for tax purposes, as being divided (the “divided partnership”).³³ As with partnership mergers, the Code and

³² As with mergers, the IRS considered including a definition of partnership “division” in the Final Section 708 Regulations, but ultimately provided little guidance regarding the definition of the term partnership “division”. *See supra* note 16. However, the Service did explain that “to have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction.” Treas. Dec. 8925, 2001-1 C.B. 496; Treas. Reg. section 1.708-1(d)(4)(iv). In the absence of a full definition of the term “division”, the IRS has generally treated the separation of one partnership into two or more partnerships (each of which has at least two members that were members of the prior partnership) as a “division” for purposes of Section 708, regardless of the form or state-law nomenclature for the transaction. *See, e.g.*, Priv. Ltr. Rul. 2002-23-045 (Mar. 3, 2002) (applying the partnership division rules to the separation of a single LLC into two LLCs). This paper adopts this approach. Further, although a division can involve the separation of one partnership into many partnerships, for simplicity, all partnership divisions discussed in this paper are assumed to be divisions of one partnership into only two partnerships, unless otherwise stated.

³³ Section 708(b)(2)(B); Treas. Reg. section 1.708-1(d)(1). The regulations employ very specific terminology in describing the tax consequences of divisions. The “prior partnership” and the “resulting partnerships” both refer to partnerships actually existing under local law, with the “prior partnership” being the partnership that exists under local law before the division, and the “resulting partnerships” being the partnerships that exist under local law after the division. Treas. Reg. section 1.708-1(d)(4)(ii), (iv). The “divided partnership” and the “recipient partnership” are tax fictions used for purposes of determining the tax consequences of the division, with the “divided partnership”

regulations look to the substance of the division in order to answer these questions. A resulting partnership is considered as a continuation of the prior partnership “if the members of the resulting partnership or partnerships had an interest of more than 50 percent in the capital and profits of the prior partnership.”³⁴ If there is only one continuing partnership, that partnership is also treated as the divided partnership, and if there is more than one continuing partnership, the regulations have a series of “tie-break” rules for determining which continuing partnership is the divided partnership.³⁵ These rules apply regardless of whether the continuing or divided partnerships existed under state law prior to the division.

Once the divided partnership (if any) has been identified, the partnership division constructs are applied. As with partnership mergers, the Treasury Regulations provide two basic constructs for partnership divisions – “assets-up” and “assets-over”.

- Under the “assets-up” construct, the divided partnership is treated as distributing certain assets to some or all of its partners in partial or complete liquidation of their interests, and then the partners are treated as contributing all of the distributed assets into the new recipient partnership in exchange for interests in the new recipient partnership.³⁶

being the partnership that is treated for tax purposes as transferring assets and liabilities to the recipient partnership in the division, and the “recipient partnership” being the partnership that is treated for tax purposes as receiving assets and liabilities from the divided partnership in the division. *Id.* at 1.708-1(d)(4)(i), (iii).

³⁴ Treas. Reg. section 1.708-1(d)(1).

³⁵ *Id.* at 1.708-1(d)(4)(i). If there are multiple continuing partnerships, the “tie-break” rules provide that, if one of the continuing partnerships actually transferred assets and liabilities in the division, that continuing partnership is the “divided” partnership, and otherwise, the continuing partnership with assets having the greatest net fair market value is treated as the “divided” partnership. *Id.*

³⁶ *Id.* at 1.708-1(d)(3)(ii)(A). If none of the resulting partnerships are continuations of the prior partnerships (and hence there is no divided partnership), then the “assets-up” construct works basically the same way, except that it is the *prior partnership* (and not the divided partnership, since there is none) that will be treated as distributing assets,

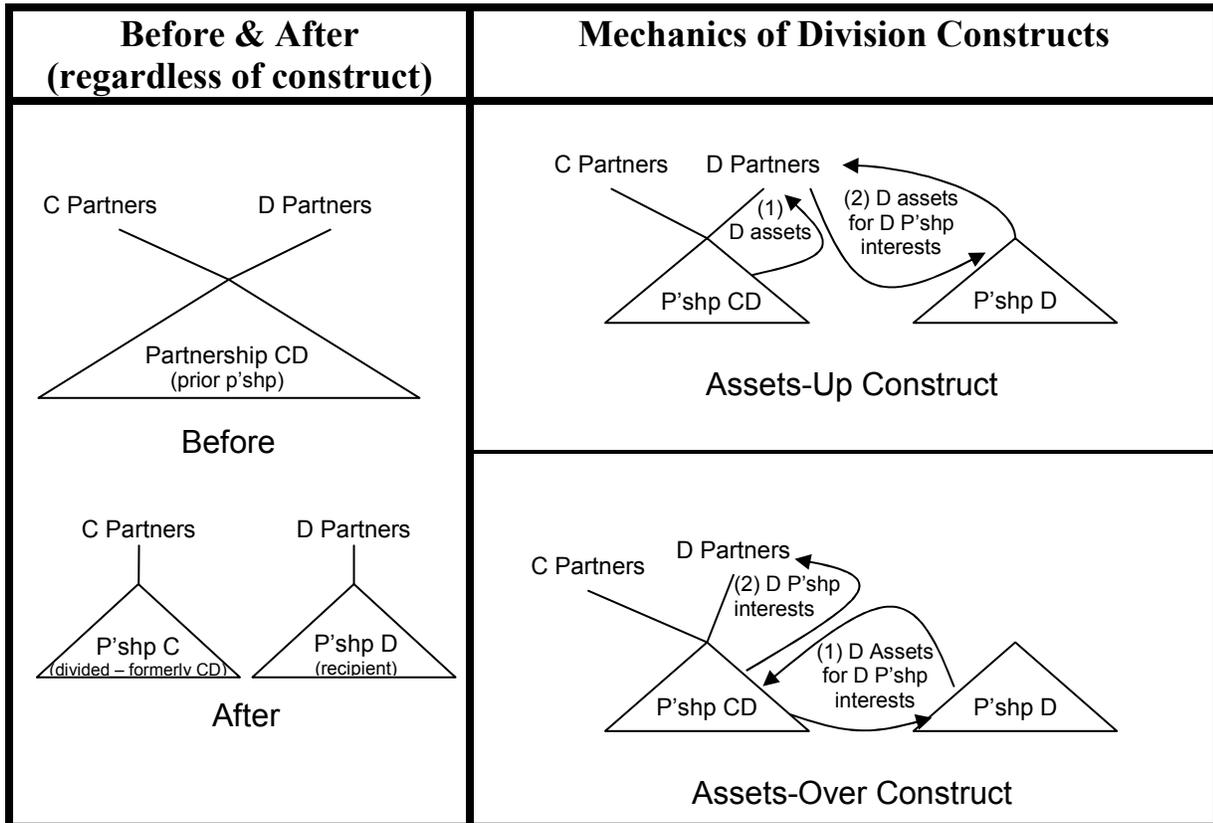
- Under the “assets-over” construct, the divided partnership is treated as contributing certain assets to the recipient partnership in exchange for interests in the recipient partnership, and then the divided partnership is treated as distributing the interests in the recipient partnership to some or all of the divided partnership’s partners in partial or complete liquidation.³⁷

There is no “interests-over” formulation for partnership divisions.

Note that both the “assets-up” and the “assets-over” constructs lead to the same substantive result:

and the partners will be treated as contributing the distributed assets into *resulting partnerships* (if there is no divided partnership, there can be no recipient partnership).

³⁷ *Id.* at 1.708-1(d)(3)(i)(A). If none of the resulting partnerships are continuations of the prior partnerships, then the “assets-over” construct works in a similar manner, except that the *prior partnership* will be treated as contributing *all* of its assets to the *resulting partnerships* in exchange for interests in the *resulting partnerships*, and then the *prior partnership* will be treated as liquidating and distributing the interests in the *resulting partnerships* to the prior partnership’s partners. *Id.* at 1.708-1(d)(3)(i)(B).



Like the partnership merger rules, the partnership division regulations include an anti-abuse rule that provides that, if the division is part of a larger series of transactions, the Service can disregard the form of the division “and recast the larger series of transactions in accordance with their substance.”³⁸

2. Application of the “Assets-Up” Construct

The “assets-up” construct largely respects form, in that it will only be respected if the assets are actually transferred up to the partners.³⁹ Such transfers are subject to the same

³⁸ *Id.* at 1.708-1(d)(6).

³⁹ *Id.* at 1.708-1(d)(3)(i).

limitations and requirements as discussed in connection with the “assets-up” construct for partnership mergers.⁴⁰ Moreover, in order for the “assets-up” form to be respected, *all assets* that are ultimately transferred to the recipient partnership must be distributed by the divided partnership to, and then contributed to the recipient partnership by, the partners of the recipient partnership.⁴¹

3. Application of the “Assets-Over” Construct

The “assets-over” construct applies not only to transactions actually taken in the “assets-over” form, but also to all partnership divisions that do not qualify for “assets-up” treatment, including formless divisions,⁴² divisions where only some of the assets of the recipient partnership are transferred through the “assets-up” form,⁴³ divisions where the prior partnership contributes certain assets into an LLC and then distributes the interests in the LLC to the prior partnership’s partners,⁴⁴ and any other divisions that do not comply with the “assets-up” requirements.

As with partnership mergers, although the tax analysis of a division may follow its form, given that the “assets-over” construct applies to a wide variety of transactions (many of which do

⁴⁰ See *supra* Part II.A.2.

⁴¹ Treas. Reg. section 1.708-1(d)(3)(ii)(A). Similarly, if there is no divided partnership, the prior partnership must transfer *all of its assets* to the resulting partnerships and then liquidate; if the prior partnership does not liquidate under the applicable jurisdictional law, then the assets that are not transferred in this “assets-up” form will be treated as transferred in an “assets-over” transaction. *Id.*

⁴² See, e.g., *id.* at 1.708-1(d)(5)(ex. 5).

⁴³ See, e.g., *id.* at 1.708-1(d)(5)(ex. 3).

⁴⁴ This may appear close to an “assets-up” form given that the transfer of all of the interests in a single member LLC is generally viewed as transferring the underlying assets for federal income tax purposes. However, since the partners receiving the distribution do not actually become owners of the underlying assets under local law (given that local law generally respects LLCs as real entities), the transfer does not qualify for “assets-up” treatment, and hence, the “assets-over” default rule applies.

not involve the transfer of assets at all) and given that the continuing and divided partnerships may not even exist as state law entities prior to the division, the transfers that are deemed to occur in a division under the Final Section 708 Regulations may be entirely fictional and markedly different from the actual transfers that occur.

C. *Partnership Incorporations*

1. General Rules

In Revenue Ruling 84-111,⁴⁵ the IRS ruled that it will respect each of three different constructs for incorporating a partnership – “assets-up”, “assets-over” and “interests-over”.

- Under the “assets-up” construct, the partnership is treated as distributing all of its assets and liabilities up to its partners in liquidation, and then the partners are treated as contributing all of the distributed assets to a newly-formed corporation in exchange for all of the stock of the corporation and the assumption by the new corporation of all of the partnership’s liabilities that had been assumed by the partners.⁴⁶
- Under the “assets-over” construct, the partnership is treated as transferring all of its assets over to a newly-formed corporation in exchange for all of the stock in the corporation and then distributing the stock to the partnership’s partners in liquidation.⁴⁷

⁴⁵ 1984-2 C.B. 88.

⁴⁶ Rev. Rul. 84-111, 1984-2 C.B. 88.

⁴⁷ *Id.*

- Under the “interests-over” construct, the partners of the partnership are treated as transferring all of their partnership interests over to a newly-formed corporation in exchange for all of the stock in the newly formed corporation, and the newly formed corporation is treated as receiving all of the assets and liabilities of the partnership.⁴⁸

The Service recently addressed the treatment of “formless” incorporations (i.e., a conversion of a partnership to a corporation under a state law statute that does not require an actual transfer of assets or interests) and concluded that Revenue Ruling 84-111 does not apply to formless conversions.⁴⁹ Instead, the Service ruled that a partnership that undertakes a “formless” conversion will be treated as if it elected to be treated as an association taxable as a corporation under the “check-the-box” regulations,⁵⁰ i.e., as engaging in an “assets-over” incorporation.⁵¹

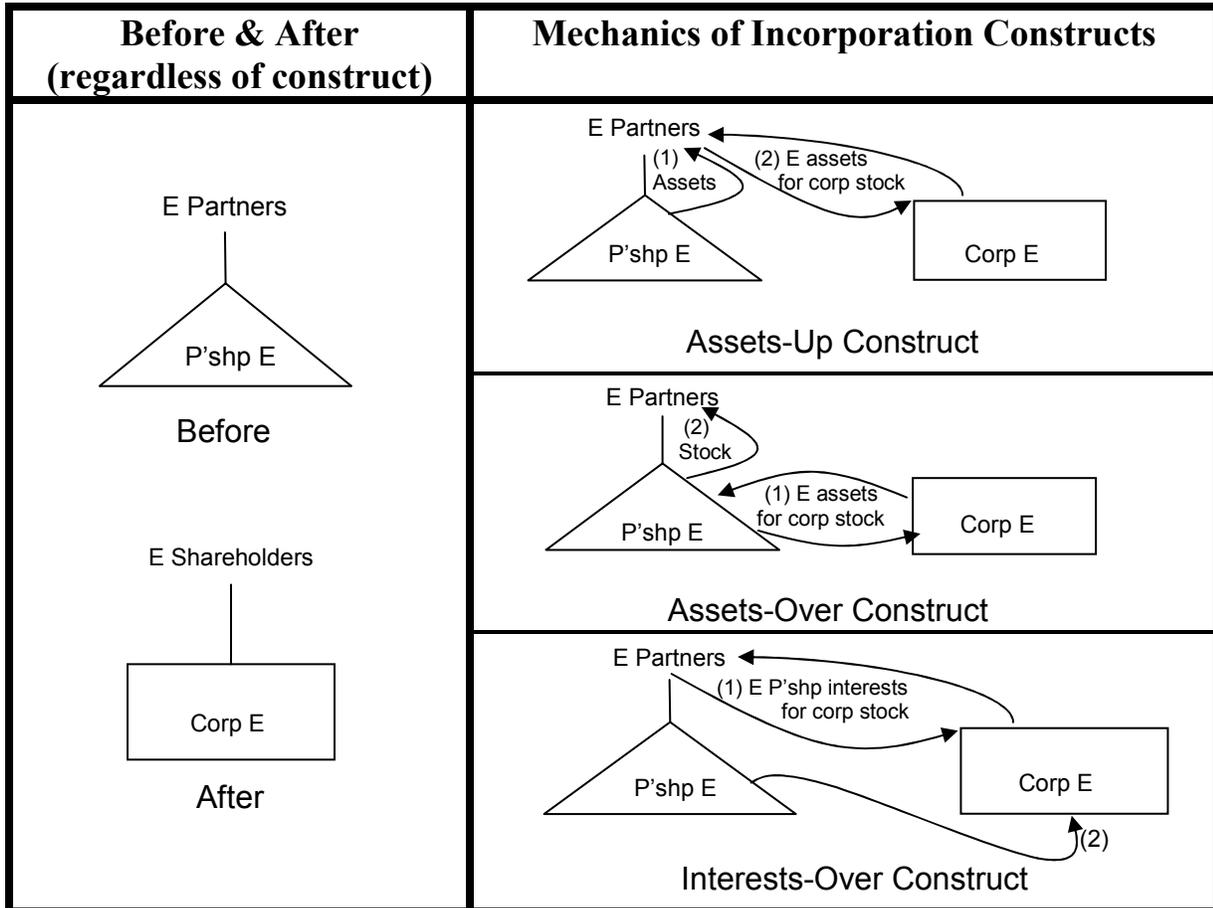
⁴⁸ *Id.* Note that the “interests-over” construct produces asymmetrical treatment for the partners and the corporation – the partners are treated as transferring interests, but the corporation is treated as receiving assets. In the general counsel memorandum supporting Revenue Ruling 84-111, the IRS cited *McCaulsen v. Commissioner*, 45 T.C. 588 (1966) and Revenue Ruling 67-65, 1967-1 C.B. 168, for the proposition that “although the partners are transferring their partnership interests, for purposes of determining tax consequences to [the new corporation, the new corporation] is viewed as receiving not interests in an ongoing partnership, but rather as receiving the partnership assets.” Gen. Couns. Mem. 37,540 (May 18, 1978).

⁴⁹ Rev. Rul. 2004-59, 2004-24 I.R.B. 1050.

⁵⁰ Treas. Reg. section 301.7701-2, -3. The “check-the-box” regulations govern the tax classification of business entities. They provide default rules for the tax classification of business entities (e.g., as a disregarded entity, partnership or association taxable as a corporation), and with some exceptions for entities that are “per se” corporations, the regulations generally allow business entities to elect their tax classification by filing a form and checking a box (hence, the “check-the-box” moniker). *See infra* Parts II.B.3, IV.A.2.c. and IV.B., for discussions of the “check-the-box” rules and how they coordinate and should coordinate with the rules regarding partnership mergers, divisions and incorporations.

⁵¹ Treas. Reg. section 301.7701-3(g)(1)(i). The “check-the-box” regulations also set forth the tax treatment upon an entity’s election to change its tax classification; when a partnership elects to be treated as a corporation for federal income tax purposes, the “check-the-box” regulations provide that the “assets-over” construct applies to the conversion. *See id.*

Again, note that all of the forgoing approaches to incorporations lead to the same substantive result:



2. Application of the “Assets-Up,” “Assets-Over” and “Interests-Over” Constructs

Under Revenue Ruling 84-111, the application of the different constructs follows form. Specifically, the “assets-up” construct appears to require the actual distribution of all of the partnership’s assets and liabilities up to the partnership’s partners, followed by an actual transfer

of those assets to the new corporation in exchange for all of the stock in the corporation.⁵² Note that the “assets-up” requirements in incorporations are slightly different from the “assets-up” requirements in partnership mergers and divisions, in that, (a) Revenue Ruling 84-111 requires an actual distribution of assets, but does not explicitly rely on local law like the partnership merger and division regulations do, and (b) Revenue Ruling 84-111 seems to require that the partners actually assume the partnership’s liabilities in addition to receiving the partnership’s assets, whereas the partnership merger and division regulations do not require liability assumption.

Although the “assets-up” and “interests-over” constructs are based on the actual form of the transaction, the “assets-over” construct applies not only to incorporations actually undertaken in an “assets-over” form, but also applies, as a fiction, to formless incorporations.

D. *Tax Consequences of the Different Constructs*

The tax consequences of partnership mergers, divisions and incorporations to the partners and entities can vary widely based on whether an “assets-up”, “assets-over” or, where applicable, “interests-over” construct is applied to analyze the tax consequences of the transaction, and the IRS, in promulgating the guidance regarding the tax treatment of these transactions, has explicitly acknowledged these differences.⁵³ Particularly since the promulgation of the Proposed

⁵² Rev. Rul. 84-111, 1984-2 C.B. 88; *see also* Priv. Ltr. Rul. 86-13-051 (Dec. 31, 1985) (applying the “assets-up” construct where the partnership liquidated and distributed its assets and liabilities to the partners). *But see* Priv. Ltr. Rul. 94-21-018 (Feb. 23, 1994) (applying the “assets-up” construct where the assets are “constructively distributed” and the partners “direct the transfer of assets” to the corporation).

⁵³ Rev. Rul. 84-111, 1984-2 C.B. 88 (“The premise in Rev. Rul. 70-239 that the federal income tax consequences of the three situations [an “assets-over” transaction, an “assets-up” transaction, and an “interests-over” transaction] described therein would be the same, without regard to which of the three transactions was entered into, is incorrect. As described below, depending on the format chosen for the transfer to a controlled corporation, the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock

Section 708 Regulations regarding the various constructs for partnership mergers and divisions, considerable attention has been focused on the tax consequences of the different constructs, and other commentators have ably provided technical analyses of these disparate tax consequences, both in the context of mergers and divisions⁵⁴ and in the context of incorporations.⁵⁵ Although this paper does not intend to retread this well-traveled path, it is useful to summarize the key potential differences between the constructs.

Depending on the form of merger or division, 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.⁵⁶ The form of a merger or division can also affect the likelihood and extent

received by the former partners can vary.”); Prop. Treas. Reg. § 1.708-1, 65 Fed. Reg. 1572 (Jan. 11, 2000) (“Like partnership incorporations, each form of a partnership merger has potentially different tax consequences. . . . As with partnership mergers, the IRS and Treasury recognize that different tax consequences can arise depending on the form of partnership division.”).

⁵⁴ See, e.g., MCKEE, *supra* note 16 at ¶12.06; ARTHUR B. WILLIS, JOHN PENNELL & PHILIP POSTLEWAITE, PARTNERSHIP TAXATION (hereinafter “WILLIS”) ¶16.03 (6th ed.); Eric B. Sloan et al., *Partnership Mergers and Divisions: A User's Guide*, 569 PLI 56, 93-125; de Marigny, Barbara Spudis, *Mergers and Divisions of Partnerships*, 569 PLI 160, 168-71, 173-74, 180-86; Barksdale Hortenstine et al., *Final Partnership Merger and Division Regulations – Analysis, Commentary and Examples*, 568 PLI 998, 1013-18, 1068-73; Susan Kalinka, *Proposed Regulations Concerning Partnership Mergers and Divisions Provide Guidance and Some, But Not Enough, Flexibility*, 78 TAXES 15 (Aug. 2000).

⁵⁵ See, e.g., MCKEE, *supra* note 16 at ¶17.03; WILLIS, *supra* note 54 at ¶12.05; Cheryl Metrejean and Clair Y. Nash, *Tax Consequences of a Formless Conversion Following Rev. Rul. 2004-59*, 83 TAXES 43 (Feb. 2005); Sheldon I. Banoff, *Mr. Popeil Gets ‘Reel’ About Conversions of Legal Entities: The Pocket Fisherman Flycasts for “Form” but Snags on “Substance”*, 75 TAXES 887 (Dec. 1997).

⁵⁶ For example, in an “assets-over” merger, the terminated partnership's basis in the assets carries over to the resulting partnership pursuant to Section 723, whereas 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. Although this difference can 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. See de Marigny, *supra* note 54 at 169-71; see also Sloan, *supra* note 54 at 94-97 (discussing the basis consequences of different partnership division constructs); Glen E. Goold and Steven R. Schneider, *Finding the Gold Nuggets in Partnership Holding Periods*, 81 TAXES 47 (Feb. 2003) (discussing the effect of incorporations, partnership mergers and partnership divisions on holding periods).

of gain recognition, including gain recognition resulting from the shifting of liabilities⁵⁷ and gain recognition with respect to appreciated properties pursuant to Section 704(c) and Section 737.⁵⁸

Similarly, as noted by the IRS in Revenue Ruling 84-111, depending on the construct for incorporation, “the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners can vary.”⁵⁹ In addition, other tax consequences can differ based on the method of incorporation, including, among others, the occurrence and extent of gain recognition by the former partners upon incorporation (including pursuant to Sections 704(c) and 737), the character of any such gain recognized, the ability of the new corporation to elect to be taxed as an S corporation,⁶⁰ and the

⁵⁷ If a partner’s share of partnership liabilities is treated as decreasing in a merger or division, the partner is treated as receiving a deemed distribution under Section 752, which deemed distribution could result in gain recognition by the partner pursuant to Section 731. Prior to the Section 708 Regulations, the risk of gain recognition was particularly acute in the context of “assets-over” mergers because the 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 Section 708 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. Treas. Reg. section 1.752-1(f). *See* Treas. Reg. section 1.752-1(f); Prop. Treas. Reg. § 1.708-1, 65 Fed. Reg. 1572 (Jan. 11, 2000). However, this language of this netting rule technically only applies to mergers, so the application of this “netting” concept in partnership divisions is less clear.

⁵⁸ The application of Section 704(c) and Section 737 to partnership mergers and divisions has been the subject of much discussion. In the preambles to both the Proposed and Final Section 708 Regulations, the Service flagged Section 704(c) and Section 737 as areas for study and future guidance. Revenue Ruling 2004-43, 2004-4 I.R.B. 842, was intended to provide published guidance regarding the application of these provisions to an “assets-over” partnership merger, but it was revoked by Revenue Ruling 2005-10, 2005-7 I.R.B. under heavy criticism. The Service’s 2006-2007 Priority Guidance Plan includes the promulgation of regulations under Sections 704(c) and 737 regarding partnership mergers.

⁵⁹ Rev. Rul. 84-111, 1984-2 C.B. 88. *See also* Goold & Schneider, *supra* note 56.

⁶⁰ Section 1361.

availability of an ordinary loss deduction under Section 1244 if the stock of the corporation becomes worthless.⁶¹

None of the constructs is certain to produce the most tax favorable result for the taxpayer. Although the Service has indicated that it believes that the “assets-over” constructs will generally be preferable for taxpayers and the IRS,⁶² 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.

III. INHABITING THE NO MAN’S LAND BETWEEN FORM AND FICTION

A. *The Problems of Disparate Tax Treatment of Substantively Equivalent Transactions*

As illustrated above, various forms can be used to accomplish the same economic transaction (turning two partnerships into one, one partnership into two or a partnership into a corporation), but the tax consequences can vary depending on the construct used to analyze the transaction. Since a taxpayer may prefer the federal income tax results of one construct over the results of another, the desire for certain tax consequences may incentivize a taxpayer to try to structure its transaction in a particular form in order to achieve the preferred tax results.

However, the federal income tax consequence of a merger, division or incorporation is likely to be only one factor relevant to the determination of what form to adopt for a given transaction; numerous non-tax business factors are also likely to be relevant to the choice of

⁶¹ See, e.g., WILLIS, *supra* note 54 at ¶12.05 (discussing various tax consequences of different methods of incorporation); see also generally Rev. Rul. 84-111, 1984-2 C.B. 88 (mentioning several of these issues as potential adverse tax consequences to the “assets-over” construct).

⁶² See, e.g., Preamble to Prop. Treas. Reg. section 1.708-1, 65 Fed. Reg. 1572 (Jan. 11, 2001)

form.⁶³ For example, a partnership’s bank credit agreements or debt covenants may limit or preclude the partnership from actually transferring assets and, thus, may militate in favor of an “interests-over” form or a formless structure for a transaction. Similarly, if the partnership’s contracts cannot be transferred without consent, if the actual transfer of assets would require complicated administrative filings, or if there are regulatory restrictions on the ability of the partnership to transfer assets (as there often are with permits and licenses), the “assets-over” and “assets-up” forms may be difficult to undertake. In particular, formless transactions may be the simplest from the perspective of administrative and transaction costs. On the other hand, if, for example, a resulting partnership in a merger wants to limit its exposure to undisclosed or contingent liabilities of the terminated partnership, the resulting partnership may prefer to receive the terminated partnership’s business in an actual asset transfer (either an “assets-up” or “assets-over” form) rather than in an “interests-over” transaction (in which transaction, the resulting partnership would actually end up owning the state law entity of the terminated partnership). The “assets-up” form may be particularly disadvantageous if liabilities follow the transfer of the asset (like environmental remediation responsibility, which can transfer along with the transfer of real estate), since individual partners are likely loathe to take on the exposure to such liabilities. Moreover, the partnership agreements often impose limitations on the ability of the partnership to undertake certain transactions, including liquidation, merger, division, incorporation and the transfer of all or substantially all of the assets of the partnership,⁶⁴ and these limitations may make it easier or harder for the partnership to undertake transactions in

⁶³ Certain other tax issues (e.g., transfer taxes under local law) not discussed herein may also be relevant.

⁶⁴ See, e.g., UNIFORM LIMITED PARTNERSHIP ACT [hereinafter “ULPA”] § 1110(a) (2001); UNIFORM PARTNERSHIP ACT [hereinafter “UPA”] § 905(c)(1) (1997); UNIFORM LIMITED LIABILITY COMPANY ACT [hereinafter “ULLCA”] § 904(c)(1) (1996) (each allowing a merger to be approved by less than all of the partners if the operating agreement of the entity so provides).

certain forms depending on the specific restrictions contained in the partnership agreement. For example, the “assets-up” and “interests-over” forms of transactions, by their very form, require the participation of all partners, whereas a partnership agreement may provide that a partnership can merge or transfer its assets with only an affirmative vote from a majority of the partners, but without unanimous consent; in that case, the partnership may be able to undertake a state law merger or an “assets-over” form of transaction but not an “assets-up” or “interests-over” form of transaction if there are dissenting partners.

If the business factors support the use of a form that also produces the desired tax results for the partners and partnerships, then the choice of structure is easy. However, if the form of transaction that is most desirable from a business perspective results in unfavorable tax consequences to the partners and partnerships, the parties will likely weigh the costs and benefits of each form and employ the form that produces the best result on a net basis, taking both business and tax considerations into account. Thus, the tax consequences of a transaction may influence the manner in which the transaction is undertaken. This is not an unusual result, as it is well accepted that the imposition of tax affects the taxpayer choices.⁶⁵ However, to the extent possible, such taxes should be imposed and such influence should be exerted in a manner

⁶⁵ See generally, e.g., BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 3.2 (3d ed.) (“Imposing a new tax or increasing an existing tax changes the prior relationship between the costs of engaging in the taxed activities and the rewards accruing to them”); Douglas A. Kahn, *Comments on “Tax Neutrality Between Equity Capital and Debt”*, 30 WAYNE L. REV. 1081 (1983-84) (“It is worth noting that the establishment of an income tax system necessarily introduces a bias that affects market behavior. That is not a happy consequence, but it is inevitable.”); Stanley S. Surrey, *Tax Incentives as a Devise for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). Even the government acknowledges the impact of taxes on taxpayer behavior. U.S. GOV’T ACCOUNTABILITY OFFICE, UNDERSTANDING THE TAX REFORM DEBATE: BACKGROUND, CRITERIA, & QUESTIONS (hereinafter “GAO TAX REFORM PUBLICATION”) (Sept. 2005) (“Generally, taxes alter or distort decisions about how to use resources, creating economic inefficiencies.”).

consistent with various tax policy objectives, including the related goals of neutrality, fairness and efficiency, among others.

As used herein, neutrality refers to the goal of minimizing the effect of the tax law on a taxpayer's choice of whether and how to undertake a transaction, i.e., the desire for tax law to be unbiased across taxpayer economic decisions.⁶⁶ The application of this neutrality principle in the situation where the transactions or decisions are substantively equivalent has been called “functional neutrality” – “[f]unctional neutrality calls for impartiality in the tax recognition and treatment of acquisitions which are functional equivalents of one another.”⁶⁷ Accordingly, if the tax law was functionally neutral in its application to partnership mergers, divisions and incorporations, tax law would not discriminate against any particular form of transaction or influence a taxpayer to take one form of transaction over the other given that, as illustrated above, the many forms of partnership mergers, divisions and incorporations can produce substantively equivalent results. However, taxpayers' decisions about what form of transaction to undertaken are undoubtedly influenced by the tax law because different forms of transactions lead to the application of different tax constructs, which, in turn, give rise to different tax consequences. Moreover, the impact of this bias depends partly on the non-tax business factors that are relevant to the choice of form; accordingly, in practice, these tax rules discriminate more

⁶⁶ See Groves, *Neutrality In Taxation*, 1 NAT'L TAX J. 18 (1948); David W. LaRue, *A Case for Neutrality in the Design and Implementation of the Merger and Acquisition Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations*, 43 TAX. L. REV. 85 (Fall 1987); Kahn, *supra* note 65 at 1081; William D. Andrews, *Tax Neutrality Between Equity Capital and Debt*, 30 WAYNE L. REV. 1057 (1983-84) (discussing the “elimination of bias”); AM. INST. OF CERTIFIED PUBLIC ACCOUNTANTS, UNDERSTANDING TAX REFORM: A GUIDE TO 21ST CENTURY ALTERNATIVES (hereinafter “AICPA TAX REFORM REPORT”) (Oct. 2005) (“*Neutrality* . The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.”); Inst. for Policy Innovation, *A Framework for Tax Reform*, 107 TAX NOTES 915 (May 16, 2005) (“An economically neutral tax is unbiased across economic activities”).

⁶⁷ LaRue, *supra* note 66, at 218 and n. 497 (“‘functional neutrality’ has little, if anything, to do with the formulation of policy, and everything to do with the design of rules intended to implement policy once formulated.”).

harshly against taxpayers who, for non-tax reasons, have greater difficulty in structuring their transactions to produce a desired tax result.

This concern about neutrality relates to similar concerns about fairness and efficiency. Fairness, or equity, suggests that “similarly situated taxpayers should be taxed similarly”,⁶⁸ but a party who undertakes one form of partnership merger, division or incorporation is likely to be taxed differently than a party who undertakes a different form of partnership merger, division or incorporation, respectively, even though the different forms are substantively equivalent. Further, because of the lack of neutrality and equity, a rational taxpayer, after balancing the tax and non-tax factors influencing the choice of form, may choose a form that is more costly from a

⁶⁸ AICPA TAX REFORM REPORT, *supra* note 66; *see also, e.g.*, Inst. for Policy Innovation, *supra* note 66 (“‘Fairness’ means equal treatment under the law, equal treatment for those equally situated, and no discrimination among taxpayers unequally situated unless that discrimination is consistent with the purposes and principles of a sound tax system”); LaRue, *supra* note 66, at n. 427 (“‘Horizontal equity,’ for example, requires that taxpayers of comparable economic circumstance bear correspondingly comparable tax burdens. The complementary, and generally accepted, notion of ‘vertical equity’ suggests not only that taxpayers of dissimilar economic circumstance bear dissimilar relative tax burdens, but also that this relationship be direct, rather than inverse.”). LaRue also cites Groves’ article for purposes of distinguishing neutrality from equity, as follows:

Professor Groves, perhaps one of the first commentators to explicitly isolate and define this concept, and to distinguish it from “equity,” described neutrality in the following terms:

Neutrality . . . calls for impartiality of treatment. The partiality that we are concerned with may arise from: (1) unequal treatment of essentially similar taxpayers; or (2) the same treatment of essentially different taxpayers. Discrimination may be deliberate or inept. Its curse is removed when it is supported by adequate public purpose and ample prospect for achieving that purpose.

The term “neutrality” as thus defined differs from “equity” . . . , which include(s) an interest in economic equality as well as in impartiality. Thus taxes are said to be equitable when they make for a more even distribution of economic reward. Neutrality has to do less with the standards applied to the over-all distribution of the tax load and more with the even application of those standards once they are chosen. There is no inference of conflict between the two canons. The thought is not that taxes should be neutral rather than equitable; they should be both. Or perhaps more accurately: taxes should be equitable and they should deviate from neutrality only for adequate public purpose.

Id. at n. 429 (citing Groves, *supra* note 66).

non-tax perspective solely to achieve more favorable tax results,⁶⁹ thereby diverting funds from more productive uses and introducing inefficiency;⁷⁰ if the various forms of transactions were not taxed differently, such rational taxpayer would have chose the transaction form that allowed it to use its limited funds optimally – accomplishing the transaction with fewer dollars and using the remaining dollars for more productive uses, thereby making all parties better off.

B. *Other Considerations as Possible Explanations for Disparate Treatment*

Admittedly, neutrality, fairness and efficiency are not the only policy goals of taxation, and they are sometimes sacrificed in order to accomplish other policy objectives.⁷¹ However, deviation from these goals should be supported by compelling justifications. This section discusses various alternate considerations that might explain the lack of neutrality, fairness and efficiency in the tax rules regarding partnership mergers, divisions and incorporations, but concludes that not only does none provide a satisfactory explanation for the disparate treatment, but an analysis of some alternative considerations supports revising the tax rules applicable to partnership mergers, divisions and incorporations.

⁶⁹ This assumes that the added tax benefits of the chosen form outweigh the additional non-tax costs of the chosen form. This is merely an example, and the reverse (where the rational taxpayer agrees to bear additional tax cost in order to achieve non-tax benefits) is equally plausible and problematic.

⁷⁰ See generally, e.g., AICPA TAX REFORM REPORT, *supra* note 66; Inst. for Policy Innovation, *supra* note 66; Chris Edwards, *Options for Tax Reform*, 106 TAX NOTES 1529 (Mar. 28, 2005); GAO TAX REFORM PUBLICATION, *supra* note 65 (each discussing efficiency as an important tax policy objective); see also generally A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS (2d ed. 1989) (discussing efficiency, among other economic principles, as applied to the legal system).

⁷¹ A very basic example of deviation from neutrality is the imposition of a tax on income from personal services, which influences taxpayer's choices between work and leisure. However, we accept that influence because of the need to raise revenue, among other reasons.

1. Adherence to Form⁷²

Despite the prevalence of the “substance over form” doctrine,⁷³ respect for form may still be a relevant consideration in the tax analysis of transactions, even though respecting form may lead to differing tax results for substantively equivalent transactions. This is particularly true where, as in the case of partnership mergers, divisions and incorporations, looking to the substance of a transaction does not provide enough information about the tax consequences because the substance of the transaction can be accomplished through multiple, equally plausible, alternatives; in such a case, form can serve as a “tie-break” rule. In addition, adhering to form can help ensure predictability of results, secure for taxpayers the deal they bargained for, and avoid “whipsaw” of the government.⁷⁴

However, it is difficult to justify the deviation from the principles of neutrality, fairness and equity in the tax treatment of partnership mergers and divisions on the basis of adherence to form because, in many partnership mergers and divisions, the form employed by the taxpayer is

⁷² Formless transactions, by definition, lack form to respect, so the “adherence to form” consideration cannot explain their tax analysis. Accordingly, formless transactions are excluded from this discussion. Nevertheless, for formless transactions, some construct must be adopted in order to analyze the tax consequences of the transaction. See *infra* Part IV (proposing such a construct).

⁷³ See, e.g., *Estate of Weinert v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961) (“The principle of looking through form to substance . . . is the cornerstone of sound taxation”); see also *generally* note 3 (collecting authorities).

⁷⁴ See Steinberg, *supra* note 1, at text associated with notes 181-189 (discussing these and other explanations for the continued role of form in Subchapter C). Further, in some situations, the Service has asserted and the courts have ruled that that the form chosen by taxpayers should be respected for purposes of determining the tax consequences of a transactions, and that taxpayers should be obligated to accept the tax consequences of the form of transaction that they have chosen. See, e.g., *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967). This has been referred to as the “taxpayer non-disavowal principle” – “the fundamental notion that where the taxpayer, and not the government controls the facts, the taxpayer should be restricted in its ability to assert that the substance and not the form controls for tax purposes”. Kenneth L. Harris, *Should There Be a “Form Consistency” Requirement? Danielson Revisited*, 78 TAXES 88 (Mar. 2000); see also William S. Blatt, *Lost on a One-Way Street: The Taxpayer’s Ability to Disavow Form*, 70 OR. L. REV. 381 (Summer 1991).

totally ignored,⁷⁵ in favor of an “assets-over” fiction. Further, even where form is purportedly followed for purposes of the tax analysis, as with “assets-up” transaction, the application of “form” is often as much fiction as it is form. For example, when effectuating an “assets-up” form, the Service will respect a partnership’s transfer to the partners of assets that the partners are precluded from owning under state law; hence, in order to respect this “formal” transfer, the Final Section 708 Regulations suspend the state law reality. In addition, in respecting the “assets-up” “form” without requiring that liabilities be assumed by the partners, the Service is conceding the fiction created by Section 752 – “[p]ursuant to Section 752, a partner *essentially* is *deemed* to have directly incurred a share of the partnership’s liabilities.”⁷⁶ If the Service is willing to subscribe to that fiction for purposes of the “transfer” of liabilities, query why the Service should not also be willing to respect the “assets-up” form without requiring that assets actually be transferred to the partners, on the basis of the “aggregate” theory of partnerships, pursuant to which partners are viewed as owning a direct interest in each partnership asset.⁷⁷ In addition, although an “assets-up” distribution and contribution would likely be disregarded under

⁷⁵ See *infra* Parts II.A.3. and II.B.3.

⁷⁶ Treas. Dec. 8925, 2001-1 C.B. 496 (emphasis added). To justify treating liabilities differently than assets for purposes of qualifying for treatment under the “assets-up” construct, the Service also explains that requiring partners to assume the partnership liabilities “could create a trap for the unwary”, in that “if a partner momentarily assumes an amount of the partnership’s debt that is less than the partner’s share of such debt under Section 752 . . . , the partner could inappropriately recognize gain as a result of the deemed distribution.” *Id.* However, the same could be said about distribution of assets. If a partner momentarily receives more than its share of the partnership assets, the partner could inappropriately recognize gain, just as the partner could if it assumed less than its share of partnership debt; accordingly, it seems curious that the Service is concerned that partners are at greater risk for distributing liabilities incorrectly than they are for distributing assets incorrectly. Perhaps that is a tacit admission about the incredible complexity of the Section 752 regulations. Note that I do not mean to advocate requiring that partners assume the partnership liabilities in order to qualify for “assets-up” treatment; rather, I am suggesting that perhaps this explanation that justifies not requiring partners to actually assume partnership liabilities in order for the “assets-up” construct to apply might also justify not requiring the partners to receive an actual local law transfer of the assets.

⁷⁷ See *generally* MCKEE at ¶1.02 (discussing aggregate and entity concepts in partnership taxation).

any formulation of the step transaction doctrine,⁷⁸ the Service admits that the partnership's transfer of the assets up to the partners is transitory, and Final Section 708 Regulations affirmatively state that the formal transfers will be respected despite their transitory nature.⁷⁹ Admitting that the transfers are transitory acknowledges that the transfers are empty forms, and respecting an empty form is tantamount to a respecting a fiction.

In the context of partnership incorporations (other than formless incorporations), the tax consequences are determined based on the actual form of the transactions. This reliance on form is justified, in part, by General Counsel Memorandum 37,540 (May 18, 1978), which supports Revenue Ruling 84-111. GCM 37,540 explains that the Service believed that each of the forms of transactions should qualify as tax-free exchanges under Section 351; the Service respected the interim step (the terminated partnership's contribution of assets in exchange for stock) in the "assets-over" form in order reach the conclusion that Section 351 applied, even where the partnership has a pre-arranged plan to transfer the stock of the corporation that the partnership received in exchange for the contribution of assets.⁸⁰ The regard for form, which leads to

⁷⁸ An "assets-up" transaction is likely to occur pursuant to a set of pre-arranged steps, memorialized in one set of transaction documents that obligates the partners to contribute the assets immediately after receiving the assets in a distribution that provides that the distribution will not occur without the contribution. This would likely satisfy the step transaction doctrine, regardless of whether the "end result", "binding commitment" and "interdependence" versions of the step transaction doctrine is used. *See generally* BITTKER & LOKKEN, *supra* note 65, at ¶ 4.3.5; Stephen S. Bowen, *The End Result Test*, 72 TAXES 722 (1994).

⁷⁹ Treas. Reg. section 1.708-1(c)(3)(ii) (respecting the "assets-up" form of merger "[d]espite the partners' transitory ownership of the terminated partnership's assets"); Treas. Reg. section 1.708-1(d)(3)(ii) (respecting the "assets-up" form of division "[d]espite the partners' transitory ownership of some of the prior partnership's assets").

⁸⁰ Under Section 351, if a transferor transfers property to a corporation in exchange for stock of the corporation and is in "control" of the corporation immediately after the transfer, no gain or loss is generally recognized. In order to meet the "control" test, the transferors must own at least 80% of the total voting power of all classes of the corporation's stock entitled to vote and at least 80% of the total number of shares of each class of non-voting stock. Section 368(c). In applying this rule, the Service usually takes into account any pre-planned transfers. *See generally* MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS AND BUYOUTS* ¶608.3.4 (Dec. 2003) (collecting authorities) Thus, allowing an "assets-over" incorporation to be treated as a non-recognition event under Section 351 is an exception to this general rule because under an "assets-over" transaction, the partnership has a pre-

disparate tax treatment of substantively equivalent transactions, could also be explained as a “tie-breaker” – the idea that “when the form and substance of a transaction are consistent, that form should be respected even though it was chosen in order to enhance tax efficiency and even though some other (presumably less tax-efficient) forms could have been utilized to achieve the same (non-tax) economic results.”⁸¹ Notwithstanding these plausible explanations for regarding the forms of the incorporation transactions, the creation of different tax consequences from incorporation structures that result in substantively equivalent transactions despite their technical distinctions remains an unsatisfying⁸² result in light of (a) possible alternate approaches for dealing with the Section 351 issue in the “assets-over” form,⁸³ (b) the neutrality, fairness and efficiency concerns discussed in Part III.A., (c) some taxpayers’ difficulty or inability, for non-tax reasons, to structure their transaction so as to obtain the desired tax results (also as discussed in Part III.A.), and (d) this paper’s proposal set forth in Part IV hereof that would protect Section 351 treatment, allow for the use of all three incorporation constructs and minimize the neutrality, fairness and efficiency concerns.

arranged plan to transfer the corporate stock immediately receiving the stock in exchange for a contribution of assets to the corporation. Meeting the “control” test of Section 351 is not a problem under the “assets-up” or “interests-over” forms of incorporation because in each of those cases the partners make the direct contribution to the corporation in exchange for the corporation’s stock.

⁸¹ Steinberg, *supra* note 1.

⁸² *But see* Banoff, *supra* note 55 (generally endorsing an approach that adheres to form).

⁸³ For example, the Service could take the approach that it took in Revenue Ruling 2003-51, 2003-1 C.B. 938, which concluded that the Section 351 “control” test was not violated by pre-arranged multiple drop-downs of the stock received in the first exchange where there were “alternate form of transactions that would have qualified for nonrecognition treatment.” Rev. Rul. 2003-51, 2003-1 C.B. 938. Specifically, the Service could rule that the Section 351 “control” test is not violated by the partnership’s pre-arranged liquidating distribution of the corporate stock to the partners because there are other forms of transactions specifically, “assets-up” and “interests-over” forms, that would have qualified under Section 351.

2. Simplicity and Administrability

Simplicity⁸⁴ and administrability⁸⁵ also do not explain the deviations from the goals of neutrality, fairness and efficiency identified in Part III.A. because, despite the Service’s intent to create an appropriately simple and administrable system for the tax analysis of these transactions,⁸⁶ the rules regarding the tax analysis of partnership mergers, divisions and incorporations are simultaneously too simple and not simple enough.

The partnership merger, division and incorporation rules are too simple in three respects. First, the rules allow the use of only one fiction, the “assets-over” fiction, for formless mergers, divisions and incorporations. Query why only one fiction is permitted to apply to a transaction when other, equally plausible, fictions could be used to explain and analyze the same transaction. Second, the merger rules do not allow the “interests-over” construct. The Service allowed only two merger constructs, the “assets-over” and “assets-up” constructs, in an effort “to provide a set of administrable rules that taxpayers and the IRS could apply in characterizing these

⁸⁴ As used herein, “simplification”, which is an oft-discussed goal of tax reform, generally refers to the goal of a tax system that minimizes complexity to the extent possible. *See generally* AICPA TAX REFORM REPORT, *supra* note 66; Inst. for Policy Innovation, *supra* note 66; William G. Gale & Jeffrey Rohaly, *Effects of Tax Simplification Options: A Quantitative Analysis*, in THE CRISIS IN TAX ADMINISTRATION, ch. 9 (Henry J. Aaron & Joel Slemrod, eds., 2004); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, GUIDING PRINCIPLES FOR TAX SIMPLIFICATION (2002); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON SIMPLIFICATION OF THE INTERNAL REVENUE CODE (Mar. 28, 2002); Edwards, *supra* note 70, at text associated with notes 3-19 (discussing problems that flow from complexity); *see also generally* GAO TAX REFORM PUBLICATION, *supra* note 65 at 45-47.

⁸⁵ As used herein, “administrability” generally refers to the ability of the Service to administer the tax system, including cost-effective collection and enforcement. *See generally* AICPA TAX REFORM REPORT, *supra* note 66; GAO TAX REFORM PUBLICATION, *supra* note 65 at 49-52.

⁸⁶ Before Revenue Ruling 84-111 and the Section 708 Regulations, partnership incorporations and mergers were analyzed using only an “assets-over” construct. *See infra* notes 13-14. Although this “one construct” approach was simple and easy to administer, by publishing Revenue Ruling 84-111 and promulgating the Section 708 Regulations, the IRS accepted multiple constructs and implicitly acknowledged that the “one construct” approach oversimplified the analysis, while simultaneously trying to “provide a set of administrable rules”. Treas. Dec. 8925, 2001-1 C.B. 496.

transactions.”⁸⁷ In specifically choosing not to allow an “interests-over” construct, the Service cites “problems . . . that are not present with respect to partnership incorporations. . . . The operation of [Section 704(c) and 737] break[] down if the partner is treated as contributing an asset that is different from the asset that the partnership is treated as receiving.”⁸⁸ However, given that the “interests-over” merger construct, if respected, might have the best tax results for the taxpayer,⁸⁹ and given that the Section 704(c) and Section 737 concerns are surmountable,⁹⁰ the marginal increase in complexity associated with allowing a third construct for partnership mergers seems justifiable. Third, the merger rules only allow partial interests sales pursuant to the “buy-out” rule in the “assets-over” construct and not the “assets-up” construct.⁹¹ The “buy-out” rule could be easily expanded to provide explicitly for interest sales prior to any asset-construct merger, thus ensuring that a partner wishing to sell out can avail itself of the tax treatment provided in Section 741 regardless of how the transaction is otherwise structured; the provision could be based on, and could operate in precisely the same way as, the “assets-over” version of the “buy-out” rule.

⁸⁷ Treas. Dec. 8925, 2001-1 C.B. 496.

⁸⁸ Preamble to 65 Fed. Reg. 1572 (Jan. 11, 2000).

⁸⁹ See Kalinka, *supra* note 54.

⁹⁰ See *id.* at notes 96-104 and accompanying text (discussing how the Section 704(c) and Section 737 could apply to an “interests-over” merger).

⁹¹ The articulated policy rationale for the “buy-out” rule is that “the IRS and Treasury believe that, under certain circumstances, when partnerships merge and one partner does not become a partner in the resulting partnership, the receipt of cash or property by that partner should be treated as a sale of that partner’s interest in the terminating partnership to the resulting partnership, not a disguised sale of the terminating partnership’s assets.” Preamble to 65 Fed. Reg. 1572 (Jan 11, 2000). This rationale seems to apply equally to any merger construct.

On the other hand, the rules regarding the use of the “assets-up” construct introduce unnecessary complexity; by imposing nuanced requirements⁹² on the ability to obtain “assets-up” treatment, less sophisticated taxpayers are disadvantaged because they may not fully appreciate the form required to avail themselves of the “assets-up” construct, and thus are more likely, albeit inadvertently, to become subject to the default “assets-over” fiction. Similarly, the particularities of the “assets-up” requirements increase the costs of administering and monitoring compliance with the partnership merger, division and incorporation rules because they require the Service to delve into the individual local law transfers in order to see whether a purported “assets-up” transaction really qualifies for analysis under the “assets-up” construct.

Since the partnership merger, division and incorporation rules do not strike the right balance of simplicity and administrability, these considerations cannot justify the disparate tax consequences of different forms of partnership mergers, divisions and incorporations. In fact, rectifying each of these oversimplifications and overcomplications would actually advance the goals of neutrality, fairness and equity and can be accomplished without substantially increasing the burden of administering these rules.⁹³

3. A Broader Approach to Equity Considerations – Consistency with Related Tax Provisions

Part III.A. was concerned with equity among the tax treatment of the various forms of substantively equivalent mergers, divisions and incorporations. However, the rules on partnership mergers, divisions and incorporations are part of a larger scheme of rules that addresses the tax consequences of changes in form (i.e., among entities characterized as

⁹² See *infra* Parts II.A.2, II.B.2 and II.C.2.

⁹³ See *infra* Part IV (suggesting such a proposal).

corporations, partnerships and disregarded entities) and transfers of partnership interests. Equity considerations⁹⁴ within this larger context are an important part of providing a cohesive framework for treating similar partnership transactions similarly and different partnership transactions differently and are useful in analyzing whether the disparate treatment of the various forms of partnership mergers, divisions and incorporations can be justified. The key sets of rules with which the partnership merger, division and incorporation rules should be coordinated are the “check-the-box” regulations regarding elective changes to an entity’s tax classification and the authorities regarding transfers of partnership interests (including the Section 708 “technical termination” regulations and Revenue Ruling 99-6).⁹⁵ These sets of rules are discussed in turn.

a. *“Check-the-Box” Regulations*

The “check-the-box” regulations⁹⁶ provide that a partnership that makes an entity classification election to be taxable as a corporation is deemed to undertake an “assets-over”

⁹⁴ See *infra* note 68 and accompanying text (discussing equity considerations).

⁹⁵ One could assert that many other sets of rules ought to be included in this list, including, but not limited to, the rulings regarding conversions between different partnership forms (*e.g.*, Revenue Ruling 84-25) or even the rules regarding transfers of interests and assets under Subchapter C (*i.e.*, Sections 301-385 of the Code). The rulings regarding conversions between different partnership forms are omitted from this discussion because they essentially conclude, without much discussion of the construct for the conversion, that the conversion is not a recognition event, except to the extent that the partners have different shares of the entity’s liability after the conversion. See Rev. Rul. 84-52, 1984-2 C.B. 157; Rev. Rul. 95-37, 1995-1 C.B. 130. However, it is interesting to note that, although these conversions could potentially be effectuated through a number of different forms for state law purposes, these rulings seem to adopt an “interests-over” construct for the conversion, in that partners are treated as exchanging their old partnership interests for new partnership interests in a transaction governed by Section 721 of the Code. See CARTER B. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 12.04. See also generally Sheldon I. Banoff, *Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalizations and Conversions: What Are the Tax Consequences?*, 83 TAXES 105 (Mar. 2005) (discussing the realization, recognition and resulting tax consequences arising from conversions, among other partnership ownership changes). The Subchapter C restructuring rules are omitted from this list because of the vast differences between the Subchapter C and Subchapter K regimes for taxing business entities. Nonetheless, a number of the criticisms levied in this paper against the Subchapter K merger, division and incorporation rules could also be levied against the reorganization rules in Subchapter C, but I leave the comparison of the Subchapter K and Subchapter C restructuring rules to another day. For a useful discussion about the role of substance and form in Subchapter C, including in the context of reorganizations, see generally, Steinberg, *supra* note 1.

⁹⁶ Treas. Reg. section 301.7701-3. See *infra* notes 50-51 and accompanying text (discussing the “check-the-box” rules).

incorporation for federal income tax purposes.⁹⁷ The Service adopted this “assets-over” fiction in Revenue Ruling 2004-59, concluding that the tax consequences of incorporations effectuated under state law formless conversion statutes are also determined based on an “assets-over” fiction. Although formless state law incorporations and “check-the-box” conversions are afforded equivalent treatment for federal income tax purposes, these methods of incorporation are treated differently than other methods of incorporation, which under Revenue Ruling 84-111, can be analyzed under three alternative constructs.⁹⁸ In order to justify this difference from Revenue Ruling 84-111 (allowing only one construct rather than three), the preambles to the “check-the-box” regulations cite Revenue Ruling 84-111’s adherence to form⁹⁹ and a desire to “achieve administrative simplicity”.¹⁰⁰ Further, in order to justify the choice of the “assets-over” construct for the single fiction to impose, the preamble to the proposed “check-the-box” regulations indicate a desire to “minimize the tax consequences of the change in classification”, but do not conclude that that the “assets-over” construct necessarily produces the best tax result for taxpayers in all circumstances. These statements provide only a weak justification, at best, for the differential tax treatment of “check-the-box” conversions and state law formless incorporations, on one hand, and state law incorporations effectuated through an actual form, on the other hand. Further, as discussed below in Part IV.A.2.c., the Service’s more general

⁹⁷ Treas. Reg. section 301.7701-3(g)(1)(i),

⁹⁸ See *infra* Part II.C. (discussing Revenue Ruling 84-111).

⁹⁹ 62 Fed. Reg. 55, 768 (Oct. 28, 1997) (“The proposed regulations do not affect the holdings in *Rev. Rul. 84-111 (1984-2 C.B. 88)*, in which the IRS ruled that it would respect the particular form undertaken by the taxpayers when a partnership converts to a corporation.”); Treas. Dec. 8844, 1999-2 C.B. 661 (“Because elective conversions are transactions without actual form, the IRS and Treasury believe that it is appropriate to provide that only one transaction form will be applied to each type of elective conversion. Furthermore, while the check-the-box regulations provide an elective regime for classifying eligible entities, the elective regime was not intended to substitute for actual transactions in all situations.”).

¹⁰⁰ 62 Fed. Reg. 55, 768 (Oct. 28, 1997).

rationale for the adoption of the “check-the-box” regulations seems to lend greater support to allowing more taxpayer choice in the tax treatment of incorporations, which could more closely align the tax treatment of “check-the-box” conversions, state law formless conversions and state law formal conversions.

Moreover, even if no change is made to the tax treatment of “check-the-box” conversions, state law formless conversions could be treated in a manner more similar to the constructs in Revenue Ruling 84-111 without violating the principles of equity. Specifically, Revenue Ruling 2004-59’s reliance on the “check-the-box” regulations reflects the Service’s implicit assumption that a formless state law incorporation is more analogous to a partnership’s “check-the-box” election to be taxable as a corporation than it is to a partnership incorporation effectuated through one of the forms described in Revenue Ruling 84-111. Query whether this analogy is appropriate given that a “check-the-box” incorporation is only a change of federal income tax status and does not change the identity of the entity or affect the application of the state law business statutes. In contrast, a state law incorporation, whether undertaken in a formless manner or in one of the prescribed forms, is not merely a tax change; it is an actual change to the entity and the entity’s state law rights and responsibilities. Accordingly, perhaps the better way to balance the equities is to conclude that *deemed* changes in tax classification are sufficiently different from changes in tax classification that result from *actual* changes to the parties rights and responsibilities under state law, such that it is reasonable for the “check-the-box” conversions to be treated differently from state law formless incorporations; then, the tax treatment of state law formless incorporations could be based on the three constructs from Revenue Ruling 84-111.

b. *Transfers of Partnership Interests*

The preamble to the Proposed Section 708 Regulations cites the rules regarding technical terminations under Section 708(b)(1)(B) as precedent for “formless movements of a partnership’s assets” as support for imposing the “assets-over” fiction on formless mergers and divisions.¹⁰¹ Section 708(b)(1)(B) provides that a partnership will be treated as “terminated” if “within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits,”¹⁰² and Treasury Regulation section 1.708-1(b)(4) provides that, upon such a “technical termination”, the partnership is treated as undertaking an “assets-over” transaction.¹⁰³ However, using the technical termination rules as precedent for using an “assets-over” fiction for formless transfers is unfounded because a technical termination is far from formless. Rather, a technical termination occurs upon a formal transfer of interests (specifically, 50% or more of such interests), and it is the regulations that recast this transfer of interests into a fictional transfer of assets. Hence, technical terminations are sufficiently different from formless mergers so that the technical termination rules ought to have little probative value for purposes of determining the fiction that should be applied to formless transactions.

¹⁰¹ The Service also cited the “check-the-box” regulations in selecting an approach to the tax treatment of formless partnership mergers and divisions. However, as with formless incorporations, it is submitted that formless mergers are even more different from the “check-the-box” conversions than are formless incorporations, such that formless mergers and divisions need not be treated in a manner similar to “check-the-box” conversions. *See infra* Part III.B.3.a.

¹⁰² This is commonly referred to as a “technical termination”. The termination is “technical” in that the partnership may be treated, for tax purposes, as terminating even though it continues to exist for state law purposes and continues to operate the same business (albeit with some different owners).

¹⁰³ Treas. Reg. section 1.708-1(b)(4) (treating the partnership as contributing all of its assets to a new partnership in exchange for interests in the new partnership, and then distributing the interests in the new partnership to the partners in liquidation). Note that prior to Treas. Dec. 8717, 1997-1 CB 125 interest transfers that resulted in technical terminations were treated as if the partnership undertook an “assets-up” transaction.

However, the technical termination rules and Revenue Ruling 99-6, both of which involve tax constructs applied when partnership interests are transferred, may be relevant for determining, from an equitable perspective, how partnership mergers effectuated through the transfer of interests should be treated for tax purposes. As discussed above, the technical termination rules provide that if 50% or more of the interests in a partnership are sold or exchanged within a 12-month period, the partnership is treated as undertaking an “assets-over” transaction. The current regulations regarding the tax treatment of partnership mergers effectuated in an “interests-over” form are consistent with this “assets-over” treatment.¹⁰⁴ On the other hand, Revenue Ruling 99-6¹⁰⁵ provides that the purchase by one person of all of the interests in a partnership is treated as an “interests-over” transaction, as in Revenue Ruling 84-111 and *McCaulsen v. Commissioner*.¹⁰⁶ The Final Section 708 Regulations are not consistent with Revenue Ruling 99-6 because if all of the interests in a partnership were acquired by another partnership, Revenue Ruling 99-6 would seem to support allowing an “interests-over” construct in partnership mergers, but the Final Section 708 Regulations would recast the transaction using an “assets-over” fiction. Although the Proposed and Final Section 708 Regulations were promulgated after Revenue Ruling 99-6 was published, neither addresses this inconsistency.¹⁰⁷ Juxtaposing the technical termination rules and Revenue Ruling 99-6 produces

¹⁰⁴ See *infra* Part II.A.3. (applying the “assets-over” fiction to mergers taken in an “interests-over” form).

¹⁰⁵ 1999-1 C.B. 432.

¹⁰⁶ 45 T.C. 588 (1966).

¹⁰⁷ One commentator, attempting (unsuccessfully) to rationalize Revenue Ruling 99-6 with the disregard for the “interests-over” construct in partnership mergers, explains as follows:

Thus, it seems that the IRS and Treasury have implicitly limited Rev. Rul. 99-6 to nonpartnership acquirers or, perhaps, to nonpartnership acquirers and to partnership acquirers in fully taxable transactions. This would be consistent with the views of one IRS official, who has indicated that, although he had not previously considered this potential conflict between Rev. Rul. 99-6 and the Proposed Regulations, he finds significant the fact that the partners in Rev. Rul. 99-6 “sell” their interests for cash. Because a merger

an odd result (assuming both are respected) – if the partners transfer 50% or more (but not all) of the interests in a partnership to one person, the “assets-over” construct applies, but if the partners transfer 100% of the interests in the partnership to one person, the “interests-over” construct applies. In the face of this incongruity, it seems just as reasonable to take the position that, from an equitable perspective, a partnership merger structured in an “interests-over” form should be treated for tax purposes under an “interests-over” construct as it does to treat the transaction under an “assets-over” construct. Hence, looking to the tax treatment in similar transactions seems to provide little guidance regarding the proper treatment of partnership mergers structured as “interests-over” forms.

4. Revenue Generation

Which construct results in more revenue¹⁰⁸ will depend on the particular facts and circumstances surrounding a transaction. Just as there could be situations where each an “assets-over”, “assets-up” and “interests-over” transaction is preferred by the taxpayer,¹⁰⁹ there are scenarios where each of the “assets-over”, “assets-up” and “interests-over” constructs of each incorporations, mergers and divisions could produce more or less revenue than another such construct. In fact, it is precisely the proposition that one construct may be less costly from a tax perspective than another form that presents the questions of neutrality and fairness in the first

transaction, according to this official, involves an "exchange" rather than a sale, the Ruling would not apply. This view, however, does not seem to be consistent with GCM 37540 (5/18/78), underlying Rev. Rul. 84-111 . . . , suggesting that McCaulsen applies to partnership incorporations, which also are exchanges rather than sale transactions.

Eric B. Sloan et al., *New Prop. Regs. Provide Expanded Guidance on Partnership Mergers and Divisions—Part I*, J. TAX’N. (Oct. 2000).

¹⁰⁸ Revenue generation is a *sine qua non* of the federal income tax system.

¹⁰⁹ See *infra* Part II.D.

place, and hence, the need for revenue generation does not explain the disparate treatment of the different forms of transactions.

5. Non-Tax Policy – Protection of Partners

Tax rules can also be used to accomplish non-tax goals.¹¹⁰ Although the Service’s statements about the partnership merger, division and incorporation rules do not indicate an intent to use these rules to accomplish non-tax goals, it is possible that non-tax goals, like the protection of partners, could have informed, or might help explain, the imposition of an “assets-over” default rule and the differential treatment of the various tax forms. For example, if a formless transaction could be effectuated without unanimous consent of the partners, treating that transaction, for tax purposes, under a construct that produced the *most* taxpayer favorable tax result would help protect partners from adverse tax consequences in case transactions are undertaken without their consent. Alternatively, treating such a transaction under a construct that produced the *least* taxpayer favorable tax result could incentivize the parties to obtain unanimous consent in order to opt out of the adverse tax treatment, thereby protecting partners by making it more likely that any transaction taken will be taken with the consent of each partner.

Setting aside the debate about which type of incentive would be more desirable, an incentive system of this sort could only be effective if it was clear what voting rights would be afforded to partners in each different form of transaction and if it was clear which construct predictably produced the most and least taxpayer favorable tax results. However, as discussed

¹¹⁰ For example, the Code contains numerous tax incentives that are designed to use the tax rules to encourage or discourage certain behavior deemed, from a non-tax social policy perspective, to beneficial or detrimental, respectively. *See generally* Surrey, *supra* note 65 (discussing the use of the tax rules to implement government policy).

above, neither is clear.¹¹¹ Accordingly, the differential tax treatment of the various tax transaction constructs does not seem to be explained by a desire to protect partners. Moreover, the disparate treatment should not be explained by a partner protection goal; if it is determined that partners need more protection than they are already afforded, that protection should be implemented either through the applicable state law statutes governing partnerships or on a case-by-case basis, through the individual partnership agreements.

C. Objecting to Disparate Treatment

Based on the foregoing, it is submitted that failure of the rules governing the tax treatment of partnership mergers, divisions and incorporations to meet the goals of neutrality, fairness and efficiency is not justified by any of the above-discussed policy considerations. Moreover, analyzing the partnership merger, division and incorporation rules in light of these other considerations only strengthens the assertion that the existing rules do not strike the right balance among regard for substance, form and fiction. Accordingly, these rules are ripe for reform.

¹¹¹ As to the latter, as discussed above, the benefits and detriments of a tax construct depend on the particular facts and circumstances of the situation. *See supra* Part II.D. As to the former, state law often allows partners to designate in a partnership agreement what portion of the partners must approve a transaction, so it would be unreasonable for the federal tax law to make assumptions about what voting rights were afforded to partners in different transactions. *See infra* note 64. Moreover, since there is already a statutory regime intended to set out the rights and responsibilities of partners and partnerships (e.g., ULPA, UPA and ULLCA) and since partners can often establish their rights through contract, query why should the *tax law* be used to protect those who already have a statutory regime designed to address their issues and those who (at least those with sufficient leverage) already have the opportunity to protect themselves.

IV. PICKING A SIDE – A PROPOSAL TO ALLOW TAXPAYERS TO ELECT A FICTION

A. *Choosing Fiction*

1. The Partnership Restructuring Election – A Proposal

In order to address the issues raised in Part III, this paper’s proposal is that partnerships should be allowed to make an explicit election of which construct applies to a partnership merger, division or incorporation undertaken by the partnership, regardless of the actual form of the transaction.¹¹² The election, which for purposes of this paper is referred to as the “Partnership Restructuring Election”, would work as follows:

Taxpayers implement the form of merger, division or incorporation that is preferable from a business perspective. Regardless of the form of transaction chosen, the entities involved in the transaction can elect which construct (for incorporations and mergers, choosing among “assets-over”, “assets-up” and “interests-over”, and for divisions, choosing between “assets-over” and “assets-up”)¹¹³ will apply to the transaction for federal income tax purposes.¹¹⁴ If no election is made, the “assets-over” construct will apply as a default. The merger “buy-out” rule would be made available in conjunction with any merger construct.

¹¹² In the context of incorporations, others have similarly suggested allowing partnerships to elect the tax construct applicable to formless incorporations. See Philip F. Postlewaite, *The Transmogrification of Subchapter K*, 83 TAXES 189 (Mar. 2005) (“Why is the latitude available to taxpayers on actual conversions not extended to actual conversions involving “formless” incorporations as well as elective conversions? . . . Parties should decide their preferred tax treatment, they should agree to report the transaction consistently both for themselves and the partnership, and the IRS should accord their choice controlling governance.”); WILLIS, *supra* note 54, at ¶12.05[6] n. 446 (“Of course, the question arises as to why latitude similar to that available to taxpayers on actual conversions was not accorded elective conversions.”). *But see* Banoff, *supra* note 55 (generally endorsing an approach that adheres to form).

¹¹³ Recall that for divisions, there is no “interests-over” construct. See *infra* Part II.B.

¹¹⁴ Note that there are a number of potential structures pursuant to which a merger, division or incorporation can be effectuated, but in an effort to ensure that this proposal is sufficiently simple and administrable, this proposal suggests that taxpayers only have a choice of three constructs. That said, taxpayers are still free to effectuate transactions in any manner that they see fit, as it is only for tax purposes that they are limited to these three choices.

In order to make the election, the entities involved in the transaction would jointly file a form of transaction election with the IRS no later than the due date for the terminated partnership's return for the year of the transaction (including extensions).¹¹⁵ The Partnership Restructuring Election must be filed jointly¹¹⁶ by the relevant entities, which in an incorporation, are the pre-incorporation partnership and the post-incorporation corporation, in a merger, are the terminated partnership and the resulting partnership, and in a division, are the divided partnership (or if none, the prior partnership) and the recipient partnership (or if none, the resulting partnerships). Note that, like many other partnership tax elections,¹¹⁷ this election would be made at the partnership, and not the partner, level; partners are, of course, free to incorporate into the partnership agreement limitations on the partnership's ability to make certain tax decisions without partner consent. The partnerships would be bound to report the transaction in a manner consistent with the election, including for the reporting reflected on the Schedule K-1s that the partnership issues to the partners; accordingly, as long as the partners report their income in a manner consistent with the K-1s that they receive, the partners would effectively be bound by the election as well.

The current anti-abuse rule for mergers and divisions would remain in place and would be expanded to cover incorporations, giving the IRS the ability to recast a transaction in

¹¹⁵ This is consistent with the due dates for Section 754 elections (i.e., elections made with respect to the tax consequences of sales or exchanges of interests in partnerships). *See, e.g.*, Treas. Reg. section 1.754-1(b).

¹¹⁶ This requirement is analogous to the requirement imposed in connection with the making of a Section 338(h)(10) election. *See* Treas. Reg. 1.338(h)(10)-1(c)(3). In addition, requiring a joint filing obligates the relevant entities to agree to treat the transaction consistently, thereby avoiding the risk of government "whipsaw."

¹¹⁷ *See, e.g.*, Treas. Reg. section 1.754-1 (Section 754 elections are made by the partnership). *see also, e.g.*, AICPA Tax Division's Partnership Taxation Technical Resource Panel, *Partnership Election Grid*, 36 TAX ADVISER 200 (Apr. 2005) (detailing a number of partnership elections).

accordance with its substance if the transaction is part of a larger series of transactions and the substance of the larger series of transactions is inconsistent with following the fiction elected.

2. Analogizing to Other Explicit Tax Elections

The tax code is littered with tax elections, both explicit, where a taxpayer files a statement with the Service selecting a specific alternative,¹¹⁸ and implicit, where a taxpayer takes a certain action among various possible actions thereby producing a particular tax result.¹¹⁹ Treasury Regulation section 1.708-1 and Revenue Ruling 84-111 already set up a system for an implicit election between certain transaction fictions – by taking certain actions rather than others, a taxpayer can implicitly elect between an “assets-over” and “assets-up” construct for mergers and divisions, and a taxpayer can implicitly elect among “assets-over”, “assets-up” and “interests-over” constructs for incorporations.¹²⁰ This paper’s proposed Partnership Restructuring Election makes the election explicit and removes the barriers that impede access to the implicit election, namely, the non-tax factors that drive taxpayers to undertake a particular form of transaction over another.¹²¹ Explicit elections of this type, where a taxpayer has the opportunity to choose to apply a tax fiction to a transaction (whether to override the tax

¹¹⁸ See *infra* Parts IV.A.2.a., b. and c. (discussing three such examples).

¹¹⁹ Tax shelters are the most obvious example of taxpayers choosing among different actions that produce different tax results, but implicit elections need not be abusive. For example, an entity that chooses to raise capital as debt rather than equity is making a choice between having the tax consequences associated with debt (e.g., corporate level interest deduction, holders pay tax at ordinary income rates on the interest) rather than having the tax consequences associated with equity (e.g., no deduction for dividends paid, but holders may be able to pay tax at reduced rates, and corporate taxpayers may benefit from the dividends-received deduction).

¹²⁰ See *infra* Part II (discussing different actions that lead to the application of different constructs). The Service has acknowledged the implicit nature of this election. Revenue Ruling 84-111 explains that “[r]ecognition of the three possible methods to incorporate a partnership will . . . will facilitate flexibility” However, in promulgating the Final Section 708 Regulations, the Service acknowledged, but wanted to limit, the elective nature of the partnership merger and division rules. Treas. Dec. 8925, 2001-1 C.B. 496 (“the IRS and Treasury did not intend to establish a regime whereby partners essentially could elect between the Assets-Up Form and the Assets-Over Form by creating different documents that have the same legal effect.”)

¹²¹ See *infra* Part III.A.

consequences of an actual form or in the absence of certainty about the tax consequences of an actual form), have precedent in the tax law. For example, the Partnership Restructuring Election can be analogized to elections under Section 338, elections under Section 754 and “check-the-box” elections.

a. *Section 338 Election – Treating Stock Purchases Like Asset Purchases*

Elections under Section 338 of the Code allow taxpayers who purchase at least 80% (by total vote and value)¹²² of a corporation’s stock to elect whether to determine the tax consequences of the acquisition on the basis of a fiction rather than on the basis of the stock purchase form. The precise fictions differ depending on which version of Section 338 election is made, but both versions of the Section 338 election enable taxpayers to choose to impose an asset purchase fiction on a stock purchase form of transaction.¹²³ The purposes of the enactment of Section 338 included, among others, simplification, the desire to mitigate the differences between asset acquisitions and stock acquisitions and the desire to allow acquirers to obtain a stepped-up basis in the target assets (a consequence of asset acquisitions but generally not of

¹²² Section 338(d)(3).

¹²³ When any Section 338 election is made, two separate corporations, the “old” target corporation and the “new” target corporation are deemed to exist for tax purposes. If an election is made under Section 338(g), the tax consequences of the transaction are determined as if both (1) the old target sold all of its assets to the new target and (2) the old target stockholders sold all of their target stock. Section 338(a); Treas. Reg. section 1.338-1; *see generally* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS ¶2.05 (Dec. 2003) (discussing “regular” Section 338 elections). If an election is made under Section 338(h)(10), the target corporation is deemed to sell all of its assets, distribute the proceeds to its owner and cease to exist; the formal stock sale is ignored for purposes of determining the tax consequences of the transaction. Section 338(h)(10); Treas. Reg. section 1.338(h)(10)-1(d); *see generally* GINSBURG & LEVIN, at ¶2.06 (discussing Section 338(h)(10) elections).

stock acquisitions) without actually requiring the parties to undertake the formal steps that would lead to the stepped-up basis.¹²⁴

Similarly, as discussed above, a key purpose of the Partnership Restructuring Election proposed herein is to mitigate the differences between the various forms of partnership transactions; that purpose would be effectuated by allowing taxpayers to elect whether they want to impose a tax fiction for purposes of determining the tax consequences of the transaction.¹²⁵ As with the partnership restructuring fictions,¹²⁶ the tax consequences of the Section 338 fictions can be beneficial or detrimental to taxpayers depending on their individual situations,¹²⁷ so Section 338, like the proposed Partnership Restructuring Election, leaves the choice of tax fiction to the discretion of the taxpayers. Admittedly, Section 338 applies to corporations and not partnerships, and given the many differences between Subchapter C and Subchapter K and given some of the complicated Subchapter C issues surrounding the enactment of Section 338 (e.g., the

¹²⁴ See S. Rep. No. 494, Vol 1, 97th Cong., 2d Sess. 191-97 (1982); H.R. Rep. No. 760, 97th Cong., 2d Sess. 535-40 (1982); *see also generally* James T. Chudy et al., 788 Tax Mgmt Portfolio, Part I.B., *Stock Purchases Treated as Asset Acquisitions -- Section 338* (discussing the legislative history behind Section 338); Raymond P. Wexler & William R. Welke, *Section 338 – Consistency and Complexity*, 63 TAXES 916, 917 (Dec. 1985) (discussing the background behind Section 338).

¹²⁵ Note that the Section 338 election only allows a unidirectional election – Section 338 lets taxpayers to choose to treat a formal interest sale as a fictional asset sale, but does not allow taxpayers to choose to treat a formal asset sale as a fictional interest sale. In contrast, the proposed Partnership Restructuring Election proposes multi-directional election, where a formal interest transfer can be treated as a fictional asset transfer (either “assets-over” or “assets-up”), and a formal asset transfer can be treated as a fictional interest transfer or as a different type of fictional asset transfer. *See infra* Part IV.A.2.c (discussing the “check-the-box” regulations as an example of a multi-directional election).

¹²⁶ *See supra* Part II.D.

¹²⁷ Given that the tax consequences that arise from a Section 338(g) election are usually unfavorable for taxpayers, except in limited situations (e.g., certain acquisitions of foreign targets and acquisitions of domestic targets with significant and expiring net operating losses), Section 338(g) elections are rare. However, Section 338(h)(10) elections are quite common. *See generally* GINSBURG & LEVIN, *supra* note 123, at ¶¶2.04, 2.05 and 2.06; Chudy, *supra* note 124.

effect of the *General Utilities*¹²⁸ doctrine on corporate transactions), the analogy between Section 338 and the proposed Partnership Restructuring Election is far from perfect, but it is useful as an example of a transaction where a taxpayer, which could have undertaken a single economic transaction in more than one form, selects a particular form for the legal steps in the transaction but elects to determine the tax consequences based on the fiction of another form.

b. *Section 754 Election – Adjusting Asset Basis Upon Interest Transfers & Property Distributions*

Within Subchapter K, if a partnership makes an election under Section 754, the basis in partnership property is adjusted upon the sale or exchange of an interest in the partnership¹²⁹ and upon the distribution of property out of the partnership.¹³⁰ Although the regulations under Section 754 (and under Sections 734 and 743, which are triggered by a Section 754 election) do not explicitly create an asset-transfer fiction like the Section 338 regulations do, the Section 754 election, very generally, shifts the tax analysis of transfers of partnership interests and distributions of partnership property from an approach that respects the formal transactions involving partnership interests to a fictionalized approach that determines certain tax consequences of the transaction in a manner more akin to the way in which the tax consequences would be determined if the partners owned a direct interest in the partnership assets; this is essentially an election between an “entity” and “aggregate” approach to partnerships.¹³¹

¹²⁸ *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935) .

¹²⁹ Section 743(b). Note that any adjustment to the basis of partnership property under Section 743(b) is treated as an adjustment with respect to the transferee partner only.

¹³⁰ Section 734(b).

¹³¹ For example, if a Section 754 election is in effect, a transferee of partnership interests becomes entitled to the same aggregate basis in its share of the partnership assets as it would have had if the transferee had actually acquired direct interests in the assets; the adjustment to the asset basis accounts for the difference between the transferee

Similarly, the proposed Partnership Restructuring Election would allow partners in mergers and incorporations to elect whether to regard transfers of interests or whether to analyze the tax consequences of a transaction as a deemed transfer of the underlying assets (either as an “assets-over” fiction or an “assets-up” fiction). Moreover, allowing the partnership to elect an “aggregate” approach to mergers, divisions and incorporations should mean that the partnership ought not to be required to make actual distributions of the assets up out of the partnership in order to have the “assets-up” construct apply because the “aggregate” approach to partnership already treats the partners as owning direct interests in the assets. As with Section 338 and the proposed Partnership Restructuring Election, the Section 754 election’s shift to the more fictionalized approach can be beneficial or detrimental to the parties depending on the particular facts and circumstances,¹³² but subject to certain limitations,¹³³ taxpayers are afforded the choice of whether or not to make the Section 754 election and the resulting basis adjustments under Sections 734(b) and 743(b).

c. *“Check-the-Box” Election – Choosing Entity Characterization*

The “check-the-box” regulations also provide a useful comparison to the proposed Partnership Restructuring Election both because the “check-the-box” regulations are an example

partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. Section 743(b). However, the fiction is not fully respected, in that, the allocation of the basis among the assets under Section 755 may differ from the allocation that would have been made if the transferee had acquired direct interests in the partnership assets. *See generally* MCKEE, *supra* note 16, at ¶¶24.01, 25.01 (discussing how Section 754 changes the analysis under Sections 743(b) and 734(b), respectively, from an “entity” approach to partnerships to an “aggregate” approach to partnerships).

¹³² *See generally* MCKEE, *supra* note 16, at ¶¶24.01 *et seq.*, 25.01 *et seq.* (discussing the details and consequences of making a Section 754 election).

¹³³ Basis adjustments are mandatory under Section 734 and 743 if there are “substantial built-in losses.” Section 734(a); Section 743(b). Also, once a Section 754 election is made, revocation generally requires the approval of the Service. Treas. Reg. section 1.754-1(c). In addition, the elective nature of Section 754 has been subject of debate in Congress and may be changed in the future. *See* S. Rep. No. 108-192, at 188 (2004) (proposing that Section 754 elections be mandatory and not elective).

of an explicit tax election that offers taxpayers the flexibility to choose one tax construct over another and because the “check-the-box” regulations are part of the larger analysis of whether the partnership merger, division and incorporation rules meet the goal of equitable treatment.¹³⁴ As discussed above, the “check-the-box” rules generally allow entities to elect whether to be treated as an association taxable as a corporation or as a partnership (or disregarded entity, in the case of a wholly-owned entity),¹³⁵ regardless of the entity’s default classification under the “check-the-box” rules¹³⁶ and regardless of what the entity’s classification would have been under the prior regulations.¹³⁷ So too does the proposed Partnership Restructuring Election contemplate that taxpayers can choose among the various tax fictions regardless of form.

Although an analogy to the “check-the-box” regulations may support allowing explicit elections in general, the particular treatment of partnership-to-corporation conversions under the “check-the-box” regulations¹³⁸ conflicts with the way in which the proposed Partnership Restructuring Election would treat incorporations. Further, the Service, in the preamble to the “check-the-box” regulations, explicitly rejected precisely the type of choice for incorporations proposed by the Partnership Restructuring Election.¹³⁹ Nevertheless, echoing the comment made

¹³⁴ See *infra* Part III.B.3.a.

¹³⁵ Note that, unlike the Section 338 election, the “check-the-box” election is multi-directional, in that, entities that would otherwise be treated as corporations can elect, with some limitations, to be treated as partnerships or disregarded entities for tax purposes, and entities that would otherwise be treated as partnerships or disregarded entities can elect to be treated as corporations for tax purposes.

¹³⁶ Treas. Reg. section 301.7701-3(b) (providing default rules).

¹³⁷ See Prior Treas. Reg. section 301.7701-2 (determining whether an entity was treated as a partnership or a corporation for tax purposes using a multi-factored test, which included a determination of whether the entity had continuity of life, centralized management, limited liability, and free transferability of interests).

¹³⁸ See *infra* Parts II.C. and III.B.3.a.

¹³⁹ Treas. Dec. 8844, 1999-2 C.B. 661 (rejecting “[c]ommentators[’] recommend[ation] that taxpayers be allowed to choose which [construct] to apply to an elective conversion[, which choice] would allow taxpayers to avoid having to take the actual steps of a conversion to produce the most favorable tax results.”).

by one commentator in connection with the proposed “check-the-box” elections that “the lack of choice in the [“check-the-box”] regulations is inconsistent with the[ir] intent,”¹⁴⁰ it is submitted that the rationale articulated in connection with the promulgation of the “check-the-box” elections actually supports allowing an elective approach, both for the “check-the-box” regulations themselves and as suggested in the proposed Partnership Restructuring Election. Specifically, the partnership incorporation rules and certain of the limitations on the use of the “assets-up” construct in partnership mergers and divisions include a number of formalistic distinctions,¹⁴¹ and the formalism is based largely on differences in local law and other distinctions that are not particularly meaningful for tax purposes – query why should the ability to obtain “assets-up” treatment depend on the type of assets held by a particular partnership and the ease with which the assets can be transferred under local law, pursuant to contracts and otherwise.¹⁴² Further, as discussed herein, the regime governing the tax analysis of partnership mergers, divisions and incorporations could be simplified,¹⁴³ thereby avoiding some of the considerable and inefficient expenditures that taxpayers might need to make in order to take the steps that would ensure the application of the desired tax construct.¹⁴⁴ In the face of similar concerns, where there were “increasingly formalistic” rules based on “historical differences under local law”, where “legal distinctions previously drawn . . . were no longer meaningful” and where “taxpayers still were required to expend considerable resources to ensure that they obtained the classification they desired”, the Service “replaced [the prior] rules with much a

¹⁴⁰ *Id.*

¹⁴¹ *See infra* Parts II.A., B. and C. and III.B.1.

¹⁴² *See infra* Parts III.A. (discussing business limitations on obtaining preferred tax treatment).

¹⁴³ *See infra* Parts III.B.2.

¹⁴⁴ *See infra* Parts III.A. (discussing inefficiencies resulting from the current partnership merger, division and incorporation regime).

much simpler approach[, namely, the “check-the-box” regulations,] that generally is elective.”¹⁴⁵

Accordingly, it is submitted that the Service was mistaken when concluding that the concerns that motivated the adoption of the “check-the-box” regulations “are generally not present in determining the form of a conversion transaction”, and it is respectfully suggested that the treatment of partnership-to-corporation “check-the-box” conversions be reconsidered and that the existing “check-the-box” regulations not be viewed as an impediment to the adoption of the Partnership Restructuring Election proposed herein.¹⁴⁶

B. *Achieving Consistent Treatment for Substantively Equivalent Transaction (While Furthering Other Policy Goals As Well)*

By allowing partnerships to elect which tax fiction applies to a merger, division or incorporation, the proposed Partnership Restructuring Election remedies the problem of disparate treatment discussed in Part III. Every partnership engaged in a merger, division or incorporation would be given the same choice about tax fictions, and thus each merger, division and

¹⁴⁵ Treas. Dec. 8697, 1997-1 CB 215 (“The existing regulations for classifying business organizations as associations (which are taxable as corporations under section 7701(a)(3)) or as partnerships under section 7701(a)(2) are based on the historical differences under local law between partnerships and corporations. Treasury and the IRS believe that those rules have become increasingly formalistic. This document replaces those rules with a much simpler approach that generally is elective.”); Preamble to 62 Fed. Reg. 55,768 (Oct. 28, 1997) (“The proposed regulations provide a specific characterization for each of the four possible elective changes. In each case, the characterization provided in the proposed regulations attempts to minimize the tax consequences of the change in classification and achieve administrative simplicity.”); Treas. Dec. 8844, 1999-2 C.B. 661 (“Instead, the purpose of implementing the regime was to simplify an area of the law where legal distinctions previously drawn in determining an entity’s classification were no longer meaningful. While the factors considered under prior law did not meaningfully distinguish between business organizations, taxpayers still were required to expend considerable resources to ensure that they obtained the classification they desired. Small business organizations often lacked the resources and expertise to achieve their desired tax classification. This was viewed as unfair. . . . The IRS was also expending considerable resources providing guidance on these classification issues. These same concerns generally are not present in determining the form of a conversion transaction. Therefore, the final regulations maintain only one form for each type of elective conversion.”).

¹⁴⁶ Changes to the treatment of partnership-to-corporation conversions under the “check-the-box” regulations to allow taxpayers to elect the applicable construct might, on the basis of equity considerations, mandate a similar changes to the treatment of corporation-to-partnership conversions, corporation-to-disregarded entity conversions and disregarded entity-to-corporation conversions. See Treas. Reg. section 301.7701-3(g) (prescribing tax constructs applicable to each such conversion). Alternatively, the Partnership Restructuring Election could be adopted without any change to the “check-the-box” regulations on the basis articulated above in Part III.B.3.a.

incorporation would be treated in the same manner as each other merger, division and incorporation, respectively, regardless of the actual form (or formlessness) of the transaction. Although the tax consequences of a given merger, for example, may be determined based on a different fiction than are the tax consequences of another merger if the partnerships involved in the particular mergers elect different tax fictions, each partnership can choose to implement the form of merger that is preferred from a business perspective without influence or distortion of their incentives based on the tax consequences of the form of merger. This removes the discrimination that is inherent in the current partnership merger, division and incorporation tax regime against certain taxpayers who, because of their type of assets, industry, regulatory limitations, financing arrangements or other particular circumstances, cannot, without great difficulty or expense, undertake transactions in the form that would entitle them to determine their tax consequences based on the most favorable tax construct. Hence, the Partnership Restructuring Election achieves the goal of functional neutrality – impartial tax treatment among various forms for combining two partnerships into one, for separating one partnership into two, and for converting a partnership into a corporation – where the current authorities do not. Further, under the Partnership Restructuring Election, if a formless transaction is most efficient, partnerships would no longer be forced to implement a *form* of transaction in order to obtain a particular tax result, nor would rational partnerships be willing to divert resources from more productive uses in order to pay for the increased business or tax costs required to achieve competing tax or business goals.

Admittedly, the goal of functional neutrality could also be achieved by adopting a single blended approach to the tax consequences of a partnership merger, division or incorporation; that

is, adopting a single set of rules that override the provisions of Subchapter K (regarding tax consequences of distributions and transfers) and, instead, specify basis, holding period, recognition of gain, etc. consequences of partnership mergers, divisions and incorporations regardless of the form of the transaction. Under such a proposal, the implicit elections in the existing regimes are eliminated, and equal treatment is provided for various forms for combining two partnerships into one, for separating one partnership into two, and for converting a partnership into a corporation. Further, transaction costs would be reduced because partnerships are not required to analyze the various alternative tax analyses in order to choose (implicitly, as in the current regimes, or explicitly, under the proposed Partnership Restructuring Election) among them. However, in order to adopt such a single approach, choices would have to be made among the competing basis, holding period, and gain recognition rules.¹⁴⁷ Since it is not clear which rules will produce the most favorable result for the taxpayer or the government in every situation, the choice of any single set of rules will necessarily produce favorable results for some taxpayers and unfavorable results for others depending on their particular facts and circumstances. This result is often acceptable, but in the context of partnership restructurings, it is hard to predict with any certainty which taxpayers will experience a windfall from the chosen rules (and hence might, as a result, be incentivized to engage in an otherwise inefficient transaction) and which taxpayers will be deprived of the use of properly obtained tax attributes as a result of the chosen rules (and hence which taxpayers might, as a result, refrain from engaging in otherwise efficient transactions). Moreover, adopting a single blended approach to the analysis of the tax consequences of partnership mergers, divisions and incorporations would be a step backward toward the “assets-over” regimes that were in place under Revenue Rulings 68-289 and 70-

¹⁴⁷ See, e.g. note 56 and associated text.

239;¹⁴⁸ even though it would provide equal treatment to restructurings regardless of their form, a single blended approach to the tax consequences of partnership restructurings would suffer from the same failure that doomed these old rulings – failure to acknowledge and respect the possibility that different tax consequences could arise from different approaches to the transactions. In contrast, the proposed Partnership Restructuring Election simultaneously acknowledges the various possible tax consequences for a given type of restructuring and provides equal treatment to the various forms of mergers, divisions and incorporations, by allowing the relevant parties to which construct will be employed for purposes of determining the tax consequences of the restructuring.

Despite the Partnership Restructuring Election’s like treatment of like transactions and although there is precedent for explicit elections like the proposed Partnership Restructuring Election both in and out of Subchapter K, the proposed Partnership Restructuring Election cannot resolve all broader equity considerations. Unless the “check-the-box” regulations are changed to allow for taxpayers to choose the fiction applicable to the partnership-to-corporation conversion, the treatment of these federal tax classification changes will differ from the tax treatment of state law incorporations under the Partnership Restructuring Election. Although this paper suggests that the IRS ought to reconsider making the tax treatment of “check-the-box” conversions elective, in the absence of such a change, differential treatment of the “check-the-box” conversions and state law incorporations (whether formal or formless) could be justified because the “check-the-box” conversion is itself a fiction and, unlike state law incorporations,

¹⁴⁸ See note 13 (discussing the evolution of the tax treatment of partnership mergers and divisions); Rev. Rul. 70-239, 1970-1 C.B. 74 (prior to the Rev. Rul. 84-111, concluding that all partnership incorporations have the same tax consequences of “assets-over” incorporations).

lacks non-tax significance. As to the authorities regarding transfers of partnership interests, the technical termination rules under Section 708 and Revenue Ruling 99-6 are inconsistent with each other as discussed in Part III.B.3.b. Reconciling these authorities is outside the scope of this paper, but given the inconsistency, it is impossible for the treatment of partnership restructurings to be consistent with both. Nevertheless, the proposed Partnership Restructuring Election draws a little bit from each; the proposed Partnership Restructuring Election uses an “assets-over” default rule, which is aligned with the treatment of technical terminations, and the proposed Partnership Restructuring Election allows an “interests-over” fiction for partnership mergers, which is in accord with Revenue Ruling 99-6’s treatment of the acquisition of all interests in a partnership by one person.

Further, by expanding the use of fictions, the proposed Partnership Restructuring Election promotes flexibility, which is an expressly stated goal of Revenue Ruling 84-111’s conclusion that different incorporation constructs have different tax consequences and which is, with respect to the allocation of tax burdens of partnership transactions among partners, “one of the principal legislative goals of Subchapter K.”¹⁴⁹ This increased flexibility ought not to increase the risk of abuse since the proposed Partnership Restructuring Election does not give partnerships any tax options that were not already implicitly available,¹⁵⁰ rather, the election merely removes the non-tax barriers from the use of the tax constructs. Moreover, since the parties to the transaction

¹⁴⁹ MCKEE, *supra* note 16, at ¶1.03 (citing HR Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954)).

¹⁵⁰ Furthermore, Section 754 allows partnerships to elect whether or not to adjust inside basis upon the occurrence of certain events that could cause outside basis to be adjusted. Making or failing to make this election can be a common reason why the partnership’s basis in its assets may differ from the partners’ bases in their partnership interests, and hence why there might be a difference in the tax consequences depending on whether the assets-over, assets-up or interests-over constructs apply. To the extent that making or not making the Section 754 election is the source of the disparate tax treatment, the Partnership Restructuring Election would merely afford the partnership a choice that Subchapter K has already concluded that partnerships should be allowed to make.

would all be obligated to agree on and to be bound by the chosen fiction, the risk of government “whipsaw” is not increased by this decreased emphasis on form and expanded use of fictions. Additionally, the current anti-abuse provisions would be retained for partnership mergers and divisions and expanded to cover incorporations, which would also help mitigate the risk of abuse.

The proposed Partnership Restructuring Election would also be a simplifying and easily administrable change. Because there would be one default rule and because the election only allows for three alternative constructs,¹⁵¹ the rules would be relatively easy to follow. The nuanced rules about how to qualify for “assets-up” treatment could be removed, and taxpayers and the IRS would not have to spend time analyzing how to comply or analyzing whether taxpayers have complied, respectively, with the particular requirements for the different tax constructs. An election does increase the filing burden from an administrative perspective, but the filing should not be any more complicated than the filings made in connection with a Section 338 election¹⁵² and could be as simple as the one-page filing associated with making a “check-the-box” election.¹⁵³ Moreover, because there is a default rule, a filing will often not be necessary.

V. CONCLUSION

Ultimately, this paper’s proposed Partnership Restructuring Election is an acknowledgement that various forms for mergers, divisions and incorporations effectuate the same substantive transactions, which should, and can, be treated the same way for tax purposes.

¹⁵¹ See *supra* note 114 (discussing why this paper’s proposal allows for only three possible constructs).

¹⁵² IRS Forms 8023 & 8883.

¹⁵³ IRS Form 8832.

The goal of like treatment is accomplished by adopting a consistent approach to the use of fiction and form in analyzing the tax consequences of these substantively equivalent transactions.

Rather than sometimes strictly adhering to form (like Revenue Ruling 84-111 with respect to incorporations), sometimes regarding purported “form” with some fictional caveats (as with the requirements for the “assets-up” construct in partnership mergers and divisions) and sometimes disregarding form entirely in favor of only one fiction (as with merger and division structures not meeting the “assets-up” or “assets-over” requirements), the proposed Partnership Restructuring Election lets form (or formlessness) merely be a reflection of the business needs of the parties to the transaction and uses a single set of elective fictions to determine the tax consequences. This proposal results in an increasingly prominent role for fiction in the tax analysis of partnership transactions, but justifiably so – fiction can be an incredibly valuable tool for interpreting transactions to reflect coherent tax policy – assuming we are willing to see the truth in the lie.¹⁵⁴

¹⁵⁴ “And, after all, what is a lie? ’Tis but The truth in masquerade.” GEORGE GORDON BYRON, DON JUAN, canto XI, st. 37 (T.G. Steffan et al., eds., Penguin Books 1973) (1823).