

**OVERVIEW OF CHOICE OF ENTITY CONSIDERATIONS FOR
ACQUISITIONS IN A RECOVERING ECONOMY
(WITH AN EMPHASIS ON ALTERNATIVE FORMS OF ACQUISITION)**

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I: TAXABLE SALES.

A. Allocation Rules Applicable to Sales of a Trade or Business.

1. Background.

a. Sale of Ongoing Business Viewed as Sale of Individual Assets.

For U.S. federal income tax purposes, the sale of an ongoing trade or business for a lump sum amount is viewed as a sale of each individual asset rather than a single capital asset.² The seller must allocate the purchase price among the assets sold to determine the amount and character of its realized gain or loss on the sale. The purchaser's allocation determines its basis in each asset and will affect its amount of allowable depreciation, cost depletion, or amortization deductions, its realized gain or loss on a subsequent sale of those assets, and may have other tax consequences.

b. Application of Asset Allocation Rules of Section 1060. In 1986, Congress added the asset allocation rules of Section 1060(a) to the Internal Revenue Code (the "Code"). These rules generally provide that, in certain asset acquisitions, the seller and purchaser must allocate the purchase price among the assets transferred in accordance with the method prescribed by the Treasury in regulations. The Service has observed that "Section 1060 provides no independent basis for determining the amount a taxpayer realizes on the sale of the

¹The author appreciates the assistance of Matthew S. Beard in the preparation of this outline.

²See *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); Rev. Rul. 70-465, 1970-2 C.B. 162 ("For Federal income tax purposes, the sale of a going business is a sale of the individual assets. The selling price must be allocated among all the assets sold according to their respective fair market values, and separate computations must be made of the gain or loss with respect to each asset sold for which there is a separately identifiable basis making this computation possible."); cf. *Leon H. Perlin Company, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2013, 2022 n. 11 (1993) ("Williams v. McGowan holds that the sale of a hardware business as a going concern should not be treated as a single piece of property representing a "capital asset" but rather should be divided into its components, each of which would then be separately matched against the statutory definition of capital asset. Although Williams does not specifically require that an allocation of purchase price be based upon fair market value of the assets sold, such a requirement is generally recognized." [Citation omitted.]), *rev'd on other grounds*, 47 F.3d 1165 (4th Cir. 1995) ("The parties agree that the tax court properly attempted to allocate the proceeds of the Realtec sale among the assets purchased based on their fair market value on the date of the sale and that to the extent that a portion of the sales price was properly allocated to the claim for the unsecured advances the claim correctly could be viewed as having that value for purposes of determining whether the Perlin Company was entitled to a bad-debt deduction and the amount of the constructive dividend received by Perlin."); Tech. Adv. Memo 9639009 (Sept. 27, 1996) ("Where several capital assets are sold as a group at the same time, the transaction must be treated as the sale of separate assets, and the holding period of each asset determined independently."); Priv. Ltr. Rul. 8946001 (June 28, 1989) ("When a group of assets is purchased for a lump sum purchase price, the basis of each asset acquired must be determined by an allocation of purchase price among the assets purchased, Williams v. McGowan." [Citation omitted.]). Although private letter rulings, field service advice and technical advice memoranda are not binding as "precedent," they often represent a substantial indication of the position of the Internal Revenue Service on an issue.

assets or the time such amount may be taken into account; the amount realized and the time such amount is taken into account are determined solely under generally applicable tax accounting principles.”³

c. Weight Accorded to Allocation. If parties to an acquisition of a business make a specific contractual allocation with appropriate regard to value, they are generally bound by this allocation for U.S. federal income tax purposes.⁴ The Internal Revenue Service (“Revenue Service” or the “Service”), however, is not bound by the parties’ allocation agreement. The Service is not restricted from challenging the allocations or values set forth in the allocation agreement.⁵ When reviewing the parties’ allocation agreement, two different standards apply. The Tax Court will generally give deference to the parties when they have competing tax interests. If, on the other hand, the parties do not have adverse tax interests, the Tax Court will strictly scrutinize the allocation agreement.⁶ The courts use a higher standard in such cases because competing tax interests deter allocations which lack economic reality.⁷

³*Cf.* Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) (“Section 1060 provides no independent basis for determining the amount a taxpayer realizes on the sale of the assets or the time such amount may be taken into account; the amount realized and the time such amount is taken into account are determined solely under generally applicable tax accounting principles.”).

⁴I.R.C. § 1060(a); *see* Treas. Reg. § 1.1060-1(c)(4); *see also* H. Rept. 101-881, 101st Cong., 2nd Sess. at 351 (1990) (“The committee does not intend to restrict in any way the ability of the IRS to challenge the taxpayer’s allocation to any asset or to challenge the taxpayers’ determination of the fair market value of any asset by any appropriate method, particularly where there is a lack of adverse tax interests between the parties.”); *cf.* F.S.A. 1999-960 (Oct. 14, 1992) (“If a buyer and seller agree upon a specific purchase price allocation upon the sale of a business, they are bound by such allocation for tax purposes.”).

⁵*See* Treas. Reg. § 1.1060-1(c)(4); *Langdon v. Commissioner*, 2003-1 USTC 50,244, at 87,520 (8th Cir. 2003), *aff’g* 82 T.C.M. (CCH) 677 (2001); *cf.* NSAR 020063 (Apr. 4, 2002) (“In our case, the government has determined that the allocation of the purchase price made by the taxpayers was not appropriate. The government can go beyond the formal dealings of the parties to see if they reflect meaningful substance. One thing that the government should consider is whether different allocations of the purchase price would result in adverse tax consequences for the purchaser. This is important because adverse tax interests deter allocations which lack economic reality. The court strictly scrutinizes an allocation if it does not have adverse tax consequences for the parties. In our opinion, no adverse tax consequences existed for the purchaser.” [Citations omitted.]

⁶*Langdon*, 2003-1 USTC ¶ 50,244, at 87,520 (“When reviewing the parties’ allocation agreement, two different standards apply. The tax court will give deference to the parties when they have competing tax interests. If, on the other hand, the parties do not have adverse tax interests, the tax court will strictly scrutinize the allocation agreement. Courts use a higher standard in such cases because competing tax interests deter allocations which lack economic reality.”), *aff’g Bemidji Distributing Co., Inc. v. Commissioner*, 82 T.C.M. (CCH) 677, 681 (2001) (“We strictly scrutinize an allocation if it does not have adverse tax consequences for the parties; adverse tax interests deter allocations which lack economic reality.”); *Lorvic Holdings, Inc. v. Commissioner*, 76 T.C.M. (CCH) 220, 226 (1998) (“We strictly scrutinize an allocation if it does not have adverse tax consequences for the parties; adverse tax interests deter allocations which lack economic reality.”); *Howard Pontiac-GMC Inc. v. Commissioner*, 74 T.C.M. (CCH) 45, 49 (1997) (“The amount a taxpayer pays or allocates to a covenant not to compete is not always controlling for tax purposes. We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality.”); *Thompson v. Commissioner*, 73 T.C.M. (CCH) 3169, 3174 (1997) (“The amount a taxpayer pays or allocates to a covenant not to compete is not always controlling for tax purposes. We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality.”); *Heritage Auto Center, Inc. v.*

2. When Does Section 1060 Apply? Section 1060(a) applies in the case of an “applicable asset acquisition,” which is generally any transfer of a group of assets constituting a trade or business (in the hands of either the seller or purchaser)⁸ if the purchaser’s tax basis in the assets is determined wholly by reference to the amount paid for the assets.⁹

a. Group of Assets Constituting a Trade or Business. A group of assets constitutes a trade or business if: (1) the use of such assets would constitute an active trade or business (within the meaning of Section 355 of the Code); or (2) its character is such that goodwill or going concern value could under any circumstances attach to such group.¹⁰

(1) Active Trade or Business. In determining whether a group of assets constitutes an active trade or business, a “trade or business” is generally defined as a specific group of activities carried on for the purpose of earning income or profit.¹¹ Such group of activities ordinarily must include the collection of income and the payment of

Commissioner, 71 T.C.M. (CCH) 1839, 1846 (1996) (“In the case at bar, respondent has noted this lack of a tax rate differential, and she argues that the buyers and Mr. Wright did not have adverse tax interests when negotiating the allocations which are the subject of this case. We agree. Accordingly, we strictly scrutinize these allocations.” [Citations omitted.]); *Freres v. Commissioner*, 70 T.C.M. (CCH) 1549, 1553 (1995) (“We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality.”); *Beaver Bolt, Inc. v. Commissioner*, 70 T.C.M. (CCH) 1364, 1368 (1995) (“We must decide whether any of the amount allocated to the covenant not to compete was a disguised payment for Grecco’s stock in petitioner. The amount a taxpayer allocates to a covenant not to compete is not always controlling for tax purposes. We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality.”).

⁷*Langdon*, 2003-1 USTC ¶ 50,244, at 87,520.

⁸See Treas. Reg. § 1.1060-1(b)(3), Example 1 (purchaser cannot avoid application of Section 1060 by arguing that assets of acquired business will not be used in same business).

⁹I.R.C. § 1060(c); Treas. Reg. § 1.1060-1(b)(1); *West Covina Motors, Inc. v. Commissioner*, 98 T.C.M. (CCH) 515, 616 (2009) (“An applicable asset acquisition is any transfer (whether direct or indirect) of assets constituting a trade or business and in which the transferee’s basis is determined wholly by reference to the consideration paid for such assets. Generally, a written agreement is binding in such an acquisition as to the allocation of the consideration or as to the fair market value of any of the assets. Where the parties do not allocate the consideration entirely, however, the residual method of purchase price allocation may apply to determine both the purchaser’s basis in, and the seller’s gain or loss from, each of the transferred assets.”); *cf.* Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) (“Seller’s nuclear assets, including Plant, equipment, operating assets, and the assets of the nonqualified nuclear decommissioning fund, constitute a trade or business in Seller’s hands and the gain or loss recognized with respect to those assets will be determined wholly by reference to Seller’s amount realized. Thus, Seller’s transfer of its c percent undivided interest in Plant, equipment, operating assets, and the assets of the nonqualified nuclear decommissioning fund to Buyer in exchange for cash, the assumption of Seller’s nuclear decommissioning liability is an applicable asset acquisition as described in section 1060 and the regulations thereunder.” [Footnote omitted.]). For a recent insightful article discussing the application of Section 1060, see Rizzi, *Purchasing Assets in a Depreciating Economy: Allocations and Anomalies*, 36 J. Corp. Tax’n 22 (Jan/Feb 2009).

¹⁰Treas. Reg. § 1.1060-1(b)(2).

¹¹Treas. Reg. § 1.355-3(b)(2)(ii).

expenses.¹² The determination whether a trade or business is actively conducted will be made from all of the facts and circumstances.¹³

(2) Attachment of Goodwill or Going Concern Value. For purposes of determining whether goodwill or going concern value could under any circumstances attach to a group of assets, the regulations provide that goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.¹⁴

b. Purchaser's Tax Basis Must Be Determined Wholly by Reference to Amount Paid. Section 1060 applies in cases where a purchaser of assets obtains a "cost" basis in an applicable asset acquisition.¹⁵

3. How Does Section 1060 Allocate Consideration Among Assets? Section 1060(a) provides that, in the case of an applicable asset acquisition, the consideration received for such assets must be allocated among the acquired assets in the same manner as amounts are allocated to assets under Section 338(b)(5) of the Code.¹⁶ Treasury Regulation § 1.1060-1(a)(1) provides additional guidance by prescribing rules relating to the allocation requirements of Section 1060.¹⁷ That section of the regulations provides that, in the case of an applicable asset acquisition, sellers and purchasers must allocate the consideration under the "residual method" as described in Treasury Regulation §§ 1.338-6 and 1.338-7 in order to

¹²*Id.*

¹³Treas. Reg. § 1.355-3(b)(2)(iii).

¹⁴Treas. Reg. § 1.1060-1(b)(2)(ii).

¹⁵I.R.C. § 1060(c); *West Covina Motors Inc. v. Commissioner*, 98 T.C.M. (CCH) 615, 616 ("An applicable asset acquisition is any transfer (whether direct or indirect) of assets constituting a trade or business and in which the transferee's basis is determined wholly by reference to the consideration paid for such assets.").

¹⁶Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) ("Section 1060 provides that, in the case of an 'applicable asset acquisition,' the consideration received shall be allocated among the acquired assets in the same manner as amounts are allocated to assets under section 338(b)(5). Section 1.1060- 1(a)(1) provides that, in the case of an applicable asset acquisition, the seller and the purchaser each must allocate the consideration paid or received in the transaction under the residual method as described in sections 1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets.").

¹⁷Treas. Reg. § 1.1060-1(a)(1).

determine, respectively, the amount realized from, and the basis in, each of the transferred assets.¹⁸

a. Description of Residual Method. The residual method is based on a division of assets into seven classes. Sale consideration is first reduced by the amount of Class I assets (if any) transferred by the seller.¹⁹ The remaining consideration is then allocated among Class II assets (to the extent of and in proportion to fair market value), then among Class III assets (to the extent of and in proportion to fair market value), then among Class IV assets (to the extent of and in proportion to fair market value), then among Class V assets (to the extent of and in proportion to fair market value), then among Class VI assets (to the extent of and in proportion to fair market value), and finally to Class VII assets.²⁰

b. Description of Seven Classes of Assets. The seven classes of assets set forth in the regulations are as follows:

¹⁸Treas. Reg. § 1.1060-1(a)(1); Treas. Reg. § 1.1060-1(c)(2); *cf.* F.S.A. 200144028 (Nov. 2, 2001) (“Sections 338(b) and 1060 address the potential controversies and measurement issues that may arise regarding purchase price allocations by mandating the use of a residual method of allocation. Under the residual method, the assets of a going business, other than goodwill and going concern value, must be placed into distinct asset classes, as follows: (1) Class I — Cash and cash equivalents; (2) Class II — Certificates of deposit, U.S. government (3) All assets not in securities, readily marketable stock or securities, and foreign currency; Class I, II, IV, and V; and (4) Class IV — all section 197 intangibles, except those in the nature of goodwill and going concern value; (5) Class V —section 197 assets in the nature of goodwill and going concern value. The purchase price is then allocated among these asset classes in priority order. Under this allocation scheme, no asset in any class (except the residual class) may be allocated more than its fair market value. If the consideration allocable to a particular asset class is less than the aggregate fair market value of the assets within that class, each asset is allocated an amount of consideration in proportion to its relative fair market value and nothing is allocated to any junior class. * * * Application of the residual method eliminates the need for a separate determination of the value of goodwill and going concern value. Instead, under the residual method, any “premium.” in excess of the total fair market value of the purchased assets (other than goodwill and going concern value) is treated as a payment for goodwill and going concern value. The assignment of goodwill and going concern value to a true residual class reflects the concept that assets in the nature of goodwill and going concern value cannot be valued independently from the purchase price of the overall transaction because these intangible assets are not transferable apart from the business as a whole.”).

¹⁹Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(1).

²⁰Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(i); *cf.* Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) (“The residual method is based on a division of assets into seven classes: Class I (generally consisting of cash, and general deposit accounts held in banks, savings and loan associations, and other depository institutions), Class II (generally consisting of actively traded personal property like U.S. government securities and publicly traded stock, but also including certificates of deposit and foreign currency even if they are not actively traded personal property), Class III (accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business), Class IV (stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business), Class V (all assets other than Class I, II, III, IV, VI, and VII assets), Class VI (all section 197 intangibles, as defined in that section, except goodwill and going concern value), and Class VII (goodwill and going concern value, whether or not it qualifies as a section 197 intangible).”).

(1) **Class I Assets.** Class I assets consist of cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions.²¹

(2) **Class II Assets.** Class II assets consist of actively-traded personal property, certificates of deposit and foreign currency. Examples of Class II assets include U.S. government securities and publicly-traded stock.²²

(3) **Class III Assets.** Class III assets consist of debt instruments (including accounts receivable) and assets that the taxpayer marks to market at least annually for federal income tax purposes.²³

(4) **Class IV Assets.** Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.²⁴

(5) **Class V Assets.** Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.²⁵

(6) **Class VI Assets.** Class VI assets are all Section 197 intangibles, as defined in Section 197, except those in the nature of goodwill and going concern value.²⁶ Thus, Class VI should include such items as (1) certain specified types of intangible property generally relating to workforce, information base, know how, customers, suppliers, or other similar items;²⁷ (2) any license, permit, or other right granted by a government unit or agency;²⁸ (3) any covenant not to compete or similar arrangement entered into in connection with the acquisition of an interest in a trade or business;²⁹ and (4) any franchise, trademark, or trade name.³⁰

²¹Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(1).

²²Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(ii).

²³Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(iii).

²⁴Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(iv).

²⁵Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(v).

²⁶Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(vi).

²⁷I.R.C. § 197(d)(1)(C).

²⁸I.R.C. § 197(d)(1)(D).

²⁹I.R.C. § 197(d)(1)(E).

³⁰I.R.C. § 197(d)(1)(F); see Instructions to IRS Form 8594 (Rev. December 2008).

(7) **Class VII Assets.** Class VII assets consist of Section 197 intangibles in the nature of goodwill and going concern value.³¹

c. Allocation Not to Exceed Fair Market Value. The amount of consideration allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset on the purchase date.³² Generally, the “fair market value” of an asset is its gross fair market value determined without regard to mortgages, liens, pledges, or other liabilities.³³

d. Example Illustrating Operation of Section 1060. Suppose that on January 1, 2001, S, a sole proprietor, sells to P, a corporation, a group of assets that constitutes a trade or business for purposes of Section 1060. S, who plans to retire immediately, also executes in P’s favor a covenant not to compete. P pays S \$3,000 in cash and assumes \$1,000 in liabilities. Thus, the total consideration is \$4,000.

On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, Class V, and Class VI assets S sold to P are as follows:

<u>Asset Class</u>	<u>Asset</u>	<u>Fair Market Value</u>
II	Actively traded securities	<u>\$500</u>
	Total Class II	<u>500</u>
III	Accounts receivable	<u>200</u>
	Total Class II	<u>200</u>
V	Furniture and fixtures	800
	Building	800
	Land	200
	Equipment	<u>400</u>
	Total Class V	<u>2,200</u>
VI	Covenant not to compete	<u>900</u>
	Total Class VI	<u>900</u>

P and S each allocate the consideration in the transaction among the assets transferred in accordance with the agreed upon fair market values of the assets, so that \$500 is allocated to Class II assets, \$200 is allocated to the Class III asset, \$2,200 is allocated to Class V assets, \$900 is allocated to Class VI assets, and \$200 (\$4,000 total consideration less \$3,800 allocated to assets in Classes II, III, V, and VI) is allocated to the Class VII assets (goodwill and going concern value).

³¹Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(vii).

³²Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(c)(1).

³³Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(i).

In connection with the examination of P's return, the Revenue Service, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the Revenue Service correctly determines that the fair market value of the covenant not to compete was \$500. Since the allocation of consideration among Class II, III, V, and VI assets results in allocation up to the fair market value limitation, the \$600 of unallocated consideration resulting from the Revenue Service's redetermination of the value of the covenant not to compete is allocated to Class VII assets (goodwill and going concern value).³⁴

4. Reporting Requirements Under Section 1060.

a. In General. If Section 1060 applies to an asset acquisition, the seller and the purchaser are each required to file Form 8594 with respect to the allocation of the consideration among the assets transferred.³⁵ Each must file Form 8594 with its income tax return for the tax year that includes the purchase date.³⁶

³⁴Treas. Reg. § 1.1060-1(d), *Example 2*.

³⁵Treas. Reg. § 1.1060-1(e)(1)(i).

³⁶Treas. Reg. § 1.1060-1(e)(1)(ii)(A). In I.L.M. 1998-478 (Sept. 16, 1998), the IRS Chief Counsel's Office stated as follows:

This responds to the Technical Coordination Report submitted by George K. Nunziata of the Pacific Northwest District. Mr. Nunziata states that the Internal Revenue Code does not include an information reporting requirement for the sale of various asset components involved in the sale of a trade or business. Section 6045 of the Internal Revenue Code requires the filing of Form 1099-S to report the sale of real property, but, as Mr. Nunziata states, there is no similar reporting requirement for the sale of goodwill or a covenant not to complete.

Rev. Rul. 55-79, 1955-1 C.B. 370, states that for federal income tax purposes, the sale of a going business operated as a sole proprietorship does not constitute the sale of a single asset, but is instead a sale of the individual assets comprising the business. Section 1060 and section 1.1060-1T(h) require the filing of an information return by both transferor and transferee in any applicable asset acquisition. An "applicable asset acquisition" is defined in section 1060(c) as any transfer (1) of assets which constitute a trade or business, and (2) with respect to which the transferee's basis in those assets is determined wholly by reference to the consideration paid for the assets. If goodwill or a going concern value could under any circumstances attach to the group of assets, the group constitutes a trade or business for purposes of section 1060 (section 1.1060-1T(b)(2)). Both seller and purchaser in an applicable asset acquisition must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. Each must file Form 8594, Asset Acquisition Statement Under Section 1060, with their respective income tax returns or returns of income for the taxable year that includes the purchase date.

Very often, the sale of a trade or business that is operated as a sole proprietorship involves the sale of real property from which that trade or business had been operated. Section 6045(e) requires the filing of Form 1099-S for real estate transactions. Section 1.6045-4(b)(1) states that a "real estate transaction" is a transaction that consists in whole or in part of the sale or exchange of reportable real estate. Section 1.6045-4(b)(2) states that "reportable real estate" includes any inherently permanent structure, including any residential, commercial, or industrial building. Certain types of transactions and certain types of property are exempt from section 6045's reporting requirement; but in general, the sale of real estate as part of the sale of a trade or business must be reported under the requirements of section 6045. We are not aware of any authority that holds that Form 8594 need not be filed merely because a Form 1099-S has been filed.

b. Subsequent Adjustments to Consideration. The purchaser and seller are also required to make a supplemental statement on Form 8594 concerning increases (or decreases) in the amount of consideration allocated to an asset if such increases (or decreases) in consideration occur after the end of its tax year that includes the purchase date. Form 8594, reporting the increase (or decrease) in consideration, must be filed with the return for the tax year in which the increase (or decrease) is taken into account.³⁷

5. Information Required in Case of Certain Transfers of Interests in Entities. If a taxpayer owning at least a 10% interest (directly or indirectly) in an entity transfers an interest in the entity and, in connection with the transfer, the transferor enters into an employment contract, covenant not to compete, royalty, lease or other agreement with the transferee, Section 1060(e) requires that the transferor and the transferee report the transfer at such time and in such manner as may be required by the Revenue Service.³⁸ Thus far, the Service has not issued regulations prescribing such information.

6. Sale of Disregarded Entity. For federal income tax purposes, the sale by a partnership of an interest in an entity that is disregarded should be treated as a sale of the assets of the disregarded entity.³⁹ If an entity is disregarded, its activities are treated in the same

Under section 6041, all persons engaged in a trade or business and making payment in the course of that trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year must file an information return. The form most commonly used for this purpose is Form 1099-MISC, which fully identifies both the payor and the recipient, and states the amount of income paid to the recipient. Neither the Code nor the regulations impose on the payor a duty to determine how much of the payment will be income to the payee, e.g., if inventory is being sold, the payor/buyer is not required to determine the payee/seller's basis in the inventory, to allocate a portion of the selling price to it, and to compute the payee's gain on the sale of the inventory. As a result, very often the sale of a sole proprietorship may not require the filing of Form 1099-MISC under section 6041. However, neither the Code nor the regulations exempt a transaction from the requirements to file Form 8594 merely because section 6041's information return requirements are not applicable to the transaction.

³⁷Treas. Reg. § 1.1060-1(e)(1)(ii)(B).

³⁸I.R.C. § 1060(e).

³⁹See Treas. Reg. §§ 301.7701-2, 301.7701-3; Rev. Rul. 99-5, 1999-1 C.B. 434 (“In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, *B*, purchases an interest in the disregarded entity from the owner, *A*. *B*'s purchase of 50% of *A*'s ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by *A* for federal tax purposes. Immediately thereafter, *A* and *B* are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.”). The Service has held in Rev. Rul. 2004-77 and in several private letter rulings that a partnership with a single owner for federal income tax purposes is disregarded under the check-the-box regulations. *cf.* Priv. Ltr. Rul. 200201005 (Sept. 27, 2001) (“[Qualified subchapter S subsidiary X's] merger into Y, a state law limited partnership that is owned 1% by W, [a limited liability company] wholly owned by Z and 99% by Z will be disregarded for federal income tax purposes if no election is made under 301.7701-3(c) to treat W as an association because, at the end of the series of transactions, the assets of X continue to be held by Z for federal tax purposes.”); Priv. Ltr. Rul. 200107025 (Nov. 17, 2000) (“[E]ach of the individual shareholders of X will be the sole owner of the limited partnership that the individual shareholder formed, owning m% through the respective individual's limited liability

manner as a sole proprietorship, branch or division of the owner.⁴⁰ In Private Letter Ruling 200807005 (Feb. 15, 2008), the Service held that, for federal income tax purposes, a taxpayer's acquisition of 100% of the interests in a partnership will be treated as the acquisition of the partnership's assets by the taxpayer.⁴¹

B. Taxable Sale of a Business by An Individual.

1. Rate Structure Applicable to Individuals. For 2010, the regular income tax rate schedules for individuals are shown below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns.⁴² A separate, compressed rate schedule applies to estates and trusts.⁴³

Individual Regular Income Tax Rates for 2010⁴⁴

If taxable income is:	But not over:	Then regular income tax equals:
		<i>Single individuals</i>
\$0	\$8,375	10% of taxable income

company, a disregarded entity, and n% directly. Because each of the limited partnerships are treated as owned by a single owner, they will be disregarded for federal tax purposes and each individual shareholder will be treated as directly owning the X stock held by their respective limited partnership.”); Priv. Ltr. Rul. 199947001 (Dec. 7, 1998) (“If Company A [taxed as a partnership] makes an election under section 754, Company A’s basis in its assets, including the assets of the Partnerships that are disregarded entities for federal income tax purposes, will be adjusted under section 743(b) as a result of the transaction.”); Priv. Ltr. Rul. 199915030 (Jan. 12, 1999) (“Corporation B and Disregarded LLC1 organized a limited partnership, Disregarded Partnership. Corporation B owns the limited partnership interest and Disregarded LLC1 owns the general partnership interest. Corporation B and Disregarded LLC1 will not elect to treat Disregarded Partnership as a separate entity for federal income tax purposes * * * Disregarded LLC1, Disregarded Partnership . . . will not be treated for federal income tax purposes as entities separate from Corporation B”); Priv. Ltr. Rul. 9807013 (Feb. 13, 1998) (“Because each Replacement Entity will be disregarded as an entity separate from its owner for federal tax purposes, the assets of each Replacement Entity will be treated as assets of the Taxpayer.”).

⁴⁰Treas. Reg. § 301.7701-2(a).

⁴¹See Priv. Ltr. Rul. 200807005 (Feb. 15, 2008) (“Taxpayer will acquire 100 percent of the partners’ interests in Partnership. Pursuant to Rev. Rul. 99-6, Partnership is considered to have terminated under § 708(b)(1)(A) and made a liquidating distribution of its real property assets to its partners, and Taxpayer is treated as having acquired such real property assets from the partners for federal tax purposes. Since Taxpayer will acquire 100 percent of the partners’ interests in Partnership, Taxpayer is treated as having acquired the real property assets of Partnership rather than as having acquired partnership interests from the partners. Further, this transaction does not constitute an abuse of the type that Congress sought to remedy in the Deficit Reduction Act of 1984, which appears to be aimed at abuses by sellers of partnership interests. We view this transaction as a like-kind exchange under § 1031(a)(1), rather than as an exchange of partnership interests in violation of § 1031(a)(2)(D). * * * Accordingly, Taxpayer may defer the gain on the sale of Relinquished Property under § 1031 if Taxpayer, through QI, acquires 100 percent of the interests of the partners in Partnership, which owns the Replacement Property.”).

⁴²See I.R.C. §§ 1(a), 1(d).

⁴³I.R.C. § 1(e).

⁴⁴I.R.C. § 1; see Rev. Proc. 2009-50, 2009-45 I.R.B. 617.

Over \$8,375	\$34,000	\$837.50, plus 15% of the amount over \$8,375
Over \$34,000	\$82,400	\$4,681.25, plus 25% of the amount over \$34,000
Over \$82,400	\$171,850	\$16,781.25, plus 28% of the amount over \$82,400
Over \$171,850	\$373,650	\$41,827.25, plus 33% of the amount over \$171,850
Over \$373,650		\$108,421.25 plus 35% of the amount over \$373,650

Heads of households

\$0	\$11,950	10% of taxable income
Over \$11,950	\$45,550	\$1,195, plus 15% of the amount over \$11,950
Over \$45,550	\$117,650	\$6,235, plus 25% of the amount over \$45,550
Over \$117,650	\$190,550	\$24,260 plus 28% of the amount over \$117,650
Over \$190,550	\$373,650	\$44,672 plus 33% of the amount over \$190,550
Over \$373,650		\$105,095, plus 35% of the amount over \$373,650

Married individuals filing joint returns

\$0	\$16,750	10% of taxable income
Over \$16,750	\$68,000	\$1,675, plus 15% of the amount over \$16,750
Over \$68,000	\$137,300	\$9,362.50, plus 25% of the amount over \$68,000
Over \$137,300	\$209,250	\$26,687.50, plus 28% of the amount over \$137,300
Over \$209,250	\$373,650	\$46,833.50, plus 33% of the amount over \$209,250
Over \$373,650		\$101,085.50, plus 35% of the amount over \$373,650

2. Taxation of Capital Gain Recognized by Individuals on Sales or Exchanges.

a. Net Capital Gain of an Individual. The net capital gain of an individual is subject to lower rates of tax than the rates applicable to ordinary income.⁴⁵

(1) Net Capital Gain. Net capital gain is generally the excess of the net gain from the sale or exchange of capital assets held more than one year over the net loss from the sale or exchange of capital assets held not more than one year.⁴⁶

(2) Gains from Sales or Exchanges of Depreciable Property or Real Property Used in a Taxpayer's Trade or Business. Generally, if there is net gain from the sale or exchange of depreciable business property or real property used in a taxpayer's trade or business and held for more than 1 year (other than inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), gains and losses are treated as capital gains and losses, but if there is a net loss, the gains and losses are treated as ordinary.⁴⁷ Certain exceptions to the characterization of net gains as capital in nature

⁴⁵See I.R.C. § 1(h).

⁴⁶I.R.C. § 1222(11).

⁴⁷I.R.C. §§ 1231(a), 1231(b).

apply with respect to certain recapture of depreciation and amortization,⁴⁸ certain recapture of deductions claimed with respect to natural resource property⁴⁹ and recapture of certain prior losses.⁵⁰ Special rules also apply to timber, coal, iron ore, livestock, and unharvested crops.⁵¹

b. Applicable Rates.

(1) Maximum Tax Rate on Adjusted Net Capital Gain Is 15-Percent. For 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 15-percent⁵² (5% (or zero percent in tax years beginning after 2007⁵³) for gains that would otherwise be taxed at a regular rate of 10% or 15%⁵⁴). These rates apply for purposes of both the regular tax and the alternative minimum tax.⁵⁵ The “adjusted net capital gain” of an individual is the sum of (a) the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain; and (b) qualified dividend income.⁵⁶ The net capital gain is further reduced (but not below zero) by the amount of gain that an individual taxpayer treats as investment income for purposes of determining the investment interest limitation.⁵⁷ On May 17, 2006, President Bush signed into law the Tax Increase Prevention and Reconciliation Act (the “2006 Act”). The 2006 Act extends the favorable rates on capital gains through 2010 (instead of expiring at the end of 2008).⁵⁸

⁴⁸I.R.C. §§ 1245(d), 1250(h), 1252(b); Treas. Reg. § 1.1245-6(a); Treas. Reg. § 1.1250-1(c)(1); Treas. Reg. § 1.1252-1(d)(1).

⁴⁹I.R.C. § 1254(a); *cf.* Priv. Ltr. Rul. 8642010 (June 17, 1986) (“Section 1231 of the Internal Revenue Code provides for capital gains treatment for the disposal of property used in a trade or business to the extent not otherwise recharacterized by section 1245 and 1254.”); Priv. Ltr. Rul. 8234140 (May 28, 1982) (“Any gain recognized by the transferors will be taxed as a gain realized upon the sale or exchange of a capital asset or a section 1231 asset assuming the property transferred was held on the date of exchange as either a capital asset as defined in section 1221 or an asset used in a trade or business as defined in section 1231(b), except to the extent such gain is subject to the recapture provisions of sections 1245, 1250, and 1254.”); Priv. Ltr. Rul. 8138096 (June 25, 1981) (“Any gain recognized will be taxed as a gain realized upon the sale or exchange of a capital asset or a section 1231 asset provided the properties were held on the date of the exchange as either a capital asset (as defined in section 1221) or an asset used in a trade or business (as defined in section 1231(b)), except to the extent such gain is subject to the recapture provisions of section 1245, 1250, and 1254 (or in the case of a transferor of a Partnership Interest such gain is attributable to such Transferor’s share of Partnership items described in section 751(c) or (d) of the Code).”).

⁵⁰I.R.C. § 1231(c).

⁵¹I.R.C. §§ 1231(b)(2), 1231(b)(3), 1231(b)(4).

⁵²I.R.C. § 1(h)(1)(C).

⁵³I.R.C. § 1(h)(1)(B).

⁵⁴I.R.C. § 1(h)(1)(B)(i).

⁵⁵See I.R.C. § 55(b)(3).

⁵⁶I.R.C. § 1(h)(3).

⁵⁷I.R.C. § 1(h)(2).

⁵⁸2006 Act § 102.

(2) Maximum Tax Rate on “28-Percent Rate Gain” Is 28-Percent. “28-percent rate gain” generally means the sum of (i) the net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles, and (ii) an amount of gain equal to the amount of gain excluded from gross income on the sale of small business stock, reduced by the net short-term capital loss for the tax year, and any long-term capital loss carryover to the tax year.⁵⁹ The 28-percent rate gain is taxed at a maximum rate of 28-percent.⁶⁰

(3) Maximum Tax Rate on Unrecaptured Section 1250 Gain Is 25-Percent. “Unrecaptured section 1250 gain” means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if Section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation), reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain.⁶¹ The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of trade or business property (and certain other property) is subject to a limitation.⁶² The unrecaptured section 1250 gain is taxed at a maximum rate of 25-percent.⁶³

C. Installment Sales.

1. Background. Section 453 allows gain on an installment sale to be reported on a deferred basis. It permits “the spreading of the income tax over the period during which payments of the sales price are received” and, thus, “alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not actually been received.”⁶⁴ “This spreading of gain is achieved by dividing each installment payment and applying ‘part [to] return of capital and part to profit.’”⁶⁵

2. Installment Sale Reporting.

a. General Rule. Unless otherwise elected, a taxpayer must report income from an installment sale on the installment method if any payment is to be received in a

⁵⁹I.R.C. § 1(h)(4).

⁶⁰I.R.C. § 1(h)(1)(E).

⁶¹I.R.C. § 1(h)(6)(A).

⁶²I.R.C. § 1(h)(6)(B).

⁶³I.R.C. § 1(h)(1)(D).

⁶⁴H. Rept. 96-1042, 96th Cong., 2d Sess. 5 (1980); S. Rept. 96-1000, 96th Cong., 2d Sess. 7 (1980), 1980-2 C.B. 494, 497; *see also Professional Equities, Inc. v. Commissioner*, 89 T.C. 165, 169 (1987).

⁶⁵*Professional Equities, Inc.*, 89 T.C. at 169 (quoting *Burnet v. S.&L. Bldg. Corp.*, 288 U.S. 406, 413 (1933)).

tax year after the year of sale.⁶⁶ The installment sale rules also apply to sales for which payment is to be made in a lump sum after the tax year of sale.⁶⁷

b. Exceptions

(1) Exception for Dealers. The installment method does not apply to dispositions of (1) personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan; or (2) real property held by the taxpayer for sale in the ordinary course of business (“dealer disposition”).⁶⁸

(a) Dealer Disposition Does Not Include Disposition of Certain Residential Lots or Timeshares. A dealer disposition does not include certain dispositions on the installment plan of residential lots or “timeshares” if the taxpayer elects to pay interest on the amount of deferred tax attributable to the use of the installment method.⁶⁹ The disposition must occur in the ordinary course of the taxpayer’s business and the transferee must be an individual.⁷⁰

(b) Dealer Disposition Does Not Include Disposition of Farming Property. A dealer disposition does not include a disposition on the installment plan of property used or produced in the trade or business of farming.⁷¹

(2) Exception for Inventories of Personal Property. The installment method does not apply to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the tax year.⁷²

(3) Exception for Installment Obligations Arising out of Sales of Stocks or Securities Traded on an Established Securities Market. Any installment obligation arising out of a sale of stock or securities traded on an established securities market is not eligible for the installment method of reporting income under Section 453(a), and all payments to be received are treated as received in the year of disposition.⁷³

⁶⁶I.R.C. §§ 453(a), 453(b)(1); cf. F.S.A. 200004009 (Jan. 28, 2000).

⁶⁷Temp. Reg. § 15A.453-1(b).

⁶⁸I.R.C. §§ 453(a)(2), 453(l); *see, e.g., United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969); *Major Realty Corp. v. Commissioner*, 749 F.2d 1483 (11th Cir. 1985).

⁶⁹I.R.C. § 453(l)(2)(B).

⁷⁰I.R.C. § 453(l)(2)(B)(ii).

⁷¹I.R.C. § 453(l)(2)(A).

⁷²I.R.C. § 453(b)(2)(B).

⁷³I.R.C. § 453(k)(2)(A).

(4) Dispositions of Personal Property Under a Revolving Credit Plan. The installment method does not apply to any dispositions of personal property under a revolving credit plan.⁷⁴

c. Installment Method Does Not Apply to Losses. The installment method does not apply to losses incurred by a taxpayer on an installment sale. A loss sustained on an installment sale should be claimed as a deduction for the tax year of sale and not over the period during which payments are to be received.⁷⁵

3. Determining the Amount of Income Includible Under the Installment Method. The amount of income includible under the installment method is calculated as follows:

$$\begin{array}{rcl} \text{Installment Payment Received} & \times & \frac{\text{Gross Profit Realized}}{\text{Contract Price}} \\ \text{During The Year} & & \end{array} \quad \text{76}$$

a. Gross Profit. The “gross profit” is the selling price less the taxpayer’s adjusted tax basis in the property.⁷⁷

(1) Selling Price. “Selling price” is the gross selling price without reduction for any existing mortgage on the property (whether assumed or taken subject to by the buyer) or for any selling expenses. Neither interest nor original issue discount is considered to be a part of the selling price.⁷⁸

(2) Adjusted Tax Basis Includes Selling Expenses. The seller’s adjusted tax basis in the property includes commissions and other selling expenses.⁷⁹

b. Contract Price. “Contract price” is the selling price reduced by the amount of any qualifying indebtedness (as defined below) assumed or taken subject to by the buyer which does not exceed the seller’s adjusted tax basis in the property.⁸⁰

(1) Definition of “Qualifying Indebtedness.” “Qualifying indebtedness” means:

⁷⁴I.R.C. § 453(k)(1).

⁷⁵Rev. Rul. 70-430, 1970-2 C.B. 51.

⁷⁶I.R.C. § 453(c); Temp. Reg. § 15A.453-1(b)(2)(i).

⁷⁷Temp. Reg. § 15A.453-1(b)(2)(v).

⁷⁸Temp. Reg. § 15A.453-1(b)(2)(ii).

⁷⁹Temp. Reg. § 15A.453-1(b)(2)(v).

⁸⁰Temp. Reg. § 15A.453-1(b)(2)(iii).

and (a) A mortgage or other debt encumbering the property;

(b) Unsecured debt incurred or assumed by the purchaser incident to the acquisition, holding, or operation of the property in the ordinary course of business or investment.⁸¹

(2) Obligations Not Included Within “Qualifying Indebtedness.” “Qualifying indebtedness” does not include:

(a) an obligation incurred incident to the disposition of property (for example, legal fees relating to the taxpayer’s sale of the property); or

(b) an obligation functionally unrelated to the acquisition, holding, or operating of the property (for example, the taxpayer’s medical bill).⁸²

c. Payment.

(1) Cash or Other Property. Payment may be received in cash or other property, including foreign currency, marketable securities, and readily-tradeable debt instruments.⁸³ Payment also generally includes the receipt of a third-party note from the purchaser.⁸⁴

(2) Amounts Actually and Constructively Received Under Installment Note. Payment includes amounts actually or constructively received under an installment note.⁸⁵

(3) Receipt of Notes Secured by Cash or a Cash Equivalent. The receipt of a note which is secured by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment.⁸⁶

(4) Installment Note Generally Does Not Constitute Payment. An installment note generally does not constitute payment to the seller even if that note is guaranteed by a third party. A standby letter of credit is treated as a third party guarantee.⁸⁷

⁸¹Temp. Reg. § 15A.453-1(b)(2)(iv).

⁸²Temp. Reg. § 15A.453-1(b)(2)(iv).

⁸³See I.R.C. § 453(f)(2)(B); Temp. Reg. § 15A.453-1(b)(3)(i).

⁸⁴Temp. Reg. § 15A.453-1(b)(3)(i).

⁸⁵Temp. Reg. § 15A.453-1(b)(3)(i).

⁸⁶Temp. Reg. § 15A.453-1(b)(3)(i).

⁸⁷Temp. Reg. § 15A.453-1(b)(3)(i).

(5) Obligations Payable on Demand or Readily Tradable.

(a) Obligations Payable on Demand. An obligation payable on demand is treated as a payment in the year received and not as an installment obligation payable in future years.⁸⁸

(b) Certain Readily-Tradable Obligations Treated as Payment. Certain readily-tradable obligations are treated as payment in the year the obligations are received.⁸⁹

(c) Computation of Amount Realized if Obligation Treated as Payment. If an obligation is treated as a payment in the year received, the amount realized by reason of such payment must be determined in accordance with the taxpayer's method of accounting. For a cash method taxpayer, the amount realized on such payment is the fair market value of the obligation. For an accrual method taxpayer, the amount realized on receipt of an obligation payable on demand is generally the face amount of the obligation.⁹⁰ Special rules apply to readily tradeable obligations.⁹¹

(6) Treatment of Mortgages and Other Liabilities.

(a) Mortgage Assumed or Taken Subject to is Treated as Payment Only to the Extent it Exceeds Basis. A mortgage (or other qualifying indebtedness) assumed or taken subject to by the purchaser in an installment sale is treated as a payment in the year of sale only to the extent that the mortgage exceeds the basis of the property.⁹²

(b) Sales to Creditor. If a taxpayer sells property to a creditor and the taxpayer's debt is cancelled in consideration of the sale, such cancellation is treated as payment.⁹³

(c) Sales of Property Subject to Mortgage for Which Taxpayer Is Not Personally Liable. If the taxpayer sells property which is encumbered by a mortgage on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer is treated as having received payment in the amount of such indebtedness.⁹⁴

⁸⁸I.R.C. § 453(f)(4)(A). *See, e.g. Champy v. Commissioner*, 68 T.C.M. (CCH) 242 (1994).

⁸⁹I.R.C. § 453(f)(4)(B).

⁹⁰Temp. Reg. § 15A.453-1(e)(2).

⁹¹*See* Temp. Reg. § 15A.453-1(e)(2).

⁹²Temp. Reg. § 15A.453-1(b)(3)(i).

⁹³Temp. Reg. § 15A.453-1(b)(3)(i).

⁹⁴Temp. Reg. § 15A.453-1(b)(3)(i).

(d) **Wrap-around Mortgage.** Special rules apply to wrap-around mortgages.

4. Examples.

a. **Example 1.** Adam, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in Adam's hands, to Bob for \$100,000: \$10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. Adam's basis in Blackacre, exclusive of selling expenses, is \$38,000. Adam pays selling expenses of \$2,000.

(1) **Computation of Gross Profit.** The gross profit derived by Adam on the sale is \$60,000 [\$100,000 (selling price) less \$40,000 (basis inclusive of selling expenses)].

(2) **Gross Profit Ratio.** Adam's gross profit ratio is 3/5, computed as follows:

$$\frac{\$60,000 \text{ (gross profit)}}{\$100,000 \text{ (contract price)}}$$

(3) **Amount of Each Payment Includible in Income.** The portion of each annual \$10,000 which is includible by Adam as gain on the sale is \$6,000 (3/5 of \$10,000). The portion of each \$10,000 payment that is treated as recovery of basis is \$4,000 (\$10,000 less \$6,000). The interest received in addition to principal is ordinary income to Adam.⁹⁵

b. **Example 2.** Carl sells Whiteacre to David for a selling price of \$160,000. Whiteacre is encumbered by a mortgage in the principal amount of \$60,000. David will assume or take subject to the \$60,000 mortgage and pay the remaining \$100,000 in 10 equal annual installments together with adequate stated interest. Carl's basis in Whiteacre is \$90,000. There are no selling expenses.

(1) **Gross Profit.** The gross profit derived by Carl on the sale is \$70,000 [\$160,000 (selling price) less \$90,000 (Carl's basis in the property)].

(2) **Contract Price.** The contract price on the sale is \$100,000, which is the \$160,000 selling price less the mortgage of \$60,000 assumed or taken subject to.

(3) **Gross Profit Ratio.** Carl's gross profit ratio is 7/10, computed as follows:

$$\frac{\$70,000 \text{ (gross profit)}}{\$100,000 \text{ (contract price)}}$$

⁹⁵See Temp. Reg. § 15A.453-1(b)(5), Example 1.

(4) Amount of Each Payment Includible in Income. The portion of each annual \$10,000 which is includible by Carl as gain on the sale is \$7,000 (7/10 of \$10,000). The portion of each \$10,000 payment that is treated as recovery of basis is \$3,000 (\$10,000 less \$7,000). The interest received in addition to principal is ordinary income to Carl.⁹⁶

c. Example 3. The facts are the same as in Example 2, except that Carl's basis in the land is \$40,000.

(1) Amount of mortgage assumed or taken subject to by David exceeds Carl's basis in the property. Since mortgage assumed or taken subject to by David (\$60,000) exceeds Carl's tax basis in the property (\$40,000), Carl is deemed to have received a payment in an amount equal to the excess of \$20,000.

(2) Amount Includible as Income. Since Carl fully recovers his basis in the year of sale, the gross profit ratio is 1 (\$120,000/\$120,000) and Carl will include as gain the entire \$20,000 deemed payment in the year of sale and each \$10,000 annual payment.⁹⁷

5. Treatment of Contingent Payment Sales. Special rules apply to contingent payment sales.⁹⁸

6. Resales by Related Persons.

a. Gain Recognized on Resales by Related Persons. Section 453(e) provides a special rule applicable to sales of property to a related person using the installment method. Under Section 453(e), if:

(1) A taxpayer ("first seller") disposes of property to a related person ("related purchaser"); and

(2) Before the first seller receives all payments relating to the sale, the related purchaser disposes of the property, the first seller will be treated as receiving the total payments received by the related purchaser on the resale. The first seller will recognize gain, based upon his gross profit ratio, but only, in general, to the extent the amount realized⁹⁹ from the second disposition exceeds actual payments made under the first sale.¹⁰⁰

⁹⁶See Temp. Reg. § 15A.453-1(b)(5), Example 2.

⁹⁷See Temp. Reg. § 15A.453-1(b)(5), Example 3.

⁹⁸Temp. Reg. § 15A.453-1(c)(1); see, e.g., 200004009 (Jan. 28, 2000) ("The sale occurring in Year 1 in the present case would be a contingent payment sale because of the payments contingent on the net income of Corp. B.").

⁹⁹In the case of a second disposition which is not a sale or exchange, the fair market value of the property disposed of is treated as the amount realized for this purpose. I.R.C. § 453(e)(4).

¹⁰⁰I.R.C. §§ 453(e)(1) & (e)(3); see also I.R.C. §§ (e)(6) & 453(e)(7) (providing exceptions to resale rule); *Shelton v. Commissioner*, 105 T.C. 114, 122 (1995) (liquidation treated as disposition of property). The term

b. Treatment of Later Payments. If a resale by a related person results in the recognition of gain to the first seller, subsequent payments received by that seller are recovered tax-free until the total of such payments equals the amount realized from the resale which resulted in gain.¹⁰¹

c. 2-year Cutoff Period. The resale rule applies only with respect to resales of property (other than marketable securities) occurring within 2 years after the initial installment sale.¹⁰²

7. Installment Sales of Depreciable Property Between Certain Related Persons.

a. Installment Method Does Not Apply. Section 453(g) provides a special rule for sales of depreciable property between certain “related persons” (defined in Section 453(g)(3)). Under Section 453(g)(1), the installment method does not apply to a sale of depreciable property between related persons. Rather, all non-contingent payments to be received are treated as received in the year of disposition.¹⁰³ The purchaser cannot increase the basis of the property acquired by any amount before the time such amount is includible in the seller’s gross income.¹⁰⁴

b. Exception Applies If Tax Avoidance Not a Principal Purpose. The rule denying installment sale treatment to a sale of depreciable property between related persons does not apply if the taxpayer can establish that tax avoidance was not a principal purpose for the disposition.¹⁰⁵

8. Recapture of Income on Installment Sale. The depreciation recapture rules of Sections 1245 and 1250 of the Code override the installment sale rules. Thus, depreciation recapture income with respect to any property will be recognized in full in the year of an installment sale of such property, even if no principal payments are received in that year.¹⁰⁶

9. Electing Out of the Installment Method.

“related person” is broadly defined to include most relationships under Sections 318(a) and 267(b) of the Code. I.R.C. § 453(f)(1).

¹⁰¹I.R.C. § 453(e)(5).

¹⁰²I.R.C. § 453(e)(2).

¹⁰³I.R.C. § 453(g)(1)(i).

¹⁰⁴I.R.C. § 453(g)(1)(C).

¹⁰⁵I.R.C. § 453(g)(2).

¹⁰⁶I.R.C. § 453(i).

a. General Rule. Unless otherwise elected, an installment sale must be reported on the installment method.¹⁰⁷ The Treasury Regulations prescribe the time and manner for electing out of the installment method.

b. Time and Manner for Making Election. An election out of the installment method must be made on or before the due date (including extensions) for filing the taxpayer's return for the tax year in which the installment sale occurs. A taxpayer is generally permitted to make the election by reporting the full amount of gain on the sale on the tax return filed for the tax year in which the installment sale occurs.¹⁰⁸ The election may be revoked only with the consent of the Service.¹⁰⁹

c. Treatment of an Installment Sale When a Taxpayer Elects Not To Report on the Installment Method. A taxpayer who elects out of the installment method must recognize gain on the sale in accordance with its accounting method.¹¹⁰ Special rules apply to contingent payment obligations.¹¹¹

10. Interest Charge Imposed on Tax Deferred in Certain Installment Sales.

a. Overview of Interest Charge. For certain installment sales, Section 453A of the Code imposes an interest charge on the income tax that is deferred under the installment method. The interest charge applies to an installment sale only if (1) the sale price with respect to such sale exceeds \$150,000; and (2) the aggregate face amount of all installment obligations arising during the year and held by the taxpayer exceeds \$5,000,000.¹¹²

(1) Sales Price Must Exceed \$150,000. Section 453A applies to installment obligations arising from the sale of any property with a sales price exceeding \$150,000, other than personal use property belonging to an individual, property used or produced in the trade or business of farming and certain timeshares and residential lots.¹¹³

(2) Aggregate Face Amount of Obligations Arising During Year Exceed \$5,000,000. The interest charge under Section 453A applies to an obligation arising in a tax year (the "Sale Year") only if:

¹⁰⁷Temp. Reg. § 15A.453-1(d)(1).

¹⁰⁸Temp. Reg. § 15A.453-1(d)(3)(i).

¹⁰⁹Temp. Reg. § 15A.453-1(d)(4).

¹¹⁰Temp. Reg. § 15A.453-1(d)(2)(i).

¹¹¹Temp. Reg. § 15A.453-1(d)(2)(iii).

¹¹²I.R.C. §§ 453A(b)(1)(b)(2).

¹¹³I.R.C. § 453A(b).

(a) The obligation is outstanding at the end of the Sale Year in which it arose; and

(b) The face amount of all installment obligations arising during such Sale Year and outstanding at year-end exceeds \$5,000,000.¹¹⁴

b. Computation of Interest Charge.

(1) **In General.** If Section 453A applies to an installment obligation, the tax deferred under the installment method is subject to an interest charge determined under Section 453A.¹¹⁵

(2) **Determining the Amount of the Interest Charge.** The amount of interest payable with respect to an obligation equals the “applicable percentage” of the “deferred tax liability” with respect to such obligation multiplied by the underpayment rate under Section 6621 in effect for the month within which the tax year ends.¹¹⁶

(3) **Deferred Tax Liability.** The deferred tax liability with respect to an installment obligation is the amount of gain under the obligation that has not been recognized as of year-end multiplied by the maximum tax rate in effect for the tax year.¹¹⁷ This rate will vary depending on whether the taxpayer is a corporation or is an individual, estate, or trust.¹¹⁸

(4) **Applicable Percentage.** The applicable percentage of an installment obligation is the percentage determined by dividing:

(a) The portion of the aggregate face amount of all installment obligations outstanding as of the end of the Sale Year in excess of \$5 million, by

(b) The aggregate face amount of the installment obligations outstanding as of the end of the Sale Year.¹¹⁹

Once determined, the applicable percentage does not change as payments on the obligation are made in subsequent tax years.¹²⁰

¹¹⁴I.R.C. §§ 453A(a) & (b)(2); *see* Notice 88-81, 1988-2 C.B. 399 (For partnerships and S corporations, the \$5 million threshold is applied, and interest calculations are made, at the partner and shareholder level).

¹¹⁵I.R.C. § 453A(c).

¹¹⁶I.R.C. § 453A(c)(2).

¹¹⁷I.R.C. § 453A(c)(3).

¹¹⁸I.R.C. § 453A(c)(3).

¹¹⁹I.R.C. § 453A(c)(4).

¹²⁰H.R. Rep. No. 495, 100th Cong., 1st Sess. 930 (1987).

c. Treatment in Subsequent Years. Once Section 453A applies to an installment obligation, interest must be paid for any subsequent tax year if the installment obligation is outstanding at the end of that year.¹²¹

11. Pledge of Certain Installment Obligations Treated as Receipt of Payment. Section 453A also imposes special rules generally applicable to pledges of installment obligations arising from the sale of property for a price exceeding \$150,000. If such an installment obligation is pledged as security for a debt, the net loan proceeds are treated as the receipt of payment on such installment obligation on the later of the date that the debt is secured or the date that the net proceeds are received by the taxpayer.¹²² The amount of gain recognized is equal to the product of the net loan proceeds received and the gross profit ratio applicable to the installment obligation.¹²³

D. Taxable Sale of Assets by a Partnership.

1. Tax Consequences to Partnership. Generally, a partnership is required to recognize gain or loss on the sale of property.¹²⁴ The Treasury Regulations provide that “[t]he general rule with respect to gain or loss realized upon the sale or exchange of property . . . is that the entire amount of gain or loss is recognized except in cases where specific provisions . . . provide otherwise.” The gain or loss is measured by the difference between the amount realized from the sale or other disposition of property and the partnership’s adjusted basis in the property.¹²⁵

2. Tax Consequences to Purchaser. The purchaser of assets in a taxable sale by a partnership generally will take a cost basis in the assets.¹²⁶

E. Taxable Sale of Partnership Interests.

1. Character of Gain or Loss on Sale of Partnership Interest.

a. General Rule. In the case of a sale or exchange of a partnership interest, gain or loss is recognized by the transferor partner and, subject to certain exceptions, is considered as a gain or loss from the sale or exchange of a capital asset (and therefore capital gain or loss).¹²⁷ The gain or loss is measured by the difference between the amount realized and

¹²¹I.R.C. § 453A(c)(1).

¹²²I.R.C. § 453A(d)(1); *see also* I.R.C. 453A(d)(2)(amount treated as received subject to limitation based upon total contract price).

¹²³H.R. Rept. No. 495, 100th Cong., 1st Sess. 930 (1987).

¹²⁴I.R.C. § 1001(c); *see* Treas. Reg. § 1.1002-1(a); *see also* I.R.C. § 1060(a) (requiring allocation of purchase price in the case of certain transfers involving a group of assets constituting a trade or business).

¹²⁵I.R.C. § 1001(a).

¹²⁶I.R.C. § 1012.

¹²⁷I.R.C. § 741.

the adjusted basis of the partnership interest.¹²⁸ This treatment applies regardless of whether the interest is sold to other members of the partnership or to persons who are not members of the partnership.¹²⁹ This rule also applies even though the sale of the partnership interest results in a termination of the partnership.¹³⁰

b. Exception for Section 751 Property. Section 751 of the Code was enacted to prevent the conversion of certain potential ordinary income into capital gain upon the sale or exchange of a partnership interest.¹³¹ Under this section, money or property received by a selling partner in exchange for all or any part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership.¹³² These items include (1) certain unrealized receivables of the partnership,¹³³ and (2) inventory items of the partnership.¹³⁴

(1) Definition of “Unrealized Receivables.” “Unrealized receivables” of a partnership include rights to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as ordinary income,¹³⁵ or (2) services rendered or to be rendered.¹³⁶ Both types of rights are unrealized receivables only to the extent not previously includible in income under the partnership’s method of accounting.¹³⁷ “Unrealized receivables” of a partnership also include a variety of recapture amounts with respect to partnership property.¹³⁸

(2) Definition of “Inventory Items.” The term “inventory items” means:

(a) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the

¹²⁸Treas. Reg. § 1.741-1.

¹²⁹Treas. Reg. § 1.741-1(b).

¹³⁰Treas. Reg. § 1.741-1(b).

¹³¹H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70, 71 (1954) [hereinafter “H.R. Rep. No. 1337”]; S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954) [hereinafter “S. Rep. No. 1622”].

¹³²I.R.C. § 751(a).

¹³³I.R.C. § 751(a)(1).

¹³⁴I.R.C. § 751(a)(2).

¹³⁵I.R.C. § 751(a)(1).

¹³⁶I.R.C. § 751(a)(2).

¹³⁷I.R.C. § 751(c).

¹³⁸I.R.C. § 751(c).

close of the tax year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business.¹³⁹

(b) Any other property that, on sale or exchange by the partnership, would be considered property other than a capital asset and other than Section 1231 property. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items, as do any unrealized receivables.¹⁴⁰

(c) Any other property held by the partnership that, if held by the selling or distributee partner, would be considered property of the type described above.¹⁴¹

c. Exception for Sales of Partnership Interests in Partnership Holding Appreciated Collectibles or Section 1250 Property. On September 21, 2000, the Service issued final regulations containing special rules applicable to capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or Section 1250 property with Section 1250 capital gain.¹⁴² These regulations provide that when a partner sells or exchanges a partnership interest held for more than one year, the partner may recognize ordinary income (e.g., under Section 751(a)), collectibles gain, Section 1250 capital gain and residual long-term capital gain or loss.¹⁴³ The regulations address to what extent a partner recognizes collectibles gain or Section 1250 gain when a partnership interest is sold or exchanged.¹⁴⁴

2. Purchasing Partner's Basis in His Partnership Interest.

a. General Rule. A purchasing partner's basis in his partnership interest is generally his cost.¹⁴⁵ Generally, the basis of partnership property is not adjusted as the result of a transfer of a partnership interest by sale or exchange unless a "Section 754 election" is in effect with respect to such partnership or unless the partnership has a substantial built in loss (as defined in Section 743(d)) immediately after such transfer.¹⁴⁶

b. Section 754 Election.

¹³⁹I.R.C. § 751(d)(1); Treas. Reg. § 1.751-1(d)(2)(i).

¹⁴⁰I.R.C. § 751(d)(2); Treas. Reg. § 1.751-1(d)(2)(ii).

¹⁴¹I.R.C. § 751(d)(4).

¹⁴²Treas. Reg. § 1.741-1(e).

¹⁴³See Treas. Reg. § 1.1(h)-1(a); T.D. 8902, 65 F.R. 57092-57101.

¹⁴⁴See Treas. Reg. § 1.1(h)-1(a); T.D. 8902, 65 F.R. 57092-57101.

¹⁴⁵I.R.C. §§ 742, 1012; Treas. Reg. § 1.742-1.

¹⁴⁶I.R.C. § 743(a).

(1) Adjustments to Basis of Partnership Property if Section 754 Election in Effect. If a partnership files a Section 754 election, the partnership adjusts the basis of partnership property in the case of a transfer of a partnership interest,¹⁴⁷ as follows:

(a) The partnership increases the adjusted basis of partnership property by the excess of the transferee partner's basis in his partnership interest over the partner's proportionate share of the adjusted basis to the partnership of partnership property;¹⁴⁸ or

(b) The partnership decreases the adjusted basis of partnership property by the excess of the transferee partner's proportionate share of the adjusted basis to the partnership of partnership property over the partner's basis in his partnership interest.¹⁴⁹

The increase or decrease is an adjustment to the basis of partnership property with respect to the transferee partner only.¹⁵⁰ The Treasury Regulations provide special rules for determining a transferee partner's proportionate share of the adjusted basis to the partnership of partnership property.¹⁵¹

(2) Allocation of Basis Adjustment. The amount of the basis adjustment made pursuant to an election under Section 754 is required to be allocated among partnership assets in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of those assets, or in any other manner permitted by the regulations.¹⁵² In applying the allocation rules, the basis adjustment is first allocated between (1) capital assets and property described in Section 1231(b) and (2) any other property of the partnership.¹⁵³ The portion of the basis adjustment allocated to each class is then allocated among the items within the class.¹⁵⁴

(3) Section 754 Election. A Section 754 election applies with respect to all transfers of interests in the partnership during the taxable year with respect to which

¹⁴⁷I.R.C. § 754.

¹⁴⁸I.R.C. § 743(b)(1).

¹⁴⁹I.R.C. § 743(b)(2).

¹⁵⁰I.R.C. § 743(b).

¹⁵¹Treas. Reg. § 1.743-1(d).

¹⁵²I.R.C. § 755(a).

¹⁵³I.R.C. § 755(b); Treas. Reg. § 1.755-1(a).

¹⁵⁴Treas. Reg. § 1.755-1(a).

such election was filed and all subsequent years.¹⁵⁵ An election may be revoked only with the consent of the Service.¹⁵⁶

3. Sale of Interest in Partnership with Liabilities. In determining the amount realized on a sale or exchange of a partnership interest, liabilities are treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.¹⁵⁷ Thus, if a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized.¹⁵⁸ For example, if a partner sells an interest in a partnership for \$750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of \$250, the seller realizes \$1,000 on the transaction.¹⁵⁹

4. Installment Sales of Partnership Interests. Gain recognized on the sale of a partnership interest is generally reportable under the installment method.¹⁶⁰ The Service has concluded, however, that the portion of the gain that is attributable to Section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the Section 751 property would be reportable under such method. Thus, in Revenue Ruling 89-108, the Service determined that the installment method was not available on a sale of a partnership interest to the extent the income was attributable to the partnership's inventory. The Service reasoned that a direct sale of personal property constituting inventory in the hands of the partner would not be eligible for the installment method.¹⁶¹

5. Sale of 50-Percent or More of the Total Interest in Partnership Capital and Profits. A partnership terminates for federal income tax purposes when 50-percent or more of the total interests in partnership capital and profits is sold or exchanged within a period of 12 consecutive months.¹⁶² The federal income tax consequences of this technical termination are discussed below.

¹⁵⁵I.R.C. § 754.

¹⁵⁶I.R.C. § 754; Treas. Reg. §§ 1.754-1(a), 1.754-1(c).

¹⁵⁷I.R.C. § 752(d).

¹⁵⁸Id.

¹⁵⁹Treas. Reg. § 1.752-1(h).

¹⁶⁰Rev. Rul. 76-483, 1976-2 C.B. 131; *see* Rev. Rul. 89-108, 1989-2 C.B. 100.

¹⁶¹Rev. Rul. 89-108; *see* I.R.C. § 453(b)(2)(B); *cf.* 1995 FSA LEXIS 124 (Sept. 11, 1995) (“With regard to the sale of a partnership interest, gain recognized is generally reportable under the installment sale provisions. The sale is treated, however, as a sale of proportionate shares of the partnership's assets. Section 453A(e)(2). Accordingly, installment sale treatment is not available to the extent the partnership assets represent unrealized receivables or inventory items. Sections 453(b)(2)(B) and 751(a); Rev. Rul. 89-108.”). For an in-depth discussion of the various federal income tax issues associated with selling a partnership interest on the installment basis, *see* Jackel, “Installment Sales of Partnership Interests: Aggregate or Entity,” 95 TNT 202-75 (Oct. 16, 1995).

¹⁶²I.R.C. § 708(b)(1)(B); Treas. Reg. § 1.708-1(b)(2).

a. Sale or Exchange Requirement. For purposes of the partnership termination rules, a sale or exchange includes a sale or exchange to another member of the partnership.¹⁶³ A disposition, however, of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange.¹⁶⁴ Moreover, the contribution of property to a partnership does not constitute a sale or exchange for purposes of these rules.¹⁶⁵ If the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.¹⁶⁶

b. Taxable Year. A partnership taxable year closes with respect to all partners on the date on which the partnership terminates.¹⁶⁷

c. Form of Termination if a Partnership Is Terminated by a Sale or Exchange. If a partnership is terminated by a sale or exchange of a partnership interest, the following is deemed to occur:

(1) The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter,

(2) The terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up.¹⁶⁸

d. Capital Accounts. The deemed contribution of assets to a new partnership and the distribution of the new partnership interests to the partners of the terminated

¹⁶³Treas. Reg. § 1.708-1(b)(2).

¹⁶⁴Treas. Reg. § 1.708-1(b)(2).

¹⁶⁵Treas. Reg. § 1.708-1(b)(2).

¹⁶⁶Treas. Reg. § 1.708-1(b)(2).

¹⁶⁷I.R.C. § 706(c)(1); Treas. Reg. § 1.708-1(b)(3); *see also* Notice 2001-5, 2001-1 C.B. 327 (“[A] partnership that terminates under section 708(b)(1)(B) is required to file a short-year final return for the taxable year ending with the date of its termination. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership.”).

¹⁶⁸Treas. Reg. § 1.708-1(b)(4); *see generally* Grace, “Interaction of the Final Regs. on Partnership Technical Terminations with TRA ‘97,” 14 J. Partnership Tax’n, 275 (Winter 1998) (detailed analysis of technical termination of a partnership).

partnership are disregarded for purposes of maintaining capital accounts.¹⁶⁹ As a result, the termination of a partnership does not change the capital accounts of the partners or the books of the partnership. The capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership.¹⁷⁰

e. Section 704(c) Property. The deemed contribution of assets to a new partnership does not create additional Section 704(c) property.¹⁷¹ The new partnership is not bound by the Section 704(c) method used by the terminated partnership.¹⁷²

f. Employer Identification Number. The new partnership retains the Employer Identification Number (“EIN”) of the terminated partnership.¹⁷³

g. Section 754 Election. If a partnership is terminated by a sale or exchange of an interest in the partnership, a Section 754 election (including a Section 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted prior to their deemed contribution to the new partnership.¹⁷⁴

h. Example. Suppose that A and B each contribute \$10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for \$20,000. Property X increases in value to \$30,000, at which time A sells its entire 50-percent interest to C for \$15,000 in a transfer that terminates the partnership. At the time of the sale, Property X had an adjusted tax basis of \$16,000 and a book value of \$16,000 (original \$20,000 tax basis and book value reduced by \$4,000 of depreciation). In addition, A and B each had a capital account balance of \$8,000 (original \$10,000 capital account reduced by \$2,000 of depreciation allocations with respect to Property X).

Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is \$16,000. The book value of Property X in the hands of new partnership AB is also \$16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of \$8,000 in new AB (the balance of their capital accounts in AB prior to the termination). The deemed contribution and liquidation with regard to the terminated partnership are disregarded in

¹⁶⁹See Treas. Reg. § 1.704-1(b)(2)(iv)(1).

¹⁷⁰Treas. Reg. § 1.704-1(b)(2)(iv)(1).

¹⁷¹Treas. Reg. § 1.704-3(a)(3)(i).

¹⁷²Treas. Reg. § 1.704-3(a)(2).

¹⁷³Treas. Reg. § 301.6109-1(d)(2)(iii).

¹⁷⁴Treas. Reg. § 1.708-1(b)(5).

determining the capital accounts of the partners and the books of the new partnership. New AB retains the employer identification number of the terminated AB partnership.

Property X was not Section 704(c) property in the hands of terminated AB and is therefore not treated as Section 704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the fair market value of Property X (\$30,000) was different from its adjusted tax basis (\$16,000).¹⁷⁵

6. Special Issues Relating to 2-Member Limited Liability Companies.

The Revenue Service has issued guidance with respect to sales of interests in 2-member limited liability companies (“LLCs”).

a. Existing Member in 2-Member LLC Purchases All Ownership Interests Held by Other Member. In Revenue Ruling 99-6, the Revenue Service addressed the federal income tax consequences if an existing member of a 2-member domestic LLC (classified as a partnership) purchases all of the ownership interests in the LLC from the other member and thereby causes the LLC’s status as a partnership to terminate.¹⁷⁶ Under the Ruling, the partnership terminates and the Ruling concludes that the selling partner should treat the transaction as the sale of a partnership interest and report the gain or loss, if any, resulting from the sale of its partnership interest in accordance with the general rules applicable to a sale of a partnership interest.¹⁷⁷ With respect to the purchasing partner, the Ruling holds that, for purposes of determining the tax treatment of the purchasing partner, the partnership is deemed to make a liquidating distribution of all of its assets to the purchasing partner and the selling partner, and following this distribution, the purchasing partner is treated as acquiring the assets deemed to have been distributed to the selling partner in liquidation of the selling partner’s partnership interest.

To illustrate, assume that A and B are equal partners in TexLLC, a Texas limited liability company classified as a partnership for federal income tax purposes. TexLLC does not hold any unrealized receivables or inventory items. Suppose further that TexLLC is not liable for any indebtedness and none of its assets are subject to any indebtedness. Suppose that A sells A’s entire interest in TexLLC to B for \$10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

Under Revenue Ruling 99-6, the AB partnership terminates when B purchases A’s entire interest in AB. A must treat the transaction as the sale of a partnership interest¹⁷⁸ and report gain or loss, if any, resulting from the sale of A’s partnership interest.

For purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is

¹⁷⁵See Treas. Reg. § 1.708-1(b)(4), Example.

¹⁷⁶Rev. Rul. 99-6, 1999-1 C.B. 432,

¹⁷⁷Id.

¹⁷⁸Treas. Reg. § 1.741-1(b).

treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest.¹⁷⁹ B's basis in the assets attributable to A's one-half interest in the partnership is \$10,000, the purchase price for A's partnership interest.¹⁸⁰ B's holding period for these assets begins on the day immediately following the date of the sale.

Upon the termination of AB, B is considered to receive a distribution of those assets attributable to B's former interest in AB. B must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by the partnership distribution provisions of the Code.¹⁸¹ B's basis in the assets received in the deemed liquidation of B's partnership interest is equal to B's basis in his partnership interest reduced by any money distributed in the same transaction.¹⁸² B's holding period for the assets attributable to B's one-half interest in AB includes the partnership's holding period for such assets.¹⁸³

b. Third Party Purchases All Ownership Interests in 2-Person LLC. In Revenue Ruling 99-6, the Revenue Service also addresses the federal income tax consequences if the two members in a 2-member LLC classified as a partnership for federal income tax purposes sell all of their LLC interests to a third party and thereby cause the LLC's status as a partnership to terminate. The Ruling holds that the selling partners should treat the transaction as the sale of a partnership interest¹⁸⁴ and should report gain or loss, if any, resulting from the sale of their partnership interest in accordance with the general rules applicable to a sale of a partnership interest.¹⁸⁵ The Ruling also concludes that, for purposes of classifying the acquisition by the third party, the partnership is deemed to make a liquidating distribution of its assets to the pre-sale partners. Immediately following this distribution, the third party purchaser is deemed to acquire, by purchase, all of the former partnership's assets.

To illustrate, assume that C and D are equal partners in CD, an LLC classified as a partnership for federal income tax purposes. C and D sell their entire interests in CD to E, an unrelated person, in exchange for \$10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E. Under the Ruling, CD's status as a partnership terminates when E purchases the entire interests of C and D in CD. C and D must report gain or loss, if any, resulting from the sale of partnership interests for federal income tax purposes. For purposes of classifying the acquisition by E, the CD partnership is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, by

¹⁷⁹Rev. Rul. 99-6.

¹⁸⁰I.R.C. § 1012.

¹⁸¹See I.R.C. § 731(a).

¹⁸²I.R.C. § 732(b).

¹⁸³I.R.C. § 735(b); see Rev. Rul. 99-6.

¹⁸⁴Treas. Reg. § 1.741-1(b); Rev. Rul. 99-6.

¹⁸⁵Rev. Rul. 99-6.

purchase, all of the former partnership's assets. E's basis in the assets is \$20,000. E's holding period for the assets begins on the day immediately following the date of sale.¹⁸⁶

c. Third Party Purchases Interest in LLC. In Revenue Ruling 99-5,¹⁸⁷ the Service analyzed the federal income tax treatment of a sale of an interest in an LLC by the existing sole member of the entity. In that Ruling, the LLC has a single owner, A, and is disregarded as an entity separate from its owner for federal tax purposes. The Ruling states that the LLC would not be treated as an investment company (within the meaning of Section 351) if it were incorporated. All of the assets held by each LLC are capital assets or property described in Section 1231. For the sake of simplicity, the Ruling assumes that the LLC is not liable for any indebtedness and that the assets of the LLCs are not subject to any indebtedness. In Situation 1 of the Ruling, B, who is not related to A, purchases 50% of A's ownership interest in the LLC for \$5,000. A does not contribute any portion of the \$5,000 to the LLC. A and B continue to operate the business of the LLC as co-owners of the LLC. The Ruling holds that, in this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

In Situation 2 of Revenue Ruling 99-5, B, who is not related to A, contributes \$10,000 to the LLC in exchange for a 50% ownership interest in the LLC. The LLC uses all of the contributed cash in its business. A and B continue to operate the business of the LLC as co-owners of the LLC. In this situation, the Ruling holds that the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.¹⁸⁸

¹⁸⁶Rev. Rul. 99-6, 1999-1 C.B. 432

¹⁸⁷1999-1 C.B. 434.

¹⁸⁸See Priv. Ltr. Rul. 200934013 (Aug. 21, 2009) ("The admission of Shareholder A to LLC caused LLC to convert to a partnership for U.S. federal income tax purposes. Pursuant to Rev. Rul. 99-5, CORP, as the sole owner of LLC prior to the admission of Shareholder A, is deemed to contribute the existing assets of LLC to the newly-formed LLC partnership in exchange for a membership interest in LLC. This deemed transaction is treated as a contribution of property to LLC by CORP within the meaning of § 721(a). Additionally, because the assets of LLC are represented to be a diversified portfolio of assets within the meaning of § 1.351-1(c)(6)(i), CORP's contribution of these assets, when combined with Shareholder A's contribution of cash, does not cause LLC to be treated as an investment company within the meaning of § 351(e) if LLC were incorporated. Therefore, § 721(b) does not apply to Shareholder A's contribution of cash and to CORP's deemed contribution of property to LLC."); Priv. Ltr. Rul. 200910030 (Mar. 6, 2009) ("Upon the distribution of the LLC interests pro rata to the shareholders of Taxpayer on Date 5, a distribution of property to which section 311(b) applies, gain on the deemed sale of the Stock shall be recognized to Taxpayer in its taxable year ending at that time."); Priv. Ltr. Rul. 200825008 (June 20, 2008) ("The distribution of membership interests in LLC will be taxed under the principles set forth in Rev. Rul. 99-5, 1999-1

F. Taxable Stock Sales.

1. General Rule. If the stock of a corporation is sold in a taxable sale, the selling shareholder recognizes gain or loss from their sale of stock. The gain or loss is measured by the difference between the amount realized by the shareholder from the sale and the taxpayer's adjusted basis in the stock.¹⁸⁹ The amount realized from the sale is the sum of any money plus the fair market value of property received.¹⁹⁰ The purchaser of the stock takes a basis in the stock equal to his cost.¹⁹¹

If all of the stock of a C corporation is acquired in a taxable sale, the basis of assets inside the acquired corporation does not change to reflect the stock purchase price.¹⁹² If a corporation

C.B. 434. For federal income tax purposes, the distribution of the membership interests in LLC will be treated as a distribution to the Partners of LLC's assets and liabilities, immediately followed by a deemed contribution of those assets to a new LLC. Pursuant to § 731(a) gain shall not be recognized by the Partners on the distribution of the LLC assets, except to the extent any money distributed exceeds a Partner's basis in the Partner's partnership interest."); Priv. Ltr. Rul. 200812012 (Mar. 21, 2008) ("On Date I, pursuant to the Termination Plan, the Trust distributed all of its shares in Successor Entity, which then held almost all of the Trust's real estate and other investment operation assets, including its interests in LLC, to the remainder beneficiaries. Under Rev. Rul. 99-5, 1999-1 C.B. 434, the distribution of the shares to the remainder beneficiaries is treated as a distribution of Trust's assets followed by a recontribution of those assets by the remainder beneficiaries to Successor Entity. Because assets held by Successor Entity include a greater than 50 percent interest in LLC, this distribution and deemed recontribution of the shares resulted in a § 708(b)(1)(B) termination of LLC."); Priv. Ltr. Rul. 200701032 (Jan. 5, 2007) ("Because the contractual arrangement is treated as a business entity, the transfer of the interest to the second owner should be analyzed in accordance with the holding of Situation One of Rev. Rul. 99-5."); Priv. Ltr. Rul. 200613025 (Mar. 31, 2006) ("P was created as a limited liability company with a single owner, and, thus, disregarded as an entity separate from its owner, T, for federal tax purposes. When T distributes interests in P to the Bs, P will convert from a disregarded entity to a partnership. In addition, each B that receives an interest in P will be treated as receiving a proportionate share of the P's Assets, subject to a proportionate share of P's liabilities, and immediately thereafter, each B will be treated as contributing those Assets subject to the liabilities to a partnership in exchange for ownership interests in the partnership. See Rev. Ru,l. 99-5, 1991-1 C.B. 434. Because P will thus received property subject to the Debt, and receive no cash Debt proceeds, P effectively will be treated as borrowing the balance of the Debt and investing the proceeds in the property so received.); Priv. Ltr. Rul. 200512020 (Mar. 25, 2005) ("Because the Primary Trust is treated as a business entity, the transfer of the interest to the second owner should be analyzed in accordance with the holding of Situation One of Rev. Rul. 99-5.").

¹⁸⁹I.R.C. § 1001(a).

¹⁹⁰I.R.C. § 1001(b).

¹⁹¹I.R.C. § 1012.

¹⁹²The Service has ruled that a subsidiary used to acquire the stock of a target corporation in a reverse subsidiary cash merger should be disregarded for federal income tax purposes if it was formed solely for the purpose of acquiring stock and did not conduct any activities other than those required for the merger. See Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 79-273, 1972-2 C.B. 125; Rev. Rul. 90-95, 1990-2 C.B. 67. The Service concluded that such a transaction is properly viewed as the acquiring corporation's direct acquisition of target stock.

In Revenue Ruling 73-427, 1973-2 C.B. 301, corporation P had purchased 97.9% of the outstanding stock of corporation Y for cash. In order to acquire the remaining 2.1% of the Y stock outstanding, P created S, a wholly owned subsidiary, by contributing P stock and a small amount of cash (sufficient to meet the capital requirements of state law) to S in exchange for all the S stock. S then merged into Y. By operation of state law, all S stock held by P was converted into Y stock. Y distributed all of the P stock to Y's minority shareholders in return for their Y stock. The small amount of cash transferred from S to Y in the merger was returned to Y. The ruling held that the

acquires 80-percent or more of the stock of another corporation within a 12-month period in a taxable purchase, an election is available under certain circumstances to recognize corporate level gain and pay corporate level tax on such gain.¹⁹³

2. 50-Percent Exclusion of Gain for Certain Stock in Small Business.

Current tax law also generally allows a noncorporate taxpayer who holds certain qualified small business stock for more than 5 years to exclude 50-percent of any gain on the sale or exchange of the stock.¹⁹⁴ The amount of gain eligible for the 50-percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) \$10 million gain from stock in that corporation.¹⁹⁵ For qualified small business stock acquired from February 18, 2009, through December 31, 2010, and held for five years, the percentage exclusion is 75-percent.¹⁹⁶

3. Section 1244 Stock.

Generally, a loss incurred by an individual taxpayer on a sale or exchange of corporate stock is characterized and reported for federal income tax purposes as a capital loss.¹⁹⁷ Section 1244(a) provides a limited exception to this general rule in that it allows an individual taxpayer to treat a loss on "section 1244 stock" as an ordinary loss where it would otherwise be treated as a loss from the sale or exchange of a capital asset. The aggregate amount of the loss that may be treated as an ordinary loss under section 1244 cannot exceed \$50,000 (\$100,000 in the case of a husband and wife filing a joint return).¹⁹⁸ The term "section 1244 stock" generally means stock of a qualifying domestic small business corporation

transaction would be treated for federal income tax purposes as though P transferred its stock directly to the minority shareholders of Y in exchange for their Y stock.

The Service similarly concluded in Rev. Rul. 79-273, 1979-2 C.B. 125, that the cash acquisition of the target corporation's stock by means of a reverse subsidiary merger represents a sale of such stock by the target corporation's shareholders to the acquiring corporation. That Ruling involves two unrelated corporations, X and P. X desired to purchase the P stock for cash, but not the business of P's subsidiary, S. X formed Z. Z was merged into P. The shareholders of P received the cash contributed to Z by X and stock of S. The Ruling ignores the transitory existence of Z and treats the transaction as an integrated plan to directly acquire a portion of the P stock by X for cash, and a redemption of P's remaining stock with P property (i.e., the S stock.).

In Situation 1 of Rev. Rul. 90-95, 1990-2 C. B. 67, corporation P formed a wholly owned corporation, S, for the sole purpose of acquiring all of the stock of an unrelated target corporation, T, by means of a reverse subsidiary cash merger. The only activities that S conducted were those required by the merger. Pursuant to a plan of merger, S merged into T with T surviving. The shareholders of T exchanged all of their T stock for cash from S. Part of the cash used to carry out the acquisition was received by S from P, and the remaining cash was borrowed by S. Following the merger, P owned all of the stock of T. The Service held that because S had no significance apart from P's acquisition of the T stock, the step transaction doctrine should be applied to disregard the existence of S for federal income tax purposes. Accordingly, the Service held that the transaction should be treated as a qualified stock purchase (under I.R.C. section 338) of T stock by P.

¹⁹³ See I.R.C. § 338.

¹⁹⁴ I.R.C. § 1202(a).

¹⁹⁵ I.R.C. § 1202(b)(1).

¹⁹⁶ I.R.C. § 1202(a)(3) (as added by the American Recovery and Reinvestment Tax Act of 2009).

¹⁹⁷ See I.R.C. §§ 165(f) and (g).

¹⁹⁸ I.R.C. § 1244 (b)(2).

(as defined in the statute) that was issued for money or other property (other than stock or securities).¹⁹⁹ The corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, must have derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.²⁰⁰

G. Taxable Asset Sales by a C Corporation.

1. Corporate Income Tax Rates. The taxable income of a C corporation is subject to federal income tax at graduated rates ranging from 15-percent to 35-percent.²⁰¹

a. Corporate Tax Rate Schedule. The tax rate schedule for a C corporation is as follows:²⁰²

If taxable income is:			
Over--	But not over--	Tax is:	Of the amount over--
\$0	\$50,000	15%	-0-
\$50,000	\$75,000	\$7,500 + 25%	\$50,000
\$75,000	\$100,000	\$13,750 + 34%	\$75,000
\$100,000	\$335,000	\$22,250 + 39% ²⁰³	\$100,000
\$335,000	\$10,000,000	\$113,900 + 34%	\$335,000
\$10,000,000	\$15,000,000	\$3,400,000 + 35%	\$10,000,000
\$15,000,000	\$18,333,333	\$5,150,000 + 38% ²⁰⁴	\$15,000,000
\$18,333,333	--	35%	-0-

Under current law, the capital gains of a corporation are taxed at the same rates as ordinary income.²⁰⁵

b. Tax Rate Applicable to Qualified Personal Service Corporation. A qualified personal service corporation is taxed at a flat rate of 35-percent on taxable income.²⁰⁶ Generally, a personal service corporation is one substantially all of the

¹⁹⁹ I.R.C. § 1244(c).

²⁰⁰ I.R.C. § 1244(c)(1)(C).

²⁰¹ I.R.C. §§ 11(a), 11(b).

²⁰² I.R.C. § 11(a).

²⁰³ The tax rate for a C corporation with taxable income in excess of \$100,000 is increased by the lesser of (i) 5 percent of such excess, or (ii) \$11,750. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 5 percent of tax is imposed on taxable income between \$100,000 and \$335,000.

²⁰⁴ The tax rate for corporations with taxable income in excess of \$15,000,000 is increased by the lesser of (i) 3 percent of such excess, or (ii) \$100,000. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 3 percent of tax is imposed on taxable income between \$15,000,000 and \$18,333,333.

²⁰⁵ See I.R.C. § 1201(a).

²⁰⁶ I.R.C. § 11(b)(2).

activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and substantially all of the stock of which is held by employees or retired employees or by their estates or by certain persons who acquired the stock from a deceased employee and who have held the stock for 2 years or less.²⁰⁷

2. Consequences of Corporate Sale and Liquidation. If the assets of a corporation are sold in a taxable sale, the selling corporation recognizes gain or loss and the buyer obtains a cost basis for the assets.²⁰⁸ If the corporation is then liquidated and the proceeds of the sale are distributed to the individual shareholders of the selling corporation, the distribution (to the extent it exceeds the shareholder's basis in his stock) is subject to taxation again in the hands of the shareholders (generally as capital gain).²⁰⁹

H. Section 338. Section 338 allows certain purchasers of stock to treat the purchases as purchases of assets. A purchasing corporation can elect to treat a stock acquisition as an asset acquisition if it acquires 80 percent of the total voting power and 80 percent of the total value of the stock of a target corporation²¹⁰ (not taking into account certain preferred stock) by purchase within a 12-month period.²¹¹ If a purchasing corporation makes a Section 338 election, the target is treated as if it (as old target) sold all of its assets at the close of the acquisition date at fair market value in a single transaction and (as new target) purchased all of the assets as of the beginning of the date after the acquisition date.²¹² The following is a summary of the elections available under Sections 338(g) and 338(h)(10).²¹³

1. Election Under Section 338(g). If a purchasing corporation acquires the stock of a target corporation in a qualified stock purchase and makes a Section 338(g) election (i.e., makes a general Section 338 election, not a Section 338(h)(10) election), old target's gain or loss from the deemed asset sale is included in old target's final return²¹⁴ unless old target is a

²⁰⁷I.R.C. § 448(d)(2); *see* Treas. Reg. § 1.448-1T(e).

²⁰⁸I.R.C. § 1001(a).

²⁰⁹I.R.C. § 331.

²¹⁰I.R.C. § 338(d)(3). In Rev. Rul. 69-6, 1969-1 C.B. 104, a state chartered savings and loan association ("State S&L") proposed to merge into a federally chartered non-stock membership savings and loan ("Federal S&L"), with the owners of the State S&L receiving mostly cash equivalent consideration from the merger. The Service ruled that, since the merger of the State S&L into the Federal S&L was a taxable transaction, the merger would be treated as (a) a sale of the State S&L's assets to the Federal S&L, with gain being recognized by the State S&L equal to the difference between the amount of consideration received and the basis of the property transferred to the Federal S&L, followed by (b) a liquidating distribution to the State S&L shareholders pursuant to Section 331(a) of the Code with gain or loss being recognized by the State S&L shareholders equal to the difference between the amount the shareholders received in the distribution and their basis in the State S&L stock.

²¹¹I.R.C. § 338(a).

²¹²I.R.C. § 338(a).

²¹³Treas. Reg. § 1.338-1(a).

²¹⁴Treas. Reg. § 1.338-10(a)(1).

member of a consolidated group or is an S corporation. In the consolidated and S corporation cases, old target files a special final return.²¹⁵ In the consolidated case, that return is not consolidated with either the selling corporation's or the purchasing corporation's consolidated group.²¹⁶ In the S corporation case, old target must file the special final return as a C corporation.²¹⁷ The Section 338(g) election (as opposed to a Section 338(h)(10) election) generally does not change the tax treatment of the selling shareholders -- that is, they are still taxed on their stock sale, notwithstanding the purchasing corporation's Section 338(g) election. The benefit of an election under Section 338(g) is economically valuable to a purchasing corporation only in limited situations because the present value of the future tax savings resulting from the increase in the basis of the target's assets will rarely exceed the current tax cost of the Section 338(g) election.²¹⁸

2. Election Under Section 338(h)(10). In certain cases, the selling shareholders may join with the purchasing corporation in making a Section 338(h)(10) election. Until 1994, a Section 338(h)(10) election could be made only for target corporations that were members of a consolidated group. The 1994 revisions to the Section 338 regulations (effective retroactively to 1992 at taxpayers' election) expanded the eligibility for Section 338(h)(10) elections to target corporations that are members of an affiliated group and S corporations.²¹⁹ The Section 338(h)(10) election changes the tax treatment of old target and the selling shareholders. Old target is deemed to sell all its assets in a single transaction while a member of the selling consolidated group (or while a non-consolidated affiliate, or while an S corporation owned by the selling shareholders) and is deemed immediately thereafter to distribute the proceeds in complete liquidation to the members of the selling consolidated group who sold the target stock (or to the selling affiliate or to all the S corporation shareholders).²²⁰ Thus, under Section 338(h)(10), the selling shareholders are not treated as selling stock but instead realize gain or loss, if any, on the stock in the deemed liquidation.²²¹ Usually, a selling consolidated group or selling affiliate will recognize no stock gain or loss on the deemed liquidation under Section 332.²²² S corporation shareholders will include their share of items of income, gain, loss, or deduction on the deemed asset sale passed through to them under Section 1366, increase or

²¹⁵Treas. Reg. § 1.338-10(a)(2); Treas. Reg. § 1.338-10(a)(3).

²¹⁶Treas. Reg. § 1.338-10(a)(2).

²¹⁷Treas. Reg. § 1.338-10(a)(3).

²¹⁸ Mark J. Silverman, *Section 338*, in 3 PLI CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 7, 19-20 (Louis S. Freeman ed., 2009).

²¹⁹Notice of Proposed Rulemaking, REG -107069-97; 64 F.R. 43462-43503, *reprinted in* 1999 TNT 158-8.

²²⁰Treas. Reg. § 1.338(h)(10)-1(d)(3); Treas. Reg. § 1.338(h)(10)-1(d)(4).

²²¹Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

²²²See Treas. Reg. § 1.338(h)(10)-1(d)(5)(i); Notice of Proposed Rulemaking, REG -107069-97; 64 F.R. 43462-43503, *reprinted in* 1999 TNT 158-8.

decrease their basis accordingly under Section 1367, and then recognize any remaining gain or loss in their stock under Section 331.²²³

I. S Corporation Considerations. There are special considerations which apply to acquisitions by S corporations and acquisitions of S corporations. A detailed discussion of these considerations is beyond the scope of this outline.

II: TAX-FREE ACQUISITIONS.

A. Tax Treatment of Contributions to a Corporations Using Section 351.

1. General Rule of Nonrecognition. Generally, no gain or loss is recognized to the corporation or to the contributing shareholder, in the case of contributions of property to a corporation solely in exchange for stock of the corporation, by one or more persons who have control of the corporation immediately after the exchange.²²⁴ Transferors are in control of a transferee corporation if, immediately after the transfer, they own stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80-percent of the total number of share of all other classes of stock of such corporation.²²⁵ (The control requirement for tax-free contributions by shareholders differs from the treatment under the partnership rules, which do not require that the partner control the partnership for his contribution to be tax-free.)

In addition to the statutory requirements of Section 351, the Revenue Service takes the position that a transaction meeting the statutory elements of Section 351 does not qualify for nonrecognition if it lacks a non-tax, business purpose.²²⁶ One court has expressly held that the transfer of property to a controlled corporation must have a business purpose to qualify under Section 351.²²⁷

²²³Treas. Reg. § 1.338(h)(10)-1(d)(5).

²²⁴I.R.C. § 351(a); Treas. Reg. § 1.351-1(a)(1).

²²⁵I.R.C. §§ 351(a), 368(c); Treas. Reg. § 1.351-1(a)(1).

²²⁶*See, e.g.*, ILM 200242006 (Jun. 27, 2002) (“Courts have held that a transaction meeting the statutory elements of §351 does not qualify for nonrecognition if it lacks a non-tax business purpose . . . You have indicated that the facts as currently developed do not suggest a plausible business purpose for the putative §351 transactions. If the Taxpayer does provide a purported business purpose for this transaction you should attempt to get as many details as possible and address any defects in that explanation.”); ILM 200235005 (May 15, 2002) (“Generally, section 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings.”); FSA 200224011 (Mar. 5, 2002) (“In addition to satisfying the technical requirements of § 351, a transfer must have a bona fide business purpose in order to qualify as a § 351 exchange.”); FSA 200135001 (Jul. 16, 1999) (“If the transfers to Sub2 lack a business purpose, the transfers would be treated as taxable sales under I.R.C. section 1001.”).

²²⁷*See Caruth v. United States*, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), *aff’d on other issues*, 865 F.2d 644 (5th Cir. 1989); *cf. Stewart v. Commissioner*, 714 F.2d 977, 989 (9th Cir. 1983) (“Both section 482 and the substance-over-form doctrine have been held to limit the extent to which a taxpayer may obtain nonrecognition treatment under section 351 for a transaction that appears formally to fall within the bounds of the provision.”); *Estate of Kluener v. Commissioner*, 154 F.3d 630, 634 (6th Cir. 1998) (“Therefore, a shareholder may use §351 so

2. Receipt of Boot.

a. Transferor Recognizes Gain upon Receipt of Boot. If the transferor in a transaction subject to Section 351(a) receives not only the transferee corporation's stock but also other property or money ("boot"), the transferor is required to recognize gain.²²⁸ The amount of gain recognized, however, is limited to the amount of money received plus the fair market value of other property received. Any loss to the transferor is not recognized.²²⁹

b. Certain Preferred Stock Treated as Boot. Certain preferred stock is treated as boot for purposes of Section 351.²³⁰ (For this purpose, the term "preferred stock" means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Stock is not treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.²³¹ If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.²³²) Preferred stock treated as boot is referred to as "nonqualified preferred stock." Nonqualified preferred stock ("NQPS") is defined as preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.²³³ Factors (1), (2), and (3) above will cause an instrument to be NQPS only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.²³⁴

The foregoing rights or obligations do not cause preferred stock to be NQPS in certain prescribed circumstances.²³⁵ In one exception, if neither the stock surrendered nor the stock received in the exchange is stock of a publicly-traded corporation, a right or obligation is

long as some valid, non-tax business purpose partially motivated the transfer, even if tax concerns also played a major role. Stewart, 714 F.2d at 987."), *aff'g in part and rev'g in part* 72. T.C.M. (CCH) 1326 (1996).

²²⁸I.R.C. § 351(b)(1).

²²⁹I.R.C. § 351(b)(2).

²³⁰I.R.C. § 351(g)(1).

²³¹I.R.C. § 351(g)(3)(A) (as amended by The American Jobs Creation Act of 2004).

²³²I.R.C. § 351(g)(3)(A).

²³³I.R.C. § 351(g)(2)(A).

²³⁴I.R.C. § 351(g)(2)(B).

²³⁵See I.R.C. § 351(g)(2)(C).

disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder.²³⁶ In another exception, a redemption or purchase right does not cause stock to be NQPS if the stock containing the right is transferred in connection with the performance of services for the issuer or a related person (and represents reasonable compensation), and the right may be exercised only upon the holder's separation from service.²³⁷

3. Treatment of Liabilities. A transferor in a Section 351 exchange is generally not treated as receiving boot where the acquiring corporation assumes a liability of the transferor.²³⁸ One exception to this general rule provides that if, in connection with the transfer of property to a controlled corporation, the transferor's principal purpose for having the controlled corporation assume a liability of the transferor or take the property subject to a liability: (1) is to avoid federal income tax on the exchange, or (2) is not a bona fide business purpose, then the total amount of liability assumed will be treated as money received by the taxpayer on the exchange.²³⁹ If this exception applies and the transferor has realized gain on the Section 351 exchange, the transferor will recognize that gain to the extent of the boot deemed received under this provision.²⁴⁰

Another exception to the general rule provides that if total liabilities assumed exceed the adjusted basis of all the property transferred, the excess is considered gain from the sale or exchange of the property transferred. This exception does not treat the assumption of excess liabilities as money received by the transferor. Instead it provides that the excess must be considered as gain.²⁴¹ Certain liabilities are excluded from the provisions of this exception.²⁴²

4. Transfers to an Investment Company. The nonrecognition rule of Section 351(a) does not apply to "a transfer of property to an investment company." A transfer of property will be considered to be "a transfer to an investment company" if: (i) the transfer results in diversification of the transferor's interests;²⁴³ and (ii) the transferee is a regulated

²³⁶I.R.C. § 351(g)(2)(c)(i)(I) & (g)(2)(c)(ii).

²³⁷I.R.C. § 351(g)(2)(C)(i)(II).

²³⁸I.R.C. § 357(a); Treas. Reg. § 1.357-1(a).

²³⁹I.R.C. § 357(b); Treas. Reg. § 1.357-1(c).

²⁴⁰I.R.C. § 357(b); Treas. Reg. § 1.357-1(c).

²⁴¹I.R.C. § 357(c)(1); Treas. Reg. § 1.357-2(a).

²⁴²See I.R.C. § 357(c)(3).

²⁴³See Staff of the Joint Committee on Taxation, 105th Cong., *General Explanation of Tax Legislation Enacted in 1997*, 184 (1997) ("The bill is intended to change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. reg. sec. 1.351-1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351-1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionately by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351-1(c)(4)), (3) the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. reg. sec. 1.351-1(c)(2)), and (4) the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas.

investment company, a real estate investment trust, or a corporation more than 80-percent of the value of whose assets are:

a. Held for investment; and

b. Consist of money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in real estate investment trusts, regulated investment companies, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed in the statute.²⁴⁴ Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are listed assets,²⁴⁵ and to the extent provided in regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to listed assets.²⁴⁶

A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets in the exchange.²⁴⁷

5. Basis.

a. Basis of Property Received by the Transferee Corporation. A corporation's basis in property acquired in a transaction to which Section 351(a) applies is generally the same as it would be in the hands of the transferor, increased by the amount of gain recognized by the transferor on the transfer.²⁴⁸ Section 362(e), as enacted by the American Jobs Creation Act of 2004, provides that if the aggregate adjusted bases of property contributed by a transferor to a corporation exceed the aggregate fair market value of the property transferred in a transaction subject to Section 351(a), the transferee's aggregate bases of the property is limited to the aggregate fair market value of the transferred property.²⁴⁹ Under the provision, any required basis reduction is allocated among the transferred properties in proportion to their respective built-in-loss immediately before the transaction.²⁵⁰ The new provision permits the transferor and

reg. sec. 1.351-1(c)(1)(i).” [footnote omitted]; *cf.* Priv. Ltr. Rul. 200211017 (Dec. 12, 2001) (“The legislative history to the Taxpayer Relief Act of 1997 amendment to section 351(e)(1) makes clear that the 1997 amendments to section 351(e) do not override § 1.351-1(c)(4).”); Priv. Ltr. Rul. 199901028 (Oct. 13, 1998) (“[T]he Act is not intended to alter the requirement of section 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under section 351(e) only if the transfer results, directly or indirectly, in the diversification of the transferors' interests.”).

²⁴⁴I.R.C. § 351(e)(1)(B).

²⁴⁵I.R.C. § 351(e)(1)(B)(vi).

²⁴⁶I.R.C. § 351(e)(1)(B)(vii).

²⁴⁷Treas. Reg. § 1.351-1(c)(5).

²⁴⁸I.R.C. § 362(a); Treas. Reg. § 1.362-1(a).

²⁴⁹I.R.C. § 362(e)(2)(A).

²⁵⁰I.R.C. § 362(e)(2)(B).

transferee to make an irrevocable election to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred.²⁵¹

b. Basis of Stock Received by Transferor. In the case of an exchange to which Section 351 applies, the basis of the stock received by the transferor without the recognition of gain or loss is generally the same as the basis of the property exchanged, decreased by the fair market value of any boot received by the taxpayer and increased by the amount of any gain to the taxpayer recognized on the exchange.²⁵² If the transferee corporation assumes a liability of the transferor or takes property subject to a liability, such assumption or acquisition (in the amount of the liability) is treated (for purposes of determining basis) as money received by the taxpayer on the exchange.²⁵³

B. Corporate Reorganizations.

1. General Purpose of Reorganization Provisions. The corporate reorganization rules of the Code provide an exception to the general rule of gain or loss recognition applicable to property exchanges.²⁵⁴ The reorganization rules provide for tax-free treatment in certain corporate readjustment transactions, provided the proper amount and type of stock consideration is given to the shareholders, and provided that a sufficient amount of stock or assets of the target corporation are acquired.²⁵⁵

2. Types of Reorganizations. The Code confers tax-free treatment on certain types of corporate reorganizations.

a. Type A Reorganization: A Type A reorganization is a statutory merger or consolidation effected pursuant to the laws of the United States or a State or the District of Columbia.²⁵⁶

b. Type B Reorganization: A Type B reorganization involves the acquisition by one corporation of stock of another corporation, solely for voting stock either of the acquiring corporation or of its direct parent (but not both).²⁵⁷ Immediately after the acquisition, the acquiring corporation must own at least 80-percent of total combined voting power of all classes of stock entitled to vote and at least 80-percent of the total number of shares

²⁵¹I.R.C. § 362(e)(2)(C)(i).

²⁵²I.R.C. § 358(a)(1); Treas. Reg. § 1.358-1(a).

²⁵³I.R.C. § 358(d).

²⁵⁴See Treas. Reg. § 1.368-1(b).

²⁵⁵See Treas. Reg. § 1.368-1(b).

²⁵⁶I.R.C. § 368(a)(1)(A); Treas. Reg. § 1.368-2(b); *see also* I.R.C. §§ 368(a)(2)(D) (forward triangular merger) and 368(a)(2)(E) (reverse triangular merger).

²⁵⁷I.R.C. § 368(a)(1)(B); Treas. Reg. § 1.368-2(c).

of all other classes of the stock of the acquired corporation.²⁵⁸ The presence of any consideration that is not voting stock can prevent a transaction from qualifying under this provision.²⁵⁹

c. Type C Reorganization: A Type C reorganization involves the acquisition by one corporation of substantially all of the properties of another corporation in exchange solely for all or a part of the voting stock of the acquiring corporation (or the voting stock of a corporation which is in control of the acquiring corporation).²⁶⁰ In determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the acquired corporation is disregarded.²⁶¹ The acquired corporation must generally distribute all of the stock, securities and properties it receives from the acquiring corporation, as well as the acquired corporation's other properties, pursuant to the plan of reorganization.²⁶²

d. Type D Reorganization: A Type D reorganization is a transaction in which all or a part of a corporation's assets are transferred to another corporation, if immediately after the transfer the transferor, or one or more of its shareholders, is in control of the transferee corporation, and if the transferor corporation distributes stock or securities of the transferee corporation in a distribution meeting certain requirements.²⁶³

e. Type E Reorganization: A Type E reorganization involves a recapitalization of a corporation.²⁶⁴ The Supreme Court has defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."²⁶⁵ The Treasury Regulations provide five examples of a recapitalization.²⁶⁶

f. Type F Reorganization: A Type F reorganization is a "mere change in identity, form, or place of organization of one corporation, however effected."²⁶⁷

g. Type G Reorganization: A Type G reorganization consists of a transfer by a corporation of all or part of its assets to another corporation in a bankruptcy or

²⁵⁸I.R.C. §§ 368(a)(1)(B), 368(c).

²⁵⁹*See Helvering v. Southwest Consol. Corp.*, 315 U. S. 194 (1942); *Mills v. Commissioner*, 331 F.2d 321 (5th Cir. 1964), *rev'g* 39 T.C. 393 (1962); Rev. Rul. 75-123, 1975-1 C.B. 115 ("To qualify under section 368(a)(1)(B) of the Code as a reorganization, the consideration for whatever stock is acquired by the acquiring corporation must be solely its voting stock and nothing else.").

²⁶⁰I.R.C. § 368(a)(1)(C).

²⁶¹I.R.C. § 368(a)(1)(C).

²⁶²I.R.C. § 368(a)(2)(G)(i).

²⁶³I.R.C. § 368(a)(1)(D).

²⁶⁴I.R.C. § 368(a)(1)(E).

²⁶⁵*Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942).

²⁶⁶*See* Treas. Reg. § 1.368-2(e).

²⁶⁷I.R.C. § 368(a)(1)(F).

similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which meets certain qualification requirements.²⁶⁸

3. Other Requirements. Generally, the Treasury regulations impose three additional requirements for a reorganization to be accorded tax-free treatment: (a) the continuity of shareholder interest requirement (except in E and F reorganizations²⁶⁹ and in certain D reorganizations); (b) the continuity of business enterprise requirement (except in E and F reorganizations²⁷⁰); and (c) the business purpose requirement.²⁷¹ Continuity of shareholder interest requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.²⁷² Continuity of business enterprise requires that the acquiring corporation either continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business.²⁷³ The business purpose requirement requires that the reorganization transaction have a business purpose.²⁷⁴

C. Transfer of Unencumbered Property to a Partnership in Exchange for a Partnership Interest.

1. General Rules.

a. Nonrecognition. Generally, no gain or loss is recognized by a partnership or any of its partners upon the contribution of property to the partnership in exchange for a partnership interest.²⁷⁵ This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating.²⁷⁶

²⁶⁸I.R.C. § 368(a)(1)(G).

²⁶⁹Treas. Reg. § 1.368-1(b) (as amended by T.D. 9182 (Feb. 25, 2005)).

²⁷⁰Treas. Reg. § 1.368-1(b) (as amended by T.D. 9182 (Feb. 25, 2005)).

²⁷¹See Treas. Reg. § 1.368-1(b).

²⁷²Treas. Reg. § 1.368-1(e)(1)(i).

²⁷³Treas. Reg. § 1.368-1(d)(1).

²⁷⁴Treas. Reg. § 1.368-1(b); see *Honbarrier, Inc. v. Commissioner*, 115 T.C. 300 (2000).

²⁷⁵I.R.C. § 721(a); cf. PLR 200606009 (Oct. 17, 2005) (Merger of multiple corporations into LLC taxable as a partnership is treated as (i) a transfer by the corporations of all their respective assets to the LLC in exchange for interests in the LLC and the assumption by the LLC of the liabilities of the corporations, followed by (ii) the distributions of the interests of the LLC in complete liquidation of the corporations).

²⁷⁶Treas. Reg. § 1.721-1(a).

b. Partnership's Tax Basis in Contributed Property. The partnership's tax basis in the contributed property is the adjusted basis of the property to the partner at the time of contribution.²⁷⁷

c. Partnership's Holding Period in Contributed Property. The partnership's holding period in the assets contributed by a partner includes the period such assets were held by the contributing partner.²⁷⁸

d. Contributing Partner's Tax Basis in His Partnership Interest. The contributing partner's initial tax basis in his partnership interest will be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution.²⁷⁹

e. Contributing Partner's Holding Period in His Partnership Interest. In determining the holding period of a taxpayer who receives property in an exchange, there is included the period for which the taxpayer held the property exchanged if the property has the same basis in whole or in part in the taxpayer's hands as the property exchanged, and the property exchanged at the time of the exchange was a capital asset or property described in Section 1231(b) (depreciable property and real property used in a trade or business and held for more than 1 year).²⁸⁰ Thus, the holding period of a partnership interest received in exchange for a partner contributing to the partnership capital assets or property described in Section 1231(b) should include such partner's holding period for the property transferred to the partnership.²⁸¹ If, however, a partnership interest is received in exchange for assets that are neither capital assets nor Section 1231(b) assets, the partner's holding period in the contributed assets should not "tack" onto the holding period of the partner's partnership interest.²⁸²

In the past, there has been some lack of clarity concerning the holding period of a partnership interest where a partner transfers both (1) capital assets or Section 1231(b) property, and (2) cash or property other than capital assets or Section 1231(b) property. There has also been some question concerning a partner's holding period in a partnership interest where a partner acquires interests in the partnership at different times.²⁸³

²⁷⁷I.R.C. § 723.

²⁷⁸I.R.C. § 1223(2); Treas. Reg. § 1.723-1.

²⁷⁹I.R.C. § 722.

²⁸⁰I.R.C. § 1223(1).

²⁸¹I.R.C. § 1223(1).

²⁸²See Treas. Reg. § 1.1223-1(a); *see generally* Banoff, "Partnership Interest Transfers Under the Holding Period Final Regs.: Opportunities and Traps Remain," 94 J. Tax'n 211 (April 2001).

²⁸³See Notice of Proposed Rulemaking, REG-106527-98, 64 F.R. 43117-43123 (Aug. 9, 1999).

On September 21, 2000, the Internal Revenue Service issued final regulations relating to dividing the holding period of a partnership interest.²⁸⁴ An overview of these regulations is presented below.

(1) General Rule. The final regulations provide that a partner will not have a divided holding period in a partnership unless (1) the partner acquired portions of a partnership interest at different times; or (2) the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.²⁸⁵

(2) Accounting for Holding Periods of a Partnership Interest. The portion of a partnership interest to which a holding period relates is determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).²⁸⁶ Special rules apply to contributions and distributions of cash by partners and to contributions of Section 751 property to the partnership.²⁸⁷

(3) Sale or Exchange of All or a Portion of a Partnership Interest.

(a) Sale or Exchange of Entire Interest in the Partnership. If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the partnership interest is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.²⁸⁸

To illustrate, assume that A contributes \$5,000 of cash and a nondepreciable capital asset A has held for two years to the PRS Partnership in exchange for a 50-percent interest in PRS. A's basis in the capital asset is \$5,000, and the fair market value of the asset is \$10,000. After the exchange, A's basis in A's interest in PRS is \$10,000, and the fair market value of the interest is \$15,000. A received one-third of the interest in PRS for a cash payment of \$5,000 (\$5,000/\$15,000). Therefore, A's holding period in one-third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. A received two-thirds of the interest in PRS in exchange for the capital asset (\$10,000/\$15,000). Accordingly, A has a two-year holding period in two-thirds of the interest received in PRS.

²⁸⁴See T.D. 8902, 65 F.R. 57092-57101; Treas. Reg. § 1.741-1(f); Treas. Reg. § 1.1223-3(g).

²⁸⁵Treas. Reg. § 1.1223-3(a).

²⁸⁶Treas. Reg. § 1.1223-3(b)(1).

²⁸⁷See Treas. Reg. §§ 1.1223-3(b)(2)-(4).

²⁸⁸Treas. Reg. § 1.1223-3(c)(1).

Suppose that six months later, when A's basis in PRS is \$12,000 (due to a \$2,000 allocation of partnership income to A), A sells the interest in PRS for \$17,000. Assuming PRS holds no inventory or unrealized receivables, and no collectibles or Section 1250 property, A will realize \$5,000 of capital gain. As determined above, one-third of A's interest in PRS has a holding period of one year or less, and two-thirds of A's interest in PRS has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.²⁸⁹

(b) Sale or Exchange of a Portion of a Partnership

Interest. If a partner has a divided holding period in a partnership interest, then the holding period of the transferred interest is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer.²⁹⁰ A special rule applies to sales of interests in publicly-traded partnerships.²⁹¹

(4) Distributions. Generally, under the final regulations, a partner's holding period in a partnership interest is not affected by distributions from the partnership.²⁹² If a partner is required to recognize capital gain or loss as a result of a distribution from a partnership, then the capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if such partner's entire interest in the partnership were transferred in a fully taxable transaction immediately before the distribution.²⁹³

To illustrate, assume that in 1997, A and B each contribute cash of \$50,000 to form and become equal partners in the PRS Partnership. More than one year later, A receives a distribution worth \$22,000 from PRS, which reduces A's interest in PRS to 36-percent. After the distribution, B owns 64-percent of PRS. The holding periods of A and B in their interests in PRS are not affected by the distribution.

f. Exceptions to the General Rule. The general rule of nonrecognition applicable to transfers of unencumbered property to a partnership does not apply (a) on a transfer of property to a partnership which would be treated as an "investment company" (if the partnership were incorporated);²⁹⁴ (b) a partnership capital interest received in exchange

²⁸⁹Treas. Reg. § 1.1223-3(f), Example 1.

²⁹⁰Treas. Reg. § 1.1223-3(c)(2)(ii).

²⁹¹Treas. Reg. § 1.1223-3(c)(2)(i).

²⁹²Treas. Reg. § 1.1223-3(d)(1).

²⁹³Treas. Reg. § 1.1223-3(d)(2).

²⁹⁴I.R.C. § 721(b).

for services;²⁹⁵ and (c) transactions between a partnership and a partner not acting in his capacity as a partner.²⁹⁶

(1) Transfer of Property to a Partnership (that Would Be Treated as an Investment Company if the Partnership Were Incorporated). The general nonrecognition rule applicable to transfers of property to a partnership will not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (if the partnership were incorporated).²⁹⁷ In the case of a transfer of property to a partnership that is classified as an investment company, the partner's basis in his partnership interest is the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized by the contributing partner at the time of contribution.²⁹⁸ The partnership's basis in the contributed property is the adjusted basis of the property to the partner at the time of contribution increased by the amount (if any) of gain recognized by the contributing partner.²⁹⁹

(a) When Is a Transfer Considered a "Transfer to an Investment Company?" A transfer of property to a partnership will be considered to be "a transfer to an investment company" if: (i) the transfer results in diversification of the transferor's interests;³⁰⁰ and (ii) more than 80-percent of the value of the partnerships assets are:

i) Held for investment; and

ii) Consist of money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals,

²⁹⁵Treas. Reg. § 1.721-1(b)(1).

²⁹⁶Treas. Reg. § 1.721-1(a); *see generally* I.R.C. 707(a).

²⁹⁷I.R.C. § 721(b).

²⁹⁸I.R.C. § 722.

²⁹⁹I.R.C. § 723.

³⁰⁰*See* Staff of the Joint Committee on Taxation, 105th Cong., *General Explanation of Tax Legislation Enacted in 1997*, 184 (1997) ("The bill is intended to change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. reg. sec. 1.351-1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351-1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionately by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351-1(c)(4)), (3) the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. reg. sec. 1.351-1(c)(2)), and (4) the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas. reg. sec. 1.351-1(c)(1)(i).") [footnote omitted]; *cf.* Priv. Ltr. Rul. 200211017 (Dec. 12, 2001) ("The legislative history to the Taxpayer Relief Act of 1997 amendment to section 351(e)(1) makes clear that the 1997 amendments to section 351(e) do not override § 1.351-1(c)(4)."); Priv. Ltr. Rul. 199901028 (Oct. 13, 1998) ("[T]he Act is not intended to alter the requirement of section 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under section 351(e) only if the transfer results, directly or indirectly, in the diversification of the transferors' interests.").

interests in real estate investment trusts, regulated investment companies, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed in the statute.³⁰¹ Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are listed assets,³⁰² and to the extent provided in regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to listed assets.³⁰³

(b) When Does a Transfer Result in Diversification of the Transferor's Interests? A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets in the exchange.³⁰⁴ For this purpose, if any transaction involves the transfer of one or more transfers of nonidentical assets, which taken in the aggregate, constitutes "an insignificant portion"³⁰⁵ of the total value of assets transferred, then such transfers are disregarded for purposes of determining whether diversification has occurred.³⁰⁶ If a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.³⁰⁷

(c) When Is Investment Company Status Determined? The determination of whether a partnership is an investment company is ordinarily made immediately after the transfer.³⁰⁸ If, however, the circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination is made by reference to the later circumstances.³⁰⁹

(2) Partnership Capital Interest Received in Exchange for Services. The receipt of a partnership capital interest by a service partner for services provided

³⁰¹I.R.C. § 351(e)(1)(B).

³⁰²I.R.C. § 351(e)(1)(B)vi).

³⁰³I.R.C. § 351(e)(1)(B)(vii).

³⁰⁴Treas. Reg. § 1.351-1(c)(5).

³⁰⁵The determination of what constitutes an "insignificant portion" of the total value of transferred assets is a factual issue. In Revenue Ruling 87-9, 1987-1 C.B. 133, the Revenue Service held that the transfer of a nonidentical asset (cash) constituting 11 percent of the total value of the transferred assets in a Section 351 exchange was not an "insignificant portion." The regulations contain an example illustrating that in a situation where two percent of the total assets transferred are nonidentical, the two percent transfer is "insignificant" and therefore disregarded for purposes of determining whether diversification has occurred. Treas. Reg. § 1.351-1(c)(7), Example 1; *cf.* Priv. Ltr. Rul. 199901028 (Oct. 13, 1998).

³⁰⁶Treas. Reg. § 1.351-1(c)(5).

³⁰⁷Treas. Reg. § 1.351-1(c)(5).

³⁰⁸Treas. Reg. § 1.351-1(c)(2).

³⁰⁹Treas. Reg. § 1.351-1(c)(2).

to or for the benefit of the partnership is taxable as compensation.³¹⁰ The Service defines a capital interest as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.”³¹¹

(3) Transactions Between a Partnership and a Partner Not Acting in His Capacity as a Partner.³¹² The general rule of nonrecognition applicable to transfers of property to a partnership does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner.³¹³ For example, a partner may sell property to a partnership rather than contributing the property. As to sales between a partner and his partnership, if a partner engages in a transaction with a partnership, other than in his capacity as a partner, the transaction will be treated as occurring between the partnership and one who is not a partner.³¹⁴ Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, the transaction will be treated as a taxable sale or exchange in which gain is recognized³¹⁵ rather than as a tax-free contribution.³¹⁶

D. Transfer of Encumbered Property to a Partnership. The Code and regulations provide rules with respect to the transfer of encumbered property to a partnership.

1. Treatment of Decrease in Partner’s Share of Liabilities. In the case of a transfer of property encumbered by debt to a partnership, any decrease in a partner’s share of the partnership’s liabilities, or any decrease in a partner’s individual liabilities by reason of the

³¹⁰*Campbell v. Commissioner*, 943 F.2d 815, 820 (8th Cir. 1991) (“When a service partner receives an interest in partnership capital, the cases clearly hold that a taxable event has occurred. The receipt of the capital interest must be included in the service partner’s income. See, e.g. *United States v. Frazell*, 335 F.2d 487, 489 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) . . . As an interest in intangible personal property, the receipt of a capital interest appears to be taxable under the authority of Section 83 of the Internal Revenue Code. [Footnote omitted.] There is little, if any, dispute that such a transaction involves the recognition of income.”); *Larson v. Commissioner*, 55 T.C.M. (CCH) 1637 (1988) (“Under Section 83, a compensatory transfer of a partnership capital interest results in taxable income to the transferee to the extent that the fair market value of the interest exceeds the amount paid for the interest, in the year that the rights to the interest are transferable or not subject to a substantial risk of forfeiture.”); Rev. Proc. 93-27, 1993-2 C.B. 343, 343 (“Under Section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation.”).

³¹¹Rev. Proc. 93-27, § 2.01, 1993-2 C.B. 343.

³¹²Treas. Reg. § 1.721-1(a); see generally I.R.C. 707(a).

³¹³Treas. Reg. § 1.721-1(a); see I.R.C. § 707.

³¹⁴I.R.C. § 707(a).

³¹⁵See I.R.C. § 707(a); I.R.C. § 1001(c).

³¹⁶Treas. Reg. § 1.721-1(a); Treas. Reg. § 1.707-1(a); Treas. Reg. § 1.731-1(c)(3).

partnership's assumption of such individual liabilities, is considered a distribution of money to the partner by the partnership.³¹⁷

2. Treatment of Increase in Partner's Share of Liabilities. Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is considered a contribution of money by that partner to the partnership.³¹⁸

3. Property Subject to a Liability. If property is contributed by a partner to the partnership and the property is subject to a liability of the contributing partner, the partnership is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution.³¹⁹

4. Netting of Increases and Decreases in Liabilities Resulting from Single Transaction. If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.³²⁰ Generally, the contribution to a partnership of property subject to a liability will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.³²¹

5. Example. Assume that Baker contributes property (adjusted basis: \$1,000) to a general partnership in exchange for a 33.33-percent interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of \$150 and has a fair market value in excess of \$150. After the contribution, Baker remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under the Code and regulations, the partnership is treated as having assumed the \$150 liability. As a result, Baker's individual liabilities decrease by \$150. At the same time, however, Baker's share of liabilities of the partnership increases by \$150. Only the net increase or decrease in Baker's share of the liabilities of the partnership and Baker's individual liabilities is taken into account. Since there is no net change, Baker is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership. Baker will take a

³¹⁷I.R.C. § 752(b); Treas. Reg. § 1.752-1(c).

³¹⁸I.R.C. § 752(a).

³¹⁹Treas. Reg. § 1.752-1(e); *see* I.R.C. § 752(c).

³²⁰I.R.C. § 1.752-1(f).

³²¹Treas. Reg. § 1.752-1(f).

basis in his partnership interest equal to \$1,000 (which is Baker's tax basis in the property contributed to the partnership).³²²

E. Merger of Partnerships.

1. Background.

a. Treatment of Partnership Mergers in the Code. The Code neither defines what constitutes a partnership merger or consolidation nor prescribes a form for a partnership merger. It provides only that “[i]n the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50-percent in the capital and profits of the resulting partnership.”³²³

b. Treatment of Partnership Mergers in the Treasury Regulations. In 1997, the Service issued proposed regulations providing guidance with respect to the treatment of partnership mergers for federal income tax purposes. On January 3, 2001, the Service issued final regulations applicable to mergers occurring on or after January 4, 2001.³²⁴ A partnership may, however, elect to apply the rules in the final regulations for mergers occurring on or after January 11, 2000.³²⁵ These regulations address (a) how to identify the continuing and terminating partnerships in a partnership merger; (b) the closing of the tax year for partnerships that are considered terminated in a partnership merger and the federal income tax return filing requirements for such terminated partnerships; and (c) the form of a partnership merger.³²⁶ The final regulations do not define what constitutes a partnership merger. Although the Preamble to the final regulations does not state why Treasury did not provide such a definition, the Preamble states that some tax practitioners have stated that the selectivity that would be created by attempting to draw lines in such definitions could lead to planning opportunities that would be adverse to the government's interest.³²⁷

2. Resulting and Terminated Partnerships in a Partnership Merger; Closing of the Tax Year for Terminated Partnerships and Filing of Federal Income Tax Returns.

a. Identifying the Terminated Partnerships in a Partnership Merger. In the case of a merger or consolidation of two or more partnerships, the final regulations provide that the resulting partnership is, for federal income tax purposes, considered the continuation of any merging or consolidating partnership whose members own an interest of

³²²Treas. Reg. § 1.752-1(g), Example 1.

³²³I.R.C. § 708(b)(2)(A).

³²⁴Treas. Reg. § 1.708-1(c)(7).

³²⁵Treas. Reg. § 1.708-1(c)(7).

³²⁶See Treas. Reg. § 1.708-1(c).

³²⁷Preamble, T.D. 8925, 2001-1 C.B. 496, 499.

more than 50-percent in the capital and profits of the resulting partnership.³²⁸ If the resulting partnership can be considered a continuation of more than one of the merging partnerships, the resulting partnership is, unless the Commissioner permits otherwise, the continuation of the partnership that is credited with the contribution of the greatest fair market value (net of liabilities) to the resulting partnership.³²⁹ Any other merging or consolidating partnerships is considered as terminated.³³⁰ If the members of none of the merging or consolidating partnerships have an interest of more than 50-percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.³³¹

b. Closing of the Tax Year for Terminated Partnerships and Filing of Federal Income Tax Returns for Such Partnerships. Under the regulations, the tax years of the partnerships that are considered terminated in the merger are closed³³² and such partnerships are required to file their returns for the taxable year ending upon the date of termination (which is the date of merger or consolidation).³³³ The resulting partnership in the merger is required to file a tax return for the tax year of the partnership that is considered to continue in the merger.³³⁴ The resulting partnership uses the employer identification number (“EIN”) of the continuing partnership on the return.³³⁵ The return is required to state that the resulting partnership is a continuation of such merging or consolidating partnership, and must include the names, addresses, and EINs of the other merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and including the date of the merger or consolidation and subsequent to the date of merger or consolidation are required to be shown as a part of the return.³³⁶

c. Example. The regulations contain an example illustrating the closing of the tax year and filing requirements for the continuing and terminated partnerships in a merger. Assume that A and B, both calendar year taxpayers, each own a 50-percent interest in the capital and profits of the AB Partnership, a calendar-year partnership. Assume further that C and D, both calendar year taxpayers, each own a 50-percent interest in the capital and profits of the CD Partnership, a calendar-year partnership. The AB Partnership and the CD Partnership merge on September 30, 1999, and form the ABCD Partnership. After the merger, the partners have capital and profits interests as follows:

³²⁸I.R.C. § 708(b)(2)(A).

³²⁹Treas. Reg. § 1.708-1(c)(1).

³³⁰Treas. Reg. § 1.708-1(c)(1).

³³¹Treas. Reg. § 1.708-1(c)(1).

³³²Treas. Reg. § 1.708-1(c)(2); *see* I.R.C. § 706(c).

³³³Treas. Reg. § 1.708-1(c)(2).

³³⁴Treas. Reg. § 1.708-1(c)(2).

³³⁵Treas. Reg. § 1.708-1(c)(2).

³³⁶Treas. Reg. § 1.708-1(c)(2).

A	30%
B	30%
C	20%
D	20%

Since A and B together own an interest of more than 50-percent in the capital and profits of the ABCD Partnership, such partnership is considered a continuation of the AB Partnership and is required to continue to file returns on a calendar year basis. Since C and D own an interest of less than 50-percent in the capital and profits of the ABCD Partnership, the taxable year of the CD Partnership closes as of September 30, 1999, the date of the merger, and the CD Partnership is terminated as of that date. The ABCD Partnership is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that, until September 30, 1999, it was the AB Partnership. The CD Partnership is required to file a return for its final taxable year, January 1 through September 30, 1999.³³⁷

3. Form of a Partnership Merger.

a. General Rules. Under the final regulations, the form of a partnership merger accomplished under applicable jurisdictional law generally will be respected if the partnership undertakes the steps of one of two forms prescribed for federal income tax purposes in the regulations: the assets-over form or the assets-up form.³³⁸ Both of these forms are discussed in detail below. The default rule for partnership mergers is the assets-over form, so that if a transaction is effected without undertaking a form for the merger or the transaction is not characterized under the assets-up form, it will be characterized under the assets-over form (regardless of whether that form is followed).³³⁹

To accomplish a merger, partners in a terminating partnership may in certain cases desire to transfer their terminating partnership interests to the resulting partnership in exchange for resulting partnership interests, and then liquidate the terminating partnership into the resulting partnership (referred to as the “interests-over form”). Under the final regulations, the partnerships will be treated as following the assets-over form of merger for federal income tax purposes.³⁴⁰

(1) Assets-Over Form.

(a) Description of Assets-Over Form. Under the assets-over form, a terminating partnership contributes its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership and, immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in

³³⁷Treas. Reg. § 1.708-1(c)(5), Example 1.

³³⁸Treas. Reg. § 1.708-1(c)(3)(i); Preamble, T.D. 8925, 2001-1 C.B. at 497.

³³⁹Treas. Reg. § 1.708-1(c)(3)(i).

³⁴⁰Notice of Proposed Rulemaking, REG-111119-99, 2000-2 C.B. 455, 460 [hereinafter “Partnership Merger Regs Notice”].

liquidation of the terminating partnership.³⁴¹ The form of the merger for state law purposes does not override the mechanical rules of the Code dictating the continuing partnership for federal income tax purposes.³⁴² Thus, as noted by one commentator, if the partnership that in form receives assets is not the resulting partnership for federal income tax purposes, the state law “direction” of the merger will be “reversed” for tax purposes, and a partnership that in form transferred the assets may be treated as the resulting partnership.³⁴³ This point is illustrated in the Example 1 below.

i) Example 1. A and B own 40-percent and 60-percent interests, respectively, in the capital and profits of the X Partnership. B and C own 60-percent and 40-percent interests, respectively, in the capital and profits of the Y Partnership. The X Partnership and the Y Partnership merge on September 30, 1999. The fair market value of the X Partnership’s assets (net of liabilities) is \$100X, and the fair market value of the Y Partnership’s assets (net of liabilities) is \$200X. The merger is accomplished under state law by the Y Partnership contributing its assets and liabilities to the X Partnership in exchange for interests in the X partnership, with the Y Partnership then liquidating and distributing its interests in the X Partnership to B and C.

B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, since the fair market value of the Y Partnership’s assets (net of liabilities) was greater than that of the X Partnership, the X Partnership is considered to terminate in the merger. As a result, even though, for state law purposes, the transaction was undertaken with the Y Partnership contributing its assets and liabilities to the X Partnership and distributing X Partnership interests to its partners, for federal income tax purposes, the transaction is treated as if the X partnership contributed its assets to the Y Partnership in exchange for interests in the Y Partnership and then liquidated, distributing interests in the Y Partnership to A and B.³⁴⁴

ii) Example 2. The X Partnership and the Y Partnership merge when the partners of X transfer their X Partnership interests to Y in exchange

³⁴¹Treas. Reg. § 1.708-1(c)(3)(i); *see also* Partnership Merger Regs. Notice, 2000-2 C.B. at 461 (“[U]nder the Assets-Over Form, gain under sections 704(c)(1)(B) and 737 is not triggered. See sections 1.704-4(c)(4) and 1.737-2(b).”); Treas. Reg. § 1.704-4(c)(4) (“Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.”); Treas. Reg. § 1.737-2(b)(1) (“Complete transfer. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.”).

³⁴²*See, e.g.*, Treas. Reg. § 1.708-1(c)(5), Example 2; *See also* Sloan, Lipton, Frediani, “Final Regulations Under Section 708 Provide Expanded Guidance on Partnership Mergers and Divisions – Part 1,” 496 PLI/Tax 1125, 1135 (June 2001) [hereinafter “Sloan”].

³⁴³*See* Sloan, 496 PLI/Tax at 1135.

³⁴⁴Treas. Reg. § 1.708-1(c)(5), Example 2.

for Y partnership interests. Immediately thereafter, X liquidates into Y. The resulting partnership is considered a continuation of Y, and X is considered terminated.

The partnerships are treated as undertaking the assets-over form because the partnerships undertook a form that is not the assets-up form. Accordingly, for federal income tax purposes, partnership X is deemed to contribute its assets and liabilities to partnership Y in exchange for interests in partnership Y, and, immediately thereafter, partnership X is deemed to have distributed the interests in partnership Y to its partners in liquidation of their interests in partnership X.³⁴⁵

(b) Treatment of Liabilities in Asset-Over Form.

Upon the merger or consolidation of two or more partnerships, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger.³⁴⁶

The regulations provide an example illustrating the effect of liabilities in an assets-over form of merger. B owns a 70-percent interest in the T Partnership. T's sole asset is property X, which is encumbered by a \$900 liability. T's adjusted basis in property X is \$600, and the value of property X is \$1,000. B's adjusted basis in its partnership interest in T is \$420. B also owns a 20-percent interest in the S Partnership. S's sole asset is property Y, which is encumbered by a \$100 liability. Partnership S's adjusted basis in property Y is \$200, the value of property Y is \$1,000, and B's adjusted basis in its partnership interest in S is \$40.

Assume that the T and S Partnerships merge and that T is considered terminated and the resulting partnership is considered a continuation of partnership S. T and S undertake the assets-over form for the merger. T contributes property X and its \$900 liability to S in exchange for an interest in S. Immediately thereafter, T distributes the interests in S to its partners in liquidation of their interests in T. B owns a 25-percent interest in S after T distributes the interests in S to B.

B nets the increases and decreases in its share of partnership liabilities associated with the merger of T and S. Before the merger, B's share of partnership liabilities was \$650 (B had a \$630 share of partnership liabilities in T and a \$20 share of partnership liabilities in S immediately before the merger). B's share of S's partnership liabilities after the merger is \$250 (25-percent of S's total partnership liabilities of \$1,000). Accordingly, B has a \$400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a \$400 distribution from partnership S. Since B's adjusted basis in its partnership S interest before the deemed distribution is \$460 (\$420 + \$40), B will not recognize gain. After the merger, B's adjusted basis in its partnership S interest is \$60.³⁴⁷

(2) Assets-Up Form.

³⁴⁵Treas. Reg. § 1.708-1(c)(5), Example 4.

³⁴⁶Treas. Reg. § 1.752-1(g), Example 2.

³⁴⁷Treas. Reg. § 1.752-1(g), Example 2.

(a) Description of Assets-Up Form. Under the assets-up form, the merged or consolidated partnership that is considered terminated distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership,³⁴⁸ and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.³⁴⁹ The regulations provide that the form of this merger or combination will be respected "[d]espite the partners' transitory ownership of the terminated partnership's assets."³⁵⁰ The Preamble to the final regulations states that a partnership can use the assets-up form for partnership mergers regardless of whether the partners could otherwise generally hold certain assets, such as undivided interests in goodwill, outside of a partnership.³⁵¹

i) Conveyance of Ownership of Assets.

While the final regulations provide that the assets-up form will be respected in accomplishing partnership mergers, the Preamble to the final regulations states that the Service and Treasury do not intend to establish a regime whereby partners essentially can elect between the assets-up form and the assets-over form by creating different documents that have the same legal effect. The Preamble states that if the assets-up form is to be respected, a partnership must actually undertake the steps that are necessary, under the laws of the applicable jurisdiction, to convey ownership of the assets that are distributed to the partners.³⁵² In the Preamble, the Service rejects the proposal that, rather than actually conveying ownership of the assets under applicable jurisdictional law, the partners be allowed 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.³⁵³

Some commentators have questioned whether a transfer of assets by a partnership to a single-member limited liability company ("LLC") followed by a distribution of interests in such LLC to the partners would qualify under the assets-up form since the partners would not actually be conveyed ownership of the assets under local law. Rather, the partners would be conveyed an

³⁴⁸The Preamble to the proposed regulations cautions that under the assets-up form, partners could recognize gain under Sections 704(c)(1)(B) and 737 when the terminating partnership distributes the assets to the partners. Partnership Merger Regs. Notice, 2000-2 C.B. at 460.

³⁴⁹Treas. Reg. § 1.708-1(c)(3)(ii).

³⁵⁰Treas. Reg. § 1.708-1(c)(3)(ii).

³⁵¹Preamble, T.D. 8925, 2001-1 C.B. at 496, 497.

³⁵²Preamble, T.D. 8925, 2001-1 C.B. at 497.

³⁵³Preamble, T.D. 8925, 2001-1 C.B. at 497.

interest in an LLC holding the assets.³⁵⁴ These commentators have concluded that this result seems rather harsh and should be formally rejected by the Service.³⁵⁵

ii) Liabilities. The Preamble to the final regulations provides that, while the Service and Treasury believe that it should be necessary for a partnership to actually convey ownership of the partnership's assets to its partners in order to follow the assets-up form, it should not be necessary for the partners to actually assume the liabilities of the partnership in order to follow such form. The Preamble states that, under the Code and regulations,³⁵⁶ a partner essentially is deemed to have directly incurred a share of the partnership's liabilities. The Service therefore concludes in the Preamble that requiring the partners to actually assume debt that they already are deemed to have incurred is unnecessary.³⁵⁷

(b) Example. A and B own 40-percent and 60-percent interests, respectively, in the capital and profits of the X Partnership. X is engaged in a trade or business and has, as one of its assets, goodwill. B and C own 60-percent and 40-percent interests, respectively, in the capital and profits of the Y Partnership. The X Partnership and the Y Partnership merge on September 30, 1999. The fair market value of the X Partnership's assets (net of liabilities) is \$100X, and the fair market value of the Y Partnership's assets (net of liabilities) is \$200X. The merger is accomplished under state law by having X convey an undivided 40-percent interest in each of its assets to A and an undivided 60-percent interest in each of its assets to B, with A and B then contributing their interests in such assets to the Y Partnership. Y also assumes all of the liabilities of partnership X.

B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, since the fair market value of the Y Partnership's assets (net of liabilities) was greater than that of the X Partnership, X is considered to terminate in the merger. The form of the partnership merger will be respected so that X will be treated as following the assets-up form for federal income tax purposes.³⁵⁸

b. Partner Buy-Out Rule. The final regulations contain a special buy-out rule to address the situation where one partner would prefer to be cashed out in an assets-over form of merger rather than becoming a partner in the resulting partnership.³⁵⁹ This rule provides that a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership as part of an asset-over form of merger or consolidation will be respected as a sale of a partnership interest if (1) the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or

³⁵⁴See Hortenstine, Jackel, Ladin, "Final Partnership Merger and Division Regulations – Analysis, Commentary and Examples," 496 PLI/Tax 1043, 1049-50 (2001) [hereinafter "Hortenstine"].

³⁵⁵*Id.*

³⁵⁶See generally I.R.C. § 752 and the regulations thereunder.

³⁵⁷Preamble, T.D. 8925, 2001-1 C.B. at 497.

³⁵⁸Treas. Reg. § 1.708-1(c)(5), Example 3.

³⁵⁹Partnership Merger Regs. Notice, 2000-2 C.B. at 457.

consolidating partnership and the consideration that is transferred for each interest sold; and (2) the selling partner in the terminated partnership, either prior to or contemporaneous with the transaction, consents to treat the transaction as a sale of the partnership interest.³⁶⁰ The timing of the selling partner's consent is important. The regulations expressly require the selling partner in the terminated partnership to provide the requisite consent prior to or contemporaneous with the transaction.

The special buy-out rule allows a resulting partnership in a merger to fund the purchase of one or more partners' interests in a terminating partnership without triggering the disguised sale rules, which otherwise would cause all of the partners in the terminating partnership to recognize gain or loss as a result of the purchase.³⁶¹ This treatment will apply even if the resulting partnership sends the consideration to the terminating partnership on behalf of the exiting partner, so long as the designated language is used in the relevant document.³⁶²

(1) Form of Merger Transaction Under Special Buy-Out

Rule. Under the special buy-out rule, the exiting partner is treated as separately selling a partnership interest in the terminating partnership to the resulting partnership (and the resulting partnership is treated as purchasing the partner's interest in the terminating partnership) immediately prior to the merger.³⁶³ Immediately after this sale, the resulting partnership becomes a momentary partner in the terminating partnership.³⁶⁴ The terminating partnership is then treated as contributing its assets and liabilities attributable to the continuing partners' interests to the resulting partnership in exchange for interests in the resulting partnership and, immediately thereafter, distributing such interests to the continuing partners in liquidation of their interests in the terminating partnership.³⁶⁵ At the same time, the terminating partnership, as part of the merger, is treated as distributing assets to the resulting partnership in liquidation of the resulting partnership's interest in the terminating partnership. The resulting partnership should take an exchanged basis in the distributed assets under Section 732(b).³⁶⁶

(2) Document Specifying Buy-Out and Consideration;

Form of Consent from Selling Partner. The final regulations provide that the merger agreement or another document must specify that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is

³⁶⁰Treas. Reg. § 1.708-1(c)(4); For a discussion of the advantages and disadvantages of an exiting partner consenting to an interest sale as opposed to a partnership redemption, *see* Sloan, 496 PLI/Tax at 1140-47.

³⁶¹Treas. Reg. § 1.708-1(c)(4).

³⁶²Partnership Merger Regs Notice, 2000-2 C.B. at 458.

³⁶³Partnership Merger Regs Notice, 2000-2 C.B. at 459-460; Treas. Reg. § 1.708-1(c)(5), Example 5(iii).

³⁶⁴Partnership Merger Regs Notice, 2000-2 C.B. at 460.

³⁶⁵Treas. Reg. § 1.708-1(c)(5), Example 5(iii).

³⁶⁶Preamble, T.D. 8925, 2001-1 C.B. at 499; *see, e.g.*, Treas. Reg. § 1.708-1(c)(5), Example 5(iv); For some insightful criticism of some aspects of Example 5 in Treas. Reg. § 1.708-1(c)(5), *see* Hortenstine, 496 PLI/Tax at 1054.

transferred for each interest sold.³⁶⁷ The Preamble clarifies that the exiting partner does not have to be a party to the merger agreement in order to obtain the benefit of the special buy-out rule. To ensure, however, that all partners to the transaction treat the transaction consistently when filing their returns, the final regulations require that, prior to or contemporaneous with the transfer, the exiting partner must consent to the sale treatment provided in the special buy-out rule.³⁶⁸

(3) Example of Application of Special Buy-Out Rule. The regulations contain an example illustrating the application of the special buy-out rule. Assume that A, B, and C are partners in the X Partnership. D, E, and F are partners in the Y Partnership. The X Partnership and the Y Partnership merge. Assume that the resulting partnership is considered a continuation of the Y Partnership and that the X Partnership is considered terminated. Under state law, X and Y undertake the assets-over form to accomplish the partnership merger. C does not want to become a partner in Y, and X does not have the resources to buy C's interest before the merger. C, X Partnership, and Y Partnership enter into an agreement specifying that Y Partnership will purchase C's interest in X Partnership for \$150 before the merger, and as part of the agreement, C consents to treat the transaction in a manner that is consistent with the agreement. As part of the merger, X Partnership receives from Y Partnership \$150 that will be distributed to C immediately before the merger, and interests in the Y Partnership in exchange for X Partnership's assets and liabilities.

Since the merger agreement satisfies the requirements of the buy-out provisions of the regulations and C provides the necessary consent, C will be treated as selling its interest in partnership X to partnership Y for \$150 before the merger.³⁶⁹ Moreover, since the merger agreement satisfies the requirements of the regulations, partnership Y is considered to have purchased C's interest in partnership X for \$150 immediately before the merger.

Partnership X is treated as contributing its assets and liabilities attributable to the interests of A and B to partnership Y in exchange for interests in partnership Y and, immediately thereafter, distributing the interests in partnership Y to A and B in liquidation of their interests in partnership X. At the same time, partnership X is treated as distributing assets to partnership Y in liquidation of partnership Y's interest in partnership X. Partnership Y's bases in the distributed assets are determined under Section 732(b).

(4) Sale of 50-Percent or More of Total Interests in the Partnership. Although not discussed in the final regulations, the Preamble states that if exiting partners sell 50-percent or more of the total interests in the terminating partnership's capital and profits as part of a merger, then a partnership termination under Section 708(b)(1)(B) will occur immediately before the merger.³⁷⁰

³⁶⁷Treas. Reg. § 1.708-1(c)(4).

³⁶⁸Preamble, T.D. 8925, 2001-1 C.B. at 499.

³⁶⁹Treas. Reg. § 1.708-1(c)(5), Example 5(ii).

³⁷⁰Preamble, T.D. 8925, 2001-1 C.B. at 499.

c. Treatment of Partnership Merger Utilizing More Than One Form. Under the final regulations, each partner must participate (or will be deemed to participate) in the partnership merger in the same manner (with the exception of those partners who are subject to the buy-out rule).³⁷¹ The Preamble to the final regulations offers some insight into the Service's thinking on this issue. It states that the final regulations were not intended to provide unlimited flexibility among the various structural alternatives for accomplishing merger or consolidation transactions. Instead, the regulations were intended to provide a set of administrable rules that taxpayers and the Service could apply in characterizing these transactions. The Service and Treasury do not believe it is appropriate for a partnership merger to be accomplished using both the assets-over form and the assets-up form when all the assets and liabilities of the terminated partnership are transferred to a single resulting partnership. Therefore, if the partners wish for a partnership merger to be characterized under the assets-up form, the terminated partnership must undertake the steps of the assets-up form for all of its assets when it distributes the assets to its partners. Otherwise, the transaction will be characterized under the assets-over form.³⁷²

The final regulations provide a caveat to the foregoing rule. Where more than two partnerships are combined, each combination will be viewed under the final regulations as a separate merger so that the characterization of a merger of one partnership into the resulting partnership under the assets-over form will not prevent a simultaneous merger of another partnership into the same resulting partnership from being characterized under the assets-up form.³⁷³

d. Authority Granted to Revenue Service to Disregard Form of Transaction in Certain Cases. If a partnership merger is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form, the final regulations give the Revenue Service the authority to disregard such form and to recast the larger series of transactions in accordance with their substance.³⁷⁴

F. Partnership Divisions.

1. Effecting a Division. The Code neither defines what constitutes a partnership division nor prescribes a form for a partnership division. The Code provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50-percent or less in the capital and profits of the prior partnership) are considered a continuation of the prior partnership.³⁷⁵ The regulations provide that any other resulting partnership is not considered a

³⁷¹Treas. Reg. § 1.708-1(c)(3); Preamble, T.D. 8925, 2001-1 C.B. at 498.

³⁷²Preamble, T.D. 8925, 2001-1 C.B. at 498.

³⁷³Preamble, T.D. 8925, 2001-1 C.B. at 498; *see* Treas. Reg. § 1.708-1(c)(3).

³⁷⁴Treas. Reg. § 1.708-1(c)(6).

³⁷⁵I.R.C. § 708(b)(2)(B).

continuation of the prior partnership but is considered a new partnership.³⁷⁶ If none of the members of the resulting partnerships owned an interest of more than 50-percent in the capital and profits of the prior partnership, the prior partnership is terminated.³⁷⁷ Where members of a partnership that has been divided do not become members of a resulting partnership that is considered a continuation of the prior partnership, such partner's interest is considered liquidated as of the date of the division.³⁷⁸

2. Form of Partnership Division. Simultaneous with the issuance on January 3, 2001, of final regulations addressing the form of partnership mergers, the Revenue Service issued regulations addressing the form of partnership divisions.³⁷⁹ These final regulations apply to partnership divisions occurring on or after January 4, 2001.³⁸⁰ A partnership, however, may elect to apply the final regulations to partnership divisions occurring on or after January 11, 2000.³⁸¹

The final regulations describe the tax consequences of a partnership division and the alternative forms of a division, but do not provide a comprehensive definition of what constitutes a partnership division.³⁸² The Preamble to the final regulations, however, provides some insight into the Service's thinking on the issue of what constitutes a partnership division. The Preamble states that "[t]o have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction." As an illustration of this point, the Preamble provides the following example of a transaction that the Service concludes does not constitute a division: ABC partnership owns X business and Y business. A and B each own a 20-percent interest, and C owns a 60-percent interest in the ABC partnership. C does not want to continue in the partnership with A and B and would like to operate X business with D. Accordingly, ABC partnership distributes X business to C in liquidation of C's interest in partnership ABC. Subsequently, C forms a partnership with D and contributes X business to the CD partnership. After the distribution and contribution of X business, AB partnership owns Y business and CD partnership owns X business. In concluding that the transaction does not constitute a division, the Service reasoned that, for a division to occur, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction. In the above example, C is the only member of the ABC partnership in the CD partnership. Accordingly, the Preamble states that this transaction would not be treated as a

³⁷⁶Treas. Reg. § 1.708-1(b)(2)(ii).

³⁷⁷Treas. Reg. § 1.708-1(b)(2)(ii).

³⁷⁸Treas. Reg. § 1.708-1(b)(2)(ii).

³⁷⁹Preamble, T.D. 8925, 2001-1 at 496.

³⁸⁰Treas. Reg. § 1.708-1(d)(7).

³⁸¹Treas. Reg. § 1.708-1(d)(7).

³⁸²See Preamble, T.D. 8925, 2001-1 C.B. 496, 499; see also Treas. Reg. § 1.708-1(d)(4)(iv) (Defining a resulting partnership as "a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two members who were partners in the prior partnership.").

division for federal income tax purposes.³⁸³ Some commentators have observed that this still leaves many unanswered questions.³⁸⁴ For instance, suppose A is already a partner in CD (or, alternatively, assume A contributes other assets to CD as part of this transaction). Would this constitute a division even though A did not receive a distribution from ABC as part of this transaction? The Preamble does not address this issue.

a. Defined Terms Used in Treasury Regulations to Describe Form of Partnership Division. In describing the form of a partnership division, the final regulations use four defined terms: (1) prior partnership; (2) resulting partnership; (3) divided partnership; and (4) recipient partnership.³⁸⁵ Knowing the meaning of these terms is key to understanding the form of a partnership division.

(1) Prior Partnership; Resulting Partnership. The terms prior partnership and resulting partnership describe partnerships that exist under the applicable jurisdictional law.

(a) Prior Partnership. The prior partnership is the partnership subject to division that exists under the applicable jurisdictional law before the division.³⁸⁶

(b) Resulting Partnership. A resulting partnership is a partnership resulting from the division that exists under the applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership.³⁸⁷ For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.³⁸⁸

(2) Divided Partnership and Recipient Partnership. The terms divided partnership and recipient partnership are federal income tax concepts prescribed by the regulations.³⁸⁹

(a) Divided Partnership. A divided partnership is the continuing partnership which is treated, for federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form).³⁹⁰ The divided partnership must be a

³⁸³Preamble, T.D. 8925, 2001-1 at 503.

³⁸⁴*Hortenstine*, 496 PLI/Tax at 1057.

³⁸⁵See Treas. Reg. § 1.708-1(d)(4).

³⁸⁶Treas. Reg. § 1.708-1(d)(4)(ii).

³⁸⁷Treas. Reg. § 1.708-1(d)(4)(iv).

³⁸⁸Treas. Reg. § 1.708-1(d)(4)(iv).

³⁸⁹See Preamble, T.D. 8925, 2001-1 C.B. at 503.

³⁹⁰Treas. Reg. § 1.708-1(d)(4)(i).

continuation of the prior partnership.³⁹¹ The rules in the regulations for identifying the divided partnership are as follows:

i) If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership.³⁹²

ii) If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership.³⁹³ Although the divided partnership is considered one continuing partnership for federal income tax purposes, it may actually be two different partnerships under the applicable jurisdictional law (i.e., the prior partnership and a different resulting partnership that is considered a continuation of the prior partnership for federal income tax purposes).³⁹⁴

iii) If a partnership divides into two or more partnerships without undertaking the assets-over or assets-up form for the division, or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.³⁹⁵

(b) Recipient Partnership. A recipient partnership is a partnership that is treated as receiving, for federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).³⁹⁶

b. General Rules Concerning Form of Partnership Division. The regulations respect for federal income tax purposes the form of a partnership division accomplished under laws of an applicable jurisdiction if the partnership undertakes the steps of either the assets-over form or the assets-up form as prescribed in the regulations. Thus, the same forms allowed for partnership mergers are allowed for partnership divisions. Consistent with partnership mergers, if a partnership divides using a form other than the two prescribed, it will be treated as undertaking the assets-over form.³⁹⁷

³⁹¹Preamble, T.D. 8925, 2001-1 at 502.

³⁹²Treas. Reg. § 1.708-1(d)(4)(i).

³⁹³Treas. Reg. § 1.708-1(d)(4)(i).

³⁹⁴Preamble, T.D. 8925, 2001-1 C.B. at 503.

³⁹⁵Treas. Reg. § 1.708-1(d)(4)(i).

³⁹⁶Treas. Reg. § 1.708-1(d)(4)(iv).

³⁹⁷Treas. Reg. § 1.708-1(d)(3)(i).

(1) **Assets-Over Form.**

(a) **Assets-Over Form Where at Least One Resulting Partnership Is a Continuation of the Prior Partnership.** In a division under the assets-over form where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to a recipient partnership or recipient partnerships in exchange for interests in such recipient partnership or partnerships; and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership or partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.³⁹⁸

i) **Example 1.** To illustrate, assume that the ABCD Partnership owns three parcels of property: property X, with a value of \$500; property Y, with a value of \$300; and property Z, with a value of \$200. A and B each own a 40-percent interest in the capital and profits of the ABCD Partnership, and C and D each own a 10-percent interest in the capital and profits of the ABCD Partnership. On November 1, 1999, the ABCD Partnership divides into three partnerships (AB1, AB2, and CD) by contributing property X to a newly formed partnership (AB1) and distributing all interests in such partnership to A and B as equal partners, and by contributing property Z to a newly formed partnership (CD) and distributing all interests in such partnership to C and D as equal partners in exchange for all of their interests in the ABCD Partnership. While the ABCD Partnership does not transfer property Y, C and D cease to be partners in the partnership. Accordingly, after the division, the partnership holding property Y is referred to as partnership AB2.

The AB1 and AB2 Partnerships both are considered a continuation of the ABCD Partnership, while the CD partnership is considered a new partnership formed at the beginning of the day on November 2, 1999. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property X to the AB1 Partnership and property Z to the CD Partnership, and distributing the interests in such partnerships to the designated partners.³⁹⁹

ii) **Example 2.** Suppose that the facts are the same as in Example 1 except that the ABCD Partnership divides into three partnerships by operation of state law, without undertaking a form. The AB1 Partnership will be treated as the resulting partnership that is the divided partnership. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property Y to the AB2 Partnership and property Z to the CD partnership, and distributing the interests in such partnerships to the designated partners.⁴⁰⁰

iii) **Example 3.** Suppose the facts are the same as in Example 1, except that the ABCD Partnership divides into three partnerships by

³⁹⁸Treas. Reg. § 1.708-1(d)(3)(i)(A).

³⁹⁹Treas. Reg. § 1.708-1(d)(5), Example 4.

⁴⁰⁰Treas. Reg. § 1.708-1(d)(5), Example 5.

contributing property X to the newly-formed AB1 Partnership and property Y to the newly-formed AB2 Partnership and distributing all interests in each partnership to A and B in exchange for all of their interests in the ABCD Partnership. Because the resulting CD Partnership is not a continuation of the prior partnership (ABCD Partnership), the CD Partnership cannot be treated, for federal income tax purposes, as the partnership that transferred assets (i.e., the divided partnership), but instead must be treated as a recipient partnership. The AB1 Partnership will be treated as the resulting partnership that is the divided partnership. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property Y to the AB2 Partnership and property Z to the CD Partnership, and distributing the interests in such partnerships to the designated partners.⁴⁰¹

(b) Assets-Over Form Where None of the Resulting Partnerships Is a Continuation of the Prior Partnership. In a division under the assets-over form where none of the resulting partnerships is a continuation of the prior partnership, the prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships; and, immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership's partners.⁴⁰²

(2) Assets-Up Form.

(a) Assets-Up Form Where the Partnership Distributing Assets Is a Continuation of the Prior Partnership. Despite the partners' transitory ownership of some of the prior partnership's assets, the form of a partnership division will be respected for federal income tax purposes if the divided partnership (which must be a continuing partnership) distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership, and immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partnerships.⁴⁰³ In order for such form to be respected for transfers to a particular recipient partnership, all assets held by the prior partnership that are transferred to the recipient partnership must be distributed to, and then contributed by, the partners of the recipient partnership.⁴⁰⁴

The regulations contain an example illustrating this form of division. Assume that the ABCD Partnership owns properties W, X, Y, and Z, and divides into the AB Partnership and the CD partnership. Assume further that the AB Partnership is considered a continuation of the ABCD Partnership and that the CD Partnership is considered a new partnership. The ABCD

⁴⁰¹Treas. Reg. § 1.708-1(d)(5), Example 6.

⁴⁰²Treas. Reg. § 1.708-1(d)(3)(i)(B).

⁴⁰³Treas. Reg. § 1.708-1(d)(3)(ii)(A).

⁴⁰⁴Treas. Reg. § 1.708-1(d)(3)(ii)(A).

Partnership (i) distributes property Y to C and titles property Y in C's name; and (ii) distributes property Z to D and titles property Z in D's name. C and D then contribute properties Y and Z, respectively, to the CD partnership in exchange for interests in the CD partnership. Properties W and X remain in partnership AB. The regulations conclude that the ABCD Partnership will be treated as following the assets-up form for federal income tax purposes.⁴⁰⁵

(b) Assets-Up Form Where None of the Resulting Partnerships Are a Continuation of the Prior Partnership. If none of the resulting partnerships are a continuation of the prior partnership, then despite the partners' transitory ownership of some or all of the prior partnership's assets, the form of a partnership division will be respected for federal income tax purposes if the prior partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests in such resulting partnership or partnerships.⁴⁰⁶ In order for such form to be respected for transfers to a particular resulting partnership, all assets held by the prior partnership that are transferred to the resulting partnership must be distributed to, and then contributed by, the partners of the resulting partnership.⁴⁰⁷ If the prior partnership does not liquidate under the applicable jurisdictional law, then with respect to the assets and liabilities that, in form, are not transferred to a new resulting partnership, the prior partnership will be treated as transferring these assets and liabilities to a new resulting partnership under the assets-over form.⁴⁰⁸

c. Treatment of Partnership Division Utilizing More Than One Form. The final regulations require consistency in applying either the assets-over form or the assets-up form to characterize a transfer of assets to a resulting partnership.⁴⁰⁹ Thus, the final regulations do not permit a partnership division to effect a transfer to a resulting partnership utilizing both the assets-over form and the assets-up form.⁴¹⁰ If, however, a single partnership is divided in a transaction that involves a transfer of assets (either actual or deemed) to multiple partnerships, the regulations permit the transfer to each resulting partnership to be viewed separately. As with mergers involving more than two partnerships, Treasury believes it is consistent with the purposes of the regulations, in the context of divisions, to allow the transfer to one resulting partnership to be characterized under the assets-over form while characterizing the transfer to another resulting partnership under the assets-up form.⁴¹¹

⁴⁰⁵Treas. Reg. § 1.708-1(d)(5), Example 2.

⁴⁰⁶Treas. Reg. § 1.708-1(d)(3)(ii)(B).

⁴⁰⁷Treas. Reg. § 1.708-1(d)(3)(ii)(B).

⁴⁰⁸Treas. Reg. § 1.708-1(d)(3)(ii)(A).

⁴⁰⁹Preamble, T.D. 8925, 2001-1 C.B. at 498; *see* Treas. Reg. § 1.708-1(d)(3)(i).

⁴¹⁰Treas. Reg. § 1.708-1(d)(3)(i).

⁴¹¹Preamble, T.D. 8925, 2001-1 C.B. at 498.

(1) **Example 1.** The final regulations contain an example illustrating when a division accomplished under both the assets-over form and the assets-up form will not be respected. Assume that the ABCD Partnership owns properties W, X, Y, and Z, and divides into the AB Partnership and the CD partnership. Assume further that the AB Partnership is considered a continuation of the ABCD Partnership and that the CD Partnership is considered a new partnership. ABCD Partnership distributes property Y to C and titles property Y in C's name. C then contributes property Y to partnership CD. Simultaneously, the ABCD Partnership contributes property Z to the CD Partnership in exchange for an interest in the CD Partnership. Immediately thereafter, the ABCD Partnership distributes the interest in the CD Partnership to D in liquidation of D's interest in the ABCD Partnership.

The regulations conclude that since the ABCD Partnership did not undertake the assets-up form with respect to all of the assets transferred to the CD Partnership, the ABCD Partnership will be treated as undertaking the assets-over form in transferring the assets to the CD Partnership. Accordingly, for federal income tax purposes, the ABCD Partnership is deemed to contribute property Y and property Z to the CD Partnership in exchange for interests in the CD Partnership, and immediately thereafter, the ABCD Partnership is deemed to distribute the interests in the CD Partnership to partner C and partner D in liquidation of their interests in the ABCD Partnership.⁴¹²

(2) **Example 2.** The final regulations provide an example that illustrates when a division accomplished under both the assets-over form and the assets-up form will be respected. Assume that the Partnership ABCDE owns Blackacre, Whiteacre, and Redacre, and divides into the AB Partnership, the CD Partnership, and the DE Partnership. Assume that the ABCDE Partnership is considered terminated (and, hence, none of the resulting partnerships are a continuation of the prior partnership) because none of the members of the new partnerships (AB Partnership, CD Partnership, and DE Partnership) owned an interest of more than 50-percent in the capital and profits of the ABCDE Partnership.

ABCDE Partnership distributes Blackacre to A and B and titles Blackacre in the names of A and B. A and B then contribute Blackacre to the AB Partnership in exchange for interests in the AB Partnership. The regulations conclude that the ABCDE Partnership will be treated as following the assets-up form for federal income tax purposes.

ABCDE Partnership distributes Whiteacre to C and D and titles Whiteacre in the names of C and D. C and D then contribute Whiteacre to the CD Partnership in exchange for interests in the CD Partnership. ABCDE Partnership will be treated as following the assets-up form for federal income tax purposes.

ABCDE Partnership does not liquidate under state law so that, in form, the assets in the new DE partnership are not considered to have been transferred under state law. ABCDE Partnership will be treated as undertaking the assets-over form for federal income tax purposes with respect to the assets of the DE Partnership. Thus, the ABCDE Partnership will be treated as contributing Redacre to the DE Partnership in exchange for interests in the DE Partnership, and,

⁴¹²Treas. Reg. § 1.708-1(d)(5), Example 3.

immediately thereafter, ABCDE Partnership will be treated as distributing interests in the DE Partnership to D and E in liquidation of their interests in the ABCDE Partnership. The ABCDE Partnership then terminates.⁴¹³

d. Authority Granted to Revenue Service to Disregard Form of Transaction in Certain Cases. If a partnership division is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form, the final regulations grant the Revenue Service the authority to disregard such form and to recast the larger series of transactions in accordance with their substance.⁴¹⁴

e. Application of Sections 704(c)(1)(B) and 737 to Partnership Divisions. The rules of Sections 704(c)(1)(B) and 737 may be implicated in the context of partnership divisions and deserve careful consideration. Section 704(c)(1)(B) requires a contributing partner to recognize pre-contribution built-in gain if property contributed to a partnership is distributed by the partnership (other than to the contributing partner) within 7 years of being contributed to the partnership. Section 737(a) provides that a partner that contributed property to a partnership recognizes pre-contribution built-in gain if the partnership distributes property to him within 7 years of the contribution. Any portion of a distribution, however, that consists of property that had been contributed by the distributee partner to the partnership is not taken into account under Section 737(a).⁴¹⁵

The Preamble to the proposed regulations addressing partnership mergers and divisions discusses some of the Section 704(c)(1)(B) and 737 issues implicated in a partnership division.⁴¹⁶ The Service announced in the Preamble to the final regulations that it is studying these issues and is requesting comments on the application of Sections 704(c)(1)(B) and 737 in situations where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division.⁴¹⁷

3. Tax Return; Elections.

a. Tax Returns. The Treasury Regulations provide that the resulting partnership that is treated as the divided partnership retains the EIN of the prior partnership and is required to file a return for the taxable year of the partnership that has been divided.⁴¹⁸ The return is required to include the information prescribed in Treasury Regulation § 1.708-1(d)(2)(i). All other resulting partnerships that are considered as continuing and all new partnerships (i.e., resulting partnerships that are not considered continuing) will file separate

⁴¹³Treas. Reg. § 1.708-1(d)(5), Example 7.

⁴¹⁴Treas. Reg. § 1.708-1(d)(6).

⁴¹⁵I.R.C. § 737(d)(1).

⁴¹⁶Partnership Merger Regs. Notice, 2000-2 C.B. at 499.

⁴¹⁷Preamble, T.D. 8925, 2001-1 C.B. at 499-500.

⁴¹⁸Treas. Reg. § 1.708-1(d)(2)(i).

returns for the taxable year beginning on the day after the date of the division with new EINs for each partnership.⁴¹⁹ The return for a resulting partnership that is regarded as continuing and that is not the divided partnership is required to include the name, address, and EIN of the prior partnership.⁴²⁰

To illustrate, assume that the ABCD Partnership is in the real estate and insurance businesses. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of ABCD. The partnership and the partners report their income on a calendar year. On November 1, 1999, they separate the real estate and insurance businesses and form two partnerships. AB Partnership takes over the real estate business, and CD Partnership takes over the insurance business. Because members of resulting AB Partnership owned more than a 50-percent interest in the capital and profits of ABCD Partnership (A, 40-percent, and B, 20-percent), AB partnership is considered a continuation of ABCD Partnership. AB Partnership is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that until November 1, 1999, it was the ABCD Partnership. CD Partnership is considered a new partnership formed at the beginning of the day on November 2, 1999, and is required to file a return for the taxable year it adopts.⁴²¹

b. Elections. All resulting partnerships that are regarded as continuing are subject to preexisting elections that were made by the prior partnership. A subsequent election that is made by a resulting partnership does not affect the other resulting partnerships.⁴²²

⁴¹⁹Treas. Reg. § 1.708-1(d)(2)(i).

⁴²⁰Treas. Reg. § 1.708-1(d)(2)(i).

⁴²¹Treas. Reg. § 1.708-1(d)(5), Example 1.

⁴²²Treas. Reg. § 1.708-1(d)(2)(ii).