Rulings Shed Some Light on the Application of Partnership Merger and Division Rules, but Not a Roadmap

Transactions involving partnerships can be tricky to characterize for U.S. federal income tax purposes, to say the least. Too often, the results can be unexpected and counterintuitive, and the complexity can dramatically increase in cases where there are multiple entities and/or steps. Examining a series of substantially identical letter rulings that involved a multistep transaction and the treatment for U.S. federal income tax purposes as a partnership division followed immediately after by a partnership merger can shed light on the issues.

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In PLR 201619001 and four other substantially identical private letter rulings (PLRs),[1] the IRS addressed the tax consequences of a division and merger of a partnership in connection with an initial public offering (IPO) for a real estate investment trust (REIT). The PLRs conclude, in part, that certain steps in an overall transaction involving an entity that divided into two entities, both of which were classified as a partnership for U.S. federal income tax purposes, will be treated as a partnership division.[2] The PLRs also conclude that subsequent steps in the transaction involving a merger of one of the resulting partnerships from the partnership division with another entity classified as a partnership for U.S. federal income tax purposes will be treated as a partnership merger.[3] Finally, the PLRs conclude that the subsequent distribution of public REIT shares by the partnership that terminated in the partnership merger to some of its partners will be treated as sales of partnership interests.[4] Though the facts and taxpayer representations of the PLRs are extensive, the IRS did not provide much analysis in arriving at its conclusions. However, a careful review of the facts and taxpayer representations, along with knowledge of the partnership division and merger rules can help connect some of the dots.

Facts of the PLRs

The transaction described in the PLRs involved X, a local law entity which was classified as a partnership for U.S. federal income tax purposes; OP, a newly formed entity classified as a partnership for U.S. federal income tax purposes; and Public REIT, a REIT as defined in § 856. X owned certain assets that were desired by the Public REIT (the "Desired Assets") and certain other assets that X would retain (the "Retained Assets"). Public REIT sought to own all of its investments in real estate properties (presumably including the Desired Assets owned by X) and conduct all of its operations through OP. To accomplish this, the parties proposed to enter into a transaction to be achieved in a series of steps as described below.

- Step 1: X would form a single-member LLC ("Wanted") by contributing the Desired Assets to the capital of Wanted.
- Step 2: X would form another single-member LLC ("Legacy") that in turn would form another single-member LLC ("Mergerco").
- Step 3: X would distribute the entirety of its interest in Legacy to its partners in accordance with each partner's economic right based on the X partnership agreement.[5]
- Step 4a: Wanted and Mergerco would merge pursuant to a merger agreement, with Wanted surviving and all of the interests in Wanted would be owned (after the merger) by Legacy.
- Step 4b: Wanted would distribute shares in Public REIT ("Public REIT Shares") to Legacy, which in turn would make a pro rata distribution of these Public REIT Shares to all of its partners.[6]
- Step 5: Public REIT would contribute some of its Public REIT Shares to the capital of OP in return for units of partnership interest in OP ("OP Units"). The share of Public REIT that would be contributed to OP are referred to as "OP Merger REIT Shares."
- Step 6: Pursuant to a contribution agreement ("Contribution Agreement"), Legacy would contribute the entirety of its interests in Wanted to the capital of OP in return for OP Units and Public Shares.
- Step 7: Legacy would liquidate by distributing OP Units to a portion of its partners ("Partner Group 1"), and Public REIT Shares to the remaining partners ("Partner Group 2").

In addition, the following representations were made to the IRS:

1. OP will be formed, will have at least two owners, and will be classified as a partnership for U.S. federal income tax purposes prior to the above steps. In addition, Wanted and Mergerco will not be classified as associations for U.S. federal income tax purposes at any of the relevant times during the above steps.
2. Upon the completion of Step 4, X and Legacy will be owned by the same partners. Each partner's combined economic interest in X and Legacy will be the same as their interest in X before the Transaction.
3. The fair market value of the assets (net of liabilities) held by Legacy will exceed the fair market value of the assets (net of liabilities) held by X immediately after Step 4.
4. Public REIT will own more than 50 percent of the capital and profits interests of OP as a result of the transaction. The partners of Legacy will not own more than 50 percent of the capital and profits of OP as a result of the Transaction.
5. Neither X nor OP will be contemplating participation in any additional divisions or mergers as of the date of the above steps.
6. The Contribution Agreement will specify two points: that OP is purchasing partnership interests in Legacy from Partner Group 2; and the consideration that is transferred for each interest purchased. Each REIT Shareholder in Partner Group 2 will be deemed to have consented to treat the distribution of the Public REIT Shares as a sale of partnership interests in Legacy by Partner Group 2 to OP for U.S. federal income tax purposes.

X requested a ruling that (1) steps 1 through 4 (the "Division") would be treated as a division of X under Treas. Reg. § 1.708-1(d), (2) steps 5 through 7 (the "Merger") would be treated as a merger of Legacy and OP under Treas. Reg. § 1.708-1(c), and (3) the distribution of the Public REIT Shares by Legacy to Partner Group 2 (the "Distribution of Public REIT Shares") would be treated as a sale of partnership interests in Legacy by Partner Group 2 to OP under Treas. Reg. § 1.708-1(c)(4).

Merger and Division Regulatory Guidance

Partnership Divisions

Treas. Reg. § 1.708-1(d)(1) provides that in the case of a division of a partnership into two or more partnerships, any resulting partnership is considered a continuation of the prior partnership if the members of the resulting partnership or partnerships have an interest of more than 50 percent in the capital and profits of the prior partnership. When a partnership divides into two or more partnerships under applicable jurisdictional law without undertaking a form for the division, or undertakes a form that is not an "assets-up" form, the transaction is characterized under the "assets-over" form for U.S. federal income tax purposes.[7] In a partnership 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. Treas. Reg. § 1.708-

1(d)(4)(i) provides that the divided partnership is the continuing partnership which is treated 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). If the partnership that, in form, transferred the assets and liabilities in connection with a division is a continuation of the prior partnership, then such partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships without undertaking a form, or if the resulting partnership that had, in form, transferred assets and liabilities is not 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 (the "Division Tie-Breaker Test").

Partnership Mergers

Treas. Reg. § 1.708-1(c)(1) provides that if two or more partnerships merge or consolidate into one partnership, the resulting partnership is considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership (the "Merger Ownership Test"). If the resulting partnership can be considered a continuation of more than one of the merging or consolidating partnerships by applying the Merger Ownership Test, it will be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership (the "Merger Tie-Breaker" Test). When two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger that is not an "assets-up" form, any merged or consolidated partnership that is considered terminated under Treas. Reg. § 1.708-1(c)(1) is treated as undertaking the "assets-over" form for U.S. federal income tax purposes. Under the "assets-over" form, the merged or consolidated partnership that is considered terminated under Treas. Reg. § 1.708-1(c)(1) is treated as contributing all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership (Treas. Reg. § 1.708-1(c)(3)(i)). There is a special provision contained in Treas. Reg. § 1.708-1(c)(4) which states that in a transaction characterized under the assets-over form, a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership that occurs as part of a merger or consolidation under § 708(b)(2)(A) will be respected as a sale of a partnership interest if the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold, and that 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 ("Merger Buy-out" Rule).

IRS's Ruling in PLRs

The IRS granted X's request and concluded that (1) the Division would be treated as a division of X under Treas. Reg. § 1.708-1(d), (2) the Merger would be treated as a merger of Legacy and OP under Treas. Reg. § 1.708-1(c), and (3) the Distribution of Public REIT Shares would be treated as a sale of partnership interests in Legacy by Partner Group 2 to OP under the Merger Buy-out Rule of Treas. Reg. § 1.708-1(c)(4). However, the IRS provided little detail as to how it arrived at its conclusions in the PLRs.

For instance, with respect to the Division, the PLRs were silent as to which entities (if any) would be viewed as a continuation of the prior partnership, X. Representation #2, which stated that upon completion of Step 4, X and Legacy would be owned by the same partners and that each partner's combined economic interest in X and Legacy would be the same as their interest in X before the Transaction, may shed some light on this matter. By application of the partnership division rules under Treas. Reg. § 1.708-1(d) to Representation #2, both X and Legacy as the resulting partnerships seem to be a continuation of the prior partnership, X, because the members of the resulting partnerships (X and Legacy) appear to have had an interest of more than 50 percent in the capital and profits of the prior partnership, X, immediately after the Division. The PLRs were silent with respect to which form X undertook in the Division and the Division did not appear to undertake a form prescribed in Treas. Reg. § 1.708-1(d)(3). Thus, the form of the Division would apparently default to "assets-over." The PLRs similarly did not indicate which entity should be viewed as the divided partnership. Because the form of the Division apparently defaulted to assets-over and X and Legacy both appear to be continuations of X as discussed above, the Division Tie-Breaker Test must be applied to determine which resulting partnership should be viewed as the divided partnership. As noted above in Representation #3, the fair market value of assets (net of liabilities) held by Legacy exceeded the fair market value of assets (net of liabilities) held by X immediately after the Step 4. By applying the Division Tie-Breaker Test, it seems appropriate to view Legacy as the divided partnership and X as the recipient partnership.

The notion that Legacy may be the divided partnership (*i.e.*, the partnership that contributes certain assets and liabilities to the recipient partnership) seems counterintuitive as X was the prior partnership. However, viewing Legacy as the divided partnership may have been important in respecting the Merger aspect of the transaction. As discussed above, Legacy merged with OP and apparently terminated shortly after springing to life as a partnership in Step 3. Generally, transitory entities are ignored and the steps of a transaction involving a transitory entity may be recast to better reflect the substance of the transaction.[8] However, because Legacy is characterized under the partnership division rules as the divided partnership, its existence is arguably not being viewed as transitory under the PLRs. Being the divided partnership means that Legacy was (1) a continuation of the prior partnership, X, and (2) the partnership that is viewed as contributing the Retained Assets to X (the recipient partnership). In other words, for U.S. federal income tax purposes, Legacy's existence as a partnership would appear to precede the division discussed in the PLRs and thus, Legacy is not a transitory entity.

Another aspect of the transaction to which the PLRs were silent was which partnership (Legacy or OP) survived the Merger for U.S. federal income tax purposes. However, applying the partnership merger rules of Treas. Reg. § 1.708-1(c) to Representation #4 may reveal which partnership would be considered a continuation. According to Representation #4, the partners of Legacy would not own more than 50 percent of the capital and profits of the resulting partnership after the Merger. Thus, applying the Merger Ownership

Test, OP would likely be viewed as the continuing partnership and the Merger Tie-Breaker Test would not need to be applied. Because the Merger did not seem to take a prescribed form in the partnership merger rules, its form would default to "assets-over." As a result, Legacy, as the terminating partnership would be viewed as contributing all of its assets and liabilities to OP in exchange for an OP interest, and immediately afterward, would distribute its OP interest to its partners in complete liquidation of their interests in Legacy.

The PLRs did also not explicitly state how the Merger-Buyout Rules would apply to the Distribution of Public REIT Shares. Again, the facts and representations of this transaction serve to help decipher this transaction. As discussed above, the Merger apparently undertook the default "assets-over" form. In addition, Representation #6 provided that the Contribution Agreement specified that OP was purchasing Legacy partnership interests from Partner Group 2, and that Partner Group 2 was deemed to have consented to treat the Distribution of Public REIT Shares as a sale of their Legacy partnership interest. The combination of the apparent "assets-over" form that the Merger undertook and the provision in the Contribution Agreement was apparently sufficient for the IRS to characterize the transaction under the Merger Buy-out Rule. What is also interesting with regard to this part of the transaction is that Public REIT Shares, rather than cash, were used as consideration in the sale of Legacy partnership interests. This raises the question as to whether any property could be used as consideration in applying the Merger Buy-out Rule, provided that all the other requirements of the Merger Buy-out Rule are met.

Another important question is whether the transaction described by the PLRs fell within the scope of the partnership merger and division regulations. The PLRs apparently answers that question in the positive. However, the terms, "partnership merger" and "partnership division," are not defined in the Internal Revenue Code or in Treasury Regulations, and it can be difficult in some situations to conclude whether a transaction is covered by the partnership merger or partnership division rules in § 708. In the preamble to the final regulations on the tax consequences of partnership mergers and divisions, the IRS and Treasury specifically declined to provide a definition of what is a partnership merger or division.[9]

Although not defined by statute or regulations, some considerations in determining whether a transaction constitutes a partnership merger occurred might be:

1. Is this a transaction that begins with two or more partnerships and results in one combined partnership?
2. Are the partnerships that merged or consolidated "old and cold," or was one of the partnerships in the transaction formed merely to facilitate the transaction?
3. Is at least one of the partners of the resulting combined partnership a partner of each of the merging or consolidating partnerships?
4. Has any consideration been paid in connection with a transaction involving the potential merger of two or more partnerships?

Similarly, in the context of determining whether a partnership division occurred, some considerations might be:

1. Did the transaction begin with just one partnership and result in the formation of at least two partnerships at the end of the transaction?
2. Are there at least two partners from the prior partnership in each of the resulting partnerships[10]?

The PLRs undoubtedly raise several other questions, such as the timing of the overall transaction, as well as the timing in between each individual step of the transaction, and whether OP should be respected as a partnership for U.S. federal income tax purposes.[11] Given the uncertainties and lack of specific detailed facts in the PLRs, the PLRs are helpful, but do not provide a full roadmap for practitioners. ⊙

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Endnotes

[1]*See also* PLRs 201643016, 201643017, 201643018, and 201643019.
[2]Under Treas. Reg. § 1.708-1(d).
[3]Under Treas. Reg. § 1.708-1(c).
[4]Under Treas. Reg. § 1.708-1(c)(4).
[5]Presumably, Legacy becomes a partnership for U.S. federal income tax purposes at this point in time. *See* Treas. Reg. Section 301.7701-3(b)(i), which provides that a domestic eligible entity is classified as a partnership if it has two or more members.
[6]Note this step only appears in PLRs 201643018 and 201643019. The IRS' conclusions did not appear to be affected by this step.
[7]Treas. Reg. § 1.708-1(d)(3)(i).
[8]*See, e.g.,* Rev. Rul. 78-250 1978-1 C.B. 83 (in which the IRS disregarded the transitory existence of a newly created corporation, Y, that was owned by the majority of a second corporation X, and that merged into X with the majority shareholder receiving stock of X and the minority shareholders as receiving cash for their shares of X. The IRS treated the entire transaction as a redemption of X's minority shareholders.; Rev. Rul. 67-448, 1967-2 C.B. 144 (in which the IRS held that a series of interrelated steps involving the transitory existence of a newly created corporation is disregarded and the transaction is treated for federal income tax purposes as the mere exchange by a corporation of shares of its voting stock for the outside minority stock interest in its subsidiary, which transaction qualified as a reorganization under § 368(a)(1)(B).; Rev. Rul. 73-427, 1973-2 C.B. 301 (which disregards the creation and elimination of a corporation in an integrated transaction).
[9]*See* T.D. 8925, 66 Fed. Reg. 715 (1/04/2001).
[10]*See* T.D. 8925. Although no definition of what constitutes a partnership division was provided in the final regulations, the IRS and Treasury clarified in the preamble to the final regulations that a partnership division does not occur when only one partner from the prior partnership is a partner in the resulting partnership. In order to have a partnership division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction.
[11]The IRS apparently accepted X's representation that OP would be classified as a partnership (see Representation #1).