

Comment letter on I.R.S. Revenue Ruling 2004-43, 2004-18 I.R.B.842 (partnership "anti-mixing bowl rules")

Note: *The views expressed herein represent only those of the Taxation Section of the District of Columbia Bar and not those of the D.C. Bar or of its Board of Governors.*

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Re: Comments On Revenue Ruling 2004-43, 2004-18 I.R.B. 842

Gentlemen:

Enclosed please find comments from the District of Columbia Bar Taxation Section¹ on Rev. Rul. 2004-43, 2004-18 I.R.B. 842. Rev. Rul. 2004-43 analyzes the application of the partnership anti-mixing bowl rules after an “assets-over” partnership merger.

The partnership anti-mixing bowl rules provide that, following an “assets-over” partnership merger, a distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to the anti-mixing bowl rules “to the same extent” that a distribution by the transferor partnership would have been subject to those rules. Contrary to the plain language of the regulations and to the understanding of the great majority of taxpayers and practitioners, Rev. Rul. 2004-43 provides that the transferee partnership is subject to the anti-mixing bowl rules to a greater extent than the transferor partnership. Our comments suggest that Rev. Rul. 2004-43 be withdrawn, or, at the very least, made applicable on a prospective basis to partnership mergers occurring after the date the Ruling was published.

If you have any questions please contact Andrea Whiteway at (202) 942-5863 or me at (202) 626-5962.

Respectfully submitted,
Steven M. Rosenthal, Chair
Enclosure

cc: Eric Solomon, Deputy Assistant Secretary (Regulatory Affairs), Department of Treasury
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1. The Section of Taxation is comprised of approximately 1,600 members. These materials were prepared by an ad hoc committee of the District of Columbia Bar Taxation Section. The members of the ad hoc committee were Brian Blum, Jon Finkelstein, Christian McBurney, Blake Rubin, Charles Temkin, Eric Wang and Andrea Whiteway. The views expressed herein represent only those of the Taxation section of the District of Columbia and not those of the D.C. Bar or of its Board of Governors. Although members of the Taxation Section who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization with which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Executive Summary of Comments on Revenue Ruling 2004-43, 2004-18 I.R.B. 842⁽¹⁾

On April 12, 2004, the Internal Revenue Service issued Rev. Rul. 2004-43, 2004-18 I.R.B. 842, which analyzes regulations concerning the application of the partnership “anti-mixing bowl” rules to transactions that constitute “assets-over” partnership mergers.

The regulations under section 704(c)(1)(B) and section 737 provide that, after an assets-over partnership merger, the surviving transferee partnership is subject to the partnership anti-mixing bowl rules “to the same extent as” the transferor partnership was subject to the partnership anti-mixing bowl rules.

Rev. Rul. 2004-43, however, concludes that, after an assets-over partnership merger, the surviving transferee partnership is subject to the partnership anti-mixing bowl rules (1) to the extent that the transferor partnership was subject to the anti-mixing bowl rules, plus (2) to the extent that the fair market value of the contributed property in the merger exceeds its section 704(b) “book” value in the hands of the transferor partnership.

Contrary to the plain language of the anti-mixing bowl regulations, under the Ruling, the transferee partnership is subject to the partnership anti-mixing bowl rules to a greater extent than the transferor partnership.

We believe that the great majority of tax practitioners apply the partnership anti-mixing bowl regulations in accordance with the plain language of the regulations and that Rev. Rul. 2004-43 represents a significant change in the government’s policy with respect to the tax consequences of an assets-over partnership merger. We believe that if such a policy change is to be effectuated,

it should be effectuated by proposing new regulations that would apply prospectively to partnership mergers that occur after the date of publication of the regulations. This would give taxpayers notice of, and the opportunity to comment on, such a change in policy.

Moreover, we believe that it is unfair to penalize taxpayers who relied on the plain language of the partnership anti-mixing bowl regulations in consummating partnership merger transactions in the seven-year period since the regulations were promulgated. Accordingly, on behalf of the D.C. Bar Taxation Section, we propose that Rev. Rul. 2004-43 be withdrawn, or, at the very least, made applicable only to partnership mergers that occur after the date of publication of the Ruling.

1. The views expressed herein represent only those of the District of Columbia Bar Taxation Section and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,600 members. These materials were prepared by an ad hoc committee of the District of Columbia Bar Taxation Section. The members of the ad hoc committee were Brian Blum, Jon Finkelstein, Christian McBurney, Blake Rubin, Charles Temkin, Eric Wang and Andrea Whiteway.

Comments on Revenue Ruling 2004-43, 2004-18 I.R.B. 842

The District of Columbia Bar Taxation¹Section makes the following comments on Revenue Ruling 2004-43, 2004-18 I.R.B. 842, regarding the application of the partnership “anti-mixing bowl” rules to partnership mergers that constitute “assets-over” mergers.

As described below, we believe that the conclusion in the Ruling is contrary to the plain language of partnership anti-mixing bowl regulations and should be withdrawn.

The Anti-Mixing Bowl Rules

Pursuant to section 704(c)(1)(A), income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

The partnership “anti-mixing bowl” rules of section 704(c)(1)(B) and the regulations thereunder require the recognition of taxable gain or loss in the event that section 704(c) property is contributed to a partnership and such property is subsequently distributed to another partner in the partnership within seven years of its contribution. The amount of gain or loss recognized is the amount of gain or loss that would have been allocated to such partner under section 704(c)(1)(A) if the property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution.

Similarly, the anti-mixing bowl rules of section 737(a) and the regulations thereunder may require gain recognition in the event that a partner contributes section 704(c) property to a partnership and within seven years the partnership distributes other property (other than money) to the contributing partner. The amount of gain recognized is the lesser of (1) the amount by which the fair market value of the distributed property exceeds the distributee partner’s adjusted tax basis in the partner’s partnership interest, or ⁽²⁾ the “net precontribution gain” of the partner. The “net precontribution gain” of a partner is defined as the net gain that would have been

recognized by the distributee partner under section 704(c)(1)(B) if all property that (1) had been contributed to the partnership by the distributee partner within seven years of the distribution and (2) is held by such partnership immediately before the distribution, had been distributed by such partnership to another partner.

The anti-mixing bowl regulations promulgated on May 8, 1997, provide that, following a transaction that constitutes an “assets-over” partnership merger within the meaning of Treas. Reg. § 1.708-1(c)(3), a distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to the anti-mixing bowl rules “to the same extent” that a distribution by the transferor partnership would have been subject to those rules. Specifically, the regulations state:

4. Complete Transfer to Another Partnership

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. A subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). See section 1.737-2(b) for a similar rule in the context of section 737. [Emphasis added]

Treas. Reg. § 1.704-4(c)(4). Similarly, Treas. Reg. § 1.737-2(b) states:

b. Transfers to another partnership –

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. See section 1.704-4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

3. Subsequent Distributions

A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from that transferor partnership would have been subject to section 737. [Emphasis added] ⁽²⁾

Revenue Ruling 2004-43

Rev. Rul. 2004-43, issued on April 12, 2004, concludes that, following an “assets-over” partnership merger, the transferee partnership is subject to the anti-mixing bowl rules both (1) to

the extent that the transferor partnership was subject to the anti-mixing bowl rules, and (2) to the extent that the fair market value of the contributed property at the time of the “assets-over” merger exceeds its section 704(b) “book” value in the hands of the transferor partnership.

The facts in the Ruling are as follows.⁽³⁾ On January 1, 2004, A and B form partnership AB. A contributes Asset 1 with a basis of \$200x and a fair market value of \$300x in exchange for a 50 percent interest. B contributes \$300x of cash in exchange for a 50 percent interest. On January 1, 2004, C and D form partnership CD. C contributes Asset 2 with a basis of \$100x and a fair market value of \$200x in exchange for a 50 percent interest. D contributes \$200x of cash in exchange for a 50 percent interest. AB and CD undertake an assets-over partnership merger on January 1, 2006, in which AB is the continuing partnership and CD is the terminating partnership. At the time of the merger, AB’s only assets are Asset 1, which has appreciated in value to \$900x, and \$300x in cash. CD’s only assets are Asset 2, which has appreciated in value to \$600x, and \$200x in cash. After the merger, the partners have capital and profits interests in AB as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent.

The partnership agreements for AB and CD provide that the partners’ capital accounts will be determined and maintained in accordance with the section 704(b) regulations. The partnership agreements also require the revaluation of partnership property upon the admission of a new partner. On January 1, 2012, AB has the same assets that it had after the merger. Each asset has the same value that it had at the time of the merger. On this date, AB distributes Asset 2 to A in liquidation of A’s interest in AB.

On these facts, the Ruling concludes that, because the distribution of Asset 2 to A occurs more than seven years after the contribution of Asset 2 to CD, section 704(c)(1)(B) does not apply to the \$100x of pre-existing section 704(c) gain attributable to that contribution. However, the distribution of Asset 2 to A occurs within seven years of the contribution of Asset 2 by CD to AB. The Ruling concludes that as to the \$400x of section 704(c) gain that arose on the contribution of Asset 2 by CD to AB, C and D each succeed to one-half of this amount and upon the distribution of Asset 2 to A, C and D each recognize \$200x of gain under section 704(c)(1)(B).

With respect to A’s tax consequences, the Ruling notes that the distribution of Asset 2 occurs more than seven years after A’s contribution of Asset 1 to AB. Because A made no subsequent contributions to AB, the Ruling concludes that there is no net precontribution gain for purposes of section 737(b). Accordingly, A will not recognize gain under section 737 as a result of the distribution of Asset 2. AB’s \$600x of “reverse” section 704(c) gain in Asset 1, resulting from a revaluation of AB’s partnership property at the time of the merger, is not net precontribution gain.

As discussed below, it is clear that if CD had distributed Asset 2 to C and D, neither C nor D would have recognized any gain under section 704(c)(1)(B) or section 737. Accordingly, under the Ruling, a distribution of section 704(c) property by the transferee partnership requires greater gain recognition than a distribution of such property by the transferor partnership would have required. The Ruling applies retroactively to the effective date of the anti-mixing bowl regulations, which generally apply to partnership distributions on or after January 9, 1995.⁽⁴⁾

Analysis

As discussed below, while the conclusion reached in Rev. Rul. 2004-43 may have a policy justification, we believe that the “step-in-the-shoes” rule contained in the regulations is at least equally defensible from a tax policy perspective. Irrespective of the merits of each approach from a policy perspective, however, the conclusion in the Ruling is simply inconsistent with the plain language of the anti-mixing bowl regulations.

As described above, the anti-mixing bowl regulations state that, following an “assets-over” partnership merger, “[a] subsequent distribution of section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B).” In the Ruling, AB is the “transferee partnership.” AB distributes Asset 2, which is section 704(c) property, to A, who is a partner of the transferee partnership. In the Ruling, CD is the “transferor partnership.” Therefore, the anti-mixing bowl regulations provide that the distribution of Asset 2 “is subject to section 704(c)(1)(B) to the same extent that a distribution by [CD] would have been subject to section 704(c)(1)(B).” It is beyond disagreement that, had CD distributed Asset 2, the distribution would not have been subject to section 704(c)(1)(B) to any extent because the distribution would have occurred more than seven years after the contribution of Asset 2 into CD by C. Nor would C have recognized gain under section 737(a), because C originally contributed Asset 2.⁽⁵⁾ Thus, under the plain language of the anti-mixing bowl regulations, C would recognize no gain under section 704(c)(1)(B). Nevertheless, the Ruling requires C to recognize \$200x of gain under section 704(c)(1)(B). Similarly, because D never contributed any property other than money to CD, under the plain language of the anti-mixing bowl regulations, D would not recognize gain under either section 704(c)(1)(B) or section 737(a). The Ruling, however, requires D to recognize \$200x of gain under section 704(c)(1)(B) even though D never contributed any property into CD.

The Ruling offers no justification for its conclusion that the “to the same extent” language in the anti-mixing bowl regulations applies only to section 704(c) gain that existed before the merger, and not to section 704(c) gain that arises at the time of the merger. Further, the anti-mixing bowl regulations do not contemplate or suggest any such distinction. As discussed above, if CD had distributed Asset 2, C would not have recognized any gain because the distribution would have occurred more than seven years after the contribution of Asset 2 into CD by C. The Ruling, however, concludes that a distribution of Asset 2 by AB on the same date triggers \$200x of gain to C. It cannot be said that C recognizes gain “to the same extent” as C would have recognized upon a distribution by CD (\$0). We do not believe that recognizing gain of \$200x can be said to be recognizing gain “to the same extent” as recognizing \$0 gain.

Based on discussions with other practitioners and comments made at conferences and Bar meetings, we believe that the great majority of tax practitioners apply the anti-mixing bowl regulations in accordance with the plain language of the regulations so that the amount of gain required to be recognized by the transferee partnership on a distribution of property contributed to it by the transferor partnership is an amount equal to the property’s section 704(c) gain in the hands of the transferor partnership. The amount of the property’s section 704(c) gain in the hands of the transferor partnership is the amount of gain that would have been recognized upon a distribution of the property by the transferor partnership. Thus, this application of the anti-mixing bowl regulations is consistent with the language of the relevant regulations. Moreover, at

least 11 articles published in widely read journals describe this application of the anti-mixing bowl regulations as the proper and most natural interpretation.⁽⁶⁾

From a policy perspective, we believe that the “step-in-the-shoes” rule of the regulations is at least as defensible as the position adopted in Rev. Rul. 2004-43. Presumably, the policy rationale for the “step-in-the-shoes” rule is that a partnership merger accomplishes a mere change in form and that, as in the case of a corporate merger, it is appropriate to treat certain tax attributes of the merged partnership as “carrying over” to the successor entity.⁽⁷⁾ For example, assume that A and B form a partnership for cash capital contributions that are used to purchase property that subsequently appreciates in value. Assume that C and D do the same, and that the AB partnership and the CD partnership are thereafter merged. Before the merger, a distribution of property to any partner could not trigger gain under the anti-mixing bowl rules, because no partner contributed property (other than money) to either partnership. The “step-in-the-shoes rule” would recognize that, notwithstanding the merger and the fact that Treas. Reg. § 1.708-1(c)(3) may impose the “assets-over” form, none of A, B, C and D in fact ever contributed property to a partnership and therefore they should not be subject to the anti-mixing bowl rules.

Regardless of the relative policy merits of the “step-in-the-shoes” rule compared to the rule announced in the Ruling, we believe it is improper to retroactively penalize taxpayers who relied upon the plain language of the anti-mixing bowl regulations in consummating partnership merger transactions during the seven-year period since the regulations were promulgated. Accordingly, Rev. Rul. 2004-43 should be withdrawn.

Taxpayers should have notice of, and an opportunity to comment on, a decision by the government to take a policy position that is contrary to the plain language of the regulations. Such a change should be effectuated by proposing new regulations that, under section 7805(b)(1), likely could not apply retroactively. In any case, as a matter of sound tax policy and fairness to taxpayers who undertook partnership “assets-over” merger transactions with an understanding of the “step-in-the-shoes” rule of the current regulations, any such amended regulation should apply prospectively only to partnership mergers occurring after the date of publication of the regulations.

If the Internal Revenue Service and Department of Treasury should decide not to withdraw Rev. Rul. 2004-43, for the reasons set forth above, we believe the Ruling should be made applicable only to partnership mergers that occur after the date of publication of the Ruling.

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2. The transaction described in the anti-mixing bowl regulations constitutes an “assets-over” partnership merger under Treas. Reg. § 1.708-1(c)(3). In addition, under Treas. Reg. § 1.708-1(c)(3)(i), any partnership merger or consolidation other than one occurring in the “assets-up” form described in Treas. Reg. § 1.708-1(c)(3)(ii) is deemed to occur in the “assets-over” form.

3. The facts described herein are the facts in “Situation 1” in the Ruling. “Situation 2” in the Ruling illustrates the application of the same principles in a slightly different fact pattern and will not be discussed herein.
4. Reg. §§ 1.704-4(g) and 1.737-5.
5. See section 737(d)(1)
6. See Richard M. Lipton, Stefan F. Tucker and Phillip M. Brunson, Real Estate Tax Planning When You Strike It Rich, SD31 ALI-ABA 245 (1998); Eric B. Sloan, Richard M. Lipton, Deborah Harrington and Marc Frediani, New Prop. Regs. Provide Guidance on Partnership Mergers and Divisions – Part 2, 93 J. Tax’n 261 (2000); William P. Wasserman, Interaction Between the Basis Aggregation Rule in Rev. Rul. 84-53 and Section 704(c) and Related Provisions, 475 PLI/Tax 1229 (2000); Blake D. Rubin and Andrea Macintosh Whiteway, Creative Transactional Planning Using the Partnership Merger and Division Regulations, 95 J. Tax’n 133 (2001); Howard E. Abrams, Getting Out Without Selling Out: The Proposed Partnership Merger and Division Regulations, 59th N.Y.U. Institute § 11.02[1] (2001); William S. McKee and Cornelia Schnyder, Partnership Mergers and Divisions, Materials from the Federal Bar Association Passthroughs Entities & Real Estate Symposium (2001); Richard M. Lipton, Critical Partnership Tax Issues – An Overview, 1313 PLI/Corp 409 (2002); Eric B. Sloan, Marc M. Frediani and Richard Lipton, Partnership Mergers and Divisions: A User’s Guide, 569 PLI/Tax 55 (2003); Richard M. Lipton, Critical Partnership Tax Issues – An Overview, SJ003 ALI-ABA 481 (2003); William S. McKee, Partnership Mergers and Divisions, 568 PLI/Tax 971 (2003); Barbara Spudis de Marigny, Mergers & Divisions of Partnerships, 528 PLI/Tax 769 (2003). So far as we can determine, only one commentator interpreted the regulations in a manner consistent with the Ruling. See James B. Sowell, Partnership Mergers and Divisions, 569 Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 9 (PLI 2003).
7. Compare section 381.