

SEMANTICS AND SUBSTANCE IN PARTNERSHIP MERGERS

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I. OVERVIEW

Partnership mergers, unlike their corporate counterparts, are analyzed by explicit reference to the individual steps by which the merger is accomplished. This approach is necessary because Subchapter K is just as concerned with identifying the proper taxpayer as it is with avoiding economic distortions caused by taxation. The imposition of an entity level tax under Subchapter C eliminates the former concern with regard to corporate mergers. Mergers of any sort are to be encouraged, or at least not discouraged, under the assumption that the market improves by efficiency gains brought about by mergers. Thus, Subchapter K must be carefully drafted to avoid economic distortions while still enforcing fundamental and important tax objectives. Subchapter K relies on semantics to obtain the proper result. A partnership merger is viewed in accordance with legally significant terms – “distribution,” “liquidation,” “termination,” and “contribution” – so that tax may be withheld or imposed at times most opportune to the accomplishment of both goals.

Tax semantics are usually consistent with tax substance. Sometimes, though, semantics in Subchapter K are inconsistent with substance, and therefore cause incorrect results. Revenue Ruling 2004-43 contains one example of the inconsistency between tax semantics and tax substance to the extent that it allows majority partners a nonrecognition opportunity clearly denied by Congress. From a broader standpoint, the use of semantics in partnership taxation admits to the lack of fluency amongst stakeholders such that every detail must be articulated for every conceivable transaction. Sometimes stakeholders insist that semantics be applied literally even when substance dictates a different result than that derived from semantics. Such is the case with regard to the stakeholder reaction to Revenue Ruling 2004-43. Even when Subchapter K expresses a hope that all stakeholders share a substantive fluency with regard to partnership taxation – as it does by the enactment of anti-abuse regulations – it nevertheless clings to an overwrought reliance on semantics. This, perhaps, is understandable but semantics must be carefully articulated if they are to continue to be as important as substance under Subchapter K.

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II. SEMANTICS AS SUBSTANCE IN SUBCHAPTER K

The detailed and convoluted provisions relating to corporate mergers are designed to compress any number of segregated steps into a single concept based on shareholder intent and ultimate outcome.¹ Appropriate tax consequences are determined by reference to the generic, integrated whole.² Semantics are ignored in corporate mergers – an exchange of stock for stock,³ or assets for stock⁴ is not treated according to the semantics but rather the intended substance,⁵ and shareholders from target corporations are taxed no less favorably than shareholders from acquiring corporations.⁶ Thus, if the ultimate result of a series of transactions is merely to change the form of a continuing business investment, there will be no present tax consequence notwithstanding the occurrence of preliminary steps any one of which would trigger recognition if considered separately.⁷ The substantive continuity of interest and continuity of business enterprise doctrines play key roles in the jurisprudence of reorganizations.⁸ When continuity is present, familiar mechanisms – substituted basis and tacked holding periods -- are triggered to maintain the *status quo ante*.⁹ Shareholders are taxed, if at all, only to the extent their investment is liquidated regardless of whatever labels might be applied.¹⁰ This makes good sense

¹ Hence the term “reorganization,” and its nonrecognition consequences, applies to at least seven differently structured transactions. IRC 368(a) (2004).

² The primary tax consequence of a successful reorganization is tax deferral and maintenance of the *status quo ante*. See generally IRC 354 (2004) (providing for nonrecognition to stockholders involved in a reorganization), IRC 361 (2004) (providing for nonrecognition to corporations involved in a reorganization), IRC 358 (2004) (providing for a substituted basis to reorganization participants), IRC 1223 (2004) (regarding tacked holding periods).

³ See IRC 368(a)(1)(B) (2004).

⁴ See IRC 368(a)(1)(C) (2004).

⁵ This is not to suggest that form is irrelevant in corporate mergers. As Ginsburg and Levin aptly put it, “in corporate tax, without question form greatly matters, but it is foolish to believe that inevitably form *is* the substance.” Martin D. Ginsburg and Jack S. Levin, *MERGERS, ACQUISITIONS, AND BUYOUTS*, 6-124 (2001). Even so, substance in corporate mergers is not at all affected by the manner in which form is semantically expressed. If the appropriate form is achieved, the substantive result is the same regardless of how that form is expressed. In partnership mergers, as will be shown, the semantic articulation of form is substance indeed and results in different tax consequences between acquiring and target partners.

⁶ A target shareholder’s tax consequences are the same as those pertaining to an acquiring shareholder. Basis and holding period remain the same, except to the extent a targeting shareholder cashes out her investment. See IRC 358 (2004) (providing for a substituted basis for target shareholders, adjusted for the receipt of cash or other recognition property). In that instance, basis is first reduced and liquidation proceeds in excess of basis result in gain recognition. Shareholders generally experience the same results with respect to a non-dividend distribution. Compare IRC 301(c)(2)-(3) (2004) (a non-dividend distribution reduces basis first and is generally capital gain to the extent it exceeds basis) and IRC 356 (the receipt of cash or other property will result in gain recognition to the extent the cash and other property exceed target shareholder’s basis).

⁷ See Treas. Reg. 1.368-1(b) (as amended in 2001).

⁸ See Treas. Reg. 1.368-1(d)-(e) (as amended in 2001). The continuity of interest is the more important of the two doctrines. For an historical overview and analysis see David F. Shores, *Reexamining Continuity of Shareholder Interest In Corporate Reorganizations*, 17 VA. TAX REV. 419 (1998).

⁹ See *supra* note 2.

¹⁰ See generally IRC 356 (2004) (regarding the recognition of gain in a reorganization).

because the acknowledged goal is to prevent fundamental tax principles from impeding the free flow of capital to the most efficient forms of active business investment.¹¹

It should therefore seem curious, at first, that partnership mergers are analyzed under a decidedly opposite approach.¹² The desire to encourage the most efficient uses of capital is most certainly applicable to partnerships just as it is to corporations. Nevertheless, tax consequences of partnership reorganizations are determined by explicit reference to the labeled steps by which the merger is accomplished.¹³ Semantics are important in partnership mergers and indeed throughout many partnership transactions. Semantics serve as shorthand tools for the enforcement of substance as, for example, when IRC 752 uses the terms “distribution” and “contribution” as shorthand for the substantive effects of decreases and increases in a partner’s share of liabilities.¹⁴

Subchapter K’s reliance on semantics is not so unusual, except that in Subchapter K semantics are actually more likely to determine tax outcomes than is substance. Referring to a transaction as a “distribution” for example, invokes substantive consequences even though a distribution may not have actually occurred, or whatever distribution may have occurred was merely an intermediate step in the ultimate transaction.¹⁵ This is a significant departure from the prevailing law principle that substance prevails over form.¹⁶ Indeed, different tax consequences apply if two partnership mergers are articulated differently. A merger articulated as a “distribution and termination, followed by a contribution”¹⁷ is analyzed differently than a merger articulated as a “contribution followed by a distribution and termination”¹⁸ even though the ultimate result is identical in either case. The importance of semantics in Subchapter

¹¹ See S. Rep. No. 275, 67th Cong., 1st Sess., 11 (1921), *reprinted in* 1939-1 C.B. (Part 2) 181, 188-89 (stating that fundamental recognition rule interferes with “necessary business adjustments” and is “economically unsound” because it prevents businesses from going “forward with the readjustments required by existing conditions.”).

¹² Treas. Reg. 1.708-1(c)(3) (as amended in 2002) (describing the different transactions that are deemed to occur when partnerships merge). See also Rev. Rul. 68-289, 1968-1 C.B. 314 (holding that a partnership merger would be taxed in accordance with the occurrence of a (1) contribution, (2) transfer of liabilities, and a (3) liquidation).

¹³ The labels relating to the transactions that are deemed to occur have legal significance under Subchapter K and unlike the approach under Subchapter C, the significance of each label is fully enforced. See Treas. Reg. 1.708-1(c)(5) (as amended in 2002). See also Department of The Treasury, Internal Revenue Service, *Notice of Proposed Rulemaking and Notice of Public Hearing*, 65 Fed. Reg. 1572, 1573-75 (Jan. 11, 2000) (discussing the tax consequences arising under the various steps of partnership mergers).

¹⁴ See IRC 752(a)-(b) (2004). Note that IRC 752 do not actually articulate any substantive conclusions. Stakeholders must instead refer to IRC 721 (regarding contributions) and IRC 731 (regarding distributions) to make substantive determinations.

¹⁵ In an “assets-up” merger, partnership assets are treated as though they are distributed to partners (and IRC 731 through 733, both relating to distributions, are made to apply) even if the assets are never actually transferred to partners. Department of the Treasury, Internal Revenue Service, *Partnership Mergers and Divisions*, 66 Fed. Reg. 715, 716 (Jan. 4, 2001). The reason for applying the “distribution” label is to enforce proper timing and taxpayer identification rules. See *supra* notes 23 - 29 and accompanying text.

¹⁶ For a discussion of the tension between semantics and the substance over form doctrine in general, see Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form Doctrine in Tax Law*, 43 Santa Clara L. Rev. 699 (2003).

¹⁷ This is another way of articulating an “assets-up” merger. See *supra* note 46 and accompanying text.

¹⁸ This phrase articulates the steps in an “assets-over” merger. See *supra* note 42 and accompanying text.

K is also notably different from mergers under Subchapter C where a single consequence applies to many different transactions undertaken in pursuit of a merger.¹⁹

Application of legally significant labels to the separate steps comprising partnership mergers increases the likelihood that partners will recognize gain. Like shareholders in corporate mergers, partners will be taxed to the extent they liquidate their investment.²⁰ Partners may also be taxed, though, if one or more of the segregated steps would result in a recognition event if considered separate from the integrated plan.²¹ As noted earlier, the same policies that seek to prevent taxation from distorting corporate mergers certainly apply to partnership mergers. Hence, the increased likelihood of gain recognition when partnerships merge is not an attempt to discourage such mergers, but results instead from the pursuit of other fundamental tax policies. In short, the nonrecognition concession arising from continuous ownership, though in altered entity form, is withdrawn in partnership reorganizations to the extent necessary to enforce timing rules and prevent assignment of income.²²

Detailed and interrelated rules regarding contributions and distributions to and from partnerships create an unintended opportunity to defer and assign gain by way of the familiar “mixing bowl transaction.”²³ Equally detailed and interrelated rules under IRC 704(c)(1)(B) and 737 (hereinafter, the “anti-mixing bowl rules”) apply in an effort to

¹⁹See IRC 368(a) (2004) (regarding the several different forms that meet the definition of “reorganization” for corporate tax purposes).

²⁰ For example, a merger articulated as a “distribution and termination, followed by a contribution” could be taxed as though a partner has liquidated her interest if the merging partnership distributes cash to partners and even if the cash is immediately contributed to a new partnership. See Treas. Reg. 1.708-1(c)(3)(ii) (as amended in 2002) and IRC 731(a) (2004) (relating to the recognition of gain upon the distribution of cash in excess of a partner’s basis). Accomplishing the same outcome by way of a merger articulated as a “contribution followed by a distribution and termination” will not be taxed as a liquidation. See Treas. Reg. 1.708-1(c)(3)(i) (as amended in 2002).

²¹ Even when a partnership merger is articulated as a “contribution followed by a distribution and liquidation,” partners may recognize gain if the contribution involves encumbered property and the contributor is relieved a liability that is greater than her aggregate basis prior to the merger. Treas. Reg. 1.752-1(f), (g) (Example 2) (as amended in 2001).

²² See generally Laura E. Cunningham and Noel B. Cunningham, *Simplifying Subchapter K: The Deferred Sale Method*, 51 SMU L. REV. 1 (1997) (describing the efforts undertaken since 1954 to prevent taxpayers from taking advantage of the contribution and distribution rules to assign income).

²³ Professors Cunningham succinctly describe mixing bowl transactions:

There were two basic types of mixing bowl transactions. The first was a contribution of appreciated property to a partnership, followed by a distribution of that property to a different partner. As a result, the contributor was essentially permitted to exchange the contributed property for an undivided interest in the partnership's other assets, without recognition of gain. The second variation involved a contribution of appreciated property, followed . . . by a distribution to the contributor of different property. Again, the contributor was permitted to exchange her appreciated property for different property without recognition of gain

Laura E. Cunningham and Noel B. Cunningham, *supra* note 22 at 11.

prevent exploitation of those opportunities.²⁴ Enforcement of the anti-mixing bowl rules essentially requires imposing a tax at a certain moment even if that moment occurs in the midst of an interrelated transaction that is otherwise to be encouraged by granting nonrecognition.²⁵ It is this need to preclude unwarranted nonrecognition via mixing bowl transactions that necessitates Subchapter K's focus on semantics with regard to partnership mergers.²⁶ By choosing and then enforcing the label "distribution" with regard to any given transaction, Subchapter K creates the occasion for immediate taxation, as economic substance dictates, because the anti-mixing bowl rules are triggered only by "distributions."

Subchapter K apparently relies on semantics in partnership mergers (and elsewhere) to enforce the decision to limit nonrecognition opportunities. IRC 721 explicitly condones a single deferral of tax on realized appreciation. Granting nonrecognition upon initial or continuing capitalization is justified by good economic policy reasons since capitalization is akin to investment and investment stimulates economic growth.²⁷ Nonrecognition is therefore appropriate in Subchapter K but only for capitalization purposes. Subchapter K does not condone nonrecognition in any other instance.²⁸ Accordingly, the anti-mixing bowl rules accelerate gain recognition when

²⁴See Treas. Reg. 1.704-4 (as amended in 1997); Treas. Reg. 1.737-1 (as amended in 1995). See also, Laura E. Cunningham and Noel B. Cunningham, *supra* note 22 at 11-12. (describing "inordinately complex" regulations "of uncertain breadth."). Actually, the regulations are not so terribly complex, except as they relate to the extraordinary transaction.

²⁵ Since the harm comes to fruition upon the subsequent distribution, *see infra* note 16, gain recognition occurs upon that subsequent distribution. IRC 704(c)(1)B (2004); IRC 737(a) (2004) (both of which require gain recognition to the contributing partner upon a subsequent distribution occurring within 7 years of the original contribution). Unless otherwise stated, distributions discussed in this article are presumed to occur within 7 years of a contribution.

²⁶ "Unlike the corporate rules, the partnership rules impose certain tax results on partners based upon a concept that matches a contributed asset to the partner that contributed the asset." Department of Treasury, *supra* note 13, at 1573.

²⁷ See IRC 721 (2004) (providing for nonrecognition of gain or loss when a partnership is capitalized with appreciated or depreciated property). Nonrecognition eliminates a tax cost that would otherwise be imposed when individuals joint together in joint profit making.

²⁸ This assertion, though ultimately correct, is subject to reasonable dispute. IRC 731 (2004) generally imposes nonrecognition when partners receive distributions from partnerships. But another fundamental goal of Subchapter K is to impose no more or less tax cost on joint venturers than is imposed on sole proprietors. See Treas. Reg. 1.701-2(a) ("Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."); IRC 704(c)(2) (excepting from the mixing bowl gain recognition provisions transactions that would not require recognition if engaged in by individuals outside of the partnership context). Thus, the nonrecognition treatment provided by IRC 731 is merely analogous to the nonrecognition that would result without a special concession if a sole proprietor simply withdrew assets from business use. As under IRC 731, the sole proprietor would not recognize gain or loss until she sold the asset. Thus, IRC 731 does not create a new nonrecognition concession but simply applies an existing one to the partnership context. The argument is admittedly undercut to the extent a partner receives property materially different from that which she originally contributed. It could be argued in such cases that the partner has an advantage over an individual who would be taxed upon a non-like-kind exchange. See IRC 1031 (2004). But taxation is imposed under the anti-mixing bowl provisions when a partner receives different property if she has previously contributed appreciated property to the partnership. For a thorough overview of nonrecognition with respect to distributions see Christopher Hanna, *Partnership Distributions: Whatever Happened to Nonrecognition?* 82 KY. L. J. 465 (1994).

distributions (as opposed to contributions) create a second deferral opportunity.²⁹ The application of the mixing bowl rules to partnership mergers, a context in which nonrecognition is otherwise clearly appropriate, is problematic to say the least. The goal is to remove barriers to efficiency driven reorganizations, while maintaining barriers to deferral and assignment of income made possible by unintended and unwarranted nonrecognition opportunities.³⁰

In Revenue Ruling 2004-43,³¹ the Service painstakingly describes the challenge as well as one reasonable solution. A reasonable criticism of the Service's solution, though, is that the mixing bowl rules are applied differently amongst merging partners for purely semantic reasons even though all partners have identical economic outcomes. The anti-mixing bowl provisions are applied to the continuing partners³² in a more lenient fashion than they are to the terminating partners.³³ Terminating partners have "new 704(c) gain," but continuing partners do not.³⁴ The result is an unintended and unwarranted nonrecognition opportunity for continuing partners.³⁵ Granted, the result makes semantic sense given the segregated steps comprising partnership mergers. Semantics logically dictate the distinction because terminating partnerships actually or constructively liquidate, terminating partners are deemed to make contributions to a new partnership, and the anti-mixing bowl rules are made applicable by realized, but unrecognized appreciation existing on the date property is contributed to a partnership. Semantically, continuing partners receive no distributions and make no contributions; their continuing partnership is further capitalized and the code grants nonrecognition for capitalization. Substantively, though, continuing partners are economically identical to terminating partners. The different tax consequences are derived instead from the reasonable, administratively convenient, but ultimately arbitrary distinction between

²⁹ *Supra* note 23 - 25.

³⁰ The disguised sale rules are also designed to prevent taxpayers from obtaining an additional nonrecognition opportunity. *See* IRC 707(a)(2)(A)-(B) (2004) (regarding contributions and distributions that would otherwise be accorded nonrecognition).

³¹ 2004-18 I.R.B. 842.

³² In this article, I use the term "continuing partners" to refer to partners of the continuing partnership immediately prior to the merger. *See* IRC 708(b)(2) (2004) and Treas. Reg. 1.708-1(c) (as amended in 2001) (regarding the definition of continuing and terminating partnerships).

³³ "Terminating partners" means partners of terminating partnerships immediately prior to a merger. *See* IRC 708(b)(2) and Treas. Reg. 1.708-1(c) (2004) (regarding the definition of continuing and terminating partnerships).

³⁴ Rev. Rul. 2004-43, 2004-18 I.R.B. 842. That a merger should create "new" 704(c) gain is a result intended by Congress. The legislative history of IRC 737 indicates that it should apply anew when a new partnership is formed after a deemed or "constructive" termination. H.R. Rep. No. 247, 101st Cong. 1st Sess. at 1358 (1989). "As a result, partners will recognize gain or loss in connection with any subsequent distribution of partnership property to the extent of their respective shares of the pre-termination appreciation or depreciation in the value of the partnership property that is not already required to be allocated under 704(c) to the original contributor (if any) of the property." *Id.* The application of IRC 737 is made contingent though upon the occurrence of a constructive contribution. Hence, continuing partners are not subject to IRC 737 with respect to pre-merger appreciation, even though they are presented with the same unwarranted opportunity for nonrecognition as are continuing partners.

³⁵ Nonrecognition achieved via mixing bowl transactions does not result in permanent exclusion of income, but simply provides an additional period of deferral. If the partner later sells her interest for a fair market value that includes untaxed appreciation, she will have gain at least equal to the appreciation. *See* Laura E. Cunningham and Noel B. Cunningham, *supra* note 22 at 7.

“continuing” and “terminating” partnerships.³⁶ All merging partners, like merging shareholders whether from an acquiring or target corporation, necessarily exemplify the continuity theories that justify nonrecognition. All partners are also presented with the same opportunity for additional nonrecognition after a partnership merger and yet only terminating partners are subject to IRC 737 because they make “contributions” but continuing partners do not.³⁷ The difference between terminating and continuing partners is entirely semantic. Injecting substance into the semantic differences in partnership mergers therefore creates opportunity for under-taxation of some partners. Continuing partners, who are treated as if they have made no new contributions, obtain a second, unintended and unwarranted nonrecognition event.

This article continues by summarizing Subchapter K consequences when partnerships merge. These results are determined entirely by reference to semantics though in most cases semantics and substance coincide. The article has already briefly compared the underlying theory giving rise to those consequences to the theory and consequences applicable to corporate mergers, particularly as the theories relate to minority partners and minority shareholders. The differing theories explain why Subchapter K’s merger analysis focuses on semantics, while Subchapter C’ analysis focuses on substance. There is a greater chance of gain recognition with regard to partners of terminating partnerships (i.e., minority partners) than there is with respect to shareholders of target corporations (minority shareholders), but only when partners stumble into or actively seek unwarranted deferral. Revenue Ruling 2004-43 actually condones one such effort to obtain unwarranted deferral.

The article then explores whether partners from a continuing partnership should be treated more favorably than partners from a terminating partnership given the determination that (1) there is legitimate reason why gain recognition is sometimes appropriate in partnership mergers to avoid unintended nonrecognition and assignment of income, but (2) there is no substantive economic difference between continuing and terminating partners after a merger. The answer seems obvious. It may be, though, that the administrative gains from Subchapter K’s focus on semantics outweigh the cost of tax distortions. In fact, the partnership anti-abuse regulations contain that very suggestion.

The distortion identified in this article involves under-taxing continuing partners. In discussing this point, the article summarizes and rejects some the early criticisms of Revenue Ruling 2004-43 offered by stakeholders who essentially demand that semantics be given precedence over substance, at least to the extent semantics benefit taxpayers. When semantics has resulted in over-taxation in other instances the Service has issued a regulatory fix at the behest of stakeholders. Those corrections confirmed that substance should take precedence over semantics. The calculation of a partner’s liability share immediately following a merger, and the taxation of technical terminations, are two examples discussed in Section IV. Revenue Ruling 2004-43 is therefore an aberration to

³⁶ See IRC 708 (2004) (regarding terminating and continuing partnerships).

³⁷ A post-merger distribution of previously appreciated property to new partners allows the built in gain to be shifted to the distributee partner if IRC 737 does not apply. See *supra* note 23. As a result, the previous owners of the property defer gain.

the extent it condones substantive distinctions between partners based solely on semantic differences.³⁸ The article concludes that partners from both terminating and the continuing partnerships should have new 704(c) gain to an equal extent.³⁹ It ends with a broader discussion of the theoretical and practical problems that arise from reliance on semantics. The theoretical problem is that semantics occasionally result in substantively incorrect results. The practical problem is that reliance on semantics necessitates the promulgation of problematic “anti-abuse” rules, as taxpayers become aware of, and take advantage of semantic “loopholes.” It may be that reliance on semantics is unavoidable, given the level of substantive fluency (or lack thereof) amongst taxpayers with respect to Subchapter K. Semantics provide a sort of roadmap useful for taxpayers who, by and large, do not know where they are going and are unable to navigate the Tax Code with a substantive compass. The ideal solution ironically would be to do away with semantics because semantics only perpetuate the lack of substantive fluency. Taxpayers need not, and will not actually comprehend the path they choose if a convenient, presumptively correct roadmap exists. If it is impossible to eliminate reliance on semantics, Subchapter K rules should continuously be quickly amended when, in occasional instances, semantics are inconsistent with substance. In those instances, semantics should be altered to comply with substance. Substance should not be sacrificed for semantics.

III. THE SEMANTIC TAX CONSEQUENCES OF PARTNERSHIP MERGERS

The Uniform Partnership Act (UPA),⁴⁰ after which all state partnership statutes were once modeled,⁴¹ contains no provisions relating to partnership mergers.⁴² Partnership mergers were instead accomplished by carefully planned asset or interest transfers.⁴³ In the former case, assets were transferred in one of two ways. First, a terminating partnership might have exchanged all of its assets for an interest in a continuing partnership and then distributed the continuing partnership interest to partners of the terminating partnership. This type of merger is referred to as an “assets-over” transaction because assets are never distributed down to partners.⁴⁴ Except with regard to decreases in liability shares⁴⁵ – the economic equivalent of cash liquidation – partners will not experience a recognition event in an assets-over merger.⁴⁶ In an assets-over

³⁸ One should not expect the same level of interest in correcting the distortion discussed herein as was demonstrated with regard to previous instances of semantics over substance because the distortion in this instance works to the benefit of taxpayers.

³⁹ Stakeholders acknowledge the inequity of taxing some partners to a greater extent than others, but they argue instead that neither continuing nor terminating partners should be subject to the anti-mixing bowl rules with regard to “new” 704(c) gain. *See supra* note 112.

⁴⁰ Unif. Partnership Act (1914).

⁴¹ As of 2003, 34 states have adopted the Revised Uniform Partnership Act. Robert W. Hillman, Allan W. Vestal, Donald J. Weidner, *THE REVISED UNIFORM PARTNERSHIP ACT*, Appendix B (2003).

⁴² Unif. Partnership Act (1914); Unif. Partnership Act §901 (Comment 1) (1997).

⁴³ *Id.*

⁴⁴ Department of Treasury, *supra* note 13, at 1573.

⁴⁵ *See supra* notes 139 to 142 and accompanying text.

⁴⁶ Department of Treasury, *supra* note 13, at 1573 (“Under the Assets-Over Form, gain under sections 704(c)(1)(B) and 737 is not triggered.”).

merger, partners receive neither cash nor hot assets so gain recognition is generally precluded.⁴⁷ Alternatively, a terminating partnership might have distributed its assets in liquidation and the partners would immediately contribute those assets to a continuing partnership. This form is referred to as “assets-up” since assets are distributed “down” to the partners and then contributed “up” to the continuing partnership.⁴⁸ If a terminating partnership has lots of cash or if for some bizarre reason it makes disproportionate distributions while holding hot assets, partners could conceivably have an immediate recognition event.⁴⁹

In most circumstances, partners will prefer asset-over form because that is least costly with regard to state law. And while recognition is theoretically more probable in an assets-up merger, the likelihood is nevertheless rather slight with regard to partnerships in which tax arbitrage has not been a significant goal.⁵⁰ If partners are cognizant of and avoid the circumstances that create opportunities to defer and assign income, they will likewise avoid gain recognition, notwithstanding the focus on the separate steps by which the merger is accomplished.⁵¹ Nor does it appear that the basis of assets to the continuing partnership will differ under one form or the other, though that result is theoretically more possible than is the occurrence of a recognition event.⁵²

Suppose, for example, that a two person partnership purchases depreciable property for \$2,000,000 and the cost is fully recovered via depreciation deductions prior to a merger in which the partnership terminates. Assume also that each partner has an outside basis of \$1,000,000 prior to allocating depreciation deductions equally.⁵³ In an assets-over merger, the continuing partnership will take a zero basis in the property,⁵⁴

⁴⁷ Treas. Reg. 1.708-1(c)(3) (2004) (indicating that partners receive only a partnership interest in continuing partnership in an assets-over merger). Partners recognize gain from current distributions in only three instances: (1) a distribution of 704(c) property, (2) a distribution of cash, or (3) a distribution that alters a partner’s interest in unrealized receivables or substantially appreciated inventory (hot assets). IRC 731 (2004) (regarding a distribution of cash), IRC 704(c)(1)(B) (regarding a distribution of 704(c) property), IRC 737 (regarding a distribution to a partner who has contributed 704(c) property), and IRC 751(b) (2004) (regarding a distribution that alters a partner’s interest in hot assets).

⁴⁸ Department of Treasury, *supra* note 13, at 1573.

⁴⁹ It is conceivable that a situation may exist in which partners prefer gain recognition with regard to hot assets in order that the assets have a higher basis to the continuing partnership. A partner with sufficient outside losses or other deductions, for example might accept 751(b) gain in exchange for some other future allocation concession. Partners might also use the assets-up form to trigger loss recognition which is possible (though unlikely since expended capital should have previously been deducted) if the partnership holds only cash, hot assets or both immediately prior to the merger. *See* IRC 731(a)(2) (2004).

⁵⁰ *See supra* notes 46 through 47.

⁵¹ Hence, gain recognition is triggered only as needed to prevent assignment of income via an unintended deferral. As in corporate mergers, maintenance of *status quo ante* is the norm.

⁵² “Under the Assets-Up Form, because the adjusted basis of the assets contributed to the resulting [i.e., continuing] partnership is first determined by reference to section 732 (as a result of liquidation) and then section 723 (by virtue of the contribution), in certain circumstances, the adjusted basis of the assets contributed may not be the same as the adjusted basis of the assets in the terminating partnership.”

Department of Treasury, *supra* note 13, at 1573.

⁵³ Thus, the partnership will have an inside basis of zero and each partner will have an outside basis of zero. IRC 1016(a)(2) (2004) (regarding the partnership’s inside basis); IRC 705(a)(2) (regarding partners’ outside basis).

⁵⁴ IRC 723 (2004).

each partner will have zero outside basis in the continuing partnership,⁵⁵ and neither will recognize gain or loss.⁵⁶ The same result would occur in an assets-up merger.⁵⁷ In this example semantics do not change substance.

Partnerships that have made special allocations face at least one semantic barrier with regard to mergers under either form. Suppose, for example, that all depreciation deductions in the example above were allocated to Partner A, and the property later distributed to Partner B in an assets-up merger.⁵⁸ The property would again have a zero basis to the continuing partnership but only if the “liquidation” occurring as part of the assets-up merger is given substantive effect in accordance with its semantic label. If the transaction triggers consequences in accordance with its label – “liquidation” – A will be required to contribute \$1,000,000 to eliminate her capital account deficit.⁵⁹ A’s deficit payment will be distributed to B, whose outside basis and capital account will be reduced to zero.⁶⁰ The property would thereafter take a zero basis in B’s hands and to the continuing partnership.⁶¹ The same result would occur in an assets-over merger if the “liquidation” label applies to trigger A’s deficit reduction obligation.⁶² Naturally, requiring a partner to eliminate her capital account deficit when partnerships merge creates a disincentive because a partner subject to that obligation may be unwilling or unable to comply and therefore resist the merger.⁶³

⁵⁵ IRC 732 (2004).

⁵⁶ IRC 731(a) (2004).

⁵⁷ In an assets-up merger, the partnership would distribute the property with a zero basis to the partners. The partners would take a zero basis under IRC 732 and that basis would determine the basis to the partnership under IRC 723 and the partners’ outside basis under IRC 722.

⁵⁸ For now, assume the property value has decreased as depreciation deductions were taken. The property must be distributed to B because he will have a positive capital account balance and A will not. Treas. Reg. 1.704-1(b)(2)(ii)(b)(2) (as amended in 1997).

⁵⁹ Treas. Reg. 1.704-1(b)(2)(ii)(3) (as amended in 1997). All examples in this article assume the partners seek compliance with the economic effect rules.

⁶⁰ *Id.*

⁶¹ The distribution of \$1,000,000 would reduce B’s basis to zero immediately before receipt of the property. IRC 732(a)(2) (2004). It may be more appropriate in that instance to assume that the property should thereafter be distributed pro rata to both A and B since both will then have a zero capital account balances. Regulation 1.704-1(b)(2)(ii)(b)(2)-(3) seems to preclude this result. Regardless, the property would still take a zero basis to the continuing partnership because both A and B would have zero bases. If property is first distributed to B and then A is required to contribute \$1,000,000 for subsequent distribution to B, the result would be the same. The cash distribution to B would be part of the same transaction, thus reducing her outside basis before receipt of the property. IRC 732 (2004).

⁶² In an assets-over merger, the terminating partnership would contribute the property with a zero basis to the continuing partnership in exchange for an interest in continuing partnership with a basis of zero. IRC 721 (2004); Treas. Reg. 1.708-1(c)(3)(i) (2004). Upon subsequent liquidation, A would contribute \$1,000,000 which would be distributed to B along with a pro rata share of the interest in continuing partnership. Treas. Reg. 1.708-1(c)(3)(i) (2004). Both A and B would have zero bases in their continuing partnership interest. IRC 732(a)(2) (2004).

⁶³ Professor Gergen suggests, in another context, that a partner with a deficit reduction obligation might be granted a guaranteed payment in the year in which the obligation applies and could simply use that payment to satisfy the deficit. Mark P. Gergen, *Reforming Subchapter K: Special allocations*, 46 TAX L. REV. 1, 13 (1990). This seems permissible under the literal terms of IRC 704, though another commentator argues that the gambit violates at least the spirit, if not the letter of IRC 704. See Thomas I. Hausman, *Simplifying Substantial Economic Effect: Back-End Capital Shifts*, 88 TAX NOTES 1385 (2000) (arguing that “back end capital shifts” likely violate present law but should be allowed as a policy matter).

If semantics are ignored and the merger does not trigger A's deficit reduction obligation, notwithstanding the occurrence of "liquidating distributions," the results will differ depending on the form. Under an assets-up merger, the property would have a \$1,000,000 basis to the continuing partnership because it would take a \$1,000,000 basis upon distribution to B as an intermediate step in the assets-up merger.⁶⁴ A would be treated as a partner in the continuing partnership, but with a zero basis and an immediate capital account deficit of \$1,000,000.⁶⁵ B would have a \$1,000,000 outside basis and capital account balance.⁶⁶ In an assets-over merger, however, the property would take a zero basis to the continuing partnership, though B would still take a \$1,000,000 outside basis and capital account balance in continuing partnership.⁶⁷

If the value of property from which depreciation deductions were specially allocated had actually increased (as is often the case with real property) the deficit reduction obligation would not arise. The partnership would have sufficient book gain to eliminate A's capital account deficit and the appreciation would be preserved for later taxation to the appropriate partners under IRC 704(c).⁶⁸ If the depreciable asset actually declines in value as and to the extent tax depreciations deductions are allowed, A's capital account deficit would not be eliminated. In that instance, there would need to be a resolution of whether a deficit reduction obligation is triggered by a merger.

Recall that Subchapter K enforces semantics as necessary to achieve a competing goal – preventing unintended nonrecognition and resulting assignment of income. That competing goal takes precedence over nonrecognition on an as-needed basis. Giving legal significance to a deemed or actual liquidation and, as a result, enforcing a deficit reduction obligation is probably unnecessary. Excusing Subchapter K's deficit reduction obligation is sufficiently analogous to granting nonrecognition treatment that the same policy considerations should determine whether it should be enforced. Thus, if a deficit reduction obligation will discourage mergers without achieving another important goal, it should not be enforced. A deficit reduction obligation, of course, is designed to ensure the economic effect of allocations and thereby prevent assignment of income.⁶⁹ The question, therefore, is whether enforcing the label "liquidation," and the semantically resulting deficit reduction obligation, is necessary to that goal. In substantively similar situations semantics are in fact ignored. If, as in Treasury Regulation 1.704-

⁶⁴ IRC 732(a)(2) (2004).

⁶⁵ This is admittedly inconsistent with the semantics because A's capital account would be extinguished upon liquidation of the terminating partnership. Semantically, A cannot escape the obligation to reduce her capital account deficit. If A is excused from the obligation to cure the deficit, her capital account deficit must necessarily transfer to the continuing partnership.

⁶⁶ Again, if semantics are ignored B's capital account must also transfer to the continuing partnership. *Id.*

⁶⁷ The primary effect of this outcome would be to further delay A's capital recovery since the partnership would have no tax depreciation to allocate to A. This seems appropriate since the property was fully depreciated prior to its transfer to continuing partnership and A previously agreed to delay her capital recovery by way of special allocations of depreciation deductions to B prior to the merger.

⁶⁸ Book gain on distributed property must be reflected in the partners' capital accounts immediately prior to the distribution. Treas. Reg. 1.704-1(b)(2)(iv)(e)(1) (as amended in 2004). Book gain might also be allocated to eliminate A's capital account deficit by way of a revaluation of capital accounts. Treas. Reg. 1.704-1(b)(2)(iv)(f)(5)(ii) (as amended in 2004).

⁶⁹ See *Orrisch v. Commissioner*, 55 T.C. 395 (1970).

1(b)(2)(iv)(l), a terminating partner's capital accounts automatically transferred to her interest in the continuing partnership, it would be unnecessary to force A to make good her deficit simply because a "liquidation" is one step of a merger.⁷⁰ A's transferred capital account would preserve her deficit reduction obligation and therefore ensure the continuing economic effect of earlier special allocations even though semantically the allocations were made with respect to a terminated partnership. Treasury Regulation 1.704-1(b)(2)(iv)(l), however, is arguably too narrowly written to override semantics in this instance. The literal terms apply, instead, when a partner transfers a partnership interest to a stranger, not in partnership mergers. Note, however, that Treasury Regulation 1.704-1(b)(2)(iv)(l) is consistent with Treasury Regulation 1.704-1(b)(2)(ii)(b)(3).⁷¹ That regulation also allows a partner with a capital account deficit to transfer her interest without first eliminating the deficit, even though an actual liquidation has occurred. This makes sense in light of the reasonable assumption that a buyer will pay a reduced purchase price to account for the liability (represented by the capital account deficit) encumbering the partnership interest.⁷² In one sense, seller is paying the deficit by way of a reduction in her sale price.⁷³ In those situations, semantics are ignored in favor of substance. If semantics are appropriately enforced only as necessary to prevent assignment of income, the cited regulations or at least their underlying principle should be extended to excuse the deficit reduction obligation semantically triggered by a partnership merger.

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[U]pon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See paragraph (b)(2)(iv)(m) of this section for rules concerning the effect of a section 754 election on the capital accounts of the partners.) If the transfer of an interest in a partnership causes a termination of the partnership under section 708(b)(1)(B), 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 under §1.708-1(b)(1)(iv). Moreover, the deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur under §1.708-1(b)(1)(iv) are disregarded for purposes of this paragraph (b)(2)(iv).

Treas. Reg. 1.704-1(b)(2)(iv)(l) (as amended in 2004).

⁷¹Treasury Regulation 1.704-1(b)(2)(ii)(b)(3) states, with regard to excusing the deficit reduction obligation:

Requirements (2) and (3) [pertaining to the deficit reduction obligation] of this paragraph (b)(2)(ii)(b) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.

⁷² Cf. *Commercial Security Bank, Inc. v. Commissioner*, 77 T.C. 145 (1981) (buyer's actual cash purchase price reduced to take into account accompanying liability).

⁷³ *Id.*

If a terminating partnership holds hot assets immediately prior to the merger, the results would be unaffected by form. Suppose, for example, that the partnership hypothesized above held \$1,000,000 in accounts receivables with a zero basis immediately prior to an assets-up merger, in addition to the \$2,000,000 initial capital. A pro rata distribution would result in neither gain nor loss to the partners and each partner would take a \$1,000,000 outside basis in continuing partnership.⁷⁴ Capital account balances in the continuing partnership would be \$1,500,000 signifying both partners' \$500,000 built-in gain liability. The result would be the same in an assets-over merger. The accounts receivables would take a zero basis to the continuing partnership. The terminating partnership would take a \$2,000,000 outside basis in the continuing partnership, and would distribute that interest pro rata to the terminating partners. They, in turn, would have a \$1,000,000 outside basis and \$1,500,000 capital account balance in continuing partnership.⁷⁵

UPA's silence with regard to partnership mergers resulted in transactional costs – title transfer expenses, state and local taxes and various filings fees – that could only serve to discourage mergers. One can expect that consolidations dictated by market factors were forgone because of transaction costs made applicable by the semantics of asset or interest transfers. Article 9 of the Revised Uniform Partnership Act (RUPA) eliminates transaction costs associated with partnership mergers in the same manner that state laws simplify corporate mergers.⁷⁶ A key feature of RUPA is that it eliminates semantics. Mergers are completed upon the adoption of a “plan of merger,” by which the need for actual transfers is eliminated.⁷⁷ Assets transfer by operation of law⁷⁸ and the parties decide which of the merging partnerships will survive and which will terminate.⁷⁹ In effect, RUPA gives effect only to the ultimate substantive outcome, making semantics entirely irrelevant.

It is worth stressing that RUPA allows merging partners to decide for themselves which partnership will continue and which partnerships will terminate.⁸⁰ Legal structures

⁷⁴ The distribution of the cash would reduce each partner's outside basis to zero. IRC 733 (2004). Each partner would then take a zero basis in her share of accounts receivables. IRC 732 (2004). Each partner would then have a \$1,000,000 basis in continuing partnership upon their contribution of cash and accounts receivables to the continuing partnership. IRC 722 (2004).

⁷⁵ It thus appears that the chances of accelerating losses via an assets-up merger are rather slim. I mention this point because the Service's statement with regard to the assets-up form provokes thoughts of that possibility. *See supra* note 13. For example, the partners might attempt to accelerate loss recognition by making capital expenditures for which a current deduction is unavailable. The expenditures would reduce the amount of cash to be distributed upon an assets-up merger and since the accounts receivables would take a zero basis, a loss deduction would seem likely. However, IRC 731 and 732 prevent that result because the partnership would have to distribute its depreciable or amortizable properties along with its cash and hot assets. The excess outside basis would be assigned to those properties rather than immediately taken as a loss deduction.

⁷⁶ Unif. Partnership Act, §§901-908 (1997).

⁷⁷ Unif. Partnership Act, §905(e) (1997).

⁷⁸ Unif. Partnership Act, §906(a)(2) (1997).

⁷⁹ Unif. Partnership Act, §905(b)(2) (1997).

⁸⁰ Unif. Partnership Act, §906(a)(1) (1997).

are most often indifferent to parties' efforts to explicitly dictate legal outcomes by their own labels when there are no substantive differences amongst the available outcomes apart from the labels to be applied. Legal structures accordingly treat self-selected labels as the least probative factor in determining substantive outcomes.⁸¹ RUPA is seemingly unconcerned with which partnership is treated as continuing and which as terminating because there are no substantive economic differences between continuing and terminating partnerships. Semantic labels are merely administrative conveniences that allow interested parties to trace partnership genealogy.⁸² If that observation holds true in all circumstances regarding partnership mergers, it weakens whatever arguments may exist in favor of tax distinctions amongst continuing and terminating partners such as those imposed by Revenue Ruling 2004-43.

Simplification and avoidance of transaction costs are also legitimate goals of tax law. Those goals, unfortunately, are more often than not subordinated to other goals the achievement of which is fundamentally important to the tax system. Identifying the proper taxpayer is one such goal with particular applicability under Subchapter K. Correct identification is made necessary by the system of progressive taxation. Incorrect identification leads to the horizontal inequities, a problem the assignment of income doctrine is ultimately designed to prevent. This means that the relatively simple rules of taxing jointly derived income under Subchapter K must be complicated by rules designed to tax previously realized gains and losses to the proper taxpayer. Simply put, Subchapter K requires that if a partner contributes appreciated property to a partnership, the partnership's subsequent recognition of that appreciation should be taxed to the contributing partner.⁸³ This rule takes precedence over the relative simplicity of allowing partners the freedom to allocate gains and losses in a manner that suits their economic circumstances.

Simplification is sacrificed in furtherance of proper taxpayer identification not only with regard to normal partnership operations but with regard to partnership mergers as well. As noted above, RUPA effectively and appropriately deprives semantic steps in partnership mergers of any legal significance for state law purposes. Tax law, on the other hand, reinforces the significance of those semantic steps. The terms "contribution," "distribution" "liquidations" and "terminations" have tax independent significance whenever they appear in Subchapter K⁸⁴ and those terms and their consequences were made explicitly applicable to partnership mergers under administrative guidance issued before and after RUPA. In Revenue Ruling 68-289, for example, the Service stated that assets-over mergers would be taxed in accordance with the contributions, distributions,

⁸¹ See, e.g., Treas. Reg. 1.752-2(b)(3) (1991) (relating to the extent to which a partner is liable for partnership obligations, notwithstanding any labels that may be used in describing partner obligations).

⁸² It may be necessary to do so, for example, so creditors and other third parties are able to assert causes of actions against proper parties. See Unif. Partnership Act, §906(c)-(d) (1997) (regarding partners' liabilities after a merger).

⁸³ IRC 704(b)(1)(A) (2004).

⁸⁴ See IRC 721 (2004) (regarding contributions); IRC 704(c) (2004) (same); IRC 731-733 (regarding distributions) IRC 751(b) (2004) (regarding distributions); IRC 751(b) (2004) (regarding distributions); IRC 708 (2004) (regarding terminations).

liquidations and terminations that necessarily comprise the merger.⁸⁵ The Service confirmed that this approach still applied after the enactment of RUPA when it issued new regulations under IRC 708.⁸⁶ Those regulations also confirmed the applicability of semantics to assets-up mergers. The application and enforcement of labels means that intermediate steps have the legal significance necessary to prevent assignment of income, but also increases complexity and transaction costs of partnership mergers.⁸⁷

IV. SEMANTICS AND SUBSTANCE IN PARTNERSHIP MERGERS

In Revenue Ruling 2004-43,⁸⁸ the Service addressed the tension between desirable nonrecognition and undesirable assignment of income in the context of partnership mergers. The facts are simple.⁸⁹ Partnerships AB and CD were both formed on January 1, 2004. Partnership AB holds \$300 cash and a nondepreciable asset (asset 1) with an adjusted basis of \$200 and a fair market value of \$300. A contributed asset 1 with \$100 of built in gain. Partnership CD holds \$200 cash and a nondepreciable asset (asset 2) with an adjusted basis of \$100 and a fair market value of \$200. B contributed asset 2, also with \$100 of built in gain. Both partnership agreements contained the “big three” requirements for economic effect⁹⁰ and both mandated restatement of capital accounts upon entry of a new partner.⁹¹ On January 1, 2006, the partnerships merged using the assets-over form. On that date, asset 1 was worth \$900 and asset 2 was worth \$600.

It is helpful to consider the proper substantive consequences if assets 1 and 2 had been sold or distributed prior to the merger. If Partnership AB had sold asset 1 for \$900, the partnership would have allocated the first \$100 to A.⁹² The remaining \$600 gain could have been allocated between A and B in whatever manner the partners specified. If asset 1 were distributed to B, A would have immediately recognized \$100⁹³ and the remaining \$600 would, in effect, have been allocated to B.⁹⁴ In fact, appreciation in property must be taxed to the person who owned the property when the appreciation

⁸⁵ Rev. Rul. 68-289, 1968-1 C.B. 314.

⁸⁶ T.D. 2001-6 I.R.B. 496 (adopting Treas. Reg. 1.708-1(c)-(d)).

⁸⁷ Nevertheless, in pursuit of simplicity and avoidance of transactional costs, the regulations assume in all cases that merging partnerships utilize the least costly method – the assets-over form – unless the terminating partnership actually transfers title to all of its assets to its partners who then contribute the assets to the continuing partnership. Treas. Reg. 1.708-1(c)(3)(i) (as amended in 2001). If the terminating partnership transfers some but not all of its assets, or uses the interest-over form, the consequences will be determined as if the partnership used the assets-over form. Treas. Reg. 1.708-1(c)(3)(ii) (as amended in 2001).

⁸⁸ 2004-18 I.R.B. 843.

⁸⁹ The discussion focuses on Situation 1 in Revenue Ruling 2004-43. The semantic and substantive rules are identical in Revenue Ruling 2004-43’s Situation 2. The only difference is that the dollar amounts are changed in Situation 2 and a tax is imposed by IRC 737 rather than IRC 704(c).

⁹⁰ See Treas. Reg. 1.704-1(b)(2)(ii)(b) (as amended in 2004).

⁹¹ See Treas. Reg. 1.704-1(b)(2)(iv)(f) (as amended in 2004).

⁹² IRC 704(c)(1)(A) (2004); See generally Treas. Reg. 1.704-3 (as amended in 1997).

⁹³ IRC 704(c)(1)(B) (2004). This result holds, of course, only if the property is distributed within seven years of its contribution.

⁹⁴ B would take a basis of \$300. IRC 737 (2004).

accrued⁹⁵ unless Congress grants an exception. In the hypothetical sale, A must be taxed on the first \$100 and the partnership (i.e., the partners in accordance with their distributive shares) would be taxed on the remaining \$600. The remaining \$600 could not have been taxed to new Partner F, if F had joined the partnership when Asset 1 was worth \$900, because F would not have been the owner of the property when the appreciation accrued and, more importantly, could not have previously received the economic benefit of that appreciation. Likewise, if Partnership CD had sold asset 2 for \$600, it would have allocated \$100 to C and the remaining \$500 could have been allocated in whatever manner specified in the partnership agreement.⁹⁶ If the property had been distributed to D, C would have recognized \$100 gain and the remaining \$500 would have been taxed [i.e., allocated] to D when she sold the property.⁹⁷ Once again, though, the remaining appreciation would have been taxed to the taxpayer benefiting from the appreciation (i.e., the partnership as comprised during the period the property appreciated).

It is also helpful to consider some fundamentals about which there is little dispute. Capital accounting and allocation rules under IRC 704, along with the distribution rules in IRC 737, preserve appreciated gain for taxation to the proper taxpayer. The imperative to identify the proper taxpayer applies along with four other overriding principles relating specifically to partnership mergers. First, nonrecognition upon capitalization should be the general rule because nonrecognition furthers the goal of resource pooling and maintains horizontal equity as between partners and sole proprietors.⁹⁸ Second, if mergers present opportunity to distort the preservation and proper taxation of built in gains and losses, Subchapter K should require immediate recognition in the manner that IRC 704(c)(1)(B) and 737 operate in other transactions. Conversely, Subchapter K should allow mergers without recognition when doing so does not alter the taxation of previously realized but unrecognized gain. Finally, a merger should not result in a better tax outcome than if the merger had not been effectuated. To do so would create a distortion of another sort.

In Revenue Ruling 2004-43, the Service seems to have misapplied at least the last of these fundamental points, though not without existing semantic support. Partners A and B together owned more than 50% of the capital and profits in the consolidated partnership. Thus, Partnership AB was the continuing partnership and Partnership CD

⁹⁵ See *United States v. Bayse*, 410 U.S. 441, 449-50 (1973) (applying assignment of income theory in a partnership context).

⁹⁶ All of this is consistent with the principle that income from property is taxed to the owner thereof. See *Helvering v. Horst*, 311 U.S. 112 (1940). As will be discussed in the text, *Helvering* is most applicable because when partners contribute appreciated property, their capital accounts are increased by an amount equal to the property's fair market value. Treas. Reg. 1.704-1(b)(2)(iv)(d)(1) (as amended in 2004). Hence, there can be no doubt that the partner has benefited from --"consumed" -- the appreciation.

⁹⁷ Taxing the post-contribution appreciation to D is the economic equivalent of allocating that gain to D if the property had been sold by the partnership. The partners could have validly done this without violating any fundamental rule of taxation, assuming the allocation was otherwise respected.

⁹⁸ If two or more sole proprietors form a partnership or a corporation, they would generally receive nonrecognition treatment. See IRC 721 (2004) (regarding nonrecognition upon contributions to partnerships); IRC 351 (2004) (regarding nonrecognition upon contributions to corporations).

was the terminating partnership.⁹⁹ As the terminating partnership, Partnership CD was treated as if it “contributed” its assets to AB in exchange for an interest in AB.¹⁰⁰ As a matter of both semantics and substance, Partnership CD obtained a basis of \$300¹⁰¹ for an interest and capital account worth \$800.¹⁰² The difference between tax and book basis was attributable to the \$500 unrealized appreciation in asset 2. Thereafter, CD “distributed” the AB interest to C and D in complete “liquidation” and in proportion to their interests in CD.¹⁰³ The Service ruled that after the merger, Partners C and D, as successors to Partnership CD had “new 704(c) gain” of \$200 each, attributable to \$400 appreciation accruing to Asset 2 before the merger.¹⁰⁴ By contrast, neither Partnership AB nor partners A or B were treated as though they made “contributions” to the continuing partnership. Accordingly, partners A and B did not have new 704(c) gain even though the substance of their economic transactions did not differ from that pertaining to partners C and D.¹⁰⁵ The resulting partnership booked-up its capital accounts and the tax/book balance sheet, had it been depicted, would have appeared as follows:

Table 1: Tax/Book Accounts for Partnership ABCD

<u>Assets</u>			Liabilities and Partners’ Capital		
			Liabilities:		
			Capital		
	<u>Tax</u>	<u>Book</u>		<u>Tax</u>	<u>Book</u>
Asset 1	200	900	A	200	600
Asset 2	100	600	B	300	600
Cash	<u>500</u>	<u>500</u>	C	100	400
	800	2000	D	<u>200</u>	<u>400</u>
				800	2000

IRC 704(c) merely applies a fundamental rule of taxation to partnerships. It ensures that income from property is taxed to the one who realized the economic benefit thereof. A contributor of appreciated property actually realizes the appreciation by virtue of her receipt of a partnership interest worth the total value of the property contributed. Adjustments to her capital account confirm an accession to wealth. Hence, the contributor immediately realizes the economic benefit of untaxed wealth. IRC 721

⁹⁹ IRC 708(b)(2)(A) (2004).

¹⁰⁰ Treas. Reg. 1.708-1(c)(3)(i) (as amended in 2001).

¹⁰¹ IRC 722 (2004).

¹⁰² Treas. Reg. 1.704-1(b)(2)(iv)(d) (as amended in 2004).

¹⁰³ Treas. Reg. 1.708-1(c)(3)(i) (as amended in 2001).

¹⁰⁴ 2004-18 I.R.B. 843.

¹⁰⁵ *Id.*

appropriately postpones taxation on the receipt of that economic benefit in accordance with Subchapter K's policy of allowing nonrecognition once – upon capitalization of the partnership. In turn, IRC 704(c) maintains the appropriate *status quo ante* by taxing previously realized appreciation to the appropriate party at a time when taxation will not interfere with the policy justifying the initial nonrecognition. It taxes appreciation to the one who previously reaped the economic benefit of that appreciation. Since C and D have new 704(c) gain as a result of the merger, they must eventually be taxed on the entire \$500 appreciation in Asset 2. This makes substantive sense because C and D were the owners of Asset 2 during the time the appreciation accrued and each of them received the benefit of that appreciation as demonstrated by their increased capital account balances. C must be taxed on the first \$100 appreciation because the property appreciated to that extent prior to being contributed to Partnership CD. C and D each must eventually be taxed on \$200 of the remaining \$400 appreciation because they have previously realized the benefit of \$200 appreciation.

Detailed tax regulations reinforce these results by accelerating gain recognition to C upon a distribution of asset 2 after the merger, but only with regard to the initial \$100 built in gain existing when the property was held by Partnership CD. In particular, Treasury Regulation 1.704-4(c)(4) indicates that gain recognition would be accelerated to “the same extent” such gain would have been accelerated if Partnership CD had distributed asset 2 prior to the merger.¹⁰⁶ A very literal application of this rule would mean that a distribution of asset 2 to D after the merger would trigger \$100 gain recognition to C, since that is the gain that would have been recognized had the property been distributed prior to the merger. The result would be only partially correct, as a substantive matter, because C has previously realized the benefit of \$200 additional

¹⁰⁶ Treas. Reg. 1.704-4(c) (as amended in 1997) states:

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 §1.737-2(b) for a similar rule in the context of section 737.

Similarly, Treas. Reg. 1.737-2(b)(1) and (3) (as amended in 1997) states:

Complete transfer. – (1) 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 §1.704-4(c)(4) for a similar rule in the context of section 704(c)(1)(B). . . . (3) 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 the transferor partnership would have been subject to section 737

appreciation in Asset 2. The acceleration of only \$100 therefore presents an additional, unwarranted opportunity for deferral and assignment of previously realized income. The distribution means that \$200 of C's previously realized \$300 will be taxed to D when D later sells Asset 2. The Service correctly perceived this problem in Revenue Ruling 2004-43 and fashioned the concept of "new 704(c) gain." The Service reasoned that Partnership CD (i.e., C and D) was subject anew to the anti-mixing bowl rules when it contributed property to Partnership AB, but only with regard to the appreciation in Asset 2 accruing after Asset 2 was contributed to Partnership CD. This makes semantic sense because the acceleration rules are made applicable, if at all, upon a contribution of property. It also makes substantive sense because Partnership CD is realizing the benefit of \$400 untaxed appreciation (as demonstrated by its initial capital account balance) and that appreciation must eventually be taxed solely to Partnership CD (i.e., C and D) under assignment of income principles.

The substantive problem with the Service's solution is precisely that it relies exclusively on semantics. There is never a discussion of the correct substantive outcome. As a result, the proper solution is inapplicable to partners A and B, when clearly those partners have an identical economic result as partners C and D. Partners A and B are subject to different semantics with regard to the merger and therefore have different tax consequences. Table 1 proves that Partners A and B have realized untaxed appreciation. Their capital accounts have been increased by their pro rata share of appreciation accruing after asset 1 was contributed to Partnership AB. Except for differing amounts, partners A and B are in precisely the same economic position after the merger as partners C and D. After the merger, the partners own an enforceable right to the untaxed appreciation inherent in their properties. But because A and B's capital accounts were not increased as a result of a "contribution," the anti-mixing bowl rules are deemed inapplicable.¹⁰⁷ Semantically, those rules become applicable only upon a "contribution." As a matter of fundamental tax substance, though, those rules should apply whenever there has been an untaxed realization of appreciation. In Revenue Ruling 2004-43, the Service treats the lack of semantic authority to condone a substantively incorrect result.¹⁰⁸ The increased capital accounts pertaining to A and B resulted from a revaluation and, as the Service points out, there is no semantic authority to ensure proper taxation of appreciation, the prior realization of which resulted from a revaluation.¹⁰⁹ Thus, the Partnership could distribute property to A or B without accelerating gain to either, even though both have previously realized untaxed appreciation and have, already used their one-time nonrecognition opportunity. This result conflicts with the substantively correct conclusion that income from property must be taxed to the beneficial recipient thereof

¹⁰⁷ "Section 1.704-3(a)(6)(i) provides that the principles of §1.704-3 apply to reverse §704(c) allocations. In contrast, the regulations under §704(c)(1)(B) and §737 contain no similar rule requiring that the principles of §704(c)(1)(B) and §737 apply to reverse §704(c) allocations. Under those regulations, §704(c)(1)(B) and §737 do not apply to reverse §704(c) allocations." Rev. Rul. 2004-43, 2004-18 I.R.B. 843.

¹⁰⁸ *Id.*

¹⁰⁹ The Service arguably had substantive authority by which to achieve the correct result. Treasury Regulation 1.737-4 indicates that that the anti-mixing bowl intent of IRC 737 should be applied in all circumstances to achieve a substantively correct result. Treas. Reg. 1.737-4 (as amended in 1995). The Service's failure to even cite to that regulation suggests the potential impotence of broadly stated anti-abuse rules, particular when those rules juxtaposed against semantically detailed rules.

when realized unless there is an explicit grant of nonrecognition, and that Subchapter K intends only one instance of nonrecognition.¹¹⁰ A and B have each received the benefit of the appreciation in asset 1, yet the application of semantics allows for the substantively incorrect taxation of that benefit.

The Service implicitly admits that the conclusion in Revenue Ruling 2004-43 raises an internal conflict with Subchapter K. The Ruling concedes that if asset 1 were sold by the partnership (rather than distributed), the partnership's gain would be taxed to partners A and B to the extent those partners previously realized the untaxed appreciation. The anti-mixing bowl distribution rules were designed to prevent erosion of that result and should therefore apply whenever capital accounts are credited with untaxed gain¹¹¹ and partners subsequently benefit from that gain. That intent is thwarted only because the Service has not articulated semantic authority that would make the mixing bowl rules applicable to distributions occurring after revaluations.¹¹² Hence partners A and B benefit from the receipt of untaxed appreciations as shown in their revalued capital accounts. They obtain a second, unintended and unwarranted nonrecognition opportunity because the label applied to partnership AB – “continuing partnership” – semantically precludes application of the anti-mixing bowl rules after a revaluation.

Semantics not only distort the analysis in Revenue Ruling 2004-43, they also distort stakeholder reactions to the rulings. Stakeholders, who had not anticipated the possibility of “new 704(c) gain,” quickly objected on the basis of two semantic arguments.¹¹³ First, they pointed to regulations that appropriately state, as a policy matter, that the anti-mixing bowl provisions do not apply to distribution that occurs as an

¹¹⁰ *Supra* notes 92 to 97 and accompanying text.

¹¹¹ William S. McKee, William F. Nelson, Robert L. Whitmire, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, 19-41 (1997 with 2003 Supplement) (“The stated purpose of 704(c)(1)(B) is to prevent partners from circumventing the rule of §704(c)(1)(A) requiring that gain or loss on §704(c) property be allocated to the contributing partner. . . . §737 was enacted ostensibly to buttress §704(c)(1)(B).”)

¹¹² *See supra* note 107.

¹¹³ *See, e.g., Letter from KPMG to Honorable Gregory F. Jenner, Acting Assistant Secretary (Tax Policy), U.S. Department of Treasury and Honorable Mark W. Everson, Commissioner of Internal Revenue, 2004 TNT 146-2004 (July 16, 2004) (“KPMG Comment”); ABA Tax Section Members Recommend Withdrawal of Revenue Ruling, 2004 TNT 135-29 (July 13, 2004) (“ABA Comment”); DC Bar Taxation Section Comments on Assets-Over Partnership Merger Guidance, 2004 TNT 135-28 (July 7, 2005) (“DC Bar Comment”)*. The D.C. Bar's comments were subsequently published in an article that essentially belies any notion of objectivity. *See* Blake D. Rubin and Andrea Macintosh Whiteway, *Partnership Mergers, The Anti-Mixing-Bowl Rules, and Rev. Rul. 2004-43: How Could the IRS Be So Wrong?* 104 TAX NOTES 739 (AUG. 16, 2004), 2004 TNT 159-18. This article asks the opposite question – “how can the stakeholders be so wrong!?” For a somewhat cynical but likely accurate answer to that question, see Lee A. Sheppard, *Added Sugars in the Partnership Built-In Gain Rules*, 104 TAX NOTES 595 (AUG. 9, 2004), 2004 TNT 154-6. An apparent fall-back assertion set forth by stakeholders is that Revenue Ruling 2004-43 was so unexpected that the analysis should be applied prospectively only. Although the substantive arguments against the ruling's conclusions are entirely without merit, as explained in the text, a prospective application of Revenue Ruling 2004-43 would nevertheless be reasonable if only to provide “CYA” for stakeholders who gave erroneous advice. It is entirely understandable that stakeholders would have rendered or followed bad advice prior to Revenue Ruling 2004-43, given their insistent over-reliance on semantics (as explained in the text below).

integral part of an assets-over merger.¹¹⁴ Those regulations also state that the anti-mixing bowl provisions would nevertheless apply to a subsequent distribution (i.e., a distribution by the consolidated partnership) “to the same extent” as those provisions would have applied if a distribution had occurred prior to the distribution.¹¹⁵ Stakeholders claim that the quoted phrase means that a post-merger distribution would not trigger the anti-mixing bowl provisions if a pre-merger distribution would not have triggered those provisions.¹¹⁶ Because post-contribution appreciation does not constitute 704(c) gain, a pre-merger distribution would not trigger the anti-mixing bowl provisions with respect to post-contribution appreciation. Hence, neither should a post-merger distribution trigger the anti-mixing bowl provisions with regard to post-contribution appreciation (i.e., appreciation accruing after property was contributed to the terminating partnership but before the merger), according to the stakeholders. The second objection is equally semantic. Stakeholders argue that the ruling’s analysis would unjustifiably subject a cash only terminated partner to the anti-mixing bowl provisions. They point out that partner D is subject to the anti-mixing bowl provisions even though he has contributed only cash to Partnership CD.¹¹⁷

The first stakeholder argument has arguable semantic support but is clearly substantively incorrect. The semantic support is merely arguable because the partnership merger rules use the term “contribution” with respect to an assets-over merger. The terminating partners are treated as if they “contributed” appreciated property to a new partnership.¹¹⁸ Semantically, the anti-mixing bowl provisions are placed on alert status, as it were, when appreciated property is contributed to a partnership. Substantively, the partners experience a realization event, as demonstrated by their capital accounts in the merged partnership. At that point, they are granted their single nonrecognition pass by virtue of IRC 721 and for good policy reasons. When, however, the contributing partners cash in on the appreciation a second time, there is no policy reason that justifies nonrecognition again, and Congress has not granted a second nonrecognition opportunity.¹¹⁹ Indeed, there is semantic support for requiring immediate recognition

¹¹⁴ See Treas. Reg. 1.704(c)(4) (as amended in 1997); Treas. Reg. 1.737-2(b)(1), (3) (as amended in 1997).

¹¹⁵ *Supra* note 112.

¹¹⁶ “Thus, under the ruling, a distribution by the Resulting Partnership of §704(c) property acquired in an Assets-Over Merger or a distribution of other property to a former member of the Terminating Partnership may Trigger gain in an amount greater than the amount of gain than would have been recognized under §§704(c)(1)(B) and 737 upon a distribution of property by the Terminating Partnership prior to the merger.” KPMG Comment. The other comments cited in footnote 111 make the same argument.

¹¹⁷ “The Ruling presents tax policy issues. Most significant among these is the treatment of a partner of the transferor who contributed only cash for her transferor partnership interest. While such a person is no doubt subject to 704(c) for shares of reverse 704(c) book-up gain, it seems counter-intuitive and surprising that she could be subject to sections 704(c)(1)(B) and 737. She has not in fact contributed any appreciated property to either partnership (transferor or transferee). This surprising result violates tax policy favoring predictability.” ABA Comment. The argument, of course, admits too much. If a cash contributing partner should be taxed on book-up gain from property acquired with her contribution, there can be no substantive reason why she should not also be subject to the anti-mixing bowl provisions when the partnership contributes her share of the appreciated property to another partnership. In any event, the argument is factually incorrect, as discussed in the text.

¹¹⁸ Treas. Reg. 1.708-1(c)(3)(i) (as amended in 2001).

¹¹⁹ When the partnership distributes appreciated property, it is, in effect, paying a debt (extinguishing in whole or in part the recipient partner’s claim) using appreciated property. Doing so constitutes a realization

because the terminating partners are treated as if they contributed appreciated property to another partnership. Ultimately, then, the only thing proven by the “to the same extent” language is that semantics can be misleading and indeed conflicting when separated from substance. The second argument has neither semantic nor substantive support. D may have contributed only cash to partnership CD, but she obtained a one half interest in asset 2 by virtue of the contribution. It was that property, not merely her share of the partnership’s cash, which D semantically and substantively contributed to the merged partnership. A subsequent cashing in of Asset 2’s appreciation, as for example by a sale or distribution of asset 2,¹²⁰ constitutes a realization event that should trigger recognition in the absence of a good policy reason to the contrary. The stakeholder criticisms of Revenue Ruling 2004-43 are incorrect because they rely on semantics without considering substance.

Revenue Ruling 2004-43 is nevertheless only half right because it grants the continuing partners a second, unwarranted nonrecognition opportunity. Extending the facts of Revenue Ruling 2004-43 demonstrates the harm. If the resulting partnership distributed asset 2 to B after the merger, B would take a \$300 basis in the property.¹²¹ The basis would preserve B’s previously realized appreciation for later taxation but that result does not address the objection. First, B gains a second nonrecognition opportunity without a corresponding societal benefit. B is wealthier because she has cashed in on her \$300 of appreciation in Asset 1 but taxes are deferred (again) for no apparent justification.¹²² Second, taxing B at a time later than either C or D creates an obvious horizontal inequity. Congress intended that a contributor of appreciated property get only one deferral and that intent is applied strictly enough to C and D. Not only would the principle of horizontal equity be violated as between B, and C and D, but also between B and unrelated taxpayers who undertake non-like-kind exchanges and are immediately taxed.¹²³ The harm might be viewed as academic, but it doesn’t take a lot of imagination to think that it will become a persistent reality once well-advised taxpayers recognize the potential for additional long term deferral.¹²⁴

The harm could be avoided simply by making the mixing bowl provisions fully applicable to appreciation occurring prior to the entry of a new partner, whether booked-up or not. That result is already imposed with regard to a sale of appreciated assets after

event. *Cf.* Treas. Reg. 1.1001-2(b), Example 8 (as amended in 1980). The gain from that realization event should be allocated to the contributing partner. IRC 704(c)(1)(B) (2004).

¹²⁰ *Id.*

¹²¹ IRC 731 (2004). In effect, A would be deferring again the tax on the appreciation in Asset 1 since she has already received her proportionate share of the appreciation in Asset 1.

¹²² If B received a distribution of her share of Asset 1, she would be more like a sole proprietor who merely withdraws her own appreciated property from business use. In that case, it would not be appropriate to impose a tax. In this hypothetical B should more properly be treated as if she sold her partnership interest and used the proceeds to purchase Asset 2, because B has different property than the property she originally contributed to the partnership. A sole proprietor would similarly be taxed unless IRC 1031 applied.

¹²³ *See* IRC 1031 (2004).

¹²⁴ Partners who want to engage in tax deferred, non-like kind exchanges could simply merge with another partnership under circumstances that ensure that the tax deferral seeking partners are labeled “continuing partners.” [give example and mention merger anti-abuse rule].

the entry of a new partner, even in the absence of any semantic authority.¹²⁵ It is therefore rather perplexing that the Service did not decide upon an analogous result with respect to post-merger distributions of appreciated property to continuing partners. It clearly could have as a matter of substantive interpretation.¹²⁶ A more fundamental point, though, is that the resulting harm could be avoided if Subchapter K did not elevate semantics to the level of substance.

V. THE PROBLEM AND SOLUTION TO SEMANTICS IN PARTNERSHIP TAXATION: FLUENCY IN PARTNERSHIP TAXATION

RUPA implies that semantics in partnership mergers are unimportant. It seems implicitly based on the notion that semantics – “distribution,” “termination,” “liquidation,” and “contribution” – are enforced at the expense of substance. As a matter of economic reality, old partnerships have not really terminated or liquidated when they merge. They continue to exist but in newly consolidated form. It makes no sense, then, to impose state law transaction costs that imply new ownership. If the same principle were transplanted to the Tax Code, it would allow partners to determine which partnerships contribute assets and which is treated as merely receiving new partners and additional capital. Tax law would then determine appropriate consequences according to substance and without regard to semantics. The irrelevancy of labels is certainly consistent with the underlying economic result common to all partners. From an economic standpoint, all partners are new partners in a new partnership notwithstanding the labels the law applies. State laws nevertheless explicitly adopt semantic labels but only to trace the genealogy of partnerships.¹²⁷ In tax law, the labels “continuing” and “terminating” partnership serve the same administrative purposes and are therefore useful to that extent.¹²⁸ The “continuing partnership” maintains its previous employer identification number, to which “terminating partnerships” become associated, and provides information by which the Service can appropriately match partners of the terminating partnerships to the continuing partnership.¹²⁹ Certainly there are no economic implications in either term notwithstanding Congress’ decision to apply the term “continuing partnership” to the partnership contributing the most capital to the consolidated entity.¹³⁰ Even that decision is ultimately based on nothing more than a need to designate one or the other partnerships as having the primary ownership of, and responsibility for administrative data and reporting requirements. Consider, in

¹²⁵ See Treas. Reg. 1.704-1(b)(5), Example (14)(iv) (partnership must allocate realized gain from the sale of property solely to partners holding interests during the period the property appreciated, even in the absence of specific authority).

¹²⁶ See *supra* notes 92 – 97, and accompanying text.

¹²⁷ Under the Revised Uniform Partnership Act, the labels “surviving” and “terminating” partnerships are used solely to keep track of partnership liabilities that follow each partner to the new partnership and as a means to notify interested third parties that an old partnership continues to exist but in new form or under new name. See Unif. Partnership Act §906-907 (1997).

¹²⁸ IRC 708(b)(2)(A) (2004) (defining a “continuing partnership”); Treas. Reg. 1.708-1(c)(1) (as amended in 2001) (defining “continuing” and “terminating” partnerships).

¹²⁹ Treas. Reg. 1.708-1(c)(2) (as amended in 2001).

¹³⁰ IRC 708(b)(2)(A) (2004).

comparison, the frequent use of the terms “forward” and “reverse” mergers in corporate reorganizations. The phrases distinguish corporate mergers in which the target corporation is swallowed by an acquiring corporation from transactions in which the acquiring corporation is swallowed by a target corporation. The labels are merely semantic; the tax consequences are identical regardless of which label applies.¹³¹ The partnership merger rules and Revenue Ruling 2004-43, in particular, demonstrate instead that semantics have been given substantive effect under Subchapter K. When semantics are consistent with substance and necessary to enforce a fundamental goal, this approach is unobjectionable. When semantics are inconsistent with substance and unnecessary to enforce a fundamental goal, as in Revenue Ruling 2004-43, the approach invariably causes problems.

Section III, above, explained how semantics might get in the way of efficiency if a terminating partnership is literally treated as though it were liquidating and one or more partners is subject to a deficit reduction obligation.¹³² The obligation imposed on partners with deficit capital account balances might logically discourage them from approving a partnership merger. Appropriate regulations indicate that the deficit reduction obligation is not triggered when partners liquidate by sale, most probably based on the notion that the partner subject to the deficit reduction obligation sells the interest for a reduced price in recognition that buying partner assumes the obligation. Section III went on to reason that it is also unnecessary to enforce the deficit reduction obligation upon a merger so long as a partner subject to the obligation remains obligated after the merger. Transferring the deficit reduction obligation to the resulting partnership continues the economic effect of previous special allocations and prevents semantics from getting in the way of substance.

To be fair, the Service has already recognized that enforcing semantics is sometimes unnecessary and counterproductive. In one situation, the Service merely changed the applicable language and imposed tax consequences in accordance with new semantics.¹³³ A broad theoretical observation would be that this solution treats the symptom rather than the disease. In another, the Service treated the disease by ignoring semantics altogether and focusing instead on substance.¹³⁴ The latter approach is broadly demonstrated in anti-abuse regulations that seem to be proliferating in Subchapter K.¹³⁵

¹³¹ Thus, Congress could have designated the smaller of two partnerships as the continuing partnership in the same manner that a smaller corporation is the continuing entity in a reverse merger. Doing so would have no effect on the substantive economic outcomes even though the semantics might very well change.

¹³² See *supra* notes 58 to 75 and accompanying text.

¹³³ Cf. Treas. Reg. 1.708-1(b)(1)(iv) (1996) (treating a technical termination as though the partnership distributed its assets to partners who then contributed the assets to a new partnership) and Treas. Reg. 1.708-1(b)(4) (1997) (treating a technical termination as though the old partnership transferred its assets in exchange for an interest in a new partnership, and then liquidated by distributing the interest in new partnership to old partners).

¹³⁴ Treas. Reg. 1.752-1(f) (as amended in 2001) (determining the amount of a deemed distribution under IRC 752(a) by reference to a partner’s share of liabilities in the terminating and continuing partnerships before and after the merger, instead of by reference solely to a partner’s interest in terminating partnership).

¹³⁵ Treas. Reg. 1.708-1(d)(6) (as amended in 2001) (stating that a partnership merger in form only should be taxed in accordance with its true substance); Treas. Reg. 1.701-2 (as amended in 1995) (essentially

Both approaches – changing the semantics, or decreeing that semantics should just be ignored if inconsistent with tax and economic substance – implicitly recognize that sometimes the convenience of labels does not justify the resulting tax distortion.

Until 1997, for example, IRC 708 regulations stated that upon a technical termination¹³⁶ a transferee partner as well as remaining partners were treated as though they received liquidating distributions from the terminating partnership and thereafter immediately contributed the assets received to a new partnership.¹³⁷ The semantic distribution and contribution caused the mixing bowl rules to be applied anew to all partners, including the transferee partner.¹³⁸ By contrast, the substance of the transaction actually involved only a continuation of the old partnership with the transferee partner stepping into the exact shoes previously occupied by the transferor partner. Certainly the non-selling partners had not made a new “contribution,” yet semantics as substance dictated that they be so treated. The adverse tax consequences arising from adherence to semantics distorted economic behavior. Partners subject to those adverse consequences could logically be expected to decline or postpone opportunities to sell their interests, or exercise their contractual rights to prevent or postpone another partner from selling her interest to an outsider. In 1997, the Service formally acknowledged the unnecessary imposition of adverse tax consequences and eliminated those consequences by changing the semantics of technical terminations.¹³⁹ Instead of treating the terminating partnership as though it makes liquidating distributions to partners, who in turn contribute assets to a new partnership, new regulations treat the terminating partnership as though it engages in an assets-over conversion to a new partnership.¹⁴⁰ By simply changing semantics, new regulations eliminated adverse tax consequences that arose solely as a matter of semantics rather than substance.

Treasury Regulation 1.752-1(f) contains a second example. In that regulation, however, the Service essentially instructs taxpayers to ignore semantics and analyze a merger transaction from a substantive standpoint. Example 2, Treasury Regulation 1.752-1(g) nicely demonstrates:

B owns a 70 percent interest in partnership T. Partnership T's sole asset is property X, which is encumbered by a \$900 liability. Partnership T's adjusted basis in property X is \$600, and the value of property X is

stating that the labels applied to any partnership transaction may be disregarded if they are not consistent with the underlying substance).

¹³⁶ The phrase “technical termination” refers to a partnership termination resulting from a sale or exchange of 50% or more of the total interest in partnership capital and profits within a twelve month period. IRC 708(b)(1)(B). See generally Monte A. Jackel and Glenn E. Dance, *Proposed Regs Offer New Approach to Partnership Terminations*, 96 TNT 118-77 (June 17, 1996) (Lexis database).

¹³⁷ Treas. Reg. 1.708-1(b)(1) (iv) (1996); See also Department of the Treasury, *Termination of a Partnership Under IRC 708(b)(1)(B)*, 61 Fed. Reg. 21985 - 21988 (May 13, 1996).

¹³⁸ Department of the Treasury, *Termination of a Partnership Under IRC 708(b)(1)(B)*, 61 Fed. Reg. at 21986 (May 13, 1996) (Notice of Proposed Rulemaking).

¹³⁹ Department of the Treasury, *Termination of a Partnership Under IRC 708(b)(1)(B)*, 62 Fed. Reg. 25498 (May 9, 1997) (Notice of Final Regulations)

¹⁴⁰ Treas. Reg. 1.708-1(b)(4) (as amended in 2001).

\$1,000. B's adjusted basis in its partnership T interest is \$420. B also owns a 20 percent interest in partnership 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 S interest is \$40. Partnership T and partnership S merge under section 708(b)(2)(A) [using the assets-over form in which T terminates and S is the continuing partnership].

Recall that under the assets-over form, T is treated as though it contributes its asset to S in exchange for a partnership interest.¹⁴¹ If semantics controlled, T would be relieved of \$900 liability and would be allocated \$100 liability for a net decrease of \$800.¹⁴² The net decrease would be treated as a cash distribution under IRC 752(b) and T would have \$200 gain,¹⁴³ \$140 of which would be taxable to B, despite her \$420 outside basis, and as if B received \$560 in liquidation of her interest in T. Substantively, though, B has received only \$400 in liquidation of her interest in T because she becomes a partner in S and is allocated \$250 of S' aggregate liabilities, including the liability attaching to property X. If anything, B has merely withdrawn part of her capital and under IRC 731 she would be entitled to defer gain recognition until cash distributions exceed her capital investment. This substantive outcome is achieved, though, only if the semantics pertaining to T's contribution to S are ignored. So long as T is treated as contributing property whose basis is less than the encumbrance, T (and therefore B) must recognize gain. Treasury Regulation 1.752-1(f) ignores semantics and treats separate transactions in accordance with a substantive view that B has actually received only a \$400 cash distribution when basis was \$460.

It may be that case by case solutions to over- or under-taxation caused by semantic labels is the only reasonable approach, even if that approach adds to the volume and complexity of Subchapter K.¹⁴⁴ The alternative would be to remove semantics and focus instead on substance in all instances. The statutory and regulatory volume could then be devoted to examples that merely remind taxpayers of fundamentals established elsewhere in the Code.¹⁴⁵ That approach is somewhat evident in certain statutes in Subchapter K. IRC 704, for example, sets forth a substantive standard that allocations should be consistent with partners' economic consequences. The mechanics are then explained in great detail in the 704 regulations, which nevertheless introduce a whole new vocabulary, along with several pages of detailed examples that seem to largely

¹⁴¹ Treas. Reg. 1.708-1(c)(3)(i) (as amended in 2001).

¹⁴² Treas. Reg. 1.752-1(f) (as amended in 2001).

¹⁴³ Treas. Reg. 1.722-1, Example 1 (1956).

¹⁴⁴ Subchapter K is actually notable to the extent that it does not introduce or provoke many, if any, new tax concepts. By contrast, Subchapter C creates a whole new taxpayer – the Corporation – and therefore necessarily provokes and then tries to resolve fundamentally different tax concepts. The challenge in Subchapter K is merely to apply fundamental concepts to a different context that raises the greater probability of abuse.

¹⁴⁵ Actually, statutes in Subchapter K seem to take this approach already, with a few exceptions. *Cf.* IRC 751 (2004) (relating to the character of gain or loss on the sale of a partnership interest) *with* IRC 732 (relating to the basis of properties received in distribution).

eliminate the need for the preceding verbiage.¹⁴⁶ IRC 752 is essentially a broadly stated, substantive application of *Crane v. Commissioner*¹⁴⁷ and *Commissioner v. Tufts*¹⁴⁸ to debt-financed, joint profit making activities. Individuals get basis credit for the amount of debt used to purchase property and basis debits for liability relief. IRC 752 broadly applies those fundamental rules to partners. The mechanics are then explained in detailed regulations, again by way of new semantics and examples. Eliminating semantics from the regulations, though, might merely shift the semantics away from regulations and into case reports. Would this be good or bad? Admittedly, semantics are helpful to the extent they do not displace substance. The words, “contribution” and “distribution,” for the most part are accurate shorthand for applicable substance – investment of capital generating basis and recovery thereof. Rather than articulating all the consequences multiple times, Subchapter K often refers to a term that implies those consequences.¹⁴⁹ This is good; it’s just that sometimes, as demonstrated in Revenue Ruling 2004-43, shorthand terms inject an inapplicable or incorrect substance to a transaction.

Nevertheless, stakeholders seem always to clamor for more “guidance” in the form of additional regulations, revenue rulings or revenue procedures.¹⁵⁰ Taxpayer representatives would likely object to greater reliance on judicial opinions. Obtaining a judicial opinion is expensive and uncertain. Judicial opinions are generally very case specific with regard to taxation and oftentimes get lost in semantics themselves. But the application of semantics to a specific case is less likely to result in substantive errors because a court can more easily discard semantics when it is faced with a conflicting, correct substantive outcome. Still, on the whole, stakeholders would probably consider removing the semantic volume from regulations a bad thing. Academics, on the other hand, recognize that semantics often get in the way of substantive understanding at least to the extent labels are applied generically to a wide variety of similar, though not identical, transactions. Academics decry semantic volume.¹⁵¹ They teach, research and write about substantive tax notions in hopes of fostering a substantive fluency, and because substance is more likely than semantics to provide the correct outcome in every case. Academics probably agree that semantics are useful, if at all, only in very broad context. As shown above, though, broadly applicable semantics can result in errors in particular contexts. When semantics are injected with as much or more authority as substance, economic distortions and incorrect tax outcomes are made possible and either exploited or provoke calls for reform.

¹⁴⁶ See Treas. Reg. 1.704-1(b)(5) (as amended in 2004).

¹⁴⁷ 331 U.S. 1 (1947).

¹⁴⁸ 461 U.S. 300 (9183).

¹⁴⁹ See, e.g., IRC 752 (2004) (using the terms “distribution” and “contribution” as shorthand terms implying, respectively, recovery of capital and gain recognition, and increased basis).

¹⁵⁰ This is a natural consequence of simply wanting to be confident that a certain transaction will invoke definite tax outcomes.

¹⁵¹ Professor Schwidetzky, for example, notes that many of the “loopholes” in tax law are the result of an over-reliance on “hyperlexis,” the process of using excessive statutory language in an effort to deny taxpayers unwarranted tax avoidance opportunities. Walter D. Schwidetzky, *Hyperlexis and the Loophole*, 49 OKLA. L. REV. 403 (1996). Footnote 1 in that article contains a long list of articles by academicians essentially decrying the use of semantics when substance would better serve the purposes. *Id.* at 403 n. 1.

Practitioners and academics would probably agree to maintain the volume of regulatory guidance if that volume were more clearly devoted to examples that elucidate substance rather than articulate semantic rules. In Revenue Ruling 2004-43, for example, the Service might have correctly concluded that the anti-mixing bowl rules applied equally to all partners had it not been constrained by the semantics of prior regulations. If the regulations pertaining to the anti-mixing bowl rules avoided articulation of semantic rules but merely contained numerous examples that focused on the fundamental principles identified earlier, the Service might not have felt constrained to condone a substantively incorrect report.

Perhaps only time will provide a real solution. Over time, a certain level of fluency with regard to the application of substantive tax principles to partnership operations might obviate reliance on detailed and infrequently misleading semantics. Stakeholders might come to share a level of substantive understanding – such as can be found now only amongst “experts” – so that semantics indeed become secondary to substance. This rather optimistic hope is gaining acceptance, in fact, in formal Subchapter K articulations, though when expressed the idea still does not yet displace excessive and sometimes misleading semantics. Treasury Regulation 1.708-1(c)(6), for example, expresses a sentiment that “semantics aside, taxpayers know what Congress meant.” The regulation allows the Service to disregard asserted tax consequences in ostensible partnership mergers that logically derive from the Service’s own semantics but are nevertheless inconsistent with presumably unmistakable substance.¹⁵² The idea is expressed in even broader context by way of the “partnership anti-abuse regulations.”¹⁵³ Those regulations, too, rely on an implicit, though unrealistic assumption that all stakeholders understand and share a common fluency.¹⁵⁴ Still, even the partnership anti-abuse regulations express a general and perhaps unfortunate preference for semantics, implicitly acknowledging the lack of Subchapter K fluency amongst stakeholders. The

¹⁵² Treas. Reg. 1.708-1(c)(6) (as amended in 2001) provides, “[i]f any [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 prescribed [for mergers], the Commissioner may disregard such form, and may recast the larger series of transactions in accordance with their substance.” The example in the regulations indicates that an ostensible merger might be disregarded, even though the transaction meets the semantic form specified in the regulations, if the parties intended something other than a merger such as sale or exchange disguised as a merger. Treas. Reg. 1.708-1(c)(6)(ii) (as amended in 2001).

¹⁵³ Treas. Reg. 1.702-1 (as amended in 1995).

¹⁵⁴ In one section, the anti-abuse regulations state:

The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (*intent of subchapter K*). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances . . . even though the transaction may fall within the literal words of a particular statutory or regulatory provision.

Treas. Reg. 1.701-2(b) (as amended in 1995).

regulations seem hopelessly self-contradictory when they state, in effect, that economic substance must always control but tax distortions are nevertheless tolerated whenever semantics render Subchapter K easier to administer.¹⁵⁵ In doing so, the anti-abuse regulations may actually discourage the level of fluency and substantive compliance upon which their own legitimacy is based. Another problem with anti-abuse regulations is that taxpayers, who have been conditioned by so much semantic authority, generally decry those regulations as “vague.”¹⁵⁶ The criticism seems to resonate with the Service as demonstrated by its reluctance to rely on those regulations in actual controversies.¹⁵⁷ One can only suspect and hope that if and when Subchapter K fluency becomes a reality, such an approach would be discarded. In the meantime, the admission that semantics are necessary and sometimes preferable means that semantics must be carefully drafted and used. When semantics prove inconsistent with substance, there should be an immediate substantive correction so that semantics do not become substance by virtue of time. Revenue Ruling 2004-43 is one such example of a semantic outcome justifying an immediate substantive correction. It is painstaking and true to the semantics of Subchapter K. Ultimately, though, its over-reliance on semantics at the expense of substance causes it to unnecessarily condone a substantively incorrect result.

¹⁵⁵ Another section of the anti-abuse regulations state:

Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

¹⁵⁶ See, e.g., Sheldon I. Banoff, *Anatomy of An Anti-Abuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 95 TNT 56-84.

¹⁵⁷ E. Carlow, *Memorandum For Regional Chief Compliance Officers re: National Guidance on the Application of Regulation Section 1.701-2 (Partnership Anti-Abuse Rule) and Announcement 94-87*, available in LEXIS at 95 TNT 207-10 (October 17, 1995) (requiring that IRS field examiners get special, national office approval before even raising an anti-abuse issue).