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Proposed Regulations under Sections 704 and 737 Would Apply Retroactively to Partnership Mergers

Treasury has issued proposed regulations that would retroactively make sections 704(c)(1)(B) and 737 applicable to partnership mergers. The regulations implement the principles of Rev. Rul. 2004-43, which was revoked in response to public criticism. The regulations are proposed to be effective for any distribution of property after January 19, 2005 if such property was contributed in a merger using the assets-over form after May 3, 2004.

Background

Section 704(c) provides that if property is contributed to a partnership, unrealized gain or loss associated with that property (the “built-in gain” or “built-in loss”) must be taken into account in allocating taxable income with respect to that property. Section 704(c)(1)(B) further provides that if the contributed property is distributed to another partner within seven years, any remaining built-in gain on the property is immediately recognized. Section 737 contains a companion rule under which a distribution of other property to the contributing partner may also cause recognition of built-in gain.

When two partnerships merge, one of the partnerships (the “Transferor Partnership”) is generally treated as having contributed all its assets and liabilities to the other (the “Transferee Partnership”) in exchange for an interest in the Transferee Partnership. The Transferor Partnership is then treated as having distributed its interests in the Transferee Partnership to its partners in liquidation (this series of events being referred to as an “Assets-Over Partnership Merger”). In Rev. Rul. 2004-43, the IRS concluded that sections 704(c)(1)(B) and 737 apply to the built-in gain associated with assets transferred from the Transferor Partnership to the Transferee Partnership in an Assets Over Partnership Merger.

A number of commentators argued that Rev. Rul. 2004-43 was inconsistent with the existing regulations and that the conclusions of that ruling should not be applied retroactively. In response to these comments, Treasury and the IRS issued Notice 2005-15 and Rev. Rul. 2005-10 revoking Rev. Rul. 2004-43, but indicating their intent to issue regulations implementing the principles of the ruling. The Notice provided that any such regulations would be effective for distributions made after January 19, 2005. On August 21, 2007, Treasury released the anticipated regulations in proposed form.

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The Proposed Regulations

The proposed regulations distinguish between preexisting built-in gain subject to section 704(c) in the separate partnerships (“Original Section 704(c) Gain”) and any additional unrealized gain at the time of the merger (“New Section 704(c) Gain”). Both the Original and New Section 704(c) Gain of the Transferor Partnership are subject to sections 704(c)(1)(B) and 737. However, the seven-year period during which those provisions are effective begins on the date of the merger only with respect to New Section 704(c) Gain. The seven-year period for Original Section 704(c) Gain does not restart, but begins on the date on which the property was originally contributed to the Transferor Partnership.

BDO Comment: Somewhat surprisingly, the Proposed Regulations specify that the Transferee Partnership is not bound by the Transferor Partnership’s method of applying section 704(c) with respect to either the New or Original Section 704(c) Gain, but may adopt any reasonable method.

The regulations do not apply to section 704(c) considerations that arise due to the revaluation of partnership assets (“reverse section 704(c) gain or loss”). Thus, the 704(c) layer created by the Transferee Partnership’s revaluation of its assets in connection with an Assets-Over Partnership Merger is not subject to sections 704(c)(1)(B) or 737.

The regulations extend these rules to subsequent mergers; clarify the effects of preexisting reverse section 704(c) gain or loss to the Transferor Partnership; specify that any partial gain recognition is attributed proportionately to the Original and New Section 704(c) Gain; and provide exceptions where ownership of the merged partnerships is identical or nearly identical.

The regulations are proposed to be effective for any distribution of property from a partnership after January 19, 2005 if such property was contributed in a merger using the assets-over form after May 3, 2004.

If you need assistance in determining how these proposed regulations may affect your clients, contact any member of the Passthrough Tax Consulting Group.

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