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## **Tax Consequences of Partnership Divisions**

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### I. INTRODUCTION

A. Scope and Purpose. This outline provides a summary of certain US federal income tax considerations associated with partnership divisions. The specific tax consequences associated with any particular transaction will depend upon the facts and circumstances of the transaction, and applicable law at the time of the transaction.

B. State Law. There are a number of ways in which to reorganize a partnership or limited liability company under state law in order to split it into two or more legal entities. One way is for the partnership or limited liability company to transfer some of its assets and liabilities to a new subsidiary partnership or limited liability company, and then distribute ownership of the new entity to its owners. Another way is for the partnership or limited liability company to distribute some of its assets and liabilities to its owners, who then transfer such assets and liabilities to one or more new partnerships or limited liability companies. Finally, in Texas (and Pennsylvania), such a split can be accomplished by way of the “merger” provisions of the Business Organizations Code (or “division” provisions under applicable Pennsylvania law). See TBOC § 10.0001 et seq.; 15 Pa. Cons. Stat. §§ 8576 & 8961.

C. US Federal Income Tax. However, regardless of the structure used to effectuate it, any such split of a legal entity that is treated as a “partnership” for US federal income tax purposes will be analyzed as a “division” of the original partnership for US federal income tax purposes (“FIT”). See Treas. Reg. § 1.708-1(d). The division of a partnership basically involves the distribution of partnership assets to one or more of its partners for FIT. Depending on the circumstances, the distribution might constitute a pro rata distribution to all partners, a liquidation of all or a part of the interest(s) held in the partnership by one or more partners, or the complete liquidation of the partnership. Whatever the circumstances, the normally operative rules under Subchapter K will apply to determine the tax consequences from the division. As a result, with certain important

exceptions, the division of a partnership generally is a tax-deferred transaction. See IRC §§ 721, 731, 732 & 736.<sup>1</sup> Generally. As with routine distributions, it is difficult to understate the potential significance of those pesky exceptions. The most challenging exceptions are the myriad anti-deferral rules applicable under Subchapter K (including the “hot asset,” “disguised sale,” and “anti-mixing bowl” rules). See IRC §§ 751(b), 752(b), 707(a)(2)(B), 704(c)(1)(B) & 737. Accordingly, while some comfort can be taken in the proposition that the division of a partnership generally does not trigger tax, a careful analysis of the anti-deferral rules (and other exceptions) must be made in order to conclude that deferral is indeed applicable with respect to any particular partnership division transaction.

D. Principal Questions. The main issue when sorting out the tax consequences from the division of a partnership is to determine which entity is treated as distributing/transferring what assets (and liabilities) to whom for FIT. In this regard, it is important to remember that the tax analysis often does not follow the state law path. However, once that issue is addressed, the normally applicable Subchapter K distribution rules can be applied to determine the tax consequences from the transaction. The principal questions that need to be answered in this regard are as follows:

- (1) Who are the players (i.e., “tax parties” to the transaction)?
- (2) What is the form of the division (for FIT)?
- (3) Are anti-deferral rules triggered?

## II. WHO ARE THE PLAYERS?

A. Principal Objective. The principal objective when analyzing the players in a division transaction is to determine whether any entity treated as a partnership for FIT existing after the transaction is considered the same partnership that was divided for FIT. Such entity, if it exists, is called the “divided partnership.” Treas. Reg. § 1.708-1(d)(4)(i). The divided partnership retains the original partnership’s EIN, and otherwise “is” the original partnership for FIT following the division. Treas. Reg. § 1.708-1(d)(2). All other partnerships are basically new partnerships for FIT (though some are able to retain, or are subject to, all of the elections made by the original partnership), and thus for example will have new EINs. Id.

B. Special Terminology. Unfortunately, in order to conduct this analysis, it is necessary to learn and apply some special terminology. The principal authorities in this regard are Section 708(b)(2)(B) and Treas. Reg. § 1.708-1(d). Section 708(b)(2)(B) was added to the Code in 1954, and reads as follows:

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<sup>1</sup> All references to “IRC” and the “Code” are to the Internal Revenue Code of 1986, as amended (except as otherwise indicated). All section references are to the Code unless otherwise indicated.

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