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Partnerships under the New Revenue Code

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PARTNERSHIPS UNDER THE NEW REVENUE CODE*

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There is no time like the present for lawyers to become acquainted or reacquainted with the law of federal taxation. Enactment of the Internal Revenue Code of 1954 has created a new interest in taxation and given the lawyer in general practice an unexcelled opportunity to join other students of this branch of the law in what is, for all, the beginners' class.

There is probably no better place for lawyers to begin than with the partnership provisions of the new Code. Lawyers are frequently called upon to draft partnership agreements and to advise partnership businesses. The 1954 law places great stress on the terms of the partnership agreement; significant income tax consequences are determined by what the agreement says.

Likewise, decisions made during the operation of the partnership business can have far-reaching tax results, and the lawyer cannot disclaim responsibility for these results when he is asked to apply the law to the facts of each situation. After all, the Internal Revenue Code is as much controlling law as the Uniform Partnership Act, and lawyers will often find it of greater interest to their clients.

The House Ways and Means Committee, in reporting on the partnership provisions of the new Code, stated that they presented the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws.[1] How well the committee has attained its stated objectives of simplicity, flexibility, and equity as between the partners is a question each lawyer can decide for himself, but no one can deny the advantages of the comprehensive coverage now provided by the Code.

This article is a summary of Subchapter K, the partnership sections, arranged under ten topics which follow, in general, the statutory scheme. No attempt is made to compare the new law with the old, except where helpful in explaining the new provisions.

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[1] H. R. REP. No. 1337, 83d Cong., 2d Sess. 65 (1954).

I. TAXABLE STATUS OF PARTNERSHIPS

The definition of partnership includes not only partnerships under state law but also business syndicates, groups, pools, joint ventures and similar unincorporated organizations.[2]

It is now expressly stated that the partnership is not a taxable entity.[3] It reports its income but pays no tax. Individual partners pay tax on their distributive shares of the partnership income, whether actually received by them or not.

As a step toward the subordination of tax considerations in determining the form of organization of small businesses, an option is given some partnerships and proprietorships to be taxed as corporations.[4] The requirements are: (1) ownership of the business is limited to a sole proprietor or not more than 50 partners, all of whom join in the election; (2) no partner with more than a 10 per cent interest is a more-than-10 per cent owner of another partnership or proprietorship reporting as a corporation; (3) no partner is a non-resident alien or foreign partnership; (4) capital is a material income-producing factor in the business, or at least 50 per cent of gross income is from trading as principal or agent.[5] For example, a manufacturing firm, real estate agency, or stock brokerage firm will qualify; a partnership in law, medicine, or accounting will not.

Under the election, a partner is not an employee for pension or profit-sharing purposes. The usual corporate taxes, including the penalty tax on accumulated earnings, are imposed. Special provisions are made for personal holding company income. The corporate reorganization rules do not generally apply.

The election is irrevocable unless there is a 20 per cent change of ownership. Thus, the option should be exercised only after careful consideration. Partners would not relish having to sell a 20 per cent interest in their business to outsiders in order to escape the burden of high corporate taxes.

In the author's opinion, the option to be taxed as a corporation has only limited usefulness. In most cases it will be more advantageous for the business desiring to be so taxed to incorporate and achieve limited liability along with corporate taxation. However, in certain situations, as, for example, a partnership with large profits which must

[2] Section 761. All section references are to the INTERNAL REVENUE CODE OF 1954, Pub. L. No. 591, 83d Cong., 2d Sess. (August 16, 1954), unless otherwise noted.

[3] Section 701.

[4] This provision and a companion option for corporations to be taxed as partnerships were introduced by the Senate Finance Committee. SEN. REP. No. 1622, 83d Cong., 2d Sess. 118-119, 452-458 (1954). The latter option was eliminated in the Conference Committee. H. R. REP. No. 2543, 83d Cong., 2d Sess. 72 (1954).

[5] Section 1361.

be retained for use in the business and with partners in high income tax brackets, the new provision may prove beneficial.

Another new feature of the Code permits certain partnerships to omit the partnership returns; the income is reported only by the individual members.[6] This election, which must be made by all members, is available to two classes of unincorporated organizations: (a) those used for investment only and not for active business; and (b) those used for the joint production, extraction or use of property, but not for selling services or such property. An investment syndicate or joint storage warehousing organization may qualify, but in all cases it is essential that the income of the members may be determined adequately without a partnership return.

The family partnership provisions are identical with former law.[7] Family partners are recognized if they actually own capital interests in a partnership in which capital is a material income-producing factor, whether or not their interests were received by gift or sale from a family member. The donor partner must be given reasonable compensation for his services, and the donee partner's share of profits based on capital must not be proportionately greater than the donor's share based on capital.

II. Partnership Income and Its Allocation Among the Partners

A. *Computing partnership income*

From the partnership income as shown on the books, certain items are isolated and listed separately on the partnership return. The remaining income is called the taxable income of the partnership.[8] The segregated items are capital gains and losses, gains and losses on depreciable property and land used in the business, gains and losses on involuntary conversions, charitable contributions, dividends from domestic corporations, foreign taxes, partially tax-exempt United States bond interest, and other items prescribed by regulations. All of these items have the same character as part of the partners' shares as on the books of the partnership. For example, if the partnership has a net long term capital gain, each partner's share of that item is net long term capital on his personal return.

Partnership taxable income is computed on the partnership return in the same way that individual income is computed on Form 1040, except that certain individual deductions such as the standard deduction and the net operating loss deduction are not allowed.[9]

[6] Section 761.
[7] Section 704(e). See Sections 191 and 3797(a)(2), Internal Revenue Code of 1939, as amended.
[8] Section 702.
[9] Section 703.

All elections affecting taxable income, except the election on foreign taxes, are made at the partnership level.[10] For example, if *AB* partnership sells real estate at a profit for a price of $10,000, on terms of $2,500 cash and the balance under a ten year mortgage, and the partnership reports the gain in the year of sale, partner *A* cannot report his share of the gain on the installment basis.

B. *Allocation of partners' distributive shares*

The terms of the partnership agreement determine the share of each partner in the partnership taxable income or loss and in the segregated items listed above.[11] If the partnership agreement contains no allocation of the segregated items, they are divided among the partners in the same way as taxable income and loss.[12]

One exception exists to this control by the partnership agreement. If the principal purpose of any provision in the agreement allocating income, gain, loss, deduction, or credit is tax avoidance or evasion, this provision is nullified and the regular profit-sharing formula applies.[13] For example, an agreement allocating all capital gains to the wealthiest partner would be suspect. On the other hand, assigning a higher proportion of sales profits to a salesman-partner would clearly be justified.

The partnership agreement may be oral or written, but, of course, should be written. Any amendments properly made prior to the time for filing the partnership return (April 15th for calendar year partnerships), and not including extensions of time, will be effective for the taxable year.[14]

Where a partner sells a part of or otherwise reduces his partnership interest, his distributive share of the partnership income must take into account his varying interests in the partnership during the year.[15] There is no similar requirement with respect to additions to his partnership interest.

In the past, guaranteed salary and interest payments made to partners were considered as in effect a division of partnership profits. In a commendable and simplifying change, these payments may now be deducted as business expenses before figuring profits.[16] Of course, the partners' salaries must meet the test of reasonableness.[17] The effect on the recipient is the same as under old law, *i.e.*, taxable income.

If the partnership sustains losses, to what extent are they deductible by the partners? Any partner's share of ordinary or capital loss is allowed up to the amount of the basis for his interest in the partner-

[10] Section 703(b).
[11] Section 704(a).
[12] Section 704(b).
[13] Section 704(b).
[14] Section 761(c).
[15] Section 706(c)(2)(B).
[16] Section 707(c).
[17] Section 162(a).

ship. He may deduct any excess loss later if he repays it to the business, either directly or out of future profits.[18] For example, a partner with a basis of $50 for his interest, who shares to the extent of $100 in partnership loss, may deduct only $50. If in the next year he puts another $50 into the partnership, the additional $50 loss will be recognized.

Every lawyer assisting in the formation of a partnership should be aware of the problems arising from the contribution of property to the partnership by one or more partners. One question which must be answered is how to allocate among the partners depreciation, depletion, and gain or loss on such contributed property. The Code gives partnerships a choice between two rules.

The general rule, also known as the entity rule, allocates depreciation, depletion, and gain or loss on contributed property just as if the property had been purchased by the partnership.[19] For example: *A* and *B* form an equal partnership. *A* contributes machinery worth $10,000 with an adjusted basis of $4,000. *B* contributes $10,000 in cash. If the machinery depreciates at a straight 10 per cent rate, the first year's depreciation of $400 will be divided equally between *A* and *B*, $200 each. Assume further that at the end of the year the partnership sells the machinery for $10,000. The gain of $6,400 on the sale will likewise be divided equally between the partners, $3,200 to *A* and $3,200 to *B*.

This rule is simpler than the alternative rule, and conforms with the usual expectations of the partners. The tax inequities produced are somewhat offset by the relatively larger capital gains tax levied on the property-contributing partner upon liquidation of the partnership or sale of his interest.

The optional or aggregate rule applies only when expressly adopted by the partnership agreement. Under this rule, depreciation, depletion, gain or loss on contributed property are allocated among the partners so as to take account of the difference between the basis of the property to the partnership and its fair market value when contributed, and to charge this difference to the contributing partner, either annually, as depreciation is deducted, or on sale of the property.[20]

Let us assume the same facts as in the above example, plus a provision in the partnership agreement which, in effect, treats the machinery as if it had a basis of its fair market value. If the machinery's basis were its value, $10,000, the annual depreciation deduction, at the 10 per cent rate, would be $1,000, of which $500 would be allocated

[18] Section 704(d).
[19] Section 704(c)(1). As indicated under V *infra*, the partnership acquires the contributing partner's basis.
[20] Section 704(c)(2).

to each partner. Since the partnership can only deduct $400, and *A* is charged with the low basis of the property, *B* gets the entire $400 deduction and *A* gets none. When the machinery is sold for $10,000, resulting in a gain of $6,400, $500 of the gain is allocated to *B* and $5,900 to *A*. This result follows because, if the machinery had had an original basis of $10,000, depreciated after one year to $9,000, the gain on the sale would have been $1,000, divided equally, $500 to *A* and $500 to *B*. *A,* the contributor, is charged with all of the actual gain in excess of $500.

This rule is more complicated than the other, but produces more equitable computation of the partners' taxable incomes. It may also prevent undesired or unexpected tax results for the partners contributing cash rather than low-basis property.

The important thing for the lawyer to remember is that the contribution to the partnership of property having a basis different from its market value calls for an agreement among the partners on the allocation of depreciation, depletion, and gain or loss. The partners' decision should then be reflected in the partnership agreement. In the absence of any provision in the partnership agreement, the general rule will apply.

A final problem with contributed property is in connection with undivided interests in property. The Senate Finance Committee wished to avoid unintentional tax results when owners of joint interests in property, by virtue of engaging in business activity, are held to be a partnership and required to file partnership returns.[21] The Code provision is not, however, limited to this situation, but also applies when owners of joint interests consciously contribute them to a partnership. Depreciation, depletion, and gain or loss on undivided interests in contributed property are allocated among the partners as though they held the property outside the partnership, if the partnership agreement does not provide otherwise and all partners had undivided interests in the property prior to contribution, which interests correspond to their interests in partnership capital and profits.[22]

An example will clarify the rule. *A* and *B* own a hotel as equal tenants in common. *A's* basis for his interest in the building (excluding land) is $20,000; *B's* basis for his interest is $30,000. They contribute the hotel to their equal partnership. If depreciation is at a straight 2 per cent rate, *A* deducts $400 per year and *B* deducts $600, just as they were doing before contribution to the partnership. Likewise, gain or loss on sale of the hotel will be computed separately for each partner.

[21] SEN. REP. No. 1622, 83d Cong., 2d Sess. 93 (1954).
[22] Section 704(c)(3).

III. Taxable Years of Partners and Partnership

A. *When do the partners report partnership income?*

Each partner reports his share of partnership taxable income or loss, his share of the segregated items mentioned above (capital gains and losses, etc.), and all guaranteed salary or interest payments in his income for his taxable year within which the partnership year ends.[23] This is the same as the old Code, but note that salary and interest are reported as if received at the end of the partnership year. For example, a partner on a calendar year basis has a guaranteed salary of $100 per week. The partnership year ends June 30, 1956. The partner actually receives $2,600 salary in 1955 but reports the entire $5,200 in his 1956 return.

B. *Adoption and change of taxable year*

In the past, by selection of the partnership fiscal year—for example, one ending January 31st—it was possible to postpone realization of partnership income by as much as eleven months. To prevent this, the Code provides that after April 1, 1954, a partnership may not adopt or change to a taxable year other than the taxable year of all its principal partners unless the Commissioner consents.[24] A principal partner is one with an interest of 5 per cent or more in partnership profits or capital.[25]

The practical result, since almost all individuals are on a calendar year basis, is that new partnerships must use the calendar year unless a valid business purpose for a fiscal year is shown to the Commissioner's satisfaction. Old partnerships may continue with their fiscal years, or they may change to the calendar year without consent, if all principal partners are on the calendar year, or simultaneously change to the calendar year.

An individual partner may no longer change to a taxable year other than the fiscal year of the partnership in which he is a principal partner, unless a good business reason is supplied the Commissioner.[26] Of course, partners now using taxable years different from their partnerships are not required to make any change.

C. *Termination of partnership and partnership year*

Contrary to common law concepts, the partnership is not terminated and the partnership year does not close when a new partner is admitted, or when a partner dies, sells all or part of his interest, reduces his interest, or withdraws his entire interest by means of a distribution.[27] The partnership year is cut short for all partners only by the

[23] Section 706(a).
[24] Section 706(b)(1).
[25] Section 706(b)(3).
[26] Section 706(b)(2).
[27] Section 706(c)(1).

"termination of the partnership," *i.e.*, the complete cessation of business, or the sale or exchange of 50 per cent or more of the total partnership interests within twelve months.[28]

The partnership year closes for a partner who sells his entire interest or withdraws his interest by a distribution.[29] For the continuing partners the partnership year runs to its normal conclusion. The selling or withdrawing partner reports his pro-rata share of partnership income for the period ending with his sale or retirement.

The death of a partner does not close the partnership year as to him.[30] Thus, bunching of more than one year's partnership income in the decedent's last year is avoided. However, it is not entirely clear from the committee reports whether the death of a partner having a 50 per cent or greater interest in the partnership and the purchase of his interest by the other partners will terminate the partnership and close the partnership year for all partners. Such closing can be avoided by drafting the partnership agreement and the buy and sell agreement to make the purchase effective at the end of the partnership year in which the partner dies.

The decedent's share of the partnership income for the partnership year in which he dies is not reported in his income tax return but in the return of his estate or successor in interest.

A partnership resulting from a merger or consolidation of two or more partnerships is considered a continuation of the merging partnership whose members own more than 50 per cent interest in the resulting partnership.[31] The partnership years of the other merging partnerships are closed by the merger.

All partnerships resulting from a division of a single partnership are considered continuations of it, unless the members of any resulting partnership had less than 50 per cent interest in the prior partnership.[32]

IV. Transactions Between Partner and Partnership

In this area the Code adopts the entity theory as the general rule. A partner's dealings with the partnership, other than in his capacity as a member of the partnership, have the same effect as if he were a stranger.[33] Examples of such transactions are the sale of property to the partnership, the purchase of property from the partnership, rendering services to the partnership for a guaranteed salary, and loaning money to the partnership at interest. Transactions which are not so treated include contributions to or distributions from the partnership.

In order to prevent sales of property between a partnership and its controlling partner, made for the purpose of establishing tax losses or

[28] Section 708(b)(1).
[29] Section 706(c)(2)(A).
[30] Section 706(c)(2)(A).
[31] Section 708(b)(2)(A).
[32] Section 708(b)(2)(B).
[33] Section 707(a).

raising the basis of property for depreciation and other purposes, two exceptions are made to the general rule. The lawyer should be sure that his clients do not enter into these excepted transactions in ignorance of the tax results.

First, losses are disallowed on sales or exchanges of property between a partnership and a partner owning more than a 50 per cent interest therein or between two partnerships in which the same persons own more than 50 per cent interests.[34] However, the loss is not completely forfeited; if the property is subsequently sold, no gain is recognized until the disallowed loss is absorbed.[35] For example, if a controlling partner sells property with a basis of $100 to his partnership for $50, his $50 loss is disallowed. If the partnership later sells the property for $75, it has no gain on the sale, because the disallowed loss is taken into account.

The second exception treats as ordinary income all gains on sales or exchanges of property, which is not a capital asset in the buyer's hands, between a partnership and a partner owning more than an 80 per cent interest therein or between two partnerships more than 80 per cent owned by the same persons.[36] For example, if a controlling partner sells a building used in his own business, with a basis of $5,000 to him, to his partnership for similar use at a price of $15,000, the $10,000 gain is ordinary income to him.

In determining whether statutory control of a partnership exists under these two exceptions, broad constructive ownership rules apply.[37]

V. Assets Contributed to the Partnership

When a partner contributes property to the partnership in return for an interest therein, no gain or loss is recognized either to the partner or to the partnership.[38] This codifies existing case law whereby property flows into a partnership tax-free.

As under prior law, assets contributed to a partnership retain the adjusted basis they had in the hands of the contributing partner at the time of contribution.[39] Similarly, the partnership's holding period includes that of the partner.[40]

Any increase in a partner's share of partnership liabilities or any increase in his individual liabilities by reason of the assumption of partnership liabilities is considered a contribution of money to the partnership.[41] Suppose partner *A* contributes property, subject to a $500 mortgage, in exchange for a one-half interest in a partnership, and partner *B* contributes $1,000 in cash. *B's* basis for his one-half interest

[34] Section 707(b)(1).
[35] Section 267(d).
[36] Section 707(b)(2).
[37] Section 267(c).
[38] Section 721.
[39] Section 723.
[40] Section 1223(2).
[41] Section 752(a).

is $1,250, because his assumption of one-half of the mortgage liability is considered an additional contribution.

VI. Partnership Distributions

Just as no gain or loss is recognized either to the partnership or to the partner on contribution of assets to the partnership, so also the general treatment of distributions by the partnership is to recognize no gain or loss either to the firm or the member on current or liquidating distributions. The basic idea is to permit property to be moved into and out of the partnership as business reasons dictate, without taxability to the partners, and to defer recognition and taxation of their gains or losses until they dispose of the properties distributed to them.

A. *Effect of distributions on the partners*

There are two types of distributions of property to partners—current distributions and liquidating distributions—and because their effects are different they are separately discussed.

Since each partner has already been taxed on his distributive share of partnership income, when he receives this share in a current distribution of cash or property, no further gain is recognized to him, unless the cash he receives exceeds his basis for his interest in the partnership.[42] Any gain is capital gain. [43] Any decrease in a partner's share of partnership liabilities or any decrease in his individual liabilities by reason of the assumption by the partnership of such individual liabilities is considered a distribution of money to the partner.[44] No loss is recognized to a partner on any current distribution.[45]

What is the basis of property in the hands of the partner who receives it in a current distribution? The general rule provides for a carryover basis, *i.e.*, the adjusted basis to the partnership.[46] Of course, this basis cannot exceed the partner's basis for his interest in the partnership, reduced by any money distributed at the same time.[47] In cases where the partnership basis of the distributed property does exceed the partner's basis for his interest, the latter basis is allocated to the distributed property, first, to any unrealized receivables and inventory items (as hereafter defined) up to their partnership bases, and second, to the remaining properties in proportion to their partnership bases.[48]

A simple example of a current distribution will clarify the rules. A partner has a basis of $1,000 for his partnership interest. He receives a current distribution of $400 cash and property with a basis to the partnership of $800, consisting of an automobile with a basis of

[42] Section 731(a).
[43] Section 741.
[44] Section 752(b).
[45] Section 731(a).
[46] Section 732(a)(1).
[47] Section 732(a)(2).
[48] Section 732(c).

$600 and office furniture with a basis of $200. The cash reduces the basis of his interest in the partnership to $600, and he receives the property at this basis, allocated $450 to the automobile and $150 to the office furniture.

One special rule on the basis of distributed property, which applies to either current or liquidating distributions, is explained below.

A liquidating distribution is either a final distribution of all partnership property in dissolution of the partnership, or a distribution of a partner's pro-rata share of the partnership property in full retirement of his interest. Just as with current distributions, no gain is recognized on a liquidating distribution, unless the cash received by a partner is greater than the basis of his interest in the partnership.[49] In the latter case the gain on receipt of the money is capital gain. Gain or loss on all other properties is deferred until the partner disposes of them.

Capital loss may be recognized on a liquidating distribution, but only if the distribution consists solely of money, unrealized receivables and inventory items, and the money plus the basis of such assets is less than the basis of the partner's interest in the partnership.[50]

These rules may give partners who are dissolving their partnerships, either voluntarily or because they are operating at a loss, a choice between realizing their gain or loss at the time of liquidation, by converting all assets into cash and distributing the cash, and postponing realization of gain or loss by distributing the assets in liquidation and selling them at a later date.

Of course, if a partnership dissolves and all assets are used to pay debts, leaving nothing to distribute, each partner suffers a capital loss in the amount of his basis for his partnership interest; and if individual property of the partner is taken to pay partnership debts, a further loss occurs.[51]

Unlike the general rule in current distributions, property received in a liquidating distribution takes a substituted basis, namely, the partner's basis for his interest in the partnership.[52] This basis is first reduced by any money distributed in the same transaction. The remaining basis is allocated to any unrealized receivables and inventory items distributed, up to their partnership bases, and then to other distributed properties in proportion to their partnership bases.[53]

Let us take as an example a partner whose basis for his interest in the partnership is $17,000. The partnership is dissolved and he receives $2,000 cash, inventory with a partnership basis of $3,000, a

[49] Section 731(a).
[50] Section 731(a)(2).
[51] Section 165.
[52] Section 732(b).
[53] Section 732(c).

capital asset with a basis of $2,000, and a depreciable asset with a basis of $4,000. The cash reduces the basis for his interest to $15,000. This is first allocated to the inventory at its partnership basis, $3,000. The remaining $12,000 is divided between the capital asset, $4,000, and depreciable asset, $8,000, in proportion to their partnership bases.

Certain provisions of the Code apply to both types of distributions. The first is a special rule on the basis of distributed property which gives relief to persons who buy into a partnership in order to obtain assets. A partner who purchases or inherits his interest and who receives a distribution of property within two years thereafter may elect to apply a rule like the *Kimbell-Diamond*[54] rule.[55] Under this rule the basis of the property is adjusted, with the result that a partner who purchases or inherits an interest in a partnership having valuable but low-basis property gets a stepped-up basis for the property when it is distributed to him.

Assume that *A* inherits a one-half interest in a partnership whose sole asset is an apartment building. The building is worth $100,000 but is on the partnership books at $25,000. Under the special rule the difference between *A's* basis for his interest in the partnership, $50,000, and his proportionate share of the basis of the building, $12,500, or $37,500, is added to the basis of the building insofar as *A* alone is concerned. If the partnership is dissolved after *A* becomes a partner and the building is distributed to the partners, *A's* basis for his one-half interest in the building is $50,000, the sum of $12,500 and $37,500.

The Commissioner may apply this special rule to any such partner's distributed property, whether or not the distribution was within two years of the purchase or inheritance of his interest, if at the time of such acquisition the fair market value of the partnership property was more than 110 per cent of its partnership basis.[56] The purpose of this provision is to require allocation of the increase in basis of the distributed properties in accordance with their relative values rather than in proportion to their partnership bases.

When a partner disposes of property distributed to him by the partnership, he tacks his holding period to that of the partnership,[57] and realizes gain or loss, which is capital or ordinary depending on whether or not the property is a capital asset in his hands.[58] However, the first of three "collapsible partnership" provisions requires the partner to report ordinary income or loss on the disposition of unrealized receiv-

[54] Kimbell-Diamond Milling Co. v. Commissioner, 14 T. C. 74 (1950), *aff'd per curiam,* 186 F. 2d 718 (5th Cir. 1951), *cert. denied,* 342 U. S. 827 (1951).
[55] Sections 732(d) and 743(b).
[56] Section 732(d).
[57] Section 735(b).
[58] Section 1221.

ables, and on the disposition, within five years, of inventory items distributed to him.[59]

These so-called collapsible partnership provisions, which became effective March 9, 1954, are intended to prevent the conversion of ordinary income into capital gain through the sale of a partnership interest or through the distribution of property which would produce ordinary income to the partnership if collected, sold, or exchanged. Accordingly, unrealized receivables are defined as rights to payment for goods and services which have not given rise to gross income under the partnership accounting method.[60] A good example is an uncollected legal fee of a cash basis law partnership.

Inventory items are non-capital assets, such as stock in trade, inventory, property held for sale to customers, and accounts and notes receivable, but not including depreciable property or real estate used in business.[61] Examples of such inventory items are automobiles in the inventory of a used car firm and accounts receivable of a wholesale grocery partnership.

The second anti-capital-gain provision is an exception to the general rule that a distribution of property (other than cash) is tax free to the partners and the partnership. Under this provision, a distribution in which a partner receives more or less than his proportionate share of unrealized receivables and substantially appreciated inventory items, in exchange for his interest in other partnership property, is a taxable exchange as to both the partner and the partnership.[62] If the partner receives more than his share of these items, he has capital gain and the partnership has ordinary income. If he receives less than his share, he has ordinary income and the partnership has capital gain.

Inventory items have appreciated substantially in value if their fair market value is more than 120 per cent of their partnership basis and more than 10 per cent of the fair market value of all partnership property other than money.[63] It can easily be seen that any business which has an inventory of merchandise is likely to have an appreciated inventory.

The danger of this special distribution section is that partners who have no tax saving or tax avoidance motive may be caught in its net. If a partnership is distributing property, whether in final dissolution or otherwise, and each partner does not receive his pro-rata share of every partnership asset, the firm's lawyer should check carefully for the application of this section.

[59] Section 735(a).

[60] Section 751(c).

[61] Section 751(d)(2).

[62] Section 751(b)(1). The third collapsible partnership provision is discussed under VIII, A *infra*.

[63] Section 751(d)(1).

Note, however, that two types of distribution are excepted from taxability even if they are disproportionate. The first is where a partner receives back property he contributed to the partnership. The second exception is in the case of payments in complete liquidation of the interest of a retiring partner or the estate or heir of a deseased partner.[64]

B. *Effect of distributions on the partnership*

The partnership has no gain or loss on any distribution of money or property to a partner, with one exception—the disproportionate distribution of unrealized receivables and appreciated inventory items as above described.[65]

As a general rule the distribution of property has no effect on the basis of the remaining partnership property.[66] But where the distribution results in gain or loss to the distributee partner, or a change in the basis of the distributed property in his hands, the partnership may elect to adjust the basis of its remaining property.[67] Under the election, the basis of the remaining property is increased by any gain realized by the partner on a cash distribution, and by any excess of the partnership basis of distributed property over its basis to the receiving partner.[68]

Assume that a partner with a basis for his interest in the partnership of $100, receives a distribution of property with a partnership basis of $150. The partner's basis for the property cannot exceed his $100 basis. If the partnership elects, the $50 excess is allocated to the basis of the remaining partnership properties.

Conversely, the election necessitates a decrease in the basis of remaining properties by the amount of any loss recognized to the distributee partner in a liquidating distribution, and by any excess of the partner's basis for property received in a liquidating distribution over its basis to the partnership.[69] General and special rules are given for the allocation of basis among the partnership properties.[70]

Once made, the election applies to subsequent years unless revoked by the partnership in accordance with regulations.[71]

VII. THE PARTNER'S BASIS FOR HIS INTEREST IN THE PARTNERSHIP

In accord with existing practice, a partner's original basis for his interest in the partnership is its cost if he purchased it, its value if he inherited it, or the adjusted basis of property contributed to it if his interest was in return for such contribution.[72] This basis is increased

[64] Section 751(b)(2).
[65] Section 731(b) and (c).
[66] Section 734(a).
[67] Section 734(b).
[68] Section 734(b)(1).
[69] Section 734(b)(2).
[70] Section 755.
[71] Section 754.
[72] Sections 705, 722, 742.

by any additional contributions, by his distributive share of partnership income, whether taxable or tax-exempt, and by his share of any depletion deductions in excess of the basis of the property depleted.[73] The basis of his interest is decreased (but not below zero) by any cash currently distributed to him, by the amount of the basis to him of any property currently distributed, by his distributive share of partnership losses, and by his share of partnership expenditures which are neither deductible nor properly chargeable to capital account.[74]

To follow these adjustments in basis, let us assume the following facts. On January 1st, *X* buys a one-fourth interest in a calendar year partnership for $5,000. He withdraws $750 during the year against his share of the profits. He also receives a distribution of a typewriter which has a basis of $75 to the partnership. His share of the partnership income for the year is $900. During the year the partnership pays off a $600 mortgage on a truck. What is *X's* basis for his partnership interest at the end of the year? It is $4,925, computed as follows: *X's* unadjusted basis, $5,000, increased by his share of partnership income, $900, and decreased by his receipt of $750 in cash and the typewriter with a $75 basis, and his share of the reduction in the partnership mortgage liability, $150 (which reduction is considered a distribution of money under Section 752(b)).

Instead of making the computations required by the general rule described above, a partner may, when permitted by regulations, determine the basis of his interest in the partnership by taking his proportionate share of the total basis of all partnership assets.[75] This alternative method is intended to be simpler and yet to yield substantially the same result as the general rule.

Of course, a partner's basis for his interest in the partnership need not be computed annually, but only when the occasion requires, such as on a sale of his interest.

VIII. Sales and Transfers of Partnership Interests

A. *Nature of gain or loss*

Following present case law, the general rule of the new Code is that an interest in a partnership is a capital asset, and on sale or exchange of such interest the seller realizes capital gain or loss.[76]

The inevitable exception to the general rule is found in the third collapsible partnership provision. All of the consideration received by the seller which is attributable to his share of partnership unrealized receivables or substantially appreciated inventory items is ordinary income to the selling partner, not capital gain.[77] The effect is as if

[73] Section 705(a)(1).

[74] Sections 705(a)(2), 733.

[75] Section 705(b).

[76] Section 741.

[77] Section 751(a).

two separate sales were made, one of the selling partner's interest in unrealized receivables and inventory items, and the other of the remainder of his partnership interest.

Every lawyer handling the details of a sale of a partnership interest should watch for the effect of this provision. It can be costly to the selling partner, as witness the following example: *C* and *D* are equal partners in a cattle raising business which has a cattle inventory with a basis of $10,000 and a value of $25,000. The remaining partnership property is worth $15,000. The basis of *C's* interest in the partnership is $8,000. *C* sells his interest to *M* for $20,000. The cattle are "substantially appreciated in value" because their value, $25,000, is more than 120 per cent of their basis, $10,000, and more than 10 per cent of the value of all partnership property other than money, $40,000. Of the sale price of $20,000, five eighths is attributable to appreciated inventory, and five eighths of *C's* gain, or $7,500, is ordinary income to him.

On a sale of an interest in a partnership, liabilities are treated in the same manner as liabilities in connection with any sale of property.[78] Thus, if a partner sells his interest in a partnership for $750 cash, and the buyer assumes the seller's share of partnership liabilities in the amount of $250, the amount realized by the selling partner is $1,000.

B. *Effect on basis of partnership property*

As would be expected, the fact that a partner sells or exchanges his interest in the partnership has no effect on the basis of property held by the partnership.[79] Nor does the transfer of a partner's interest at death make any change in this basis.

However, the partnership is given an option to make an adjustment to the basis of its property upon the happening of either of these events. The property basis may be adjusted up or down to reflect its actual value, but such adjustment applies only with respect to the buyer or inheritor of the partnership interest.[80] As far as the other partners are concerned, there is no change in the basis of the partnership property. The effect of the adjustment is the same as though the partnership had dissolved and been reformed, with the transferee of the interest as a new partner. The new partner uses the adjusted basis in figuring depreciation, gain or loss on sales of property, etc.

This optional adjustment is made by increasing the basis of partnership property by the difference between the basis to the new partner of his interest and his proportionate share of the partnership property basis, or by decreasing the property basis by the same amount if the

[78] Section 752(d).
[79] Section 743(a).
[80] Section 743(b).

basis of his interest is lower.[81] The rules for allocating the increase or decrease in basis among the partnership properties are the same as with the optional adjustment after a distribution of property, discussed above.[82]

An example of this optional adjustment may be helpful. *FG* partnership owns vacant land with a basis of $10,000 and a value of $110,000 and a building and land with a basis and value of $90,000. *F* sells his one-half interest to *K* for $100,000. If the partnership elects, the basis of the property, with respect to *K* only, may be adjusted as follows: $50,000, the difference between the cost of *K's* interest, $100,000, and his share of the basis of partnership property, $50,000, is added to the property basis. The increase is allocated between the properties so as to reduce the discrepancy between their values and their bases, as required by Section 755. The result is that the entire $50,000 is added to the basis of the vacant land, and the property bases become, for *K:* land, $55,000; building and land, $45,000.

This election is a continuing one, but may be revöked in accordance with regulations.[83]

IX. Payments to a Retiring Partner or Estate of Deceased Partner

Many partnership agreements, particularly in the case of personal service firms, provide for the payment of income of fixed amounts over a period of time to a retiring partner or the estate, or successor in interest, of a deceased partner, such payments to be in liquidation of all rights and interest in the partnership. The 1954 Code lays down definite rules for the treatment of these payments.

All payments made in liquidation of the interest of a retiring partner or the estate of a deceased partner are divided into two types or parts: first, payments for the partner's interest in partnership property, and second, all other payments. Payments which are determined under the regulations to be in exchange for the partner's interest in partnership property are treated as liquidating distributions.[84] On such distributions the retiring partner or the estate of the deceased partner realizes capital gain when the cash received exceeds the basis of the partnership interest. As with other distributions, however, any part of the gain attributable to appreciated inventory items is ordinary gain.

Payments of this type, which receive capital gain treatment, cannot include any amounts paid for unrealized receivables, nor can any amounts paid for partnership goodwill be included, unless the partnership agreement requires payment for goodwill and such payment cor-

[81] Section 743(b)(1),(2).
[82] Section 755.
[83] Section 754.
[84] Section 736(b)(1).

responds to the reasonable value of the partner's share of partnership goodwill.[85] Here again, careful drafting of the partnership agreement by the attorney is essential.

The way in which payments to a deceased partner's estate are divided and taxed under this section is shown in the following example: Jones, Botts, and Smith, attorneys, agree that on the death of any partner, his estate shall receive $5,000 annually for three years in return for all his interest in the partnership property and goodwill. On the date of Jones' death, the partnership, which is on a cash basis, had accounts receivable of $3,600. Therefore $1,200 (Jones' share of receivables) is ordinary income to Jones' estate. The remaining $13,-800 will produce capital gain or loss to the estate, depending on the value of Jones' partnership interest on his death. (This assumes that, after considering the value of tangible partnership property, the remainder corresponds reasonably to the value of partnership good will.) Each annual payment is pro-rated as between ordinary income and payment for a capital asset—that is $400 is ordinary income and $4,600 is capital. Of course, neither the partnership nor Botts and Smith get any deduction for the $15,000 paid; this sum represents the purchase price of the Jones interest to the surviving partners.

All payments which are not attributable, under the regulations, to the purchase of the retiring partner's or estate's interest in partnership property constitute ordinary income to such partner or estate.[86] If the payments are a percentage of partnership income, they are considered as distributive shares of partnership income and are excluded from the other partners' distributive shares.[87] If the payments are fixed in amount, or not related to income, they are deductible expenses of the partnership.[88]

For example, *AB* partnership pays *C*, a retired partner, 15 per cent of the partnership income for five years. It is determined that none of the payments are in exchange for *C's* interest in partnership properties or goodwill. *C* reports the 15 per cent as income, just as though he were still a partner, and *A* and *B* report the remaining 85 per cent as their distributive shares. If the agreement were to pay *C* $500 a year for five years, these payments would be deductible by the partnership and would be income to *C*.

Any amounts received by the estate or heir of a partner dying after December 31, 1954, which constitute ordinary income to the recipient are considered income in respect of a decedent.[89] The estate or heir can deduct from such income any estate tax attributable to the inclusion of the right to the income in the decedent's gross estate.[90]

[85] Section 736(b)(2).
[86] Section 736(a).
[87] Section 736(a)(1).
[88] Section 736(a)(2).
[89] Section 753.
[90] Section 691.

X. Effective Date

Except where otherwise noted above, the partnership provisions of the new Code are effective for partnership years beginning after December 31, 1954, and for partners' years falling wholly or partly within such partnership years.[91]

Conclusion

The partnership provisions of the 1954 Internal Revenue Code have fundamentally a simple structure. Their complexity is largely due to the many elective provisions designed to give flexibility, and to the provisions designed to prevent tax avoidance.

In this article the purpose has been to reveal the fundamental structure and to clarify the more complicated provisions through the use of examples.[92] The aim has not been to provide a substitute for careful study of the law when its application to a given set of facts is in question, but to aid in an understanding of the law as it stands today and to emphasize the particular situations in which an awareness of tax results is most important for the lawyer in general practice.

[91] Section 771.

[92] Other articles on the partnership provisions of the new Code are Bruton, *Subchapter K: Partners and Partnerships,* 32 Taxes 724 (September, 1954); Davis, *Partners and Partnerships: Determination of Tax Liability under the 1954 Code,* 32 Taxes 964 (December, 1954); Hauser, *Partners and Partnerships: Contributions, Distributions and Transfers under the 1954 Code,* 32 Taxes 954 (December, 1954); Willis, *Drafting Partnership Agreements under the New Internal Revenue Code,* 40 A. B. A. J. 948 (November, 1954).