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Basis Aspects of a Transfer of a Partnership Interest and Distrbution

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BASIS ASPECTS OF A TRANSFER OF A PARTNERSHIP INTEREST AND DISTRIBUTION

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Literature on the income tax basis ramifications of transfers or distributions of partnership interests is notably lacking in legal scholarship. Mr. Snead analyzes this subject with a view toward the tax consequences of the possible adjustments to basis which are available under the Code when a transfer or distribution of a partnership is made. He combines an analysis of the Code and the Regulations with examples of the practical workings of the various sections discussed. His article concludes with a discussion of allocation of basis under the adjustment rules and the elections under Sections 754 and 755 of the Code.

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INTRODUCTION

THE stated objectives of the draftsmen of subchapter K[1] of the 1954 *Internal Revenue Code* were "simplicity, flexibility, and equity as between the partners."[2] One of the areas of federal partnership income tax law in which the draftsmen appear to have fallen short of their stated objectives[3] is the matter of basis. More than one-third of the sections within subchapter K are addressed to basis determination.[4] Furthermore, it is often necessary to refer to the *Code's* basis rules of general application contained in subchapter 0.[5]

[1] INT. REV. CODE of 1964, §§ 701-71.

[2] S. REP. No. 1622, 83rd Cong., 2d Sess. 89 (1954).

[3] Dealing with the question of whether a transaction constituted the sale of an interest or the liquidation of an interest, Raum, J. made the following critical comment: "Although there can be little doubt that the attempt to achieve 'simplicity' has resulted in utter failure, the new legislation was intended to and did bring into play an element of 'flexibility.'" David A. Foxman, 41 T.C. 535, 551 (1964).

[4] Ten of the 27 sections of subchapter K contain the word "basis" in their titles. They are: § 705, Determination of Basis of Partner's Interest; § 722, Basis of Contributing Partner's Interest; § 723, Basis of Property Contributed to Partnership; § 732, Basis of Distributed Property Other Than Money; § 733, Basis of Distributee Partner's Interest; § 734, Optional Adjustment to Basis of Undistributed Partnership Property; § 742, Basis of Transferee's Partner's Interest; § 743, Optional Adjustment to Basis of Partnership Property; § 754, Manner of Electing Optional Adjustment to Basis of Partnership Property; § 755, Rules for Allocation of Basis.

[5] INT. REV. CODE of 1954, §§ 1011-23.

An understanding of the complexities of these basis sections is a necessary prerequisite to successful partnership tax planning.

The purpose of this paper is to examine the basis provisions of the 1954 *Code* that apply to the transfer of a partnership interest by a partner and to the distribution by the partnership of assets to a partner. With respect to a transfer, examination will be made of the basis aspects of the transferee's interest. Distributions present basis determination problems for the distributee and the partnership. In both areas, the *Code* provides general rules governing basis but alternative treatment is made available by election. Elections available to the partnership may have a significant impact on the present and future movement of persons and property into and out of the partnership structure. A partner may have a separate election available with significant income tax consequences. In turn, a decision to make one of the elections raises additional important issues.

The provisions of the *Code* to be examined herein clearly reflect a theoretical difference of opinion about the nature of a partnership that has continued to exist in the state law of partnerships, as well as in the federal income taxation of that form of business enterprise. The conflict exists on the question of whether a partnership is a separate entity or an aggregate of persons. "The entity theory treats the partnership itself as having an existence apart from the partners and as such it is capable of engaging in business transactions in its own right, apart from the partners themselves."[6] On the other hand, "[t]he aggregate or the conduit concept views a partnership as an association of individuals. Such concept does not recognize the business organization as having any existence apart from the individual partners."[7] The entity versus aggregate debate highlighted discussions that attended the drafting of the Uniform Partnership Act. The language of the Act supports the conclusion that both theories were embodied, although perhaps inadvertently, in the final draft.[8] Decisions of courts construing the Act have taken different positions on the question of what theory governs. On the one hand, the partnership has been treated as a separate legal person apart from the individual partners;[9] on the other, a clear intent to adopt the aggregate theory has been found by some courts.[10]

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[6] Anderson & Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX. L. REV. 285, 287 n.9 (1960).

[7] *Id.* at 287 n.10.

[8] E. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION 293-301 (1929); Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963).

[9] Note, *The Partnership as a Legal Entity*, 41 COLUM. L. REV. 698 (1941).

[10] Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937).

The entity versus aggregate distinction prevails in the basis provisions of the 1954 *Code*.[11] The general approach is the entity theory, with the result that a clear distinction is drawn between a partner's basis in his partnership interest and the partnership's basis in its assets. Upon the initial contribution of assets to the partnership, the partners' bases for their partnership interests equals the partnership's basis in the contributed assets,[12] but thereafter the respective bases are subject to changes which may affect one but not the other. The draftsmen of the *Code* embodied the aggregate theory of partnerships in the form of optional adjustments to the basis of partnership property to bring the separate bases to the same amount in the case of certain distributions and transfers. These different approaches, allowed by the 1954 *Code,* and their ramifications are the principal topics of this paper.

With certain notable exceptions, *e.g.*, the family partnership, the partnership provisions of the *Code* have not been the subject of extensive litigation. In the absence of case law, reliance must be placed upon congressional hearings, the income tax regulations, revenue rulings, authors of law review articles and books, and statutory interpretation by the writer.

A. *Subjects Not Covered*

For purposes of this discussion, the assumption implicit throughout is that the partnership, either regular or limited, is a statutory partnership within the *Code*,[13] and that no election to be treated otherwise has been made.[14] Except as otherwise noted, partnership property does not include unrealized receivables[15] or substantially appreciated inventory.[16] The matter of termination of the partnership[17] is considered where pertinent, but otherwise it is assumed that distributions and transfers do not have such an effect.

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[11] *See generally* Anderson & Coffee, *supra* note 6, at 286-89; Jackson, Johnson, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners — American Law Institute Draft,* 9 TAX L. REV. 109 (1954); B. Wolfman, *Level for Determining Character of Partnership Income — "Entity" v. "Conduit" Principle in Partnership Taxation,* 19 N.Y.U. INST. ON FED. TAX, 287 (1961).

[12] INT. REV. CODE of 1954, §§ 722, 723.

[13] The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate, or corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

INT. REV. CODE of 1954, § 7701(a)(2).

[14] *Id.* § 761(a).

[15] *Id.* § 751(a-c).

[16] *Id.* § 751(a,b,d).

[17] *Id.* § 708(b).

I. Transfers of a Partnership Interest

Although the emphasis of this discussion is directed to the special problems of the transferee of a partnership interest, it is important to be cognizant of the tax consequences to the transferor of a partnership interest because of their impact on negotiations in the case of a sale, and taxation in the case of death. Of equal significance is a description of the types of transactions which are treated as a "transfer of a partnership interest" as that terminology is used in the *Code*.

When a partner sells a part or all of his partnership interest to one or more of the other partners, or to one or more outsiders, he recognizes gain or loss on the transaction.[18] The nature of the underlying partnership assets determines the character of the gain or loss recognized. If the partnership has section 751 property, *i.e.*, unrealized receivables[19] or inventory items which have substantially appreciated in value,[20] separate treatment is accorded such assets,[21] and a two-step computation is required, which in effect treats the gain allocable to the 751 property as ordinary income. First, a proportion of the sale price is allocated to the section 751 assets on the basis of the values contained in the agreement between buyer and seller if the transaction is at arm's-length or, in the absence of an agreement on value, on the basis of the fair market value of

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[18] *Id.* §§ 741, 751.

[19] Unrealized receivables are defined by the 1954 *Code* to include,

> to the extent not previously includible in income under the method of accounting used by the partnership, any right (contractual or otherwise) to payment for — (1) goods delivered or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered.

INT. REV. CODE of 1954 § 751(c). Unrealized receivables also includes the selling partner's share of the amount that would be treated as ordinary gain (1) from the sale of section 617 mining property (property in relation to which the partnership elects to deduct exploration expenditures subject to recapture), (2) from the sale of section 1245 property, and (3) from the sale of section 1250 property, as if such section 617, 1245, or 1250 property had been sold by the partnership at its fair market value. Generally, the agreement between the buyer and seller as to the value of such property establishes its fair market value. *Id.;* Treas. Reg. § 1.751-1(c)(4) (1965).

[20] Substantial appreciation is defined by the *Code* as fair market value in excess of "(A) 120 percent of the adjusted basis to the partnership of such property, and (B) 10 percent of the fair market value of all partnership property, other than money." INT. REV. CODE of 1954, § 751(d). The definition of inventory items has broad coverage. As the name suggests, it includes stock in trade or property held for resale in the ordinary course of business. In addition, (1) partnership property which, on sale or exchange by the partnership, is not considered a capital asset or a section 1231 asset (for example, the *Regulations* point out that unrealized receivables are also "inventory items"), (2) certain foreign investment company stock, and (3) property, whether a capital asset or a section 1231 asset or not, which would be an inventory item to the selling partner or the distributee, are included in the definition of inventory items. *Id.* § 751(d)(2).

[21] INT. REV. CODE of 1954, § 751(a).

such property at the date of sale of the partnership interest.[22] For purposes of determining gain or loss, the basis of the section 751 property in the hands of the selling partner is, in most cases,[23] equal to the basis to the partnership of the selling partner's proportionate share of those assets immediately before the sale of the interest.[24] The selling partner's proportionate share of the partnership's adjusted basis for section 751 property is apparently based on his capital ratio.[25] Where the capital and profit ratios are the same, no conceptual difficulties are encountered. However, where the capital and profit ratios are different, the employment of the capital ratio will produce a questionable, and perhaps unexpected, result.[26] The difference between the allocated sale price and the basis of the section 751 assets is ordinary gain or loss.[27] The second step consist of finding the difference between the remaining balance of the sale price and the basis of the remainder of the partnership interest (*i.e.*, as reduced by the section 751 allocation).[28] This amount is capital gain or loss.[29]

When the partnership does not have unrealized receivables or inventory items which have substantially appreciated in value, capital gain or loss results as measured by the difference between the amount realized (the sale price) and the partner's adjusted basis of his partnership interest.[30]

A distinction should be made between the acquisition of a partnership interest by the contribution of money or property to the partnership and the acquisition of a partnership interest by purchase from a partner or partners. This same distinction is made in accounting terminology by referring to the former type of acquisition as "investing in a partnership" and to the latter type as

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[22] Treas. Reg. § 1.751-1(a)(2) (1965).

[23] If the basis to the partnership exceeds the partner's basis in his partnership interest, the basis for section 751 property is limited to the latter. INT. REV. CODE of 1954, § 732(a),(b); Treas. Reg. § 1.751-1(a)(2) (1965).

[24] *Contra,* Barnes v. United States, 253 F. Supp. 116 (S.D. Ill. 1966). This case is discussed in the text accompanying footnote 68, *infra.*

[25] *See* Treas. Reg. § 1.751-1(g) (example 1) (1965).

[26] When the cash-basis partnership collects its receivables or sells its appreciated inventory, the resulting income is divided among the partners in the profit and loss ratio. Where the profit and loss ratio differs from the capital ratio, a shifting of ordinary income from one partner to another results when section 751 is applied. Section 751 was intoduced to combat the "collapsible partnership," *i.e.* the conversion of ordinary income into capital gain by the sale of a partnership interest. Although it accomplishes this result, it may result in inequity among the partners if the capital ratio, rather than the profit and loss ratio, is employed in the allocation required by section 751.

[27] INT. REV. CODE of 1954, § 751(a).

[28] Treas. Reg. § 1.751-1(a)(2) (1965).

[29] INT. REV. CODE of 1954, § 741.

[30] *Id.* §§ 741, 1001.

"purchasing a partnership interest."[31] Apart from its application in the personal service partnership area, acquisition of an interest by investment may arise where an existing partnership needs additional money or property to expand its business. Where a contribution of assets is made to a partnership as an investment, the person acquiring a partnership interest does not recognize gain or loss, and the amount of money or his adjusted basis in the property[32] contributed becomes his basis in the partnership interest acquired.[33] Neither the partnership nor the other partners recognize gain or loss upon the contribution of money or property to the partnership in exchange for a partnership interest.[34] This rule applies regardless of whether the contribution is made during the formation stage of the partnership or after it is already in existence.[35] Although both the *Code* and the *Regulations* do not so specify, it seems clear that the nonrecognition rules applicable to contributions govern the situation where a new partner is admitted to the partnership as a result of a contribution that increases partnership capital in the same manner as the contribution by a person already a partner. However, when the investment method is the first step of what is in reality the sale of a partnership interest, the Internal Revenue Service may be expected to recharacterize the transaction to reflect its true nature.[36]

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[31] For a detailed discussion of this distinction and the accounting treatment for both methods see H. FINNEY & H. MILLER, PRINCIPLES OF ACCOUNTING: ADVANCED 17-23 (5th ed. 1963). "[P]artnership admissions are of two general classes: (1) The new partner *purchases* all or a part of the interests of one or more old partners and makes payment to them; [and] no new funds come into the partnership. (2) The new partner *invests* assets in the partnership; [and] the partnership funds are thus increased." *Id.* at 17.

[32] The aspects of the admission of a service partner where another partner relinquishes his right to the return of part of his capital contributions, thus giving rise to ordinary income to the service partner, are considered in Treas. Reg. § 1.721-1(b) (1960). Services, as consideration for a partnership capital interest, are not "property" as that term is used in the text.

[33] INT. REV. CODE of 1954, §§ 721, 722.

[34] *Id.* § 721.

[35] Treas. Reg. § 1.721-1(a) (1960).

[36] H. FINNEY & H. MILLER, *supra* footnote 31, make the following observations on goodwill and bonus in the investment context:

> When a new partner is admitted, the old partners may be allowed goodwill or a bonus in recognition of the profitable business they have developed.
>
> Goodwill:
>
> > If goodwill is to be allowed the old partners, it should be placed on the books before the admission of the new partner, and the credit therefore should be divided between the old partners in their profit and loss ratio.
>
> A bonus:
>
> > Instead of setting up a Goodwill account, the old partners may require that part of the capital contributed by the new partner be

credited to their accounts. Such a bonus should be credited to the old partners in their profit and loss ratio.

On the other hand, the new partner may be allowed goodwill or a bonus in recognition of a high earnings potential which he is bringing to the business.

Goodwill:

If goodwill is allowed the new partner, the entry for his admission should contain a debit to Goodwill.

A bonus:

A bonus to a new partner is recorded by making transfers from the capital account of the old partners to the capital account of the new partner, thus giving the new partner a total capital credit greater than the amount of his investment. Such a bonus should be charged to the old partners in their profit and loss ratio.

. . . .

To illustrate, assume that A and B have capitals of $10,000 and $20,000, respectively, with a 50:50 profit and loss ratio, and that C is to be admitted as a partner by making a contribution to the firm capital.

Goodwill allowed to old partners. Assume that the problem states that C is to invest, and obtain a capital credit of, $11,000, which is to be one-fourth of the total capital. The total capital, therefore, is to be $44,000. The capitals of A and B plus C's contribution amount to $41,000; therefore, there is a goodwill of $3,000. Since C's capital credit is equal to his contribution, the goodwill is allowed to A and B, by credits of $1,500 to each.

Bonus allowed to old partners. C is to invest $14,000, the total capital is to be $44,000 and C is to have a one-fourth interest therein. Since C invests $14,000 and receives a capital credit of only $11,000, A and B will be credited with $3,000 of C's contribution as a bonus, shares in the profit and loss ratio.

Goodwill allowed to new partner. C is to transfer, at a valuation of $8,000, the assets of a business he has been conducting. C is to have a one-fourth interest in an agreed capital of $40,000. Since the capitals of A and B plus C's contribution amount to $38,000, there is a goodwill of $2,000. Since C contributes $8,000 and is credited with $10,000, he must receive the credit for the goodwill.

Bonus allowed to new partner. C is to invest $8,000; the agreed capital is to be $38,000; and C is to have a one-fourth interest therein. The capitals of A and B plus C's contribution amount to $38,000; therefore, there is no goodwill. But since C invests $8,000 and receives a capital credit of $9,500, a $1,500 bonus is allowed to him; A and B are charged $750 each.

Id. at 25.

It must, of course, be remembered that the values assigned to capital contributions by the partners are, except in the case of cash contributions, independent of the income tax basis of the assets to the partnership. The partnership does not terminate for income tax purposes because operations would not be discontinued and a contribution of property, including money, is not a "sale or exchange" under section 708(b)(1)(B). Treas. Reg. § 1.708-1(b)(1)(ii) (1960).

Where goodwill is allowed to either the old partners or to the new partner, no adverse tax consequences would arise. In both situations, goodwill represents pre-contribution appreciation in the value of the assets and section 704(c) clearly allows such treatment as a reflection of the economic realities. Where bonus is allowed, however, the transaction takes on the appearance of a contribution coupled with a purchase. In the absence of a restriction upon the withdrawal of capital, where bonus is allowed to the old partners, the incoming partner, C, has immediately relinquished his right to receive $3,000 on liquidation and that amount is available for distribution to partners A and B. Assuming that the capital accounts of the old partners are the same as their respective bases for their partnership interests, the investment by C of $14,000 is (1) a contribution of $10,000 and (2) the purchase of an additional capital interest of $1,000 by the payment to A and B of $4,000. Capital gain treatment on the purchase part of the transaction may result. This same reasoning may be applied to bonus allowed to the new partner to find a bargain purchase.

Neither the *Code* nor the *Regulations* treat this problem specifically but Treas. Reg. § 1.721-1(b)(1) implies such a result. This problem is also discussed in Note, *Some Tax Consequences of Partnership Readjustments,* 67 HARV. L. REV. 360 (1954).

The investment method of acquiring an interest is not within the scope of the discussion that follows.

Upon the death of a partner, three possibilities exist with regard to ownership of the interest. Depending upon the provisions of the partnership agreement,[37] the deceased partner's successor in interest may: (1) continue as a partner, (2) sell the partnership interest to one or more of the partners, or (3) receive distributions from the partnership in liquidation of the interest. Common to (1) and (2) is the present statutory scheme establishing the following tax pattern: recognition of gain or loss by the deceased partner because diminution or appreciation in the fair market value of the partnership interest is foreclosed by the death of the partner;[38] depending upon the size of the deceased partner's estate, estate tax[39] may or may not be incurred as to the partnership interest; and regardless of whether estate taxes are incurred, the deceased partner's successor in interest receives the partnership interest with a new basis for income tax purposes. The new basis may be higher or lower than the deceased partner's basis before death. The new basis is the fair market value at the date of death or the alternative valuation date[40] plus the successor's share of partnership liabilities, if any, and minus income in respect of a decedent included in the amount of fair market value.[41] If the interest is sold by the decedent's successor in interest to one or more of the partners, the seller recognizes gain or loss in the same manner as previously described.

If the agreement provides for liquidation of the partnership interest by the partnership, the rules of section 736[42] apply. The *Code* allows the partners to determine among themselves the tax consequences of retirement of a partnership interest by liquidation. The provisions of section 736 are quite complex. For present pur-

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[37] *Uniform Partnership Act* § 31(4) (1914) provides that the death of a partner shall dissolve the old partnership. Some states have amended the uniform act to provide for an agreement to the contrary. *See* Bromberg, *Partnership Dissolutions, Causes, Consequences, and Cures,* 43 TEX. L. REV. 631 (1965). Some courts have given effect to the terms of a partnership agreement or a provision in a deceased partner's will providing for a continuation of the partnership. *See* Note, *Partnership: Continuation of the Business Upon the Death of a Partner,* 20 OKLA. L. REV. 456 (1967); Note, *Partnership Continuation Agreements,* 72 HARV. L. REV. 1302 (1959). For income tax purposes, the death of a partner, in and of itself, does not terminate the partnership, even in the case of a two-man partnership. Treas. Reg. § 1-708-1(b) (1960).

[38] INT. REV. CODE of 1954, § 1014.

[39] In the case of a deceased partner survived by a spouse, the present statutory scheme generally allows a gross estate of approximately $120,000 to go untaxed. *Id.* §§ 2031, 2051, 2052, 2056.

[40] INT. REV. CODE of 1954, § 1014(a).

[41] Treas. Reg. § 1.742-1 (1960).

[42] INT. REV. CODE of 1954, § 736(b).

poses, it is enough to note that payments made under section 736 whether made as a distributive share of income, as a guaranteed payment, for goodwill, or for an interest in the partnership, are not considered a sale, exchange, or transfer upon death, within the scope of transfers of a partnership interest.[43] The distribution aspects of section 736 are discussed *infra* in section III of this article.

The distinction between the sale of an interest after the death of a partner and liquidation of that interest by the partnership is of utmost importance.[44] To the successor in interest, the method chosen will make the difference between capital gain or ordinary gain.[45] To the remaining partners, a capital investment or reduced taxable income are the alternative consequences.[46] The *Code* puts the parties on opposite sides of the negotiating table for the reason that "one of the underlying philosophic objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* to a certain extent . . . ."[47]

When a transaction constitutes the transfer of a partnership interest, the transferee of that interest determines his basis by reference to sections 742 and 743 of the *Code*. To summarize, transactions which are treated as a transfer of a partnership interest, and thereby bring into operation the transferee basis provisions of the *Code*, are: the sale or exchange of a partnership interest by a partner or by the partner's successor in interest and the transfer of an interest by death. The statutory language "transfer . . . upon

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[43] Treas. Reg. § 1.736-1(a) (1965).

[44] In an exhaustive analysis of cases in which the distinction between a sale and a liquidation was paramount, one author has concluded that the intent of the parties as manifested by the location of the obligation to make payments controls. Swihart, *Tax Problems Raised by Liquidation of Partnership Interests,* 44 TEX. L. REV. 1209 (1966). For a case dealing with the distinction between a sale and a liquidation in the context of a buy-sell agreement funded with life insurance under a "cross-purchase" plan or an "entity" plan, *see* Victor G. Mushro, 50 T.C. 43 (1968); *see also,* Comment, *Planning the Tax Consequences of Partnership Agreements, Funded With Life Insurance, to Provide for Disposition of a Deceased Partner's Interest,* 30 MO. L. REV. 117 (1965).

[45] David A. Foxman, 41 T.C. 535 (1964). The court made the following observation:

> If the transaction were a "sale" under section 741 Jacobowitz's [the retiring partner] gain would be taxed as capital gain (there being no section 751 problem in respect of unrealized receivables or inventory items which have appreciated substantially in value), and would be reported in 1957 [the year of the sale] rather than in 1958 [the close of the partnership fiscal year]. On the other hand, if the transaction were a section 736 "liquidation," the amounts received by him (to the extent that they were not for his "interest . . . in partnership property" pursuant to section 736(b)(1)) would be taxable as ordinary income and reportable by him in 1958 rather than 1957. The tax liabilities of the remaining partners . . . would be affected accordingly, depending upon whether section 736 or 741 governed the transaction.

Id. at 550 n.7.

[46] *Id.*

[47] David A. Foxman, 41 T.C. 535, 551 (1964).

the death of a partner" is apparently synonymous with the phrase "acquired from . . . the decedent" as used in the basis provisions of section 1014(b).[48] It appears that a court ordered sale of partnership assets, depending on the facts and circumstances of each case, may be the sale of a partnership interest.[49] The basis provisions of section 743 are not operative when a partnership interest is acquired by contribution to an existing partnership or in a partnership liquidation of an interest. Furthermore, no suggestion is made in the *Code* or *Regulations* that the gift of a partnership interest is to be treated as a transfer of a partnership interest for purposes of the basis provisions of Sections 742 and 743, and it must be assumed that the basis provisions of the *Code* relating to a donee's basis, control.[50]

A. *The General "No Adjustment" Rule*

The entity approach to partnership tax law is readily apparent in the general rule of transferee basis upon the transfer of a partnership interest. It will be recalled that the entity approach views the partnership as separate and apart from the individual partners. In the corporate income tax area, the purchaser of stock takes as his basis in the shares the amount of money or other consideration paid for it,[51] without regard to the proportionate amount of the adjusted basis of the corporate assets that the purchased shares represent. This same theory was applied to transfers of partnership interests before its statement as the general rule in the 1954 *Code*.[52] The rule was succinctly stated as follows: "A partnership's basis in its assets is distinct from the partners' bases in their partnership interests, and is not affected by changes in such partnerhip interests."[53] In some cases based on pre-1954 law, taxpayer attempts to step up the basis of partnership assets were successful on the grounds that, under state law, the old partnership had terminated.[54] The 1954 *Code* settled earlier confusion and negated reliance on

[48] Dupree v. United States, 391 F.2d 753, 758 (5th Cir. 1968) (community property transfer).

[49] *See* Rev. Rul. 264, 1966-2 CUM. BULL. 248. The ruling cited the following facts: as a result of litigation among the five equal partners, the court ordered judicial sale of the *partnership assets;* three of the five partners bought the assets and continued the business; the other two partners received their respective share of the sales proceeds in liquidation of their interests.

[50] INT. REV. CODE of 1954, § 1015 (a,d).

[51] INT. REV. CODE of 1954, § 1012.

[52] Robert E. Ford, 6 T.C. 499 (1946); G.C.M. 26379, 1950-1 CUM. BULL. 212, *revoking* G.C.M. 10092, XI-1 CUM. BULL. 114 (1932).

[53] Rev. Rul. 144, 1953-2 CUM. BULL. 212, 213.

[54] Milton H. Jacobs, 14 CCH Tax Ct. Mem. 637 (1955); *contra,* Anderson v. United States, 232 F.2d 794 (9th Cir. 1956).

state law by establishing definitive rules governing termination of a partnership.[55]

Upon the transfer of a partnership interest by sale or exchange, or upon the death of the transferor, the new basis for the partnership interest to the transferee shall be its cost where sold or exchanged,[56] or the fair market value of the interest at the date of the transferor partner's death or one year thereafter.[57] Unless otherwise elected, no adjustment to the basis of partnership property to reflect differences between the market value of the assets of the business and the partnership's adjusted basis of those assets may be made.[58] Although the sales price of, or the estate tax valuation of, the partnership interest reflect appreciation or diminution in the value of the partnership assets, the basis of the underlying assets, upon which the value of the partnership interest was determined, remains separate and distinct under the general rule.

Perhaps the most illuminating method of demonstrating the principal topic of this discussion — the operation of the adjustment to basis provision of section 743(b) — is to consider in detail the effects of the general rule, mindful that the optional adjustment approach alleviates the problems described. It is quite clear that when the sales price, or the fair market value for estate tax purposes, of the transferred partnership interest equals the adjusted basis of that portion of the partnership assets attributable to the transferred partnership interest, no benefit nor detriment accrues to the transferee as a result of the application of the general rule. Therefore, an election to adjust the basis of partnership assets would be inconsequential. It is also clear that such equality of bases is a rare occurrence. Consideration must therefore be given to the effect of the general no-adjustment rule on post-transfer depreciation, depletion, gain, or loss from the sale of partnership assets and distributions.

Where the partnership has property that has appreciated in value and a partnership interest is transferred, the transferee encounters adverse tax consequences as a result of the application of the general rule. The appreciation in the value of the partnership assets is reflected in the price that he paid for the partnership interest, or its fair market value at the death of the transferring partner, but not in the transferee's proportionate share of the part-

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[55] INT. REV. CODE of 1954, § 708(b).
[56] *Id.* §§ 742, 1012.
[57] *Id.* §§ 742, 1014.
[58] *Id.* § 743(a).

nership's asset basis. To illustrate, the ABCD partnership has the following assets, liabilities, and capital:[59]

Assets	Adjusted Basis	Market Value
Cash	$ 1,000	$ 1,000
Accounts Receivable	2,000	2,000
Inventory	6,000	6,400
Building (net of straight-line depreciation)	5,000	7,000
Land	1,000	1,200
Royalty Interest in Oil and Gas Property	1,000	2,400
Total Assets	$16,000	$20,000
Liabilities & Capital		
Liabilities	- 0 -	- 0 -
Capital Accounts — A	$ 4,000	$ 5,000
— B	4,000	5,000
— C	4,000	5,000
— D	4,000	5,000
Total Liabilities and Capital	$16,000	$20,000

Assume that A sells his interest to E for $5,000 and that an election under section 754[60] to adjust the basis of partnership assets pursuant to section 743(b) is not in effect. E's basis for the purchased partnership interest is his cost, $5,000, pursuant to section 1012. The underlying partnership assets attributable to E continue to have a basis of $4,000 under the general rule of section 743(a). During the taxable year of the partnership, the following events occur: (1) the inventory is sold for its market value of $6,400; (2) depreciation on the building amounts to $250 for the year; (3) royalty income is received and the partnership elects to take a percentage depletion of $300 since cost depletion would have amounted to $200 or one-fifth of the adjusted cost basis to the partnership. E's distributive share of income and expenses are: ordinary income from the sale of inventory, $100; depreciation on the building, $62.50; depletion, $75.

The detrimental consequences to E may be readily demonstrated. Had E purchased one-fourth of the assets of the partnership, instead

[59] The type of assets and the amounts used are not intended to depict an actual partnership, but rather are chosen as a vehicle for discussion purposes.

[60] *See* section V *infra.*

of purchasing a partnership interest based on the value of partnership assets, the income and expense picture would have been much different. His basis in each asset would have been:

Cash	$ 250
Accounts Receivable	500
Inventory	1,600
Building	1,750
Land	300
Royalty Interest	600
Total	$5,000

Based on the same transactions detailed in the preceeding paragraph, E would: (1) have no income upon the sale of the inventory items, (2) have depreciation on the building of $87.50, (3) have taken cost depletion, rather than percentage depletion, in the amount of $120.00 (1/5 of $600).

In the absence of the election under section 732(d),[61] the general rule of section 743(a) also has an adverse effect on E when he receives a current or liquidating distribution of the appreciated property. Assume that E receives, as a current distribution from the partnership, one-fourth of the royalty interest in oil and gas property. E takes as his basis the partnership's adjusted basis,[62] $250.00 (1/4 of $1,000) instead of $600, the amount for which he would have purchased the interest apart from the partnership interest. Cost depletion would be limited to the $250 carryover basis. Furthermore, if E then sold the royalty interest for $600 (the amount of his original cash outlay allocable to the asset), he would realize a capital gain of $350. Distributions will be discussed in more detail later in this article.

If the ABCD partnership had section 751 assets at the time E purchased his interest, the general rule would prohibit a special basis adjustment in the absence of a proper partnership election. Thus, if the ABCD partnership's accounts receivable were, instead, unrealized receivables, the basis of the unrealized receivables would be zero as to the transferee's share and upon collection would result in $500 ordinary income to E. Other section 751 assets which could be expected to appear in this context are substantially appreciated inventory and section 1231 assets with potential section 1245 or 1250 income.

[61] *See* section II *infra*.

[62] INT. REV. CODE of 1954, § 732(a).

Whereas the purchase of an interest in a partnership with appreciated assets has an undesirable immediate impact on the purchaser, the purchase of an interest in a partnership that has assets which have declined in value has a favorable effect on the purchaser. The decline in the value of the partnership assets is reflected in the price he paid, or in the fair market value at the death of the transferring partner, for the partnership interest but not in his acquired share of the partnership assets. To illustrate, the FGHI partnership has assets, liabilities, and capital of:

Assets	Adjusted Basis	Market Value
Cash	$ 1,000	$ 1,000
Accounts Receivable	2,000	2,000
Inventory	6,000	4,000
Building	5,000	4,000
Land	1,000	500
Royalty Interest in Oil and Gas Property	1,000	500
Total Assets	$16,000	$12,000
Liabilities & Capital		
Liabilities	- 0 -	- 0 -
Capital — F	$ 4,000	$ 3,000
— G	4,000	3,000
— H	4,000	3,000
— I	4,000	3,000
Total Liabilities and Capital	$16,000	$12,000

Assume that F sells his interest to J for $3,000 and the section 754 election is not made. J's basis for the purchased partnership interest is its cost, $3,000, pursuant to section 1012. No change is made in the basis of the partnership assets attributable to his interest, which is $4,000. During the partnership taxable year, the following transactions take place: (1) the inventory is sold for its market value of $4,000; (2) depreciation on the building amounts to $250 for the year; (3) royalty income is received and the partnership computes depletion, based on cost, which amounts to $200 or one-fifth of the adjusted basis to the partnership. The partnership transactions have the following effect on J: ordinary loss from the sale of inventory, $500; depreciation expense, $62.50; depletion, $50.

In this situation, the tax consequences to J are immediately beneficial. Had he purchased the assets rather than an interest in the partnership, his basis in each asset would have been:

Cash	$ 250
Accounts Receivable	500
Inventory	1,000
Building	1,000
Land	125
Royalty Interest	125
Total Basis	$3,000

The transactions, if J had purchased the assets, would result in: (1) no gain or loss from the sale of the inventory, (2) reducing depreciation on the building to $50, and (3) reducing cost depletion to $25.

If J receives a current distribution of property that has declined in value, his basis in the distributed property is the same as it was in the hands of the partnership, provided it does not exceed his basis in his partnership interest. Hence, if one-fourth of the royalty interest is distributed to J, his basis for purposes of cost depletion or for a subsequent sale is $250, whereas the market value of the royalty interest is $125.

The preceding examples illustrate the immediate tax consequences of the general "no adjustment" rule of section 743(a), but the overall effect of that rule on the transferee must be considered. First, however, an understanding of the operation of another basis provision of the *Code* is necessary. The transferee's cost basis for his partnership interest is increased by his distributive share of partnership taxable income and decreased by: (1) distributions of money or property, and (2) his distributive share of partnership losses; but in no event shall the decreases result in a negative basis.[63]

When a sale by the partnership of assets which had increased or decreased in value at the time the transferee received his interest is followed by a liquidation of the transferee's interest, a variety of results may occur. Where the partnership has appreciated assets, the sale of the assets produces gain to the transferee partner and his basis is increased in the amount of the gain. If the transferee's interest is then liquidated by a cash distribution[64] after two years

[63] *Id.* § 705(a)(1)(A).

[64] Where a distribution is of property and the fair market value of the distributed partnership property other than money is, at the time of the transfer of the partnership interest, in excess of 110 percent of its adjusted basis to the partnership, section 732(d) must be applied. *See* section II *infra*.

from transfer of the interest,[65] the relief provisions of section 732(d) discussed in section II *infra* would not be available and a capital loss is incurred by the transferee. Isolating the two transactions, the amount of the capital loss on liquidation would equal the amount of the transferee partner's distributive share of the partnership's gain on the sale of the appreciated partnership assets. To illustrate, assume that L purchases a partnership interest for $5,000. The partnership assets attributable to L's interest have an adjusted basis of $4,600 and the difference between the purchase price of the interest and the adjusted basis of the underlying assets represents appreciation in the value of those assets. Upon the sale by the partnership of those assets for $5,000, L's distributive share of taxable gain is $400 and the basis of his partnership interest is increased to $5,400 ($5,000 cost plus taxable income of $400). After two years, L's interest is liquidated by a cash distribution. Since the partnership received $5,000 for the assets, that is the extent of the money that L receives. L has incurred a capital loss of $400 ($5,400 adjusted basis in partnership interest, minus $5,000 cash received in liquidation of his interest).[66] If the appreciated assets were capital assets, capital gain upon the sale by the partnership would be offset by capital loss on the liquidating distribution. However, if the appreciated assets were other than capital assets, *e.g.* inventory, ordinary gain to L would have been the result of the partnership's sale of those assets. Therefore, ordinary gain upon the sale is offset by capital loss on the distribution. Where the partnership has assets that have declined in value at the time of the purchase of the partnership interest, the assets are sold by the partnership, and the transferee partner's interest is liquidated by a cash distribution, the tax results are ordinary or capital loss on the sale, depending upon the type of asset, and capital gain on the cash distribution. Careful analysis demonstrates that the tax consequences do not necessarily "even out in the end."

If the transferee, instead of receiving a liquidating distribution, sells the partnership interest, the tax consequences are generally the same. Assuming a stable market value of the partnership assets, a sale by the transferee immediately after receipt of the partnership interest would result in neither gain nor loss since the sale price (market value) of the interest would equal the basis of the transferee-seller.[67] If the sale of the partnership interest by the transferee occurs after the sale by the partnership of the assets which had

[65] Section 742(d) may not be applied by the transferee after two years from the acquisition of the interest. *See* section II *infra.*

[66] INT. REV. CODE of 1954, § 731(a)(2); Treas. Reg. § 1.731-1(a)(2) (1956).

[67] INT. REV. CODE of 1954, § 1001.

increased or decreased in value at the acquisition of the interest, or after depreciation or depletion is taken on such assets, the resulting tax consequences are the same as described in the immediately preceding paragraphs where the transferee's interest is liquidated by a cash distribution. The same ordinary income-capital loss and ordinary loss-capital gain possibilities exist here as well.

The propriety of two taxable events with regard to one asset of the partnership — recognition on the sale by the partnership and recognition on subsequent liquidation or sale of the transferee's partnership interest — was recently raised in *Barnes v. United States*.[68] The transferee taxpayer had purchased an interest in a professional partnership which had unrealized receivables which were subsequently collected. No election to adjust basis was made and the taxpayer reported the collection of the receivables as ordinary income. At the time when the taxpayer sold his partnership interest, the receivables of the partnership were in excess of the amount at the time of the taxpayer's purchase of the interest. The taxpayer successfully argued that section 751, requiring ordinary income treatment of unrealized receivables owned by the partnership at the time of the sale, should not be applied to that portion of the unrealized receivables which were equal to the unrealized receivables at the acquisition of the taxpayer's interest. To illustrate, let us assume that A purchases a partnership interest for $6,000. The underlying partnership assets are unrealized receivables with a basis of zero and a fair market value of $3,000 and other assets with an adjusted basis and fair market value of $3,000. The receivables are collected, A reports his distributive share as $3,000 of ordinary income, and his partnership interest basis is increased to $9,000 ($6,000 cost plus $3,000 distributive income). At this point, if A sold his interest or received a liquidating distribution, he would incur a capital loss of $3,000 since the partnership would have money and porperty with an adjusted basis and fair market value of $6,000 attributed to A's partnership interest. This demonstrates the ordinary income-capital loss pattern previously mentioned. If, instead of liquidating or selling his interest, A works in the partnership until the partnership has again accumulated $3,000 in unrealized receivables and then A sells his interest for $9,000 ($3,000 cash from unrealized receivables collected, $3,000 market value of other assets, and $3,000 in new unrealized receivables), section 751 requires separate treatment of the unrealized receivables. At this point, A's partnership interest basis is still $9,000 since the unrealized receivables have no effect on his basis until collected. Section

[68] 253 F.Supp. 116 (S.D. Ill. 1966).

751 produces $3,000 ordinary income (fair market value less the partnership's basis of O carried over to A). This leaves $6,000 of the purchase price ($9,000 total purchase price less $3,000 allocated to unrealized receivables) to be offset by A's partnership interest basis of $9,000. Therefore, A also has a $3,000 capital loss on the transaction.

In *Barnes*, the court concluded that the $3,000 of unrealized receivables were being taxed too many times and that the taxpayer should be allowed to recoup his cost in the unrealized receivables. While it expressed doubts as to the constitutionality of the result required by the *Code*, the court rested its decision on two rather strained reconstructions of the transaction.

The case is significant in two aspects. First, the holding of the case proceeds entirely upon the assumption that when A bought into the partnership he purchased the underlying assets rather than the partnership interest — an assumption clearly in opposition to the theory of the *Code* and prior case law.[69] In the absence of this assumption regarding the purchase, the application of section 751(a) to the sale of the interest is clearly within the Congressional purpose of preventing the conversion of ordinary income into capital gain. Second, the position asserted by the court would make resort to the elective special basis adjustment provision of section 743(b) unnecessary where section 751 is applicable.

The devastating impact that the general rule of section 743(a) may have upon the unwary taxpayer was recently demonstrated in *Dupree v. United States*.[70] The factual pattern, in chronological order, may be summarized as follows: (1) a transfer upon the death of a partner; (2) a sale by the partnership of a capital asset that had appreciated greatly before the death of the partner; (3) a liquidating distribution of cash and a proportionate interest in notes taken by the partnership from the purchaser of the capital asset; and (4) the death of the transferee partner. Relief under section 732(d) was not available because the distribution occurred more than two years after the transfer of the interest. The sale of the capital asset resulted in a substantial amount of capital gain which amount was, pursuant to section 705, added to the transferee's partnership interest basis. It should be noted that the facts of the case introduce two elements not previously considered herein — a property distribution and death of the transferee-distributee. The *Code* provides for recognition of loss on a distribution in liquidation only in the event cash, unrealized

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[69] INT. REV. CODE of 1954, §§ 741-42; First Nat'l Bank of Mobile v. Commissioner, 183 F.2d 172 (5th Cir. 1950), *cert. denied* 340 U.S. 911 (1951); Commissioner v. Long, 173 F.2d 471 (5th Cir. 1949).

[70] 391 F.2d 753 (5th Cir. 1968).

receivables, or inventory are distributed.[71] The distribution of any property delays the recognition of a loss until the subsequent disposition of the property by the partner.[72] The transferee partner's basis in the partnership interest, after the reduction for the cash received, became his basis in the distributed property. Just as described in the previous examples of appreciated assets and liquidation after their sale, the basis in the transferee's partnership interest exceeds the transferee's proportionate share of assets before the liquidating distribution. Therefore, upon liquidation Dupree had a tax basis in excess of the fair market value (and for that matter, in excess of the face amount) of the notes. The capital loss that would have been realized upon collection on, or sale of, the notes, which would have offset the capital gain recognized on the partnership's sale of its asset, disappeared, much to the chagrin of his successors in interest, at his death.[73] There is, of course, "no equity in tax law."[74]

Three final comments are relevant to *Dupree* specifically and to the general rule of section 743(a). First, whenever the tax pattern is ordinary income or capital gain upon the sale of assets by the partnership and capital loss, upon liquidation of the partnership interest and the taxable events occur in different years, the capital loss may only be carried forward[75] and, in the absence of capital gains in the future, will offset up to $1,000 of ordinary income until the capital loss is used up or expires at the death of the taxpayer.[76] Accordingly, the result may be a heavy tax burden initially, followed by slow and uncertain recoupment. Where the tax pattern is ordinary loss or capital loss upon the sale of assets by the partnership and capital gain upon liquidation of the partnership interest capital gain (partnership with assets that have declined in value), the same problem does not exist. Second, death of a transferee partner in the *Dupree* situation, but with assets that have declined in value at the time of the transfer of the partnership interest, will allow the transferee's successors in interest a stepped-up basis with no capital gain treatment under existing law. Finally, and as an introduction to the next section, an election to adjust the basis of partnership assets for Dupree's benefit would have cancelled out his distributive share of the gain on the sale of the asset and made his death an innocuous tax event.

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[71] INT. REV. CODE of 1954, § 731(a)(2); Treas. Reg. § 1.731-1(a)(2) (1956).

[72] INT. REV. CODE of 1954, §§ 731(a)(2), 732(b).

[73] *Id.* § 1014.

[74] Dupree v. United States, 391 F.2d 753, 758 (5th Cir. 1968).

[75] INT. REV. CODE of 1954, § 1212.

[76] *Id.* § 1211.

B. *Optional Adjustment to Basis of Partnership Assets*

The alternative approach provided by section 743(b) clearly demonstrates an aggregate approach to partnership income tax law. It has the effect of treating the transferee of a partnership interest as the owner of his proportionate share of the individual partnership assets apart from the collective group. The partnership form that stands between the transferee under the general "no adjustment" rule of section 743(a) is removed by the operation of the basis adjustment alternative.

The special basis adjustment provision is not operative unless the election required by section 754 is in effect.[77] The *Code* contains specific rules for allocating the adjustment once it has been made.[78] A limited alternative is available under section 732(d) to the transferee when the adjustment rule is not utilized.[79]

The amount of the adjustment to the basis of the partnership property is determined by comparing the transferee partner's basis for his interest in the partnership with his proportionate share of the adjusted basis of the partnership assets. The adjusted basis of the partnership assets is increased by the excess of the basis of the transferee's partnership interest over the transferee's proportionate share of the adjusted basis of the partnership assets. A decrease results where the latter exceeds the former.[80]

The ABCD partnership example[81] may be used to illustrate the operation of the special basis adjustment that increases the adjusted basis of partnership assets. E purchased for $5,000 partner A's one-fourth interest in the partnership. E's proportionate share of the adjusted basis of partnership assets is $4,000. The special basis adjustment is $1,000.

Likewise, the FGHI partnership example [82] provides a vehicle for the illustration of the operation of the special basis adjustment that decreases the adjusted basis of partnership assets. J purchased F's one-fourth interest in the partnership for $3,000. J's proportionate share of the adjusted basis of partnership assets is $4,000. The special basis adjustment is a minus $1,000.

The adjustment to the basis of partnership assets is for the benefit of the transferee.[83] Although the adjustment is made by

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77 *See* section V *infra.*

78 *See* section IV *infra.*

79 *See* section II *infra.*

80 INT. REV. CODE of 1954, § 743(b).

81 *See* p. 345, *supra.*

82 *See* p. 347, *supra.*

83 Treas. Reg. § 1.743-1(b) (1956).

the partnership, the adjustment by itself has no effect on the other partners.

For purposes of computing the transferee partner's distributive share of depreciation, depletion, and gain or loss from the sale of partnership property and for determining basis upon the distribution of partnership property to the transferee, the special basis adjustment becomes a part of the basis of partnership assets.[84] The special basis adjustment is allocated to assets in a manner which reduce the difference between fair market value of the assets and the adjusted basis of the assets to the partnership.[85]

When the BCDE partnership sells its inventory that has an adjusted basis of $4,600 for $5,000, the gain is $400. However, the transferee partner's one-fourth share of the gain, $100 is offset by the special basis adjustment of $100 attributable to the inventory. A post-acquisition increase or decrease in the market value of the inventory would result in gain or loss, respectively, to the transferee.

When the GHIJ partnership sells its inventory with an adjusted basis of $6,000 for the market value of $4,000, a $2,000 loss results. Again, however, the special basis adjustment attributable to the transferee J's proportionate share of the inventory nullifies his distributive share of the loss. A post-acquisition change in value would also create gain or loss to the transferee.

When the special basis adjustment is allocated to depreciable partnership property and is an increase to the adjusted basis of that property, the transferee's depreciation is increased although there is no change in the method that the partnership uses in computing depreciation. A special basis adjustment that decreases the adjusted basis of depreciable property, of course, results in lower depreciation to the transferee. It should be noted that accelerated methods of depreciation, when used for partnership property to which the special basis adjustment is applicable, may not be applied to the special basis adjustment that increases the adjusted basis of that property.[86] If the special basis adjustment decreases the adjusted basis of property on which accelerated methods of depreciation are applied by the partnership, the transferee partner must report income in the amount of the difference between the accelerated method and the straight-line method.[87]

If the partnership has depletable property, cost depletion is affected in the same manner as depreciation, but the *Regulation's* approach to accelerated methods of depreciation on the special basis

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[84] *Id.*

[85] INT. REV. CODE of 1954, § 755(a)(1); *see* section IV *infra.*

[86] Treas. Reg. § 1.167(c)-1(a)(6) (1956).

[87] *Id.*

adjustment has not been carried over to the depletion area. The *Code* goes even further in giving a special "tax break" to the transferee of an interest in a partnership that has property subject to depletion by providing that "any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property."[88] "If a transferee partner has paid a high price [or if the transferee partner received the partnership interest upon the death of his predecessor in interest at a fair market value that reflects a substantial increase over the adjusted basis of the partnership assets] for his partnership interest, he may find it advisable to use cost depletion at the same time that other partners use percentage depletion."[89]

If the transferee receives a distribution of partnership property to which the special basis adjustment applies, the basis of the property in his hands includes the special basis adjustment. If another partner receives a distribution of that property, the special basis adjustment will shift from the distributed property to other partnership property. The shifting special basis adjustment is one of the topics included in section IV *infra.*

Because of the effect that the optional adjustment rule of section 743(b) has in reconciling the basis of the tranferee's partnership interest and the adjusted basis of the underlying partnership assets, the variety of post-acquisition income tax consequences of a subsequent liquidation or sale of the transferred interest encountered in the application of the general "no-adjustment" rule do not arise with the application of the optional adjustment rule. The pattern of "gain now-loss later," or vice versa, and the danger of a "gain now-loss never" *Dupree* result do not exist since the initial taxable event in those patterns does not occur under section 743(b).

The *Regulations* contain several provisions intended to clarify the effect of certain transactions which occur after the transfer of the partnership interest and the application of section 743(b). One provision deals with the subsequent transfer of the transferred interest and is designed to prevent the multiplication of special basis adjustments — a possibility clearly not intended by the draftsmen — and to allow, on the other hand, the subsequent transferee the full benefit of the purchase price of the interest. To illustrate, assume that A, B, and C contribute $5,000 each and that D contributes land with an adjusted basis and market value of $5,000. When the land has appreciated in value to $9,000, A sells his one-fourth interest

88 INT. REV. CODE of 1954, § 743(b); *see also* Neel v. United States, 266 F. Supp. 7 (N.D. Ga. 1968).

89 1 Z. CAVITCH, BUSINESS ORGANIZATIONS § 802(3) (1968).

to E for $6,000 (¼ of the value of partnership assets). E has a special basis adjustment of $1,000. The land appreciates still further to $13,000 and E sells the partnership interest to F for $7,000 (¼ of the new value of partnership assets). Does F have a special basis adjustment of $3,000 (E's adjustment of $1,000 plus F's adjustment of $2,000) or does F have a special basis adjustment of $1,000 (the purchase price less E's share of the assets and E's special basis adjustment)? In both instances, the *Regulations* would say no. F's section 743(b) adjustment is determined by referring to the common basis of the partnership property without regard to E's section 743(b) adjustment. Therefore, F's special basis adjustment is $2,000 (the purchase price less transferee's proportionate share of the common partnership basis or $7,000 minus ¼ of $20,000).[90]

Section 743(b) also provides that a section 704(c)(2) agreement between the partners shall be taken into account in determining the special basis adjustment. The *Code* recognizes that the partners may agree that precontribution appreciation or depreciation in value of the contributed property shall be allocated to the contributor upon subsequent disposition of that property by the partnership.[91] Where the contributor of the property that had increased or decreased in value from its adjusted basis before contribution transfers his partnership interest, the transferee computes his special basis adjustment by including the precontribution change in value with his proportionate share of postcontribution change in value (as reflected by the difference between the purchase price of the interest and the transferee's proportionate share of the adjusted basis of partnership property.[92]

A deficit balance in the capital account of the transferor may create some confusion when the transferee computes his special basis adjustment. The capital account must be carefully distinguished from the adjusted tax basis of a partnership interest. The former may, of course, have a negative balance but the latter may never be reduced below zero.[93] Assuming that, (1) the transferor's capital account showed a deficit balance of $2,000, (2) his proportionate share of the adjusted basis of partnership assets is zero, and (3) he sells his interest for $5,000, the transferee's special basis adjustment is $5,000. The deficit account balance, if there is an obligation on the transferor to repay "is a loan governed by section 707(a) of the Code."[94] If the transferee had assumed the transferor's

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[90] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).

[91] INT. REV. CODE of 1954, § 704(c)(2); Treas. Reg. § 1.704-1(c)(2)(i) (1964).

[92] Treas. Reg. § 1.743-1(b)(2)(i) (1956).

[93] INT. REV. CODE of 1954, § 705(a)(2).

[94] Rev. Rul. 318, 1957-2 CUM. BULL. 362, 363.

obligation to repay the deficit, it seems definite that the transferee's basis adjustment would, instead, be $7,000.

C. *Summary Comparison of Section 743(a) and Section 743(b)*

It should be apparent that the general "no adjustment" rule operates for the benefit, tax-wise, of the transferee when the price he paid for the partnership interest, or the fair market value at the date of the death of the transferee's predecessor in interest, is less than the transferor's proportionate share of the adjusted basis, for income tax purposes, of partnership assets. He receives the advantage of a higher depreciation and, perhaps higher depletion, than his purchase price would warrant had he purchased only the assets apart from the partnership. He may be able to trade an ordinary loss for a later capital gain, depending on the nature of partnership assets. Should the transferee die after an ordinary or capital loss is incurred but before a liquidating distribution of cash, or after a liquidating distribution of property still held at his death, the present statutory scheme will not tax the built-in capital gain. Because of these factors, the transferee would have little, if any, interest in the alternative rule of section 743(b).

On the other hand, the alternative rule embodied in section 743(b) is most attractive to the transferee of an interest in a partnership where his basis in that interest exceeds his proportionate share of partnership assets. He receives the full benefit of his cost, or the fair market value at his transferor's death, in computing depreciation or depletion on property that has appreciated in value. Depletion may be computed independent of the method used by the partnership. He is not subject to realized gain on the preacquisition appreciation to the value of partnership assets. Tax traps, as demonstrated by the *Dupree* case, do not exist. Movement out of the partnership is facilitated since section 743(b) makes immaterial, in regard to preacquisition appreciation, the type of partnership property chosen for a distribution liquidating his interest.

In light of the preceding discussion, it should be readily apparent that the income tax ramifications of the transfer of a partnership interest on the transferee are of utmost significance. Serious attention must be directed not only to the short range income tax effects on the transferee but also to the long range consequences of the transfer.

The purpose of the foregoing discussion has been to examine in depth the basis provisions of the *Code* and to isolate their effect on the transferee of a partnership interest; but that is only part of the story. The choice of the basis rule to be applied rests with the partnership, not solely with the transferee partner. The reason for this is that the choice may, and probably will, to a limited extent, affect the other partners both as to past transfers and distributions and those that occur in the future. The problem of the partnership election is the subject of section V *infra.*

II. DISTRIBUTIONS TO THE TRANSFEREE OF A PARTNERSHIP INTEREST SUBJECT TO THE GENERAL RULE OF SECTION 743(a)

Section 1A *supra,* emphasized the serious tax consequences that a transferee of a partnership interest may encounter as a result of the application of the general rule that the adjusted basis of partnership assets is not changed by the sale, exchange, or inheritance of a partnership interest. If the basis of the transferee's partnership interest reflects an appreciation in the value of the underlying partnership assets in excess of the adjusted basis of those assets to the partnership, the full tax advantage of the partnership interest basis is denied the transferee and adverse income recognition may occur. The draftsmen of the *Code* recognized the problems inherent in the general rule of section 743(a)[95] and provided for a limited form of relief for the transferee by the enactment of section 732(d).[96] The "consideration" for the relief provision was the mandatory application of that *Code* section in certain circumstances.

A. *Adjustment at the Election of the Transferee Partner*

As will be described *infra,*[97] the election to adjust the basis of partnership assets is a matter for the collective determination by the partners. The advantages of the election may be far outweighted by the disadvantages that are a part of the election and the result may well be a refusal by the other partners to make the election for the benefit of the transferee. Section 732(d) may be used by the transferee to avoid the operation of the general "no adjustment" rule. Although this provision of the *Code* does not require a collective decision by the partnership to make it operative in an income tax sense, an examination of the provision will make it obvious that the collective decision may still be the determining factor.

If certain enumerated conditions are satisfied, section 732(d) allows the transferee, at his election, to treat as the adjusted partnership basis of the distributed property the adjusted basis such property would have had if the optional adjustment rule of section 743(b) had been in effect at the acquisition of the transferee's interest in the partnership.

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[95] S. REP. NO. 1622, 83d Cong., 2d Sess. 391 (1954).

[96] INT. REV. CODE of 1954, § 732(d).

[97] *See* section V *infra.*

The transferee may elect to have section 732(d) applied if five conditions are met. They are: (1) a distribution of property; (2) the distributee must be a transferee as that term is used in section 743; (3) the distribution must be made within two years of the acquisition by the transferee of a partnership interest; (4) the alternative adjustment rule of section 743(b) must not have been in effect; and (5) a proper election must be made in the manner required by the *Regulations*.[98]

The first requirement contains two elements — a distribution and property. The former may be a current or liquidating distribution.[99] The need for a distribution is easily understood when it is recalled that the alternative adjustment rule requires the partners, rather than the transferee partner alone, to decide upon the use of the alternative rule and its application to partnership property. If a distribution was not required, an alternative to the alternative rule would exist. The transferee partner alone could make the decision to adjust partnership property — a result clearly negated by the express provision of section 743(b). Therefore, a distribution is required and the transferee-distributee's decision affects distributed property which is no longer partnership property.

The distribution to which the special basis adjustment applies must be of property. A fundamental principle of tax law that money cannot have a basis different from its face amount stands behind the applicability of section 732(d) to property other than money. Therefore, in the case of a current distribution of money, or if the transferee's interest is liquidated by a cash distribution, the transferee could not elect section 732(d) treatment. The transferee who receives cash in liquidation of his interest would face the results encountered under the general "no adjustment" rule of section 743(a) described in section 1A *supra.*

The Congressional proceedings[100] definitely support, and the language of the Code may be construed so as to support, the position that the property to which section 732(d) may be applied must be the identical property to which an adjustment to basis under section 743(b) would have been allocated at the time of the transfer of the partnership interest. The *Regulations* take the position that section 732(d) may be applied to both the identical property to which an adjustment to basis pursuant to section 743(b) would have been made and to "like property" if the transferee relin-

[98] INT. REV. CODE of 1954, § 732(d).

[99] *Id.* The fact that the *Code* uses the word "distribution" generally, seems to indicate that it should apply to both types of distributions.

[100] S. REP. NO. 1622, 83d Cong., 2d Sess. 392 (1954).

quishes his interest in the identical property.[101] "Like property" is not defined in the regulation dealing with section 732(d), but because of that section's interrelationship with section 743, it may be concluded that the definition of the term for purposes of section 743 also applies to section 732(d). Therefore, "like property" is "property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc."[102] The position taken by the *Regulations* seems more logical and is justified in light of the purpose of section 732(d), *i.e.* to give the transferee the benefit of the provisions of the alternative adjustment rule of section 743(b) in a manner that does not do harm to the general "no adjustment" rule of section 743(a) or to the restriction in section 743(b) that a special basis adjustment is a matter for partnership determination. It is no more than an extension of the concept that a special basis adjustment may shift from one item of property to another.[103]

The second condition to the applicability of section 732(d) is that the distributee must be a transferee as that designation is used in section 743. As used there, a transferee is one who receives a partnership interest as a result of a sale or exchange, or by inheritance.

Requirements (3) and (4) are self explanatory. The election required of the transferee is discussed in section V *infra*.

It seems advisable to consider the operation of section 732(d) as, by election, it applies to certain distributions in the context of two now familiar situations — the transferee of a partnership interest whose basis of the interest is greater than his proportionate share of the adjusted basis of partnership property, and the transferee whose proportionate share of the adjusted basis of partnership assets exceeds the adjusted basis of his partnership interest. In both cases, the partnership did not elect to adjust the basis of partnership assets pursuant to section 743(b).[104] The former type of transferee and his situation will be referred to as "appreciated assets" and the latter type as "diminished-value assets." Two different kinds of distributions may be involved in either case. In the examples that follow it is assumed that the conditions imposed by section 732(d) have been, or can be, met.

1. Appreciated Assets — Current Distribution

A current distribution of an asset with a market value in excess of its adjusted basis to the partnership, at the time of acquisition

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[101] Treas. Reg. § 1.732-1(d)(1)(v) (1956).
[102] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).
[103] *Id.*
[104] *See* p. 357, *supra*.

of the partnership interest by the transferee, will allow the transferee to avoid the detrimental tax consequences which he would otherwise encounter. To illustrate, assume that three parcels of real estate held for investment are among the assets of the LMN partnership. Each parcel has an adjusted basis to the partnership of $1,000. At a time when each parcel has a market value of $1,200, L sells his partnership interest to P for an amount which reflects L's one-third interest in the property and its appreciation. Section 743(b) is not made applicable. The partners agree to distribute one parcel of land to P in return for a partnership agreement provision that P will not share in the preagreement appreciation in the value of the other parcels. Under the *Code* provisions concerning the basis to the distributee of partnership property received in a current distribution, the adjusted basis of the distributed property to the partnership carries over to the distributee[105] subject to the limitation, not applicable here, that the basis in the hands of the distributee may not exceed his partnership interest basis.[106] Under the general rule, P's basis for the distributed property would be $1,000. However, if P elects to make section 732(d) applicable, the basis in his hands of the real property would be $1,200 ($1,000 partnership basis plus a $200 special basis adjustment P would have had under section 743(b)) and the basis of his partnership interest would be reduced by that amount. Assume, on the other hand, that one of the assets on hand at the time of the distribution is a capital asset to which a special basis adjustment would not have been made if section 743(b) had been applicable. If P relinquishes his interest in the three parcels of land, the *Regulations* provide that he may make an adjustment in the amount of $200 to the basis of the other capital asset upon receipt of it by distribution.

2. Appreciated Assets — Liquidating Distribution

The primary advantage of section 732(d) in this situation appears to be that of preventing the distributee's basis in the distributed property from shifting away from assets that will produce ordinary gain upon their sale, or shifting from depreciable assets to nondepreciable assets. The problem sought to be overcome by section 732(d) is created by the allocation rules contained in section 732(c) and in *Regulations* pertaining to it. In allocating the partnership interest basis to distributed property, the general rule is that the partnership basis for inventory carries over to the distributee and that the remaining partnership interest basis, after allocation to unrealized receivables and inventory, is allocated to the remaining

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[105] INT. REV. CODE of 1954, § 732(a)(1).

[106] *Id.* § 732(a)(2).

distributed assets "in proportion to the bases of such other properties in the hands of the partnership before distribution."[107] To illustrate, assume that A purchases W's one-fourth interest in the WXYZ partnership. The partnership assets, liabilities, and capital at the date of the transfer are:

Assets	Adjusted Basis	Market Value
Cash	$ 20,000	$ 20,000
Inventory	48,000	52,000
Buildings (net of straight line depreciation)	24,000	28,000
Land — 4 equal parcels	40,000	40,000
Total Assets	$132,000	$140,000
Liabilities & Capital		
Liabilities	$ 0	$ 0
Capital — W	33,000	35,000
— X	33,000	35,000
— Y	33,000	35,000
— Z	33,000	35,000
Total Liabilities & Capital	$132,000	$140,000

It should be noted that no section 751 assets are present here. A pays W $35,000 for his partnership interest and section 743(a) is applicable so that no adjustment to the basis of partnership assets is made. A has, however, paid W $2,000 for property appreciation in excess of its adjusted basis. A's interest is liquidated by the distribution of $5,000 in cash, one-fourth of the inventory, one building, and one parcel of land. If the general allocation rule is applied, the $30,000 partnership interest ($35,000 less $5,000 cash received) would be allocated to the distributed property in the following manner: $12,000 to inventory, $6,750 to the building ([6,000/16,000 x 18,000])[108] and $11,250 to land ([10,000/16,000] x 18,000). Thus, the appreciation of $1,000 in inventory (¼ of the market value minus ¼ of the adjusted basis) included in A's basis for his partnership interest, has shifted from property that produces ordinary gain on disposition to property that would produce

[107] Treas. Reg. § 1.732-1(c)(1) (1956).

[108] The $18,000 figure is the basis of the partnership interest after reduction for $5,000 cash received and allocation of $12,000 to inventory.

capital gain treatment. If A then sold the inventory at its market value, he will incur ordinary income of $1,000. There is, likewise, a shift from property subject to depreciation to nondepreciable property.

If section 732(d) is applied, the special basis adjustments that A would have had if section 743(b) applied, may be used to correct the results reached under the general rule for allocation. Therefore, the adjusted bases to A of the distributed assets are: $13,000 to inventory ($12,000 partnership basis plus a special basis adjustment of $1,000), $7,000 to building [([6,000/16,000] x 16,000) [109] plus a special basis adjustment of $1,000], and $10,000 to land ([10,000/16,000] x 16,000).

3. Diminished-Value Assets — Current Distribution

Upon the current distribution of an asset to which, if it had been applicable, section 743(b) would require a reduction of the proportionate share of the adjusted basis of partnership property attributable to the transferee, there appears to be no reason for an income tax conscious partner to make an election to apply section 732(d). If the property distributed is depreciable, application of section 732(d) would lower the amount of depreciation the distributee could properly take. If the property distributed is sold by the distributee and section 732(d) had been applied, the loss which was "built-in" the property would be nullified.

4. Diminished-Value Assets — Liquidating Distribution

As with a current distribution of such property, it is also true that an election by the distributee to employ section 732(d) would have adverse consequences for the taxpayer under the statutory scheme as it now stands. To illustrate, the assets, liabilities, and capital accounts of the QRST partnership are:

Assets	Adjusted Basis	Market Value
Cash	$ 20,000	$ 20,000
Inventory	48,000	40,000
Buildings (4 at equal amounts and net of straight line depreciation)	20,000	16,000
Land (4 equal parcels)	40,000	40,000
Total Assets	$128,000	$116,000

[109] The $15,000 figure is the basis of the partnership interest after reduction for $5,000 cash received, removal of the total special adjustment of $3,000, and allocation of $12,000 to inventory.

Liabilities & Capital	*Adjusted Basis*	*Market Value*
Liabilities	$ 0	$ 0
Capital — Q	32,000	29,000
— R	32,000	29,000
— S	32,000	29,000
— T	32,000	29,000
Total Liabilities & Capital	$128,000	$116,000

Q sells his partnership interest to V for $29,000. V's partnership interest is liquidated by the distribution of one-fourth of the cash and inventory, one building, and one parcel of land. Under the general rule for allocation of the partnership interest basis to distributed assets, the partnership interest basis of $24,000 (after reduction for $5,000 cash received) would be allocated as follows: $12,000 (the basis to the partnership carried over to the distributee) to inventory, $4,000 to the building ([5,000/15,000] x 12,000) and $8,000 to the land ([5,000/15,000] x 12,000). In this situation, the general allocation rule has the effect of shifting the negative special basis adjustments which would have been made if section 743(b) had applied up the scale of preferred types of tax-loss property. Thus, a sale of the inventory at its market value would produce an ordinary loss of $2,000.

If the distributee elected to have section 732(d) apply, the special basis adjustments would result in the following bases of property (other than the money distributed) in the hands of the distributee: $10,000 for inventory, $4,000 for the building and $10,000 for the land. Therefore, a sale of the inventory produces neither gain nor loss.

The lesson learned from *Dupree v. United States*[110] suggests one qualification to the desirability of foregoing the section 732(d) election in this situation. That is, of course, that death of the distributee will result in a revaluation of the distributed assets which were not sold or exchanged prior to death. Otherwise, neither the *Code* nor the *Regulation* provide for a result different from the one suggested here.

If the partnership in which an interest is acquired has both property that has increased in value over its adjusted basis to the partnership and property that has declined in value to a level below the partnership adjusted basis, the application of section 732(d)

[110] 391 F.2d 753 (5th Cir. 1968); *see* p. 000, *supra*.

must be preceded by permission to use a desired method granted by the district director.[111]

A matter of significant concern, which has not as yet been considered, is the availability of section 732(d). The time limitation imposed as a condition to its applicability is relatively brief — two years. In the case of a profitable partnership where the whole is equal to more than the constituent parts, the transferee partner may be reluctant to push the idea of a distribution to the point of jeopardizing the firm's continuity. On the other hand, the circumstances may warrant demanding the distribution even to the point of forcing dissolution.[112] In addition, the nature of partnership assets may militate against a distribution. Finally, it seems more than likely that negotiation by the partnership for the sale of assets to which section 732(d) would apply, followed by a distribution to the transferee and completion of the prearranged sale by the transferee, would be recast as a sale by the partnership and a denial of the applicability of section 732(d) to the transferee.[113]

B. Adjustment Required by the Secretary

Section 732(d) must be applied to a distribution, regardless of when made, "if at the time of the transfer [of the partnership interest] the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership."[114] The *Regulations* add the further condition that section 732(d) must be applied to a liquidating distribution of property to which section 743(b), had it been applicable at the acquisition of the transferee's partnership interest, would have given rise to a special basis adjustment, if the allocation of basis to distributed property rules of section 732(c) "would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance . . . ."[115] Apparently, the Commissioner has interpreted the *Code* provision as having no application to current distributions.

The situation sought to be corrected is demonstrated in detail in the *Regulations*[116] and may be summarized as follows. If the adjusted basis of property not subject to depreciation, depletion, or amortization is below the market value of such property (as reflected in the transferee's partnership interest basis) and the

111 Treas. Reg. § 1.755-1(a)(2) (1956).
112 UNIFORM PARTNERSHIP ACT §§ 31, 32 (1914).
113 *Cf.* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
114 INT. REV. CODE of 1954, § 732(d).
115 Treas. Reg. § 1.732-1(d)(4)(ii) (1956).
116 *Id.* at example 1.

adjusted basis of depreciable property equals or exceeds the market value of the depreciable property (as reflected in the transferee's partnership interest basis), the application of the general rule for the allocation of partnership interest basis to distributed property of both depreciable and nondepreciable property will result in a shift in basis from the latter to the former and give the transferee a higher amount of depreciation than the realities of his purchase price would warrant.

It will be recalled that in section II A *infra*, an example was given under the heading "Appreciated Value — Liquidating Distributions." That example demonstrated that the transferee may elect, under certain circumstances, to apply section 732(d) to prevent the shift of basis from inventory and depreciable assets to non-depreciable assets. The application of section 732(d) on a mandatory basis is designed to prevent the converse from happening where the transferee's partnership interest basis (or purchase price) will not justify a shift in basis.

III. BASIS ASPECTS OF DISTRIBUTIONS

A distribution of money or property by a partnership to a partner creates basis considerations in respect to three different types of property. A distribution will require the determination of: (1) the basis of the distributed property to the distributee, (2) the basis of the distributee-partner's partnership interest after the distribution, and (3) the basis of remaining partnership assets as they exist after the distribution. This wide range of effects justifies a careful analysis of partnership distributions in the contexts in which they occur.

The successful tax planning of partnership distributions requires that the tax planner have accurate information on the bases of the partners' interests in the partnership as well as the partnership's bases for partnership property. The distinction previously made between the capital accounts of the partners as reflected in the partnership accounting records and the income tax bases of the partners' interests[117] is important and should be reiterated. The values assigned to property contributed by the partners to the partnership for capital account purposes are the result of the partnership agreement. On the other hand, the *Internal Revenue Code* of 1954 provides that the basis of the partner's interest in the partnership "acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of

[117] *See* p. 356, *supra*.

the contribution."[118] The partners may also agree upon the value of property distributed to a partner and the capital account of the distributee will be reduced by the agreed amount; however, in the absence of a proper election and a particular set of circumstances described in the *Code,* the income tax basis of the distributed property or of the distributee's partnership interest governs. Confusion of partnership accounting methods with income tax methods may lead to disastrous income tax consequences.

The discussion that follows will first seek to define distribution for purposes of determining what types of transfers to partners receive treatment as distributions under the provisions of sections 731-36 of the *Code* and what types of transfers are not treated as distributions. Once the definition has been made, the basis provisions of the *Code* as they affect distributor and distributee will be examined.

A. Distributions

A distribution is the actual or constructive transfer of money or property by a partnership to a partner in his capacity as a partner and without any resulting obligation on the recipient. Thus, a loan to a partner is not a distribution.[119] Payment for services performed by the partner for the partnership and payment by the partnership for its use of capital contributed by the partner are not distributions unless the amount of such payments is determined with regard to partnership income.[120] Therefore, the payment of a salary to a partner in an amount which is not contingent upon, or measured by, partnership income reduces partnership taxable income and is reported as ordinary income by the recipient.[121] Provision for such payments in the partnership agreement should insure the desired treatment.

There are three types of transfers which satisfy the definitional requirements of a distribution but which are accorded different treatment by the *Internal Revenue Code.* Two of these exceptions are designed to prevent the employment of the partnership form as a vehicle for tax avoidance.

The first exception has been termed a disproportionate distribution of assets.[122] The *Code* and *Regulations* require that sale or

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[118] INT. REV. CODE of 1954, § 722.

[119] Treas. Reg. § 1.707-1(a) (1958).

[120] INT. REV. CODE of 1954, § 707(c).

[121] Treas. Reg. § 1.707-1(c) (1958).

[122] *See* Alexander, *Collapsible Partnership,* N.Y.U. 19th INST. ON FED. TAX. 257 (1961), Costello, *Problems Under Section 751 Upon Current and Liquidating Distributions and Sales of Partnership Interests,* N.Y.U. 15th INST. ON FED. TAX. 131 (1957).

exchange treatment be given to a disproportionate distribution if (1) the transfer is in partial or complete liquidation of the distributee's partnership interest;[123] (2) the distributed assets were not originally contributed to the partnership by the distributee;[124] (3) the transfer would not otherwise be considered a distributive share or guaranteed payment under section 736(a);[125] and (4) the distributive receives more or less than his proportionate share of the partnership's unrealized receivables or inventory items which have substantially appreciated in value.[126] The effect of a transfer being categorized as a disproportionate distribution is a constructive exchange of assets which were transferred, for assets which were not transferred, to the distributee.[127]

The second type of transaction which may be denied treatment as a distribution occurs when the transfer of property by a partnership to a partner is one step in a plan to effecuate an exchange of property among the partners. The criteria for determining whether exchange treatment will be imposed is the occurrence of contributions and distributions made "within a short period" of each other.[128] Unless the facts of a particular case could lead *only* to the conclusion that the sole purpose of the contribution-distribution pattern was to effectuate the exchange, the exchange concept set forth in the *Regulations* should not be applied because it is in contradiction to the statutory position allowing tax-free contribution of property to a partnership and providing for separate and distinct treatment of distributions. Imposition of *exchange* treatment, when sound business reasons or the operation

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[123] Treas. Reg. § 1.751-1(b)(1)(i) (1965).

[124] INT. REV. CODE of 1954, § 751(b)(2)(A).

[125] *Id.* § 751(b)(2)(B).

[126] *Id.* § 751(b)(1). For the definitions of unrealized receivables, substantial appreciation, and inventory items *see* notes 19 and 20 *supra*.

[127] *See* the detailed analysis in Alexander, *Collapsible Partnerships, N.Y.U.* 19th INST. ON FED. TAX. 247 (1957). The author's discussion suggests that the basis aspects should be considered in two categories. First, in respect to the assets received by the partner which are subject to section 751(b) sale or exchange treatment; the following basis determinations result: the assets which were constructively exchanged receive a cost basis in the distributee's and partnership's hands determined by the values both parties are considered to have paid in the exchange. The distributee's partnership interest basis is reduced by his *proportionate* share of section 751 assets or other assets which were constructively distributed to him and then exchanged with the partnership for the assets actually received by him. Second, if additional assets were distributed and not subject to the operation of section 751(b), the general rules of sections 731-36, discussed in the text *supra*, apply.

[128] Treas. Reg. § 1.731-1(c)(3) (1956). The facts contained in Rev. Rul. 200, 1957-1 CUM. BULL. 205 prompted the Commissioner to require exchange treatment where the distributions to the partners occurred "immediately after" the contributions. A and B, members of the AB partnership, each owned ½ of the stock of X Corporation and Y Corporation. A and B contributed the stocks to the partnership, the partnership was liquidated, A received all of the stock of X Corporation and B received all of the stock of Y Corporation.

of local law require termination of the partnership (resulting in a division of the contributed partnership property), would do violence to the statutory policy.

The prerequisite to treatment of a transfer of property to a partner as a distribution, depends upon the agreement of the partners. When payments are made by a partnership to a retiring partner or to the successor in interest of a deceased partner in liquidation of his partnership interest, section 736 provides that the payment or payments may represent several items. Payments for the partner's interest in the partnership are treated as distributions[129] and are subject to the general rules for determining gain or loss and basis. However, to the extent that substantially appreciated inventory items constitute partnership assets, the sale or exchange treatment required by section 751(b) applies to a disproportionate distribution as discussed *supra*.[130] Distribution treatment also applies to payment for a reasonable amount of goodwill if specifically provided for in the partnership agreement.[131] Otherwise, payment for unspecified goodwill constitutes a payment under section 736(a).[132] To the extent that the payment by the partnership is not for the retiring or deceased's partnership interest, section 736(a) requires classification of the payment as a distributive share or a guaranteed payment rather than as a distribution. This classification results in reduced partnership income for the continuing partners and ordinary income to the recipient.[133] Payment for unrealized receivables are considered section 736(a) payments.

The *Internal Revenue Code* recognizes, and the *Regulations* provide, definitions of two kinds of distributions. A *liquidating* distribution[134] is a distribution which liquidates the distributee's *entire* interest; a *current* distribution[135] is any distribution other than one which liquidates a partner's entire interest. The classification of distributions as current or liquidating encompasses a large variety of business purposes. The income tax term "current distribution" includes the distribution of partnership income to one or more of the partners,[136] payment by the partnership of its

[129] INT. REV. CODE of 1954, § 736(b)(1).

[130] *Id.* § 736(b)(2).

[131] *Id.* § 736(b)(2)(B); *see* Swihart, *Tax Problems Raised by Liquidations of Partnership Interests,* 44 TEX. L. REV. 1209, 1241-50 (1966).

[132] INT. REV. CODE of 1954, § 736(a).

[133] *Id.;* Treas. Reg. § 1.736-1(a)(4) (1965).

[134] INT. REV. CODE of 1954, § 761(d); Treas. Reg. § 1.761-1(d) (1956).

[135] INT. REV. CODE of 1954, §§ 731, 732; Treas. Reg. § 1.731-1(a)(1)(i) (1956).

[136] Treas. Reg. § 1.707-1(c) (1958).

liabilities,[137] contribution to the partnership of property subject to a liability,[138] and a *partial* liquidation of the interest of one or all the partners.[139] A partner's drawings against his distributive share of partnership income during the partnership year is treated as a current distribution made on the last day of the partnership's tax year.[140]

Examples of liquidating distributions include: (1) a distribution to all the partners upon the termination of the partnership under federal income tax law,[141] and (2) that portion of a payment made to a retiring partner which is in exchange for his partnership interest.

B. *Basis of Distributed Property*

As is frequently the case, the *Code* provides both a general approach and an alternative approach to the determination of the basis of distributed property in the hands of the distributee. The alternative provided by section 732(d) has already been discussed[142] and was shown to have only limited applicability. Section 732(d) provides for the adjustment of the basis of distributed property (other than money) at the election of a partner whose partnership interest was acquired by transfer within two years of the date of distribution. Therefore, if the distributee is not a transferee of a partnership interest, or if the distributee is a transferee but acquired his interest more than two years before the distribution, or if the distribution consists entirely of cash, the general basis rules of section 732 apply.

Before considering the basis aspects of a distribution as it affects the distributee, it is important to keep in mind the gain or loss recognition potential of a distribution. The *Code* provides for recognition in the following cases: (1) a current or liquidating distribution of money will produce a capital gain if the amount

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[137] *Id.* § 1.752-1(b)(1) (1956). This is the necessary companion rule to the provision of the *Code* which treats the incurring of, or the increase in, partnership liabilities as a contribution by the partners of money to the partnership. Therefore, liabilities of the partnership add to the basis of the partners' interests in the partnership and payment thereof reduces that basis.

[138] *Id.* § 1.752-1(c) (1956). The portion of the liability attributable to the other partners, whether expressly assumed or not, is treated as a distribution to the contributing partner.

[139] *Id.* § 1.761-1(d) (1956).

[140] *Id.* § 1.731-1(a)(1)(ii) (1956).

[141] A partnership terminates as a result of the complete liquidation of all partners' interest if "no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership . . . ." INT. REV. CODE of 1954, § 708(b)(1)(A). For the effect of the liquidation of one partner's interest in a two-man partnership, *see* Rev. Rul. 65, 1967-1 CUM. BULL. 168; Rev. Rul. 325, 1966-2 CUM. BULL. 249.

[142] *See* section II *supra.*

of money distributed exceeds the distributee's partnership interest basis before the distribution; (2) a liquidating distribution which consists solely of money, unrealized receivables, or inventory items will produce a capital loss when the distributee's partnership interest basis, before the distribution, exceeds the money distributed plus the basis of the unrealized receivables and inventory items to the partnership.[143] The holding period of the partnership interest determines the nature of the capital gain or loss. A current or liquidating distribution of property, including unrealized receivables and inventory items, will not result in the recognition of capital gain regardless of the difference between the fair market value and the distributee's partnership interest basis.[144]

When property is distributed in a current distribution, the basis of the property to the partnership carries over to the distributee and becomes his basis.[145] The basis of the partnership interest of the distributee is reduced by the basis of the property distributed.[146] If the partnership's basis of the distributed property exceeds the distributee's partnership interest basis before the distribution, the basis of the distributed property is limited to the amount of his partnership interest basis;[147] and, as a result, the distributee's partnership interest basis is reduced to zero. Therefore, while the partners would normally give effect to the fair market value of the property distributed in their negotiations, any difference between fair market value and income tax basis will not be recognized until subsequent disposition by the distributee.

Regardless of whether the distribution of cash is current or liquidating, the fundamental income tax rule that the basis of money is the amount thereof applies to such distributions. When money and property are distributed simultaneously, the distributee's partnership interest basis is reduced by the amount of money prior to assigning basis to the distributed property.[148]

In a liquidating distribution of property (or of property and money where the amount of money does not exceed the distributee's partnership interest basis), the *Code* provides for the substitution of the basis of the liquidated partnership interest for the basis of the distributed property.[149] However, the draftsmen retained the

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[143] INT. REV. CODE of 1954, § 731.
[144] *Id.* § 731(a)(1).
[145] *Id.* § 732(a)(1).
[146] *Id.* § 733.
[147] *Id.* § 732(a)(2).
[148] *Id.* § 732(a)(2)(b).
[149] *Id.* § 732(b).

use of the partnership's basis for the distributed property for purposes of allocating the substituted basis to the separate properties distributed. Therefore, the liquidated partnership interest basis is allocated first to unrealized receivables and inventory items as defined by section 751(c) and (d) in an amount equal to the basis of those assets to the partnership, and the balance of the partnership interest basis is allocated to other distributed properties in proportion to their adjusted basis to the partnership.[150]

A liquidating distribution of property will postpone the recognition of gain or loss until subsequent distribution by the distributee. Predictably, the partnership provision for non-recognition of gain or loss on distributions of property have been held to take precedence over the *Code's* loss recognition provision contained in section 165.[151] For example, the liquidating distribution of a mortgage with a face amount which is less than the distributee's partnership interest basis reflects a "built-in" loss which will not be recognized until subsequent collection or disposition, and which will disappear if the distributee dies before collection and without disposing of the note.[152]

When the distributee has a special basis adjustment resulting from the prior application of sections 734(b) and 743(b), the special basis adjustment is given effect in computing the basis of the distributed property. For example, if a transferee receives a distribution of property and relinquishes his right to property which is subject to a special basis adjustment with respect to him, the special basis adjustment will be applied to the property distributed to him if the relinquished and distributed properties are of like kind.[153]

C. *Basis of Undistributed Partnership Property*

The general rule governing the basis of undistributed partnership property is that the distribution does not give rise to an adjustment.[154] The partnership's basis of its assets is, of course, reduced by the basis to the partnership of those assets which it no longer owns as a result of the distribution; but the general rule prohibits an adjustment to reflect recognized gain or loss by the distributee or a change in the amount of basis attributed to property other than money when a property distribution occurs.

[150] *Id.* § 732(c).

[151] Dupree v. United States, 391 F.2d 753 (5th Cir. 1968).

[152] *Id.*

[153] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).

[154] INT. REV. CODE of 1954, § 734(a).

Therefore, when money is distributed in a current or liquidating distribution, in an amount which exceeds the distributee's partnership interest basis, or when assets consisting solely of money, unrealized receivables, and inventory items having a basis to the partnership which is less than the distributee's partnership interest basis are distributed in a liquidating distribution, gain and loss, respectively, are recognized, but the gain or loss does not affect the basis of remaining partnership assets. Similarly, in a current or liquidating distribution, when property other than money takes a lower basis in the distributee's hands than the property's basis to the partnership, or when a liquidating distribution of property results in an increment to the basis of the distributed property in the distributee's hands, the resulting diminution and increment, respectively, to the basis of the distributed property does not affect the basis of remaining partnership assets.

The *Code* provides an alternative approach in section 734(b) in the form of an optional adjustment to the basis of undistributed property. The effect of this provision is, as stated by a leading authority on the subject,

> that the partnership's adjusted basis of its undistributed property shall be:
>
> 1. *Increased* in the amount of *taxable gain* recognized to the distributee.
> 2. *Decreased* in the amount of *deductible loss* recognized to the distributee.
> 3. *Increased in the amount* of the *decrease in basis* of the distributed property when it is passed from the partnership to the partner.
> 4. *Decreased* in the amount of the *increase in basis* of the distributed property when it passes from the partnership to the partner.[155]

It will be recalled that the optional adjustment to basis as applied in the case of a transfer of a partnership interest gave effect to the purchase price, or the fair market value, of the underlying assets. As applied to distributions, the optional adjustment to the basis of undistributed partnership assets has the same effect in the case of a liquidating cash distribution. In the case of property distributions, however, the optional adjustment relates only to the changes which occur in the adjusted basis of the distributed property as a result of the rules for determining the basis of distributed property.

The optional adjustment is most frequently encountered when a liquidation of one of the partner's interests occurs. To illustrate,

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[155] A. WILLIS, HANDBOOK ON PARTNERSHIP TAXATION 339 (1957) [hereinafter cited as WILLIS].

the MNOP partnership has the following assets, liabilities, and capital:

Assets	Adjusted Basis	Market Value
Cash	$ 8,000	$ 8,000
Accounts Receivable	2,000	2,000
Inventory	8,000	8,000
Land	2,000	6,000
Total Assets	$20,000	$24,000
Liabilities and Capital		
Liabilities	- 0 -	- 0 -
Capital Accounts — M	$ 5,000	$ 6,000
— N	5,000	6,000
— O	5,000	6,000
— P	5,000	6,000
	$20,000	$24,000

Assume the partners agree to retire M's interest and that the liquidating distribution shall be made in exchange for it. The agreement of the partners meets the requirements of section 736(b) and thus, distribution treatment is proper. Next, it is important to note that the exception to section 736(b) for disproportionate distributions does not apply since none of the "inventory items" on the balance sheet are substantially appreciated in value.[156]

If M receives a $6,000 cash payment in liquidation of his interest, M recognizes a capital gain of $1,000 as a result of section 731 (a). If the partnership elects to adjust its basis under section 734(b), it may increase the basis of remaining assets by $1,000.[157] A close correlation exists between the adjustment under section 743(b) for the transferee of a partnership interest and the cash liquidation. The cash liquidation represents, in effect, the transfer of the interest to the partnership.

If instead, M receives the land with a market value of $6,000 in liquidation of his interest, M recognizes no gain or loss under section 731. If the distribution is subject to the special basis adjustment rule of section 734, a negative special basis adjustment, measured by the amount of the increase in basis of the distributed

[156] The *Code* as interpreted by the Commissioner, requires that the fair market value of all the inventory items be added and then compared with the sum of the adjusted basis of the inventory items. Accounts receivable are inventory items. Treas. Reg. § 1.751-1(d)(2)(ii) (1965).

[157] INT. REV. CODE of 1954, § 734(b).

property when it passes from the partnership to the partner, arises.[158] Therefore, the special basis adjustment is a minus $3,000 (the difference between the basis of the land in the distributee's hands under section 732(b), or $5,000, and the basis of the land to the partnership, or $2,000).

If, instead, M receives three-fourths of the inventory, or a fair market value of $6,000, and section 734(b) is applicable, an increasing special basis adjustment, measured by the decrease in basis of the distributed property when it passes from the partnership to the partner, arises.[159] The special basis adjustment would be $1,000 (basis of three-fourths of the accounts receivable to the partnership, or $6,000, less the basis of the receivables in M's hands under section 732(b), or $5,000).

In both examples of property distributions it is important to realize that the fair market value of the retiring partner's interest in the partnership and the fair market value of the property distributed in retirement of that interest, while of importance in the negotiations between the retiring partner and the remaining partners, play no part in the section 734(b) special basis adjustment. Section 734(b) embodies the aggregate approach to partnerships as applied to liquidating distributions. With respect to property, the adjustment has the effect of applying the principle that in a nontaxable exchange of property, the basis of the property exchanged becomes the basis of the property acquired.[160] Thus, in the distribution of the land, section 734(b) treats the remaining partners as having exchanged their share of the land with a basis of $1,500 (three-fourths of $2,000) for the retiring partner's one-fourth share of the basis of undistributed partnership properties, or $4,500 (one-fourth of $8,000 cash, $2,000 accounts receivable, and $8,000 inventory). In the absence of section 734(b), the basis of the remaining assets is $18,000 ($20,000 total basis minus partnership basis for land of $2,000). Applying the nontaxable exchange rationale, the remaining partners' proportionate share of the partnership assets not distributed ($13,500 — three-fourths of the cash, accounts receivable, and inventory) is added to the remaining partners' basis for the property exchanged which, as previously determined, was $1,500. The difference between the unadjusted basis of $18,000 and the $15,000 basis computed under the aggregate exchange approach is the same amount that the statutory computation of section 734(b) produces.

Current distributions of money and current distributions of property, where there is a decrease in the basis of the property, are

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158 *Id.* § 734(b)(2)(B).

159 *Id.* § 734(b)(1)(B).

160 WILLIS, *supra* note 155, at 338.

also subject to the special basis adjustment provision if the election to make the provision applicable has been made.[161] The rationale in the case of liquidating distributions cannot be applied to current distributions since such distributions do not embody the concept of an exchange. The possibility of a current distribution being subject to the provision of section 734(b) are more prevalent than might be expected. A current distribution to a partner who contributes property with a low basis and a high fair market value may well require an adjustment.[162] The contribution of property subject to a liability in excess of its adjusted basis could result in section 734(b) treatment if the amount of the liability assumed by the noncontributing partners exceeds the adjusted basis of the contributed property.[163] A decreasing special basis adjustment upon the distribution of property is only possible where the distribution liquidates the entire interest of the distributee.[164] A current distribution of property will not result in a decreasing special basis adjustment.

As in the case of a transfer of a partnership interest, the special basis adjustment is allocated to the partnership properties under rules provided by section 755[165] and will affect: (1) the subsequent recognition of gain or loss by the partnership upon disposition of properties subject to the special basis adjustment, (2) depreciation on such properties, and (3) basis if the properties are subsequently distributed. A special basis adjustment that increases the basis of partnership properties is generally desirable to the remaining partners, whereas a decreasing special basis adjustment is generally undesirable. The special basis adjustment is more troublesome in its applicability to distributions. When applied to transfers of a partnership interest, the nature of the special basis adjustment is readily apparent from a comparison of the transferee's basis and the adjusted basis of the assets of the partnership. With distributions, the comparison required is that of the distributee's partnership interest basis and the partnership's basis of the property to be distributed. It is therefore possible to have an overall appreciation in the value of partnership assets above their adjusted basis, but nevertheless to have a special basis adjustment which decreases the basis of remaining assets. In the MNOP partnership example *supra*, the adjusted basis of partnership assets was $20,000 and their fair

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[161] INT. REV. CODE of 1954, § 734(b)(1)(A); *id.* § 734(b)(1)(B).

[162] Milroy, *Tax Aspects of Partnership Distributions and Transfers of Partnership Interests*, 41 IND. L.J. 636 (1966).

[163] Treas. Reg. § 1.752-1(c) (1956).

[164] INT. REV. CODE of 1954, § 734(b)(2)(B). Section 734(b)(2)(B) applies only to distributions "to which section 732(b) applies" — *i.e.* distributions in liquidation.

[165] *See* section IV,A *infra*.

market value was $24,000. The distribution of inventory produced an increasing special basis adjustment, but the distribution of land would result in a decreasing special basis adjustment. This demonstrates the need for careful selection of the property to be distributed to avoid unwanted results when section 734(b) is applicable.

IV. Allocation of the Special Basis Adjustment and the Shifting Special Basis Adjustment

In the foregoing discussion, a number of assumptions were made about the nature of the special basis adjustment for purposes of illustration and clarity. The assumptions were: (1) the partnership owned classes of assets which had all appreciated in value when compared with their respective adjusted bases or which all had declined in value to amounts less than their adjusted bases, (2) the classes of assets represented either one particular item of property or a number of items of property all of which had increased or decreased in value as compared with their respective adjusted partnership bases, (3) the transferee's partnership interest basis did not reflect payment for goodwill or going concern value of the business enterprise, and (4) the property to which the special basis adjustment attaches either remained a partnership asset or was distributed to the transferee. Each of these assumptions, while justified for the purposes made therein, do not comport with the realities of the circumstances in which a transfer or distribution subject to section 743(b) is made. Therefore, it is the purpose of this section to examine the operation of the 1954 *Code* with respect to the actualities of the usual type of transfer of a partnership interest and distribution of property to a transferee of that interest.

A. *Allocation of Basis*

Subchapter K of the 1954 *Code* contains rules for the allocation to partnership assets of a special basis adjustment occasioned by a transfer to which section 743(b), and a distribution to which section 734(b), are applicable.[166] In transfers and liquidating distributions of cash, the special basis adjustment is presumably a reflection of changes in the values of partnership properties when such values are compared with the adjusted bases of the properties to the partnership.[167] The special basis adjustment may be attribut-

[166] INT. REV. CODE of 1954, § 755.

[167] It has been accurately pointed out that a special basis adjustment may arise absent consideration of the value of the partnership property. For example, "a dissident partner who is threatening legal action" may receive an excessive payment for his interest in exchange for his partnership interest with the sole purpose of the remaining partners being to exclude him from the partnership. In certain circumstances, the excessive payment would not represent goodwill or going concern value. WILLIS, *supra* note 155, at 245.

able to tangible and intangible partnership property, including goodwill.

A basic feature of the allocation section is its reliance on fair market value as one of the factors employed to make the allocation. A question of significant importance is the role of the negotiating parties to a transfer or a distribution in the determination of fair market value. Unlike other partnership provisions,[168] neither the *Code* nor the *Regulations* mention the agreement between the parties in the allocation provision. It does not seem, however, that omission of a reference to the agreement between the buyer and seller, or the partners and the distributee, should prejudice market values established by it so long as they are reasonable. Section 751, dealing with the sale or exchange of an interest in a partnership which has unrealized receivables or inventory which has substantially increased in value, has been construed by the *Regulations* to give effect to the reasonable values contained in an agreement between the parties.[169] Considering the relative similarity between section 751 and sections 741-43 (to which the allocation section may be applicable), a good reason does not appear for according differing treatments to the values established by negotiations, subject, of course, to the requirement of reasonableness.

The application of the allocation provisions of section 755 requires four steps in a transfer. The first step requires the segregation of the partnership property into two classes. Capital assets[170] and property used in a trade or business[171] are combined into one class and all other partnership assets constitute the other class.[172] The next step is to determine the proportionate share of the special basis adjustment that is attributable to each of the two classes. This is accomplished by comparing the fair market value of each asset in the class with its adjusted basis to the partnerhip and adding the individual increases and decreases together to determine the net increase or decrease for each class. Third, the special basis adjustment is then allocated to each class in an amount representing the proportion of that class' increase or decrease to the total increase or decrease.[173] The fourth step is to allocate the special basis adjustment attributable to the assets within the class "in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of

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[168] *See* Treas. Reg. § 1.751-1(a)(2) (1965).

[169] *Id.* § 1.751-1(c)(ii)(3) (1965).

[170] INT. REV. CODE of 1954, § 1221.

[171] *Id.* § 1231(b).

[172] *Id.* § 755(b).

[173] Treas. Reg. § 1.755-1(c) (example 3) (1956).

partnership properties . . . ."[174] Presumably, this would be done by allocating the special basis adjustment attributable to the class: (1) in the case where the special basis adjustment to the class is an addition to the adjusted basis of the partnership assets, to each asset in the proportion of its increase in fair market value over its partnership adjusted basis to the total increases within the class, without reference to any decreases attributable to assets in the class, and (2) in the case where the special basis adjustment to the class results in a decrease in the adjusted basis of the partnership assets, to each asset in the proportion of its decrease in fair market value below its partnership adjusted basis to the total decreases within the class, without regard to any increases attributable to assets in the class.

In the event of a distribution of money in liquidation of a partner's interest, the *Regulations* provide that an adjustment to the basis of partnership assets pursuant to section 734(b) "must be allocated only to capital assets or section 1231(b) property [used in a trade or business]."[175] When applied to a liquidating distribution of cash, the position taken in the *Regulations* is wholly untenable. It ignores the realities of circumstances that attend a liquidating distribution. The decision by the partners of the amount to be distributed to the outgoing partner in most cases is based on the market value of the partnership assets. If, for instance, the partnership has inventory that has appreciated in value (but not to the extent that it is substantially appreciated inventory within the scope of section 751), that appreciation is reflected in the amount of the cash distribution. The effect of the *Regulation* is to shift the adjustment to basis from property that will produce ordinary gain upon its sale to capital assets and depreciable property. On the other hand, the allocation of a *minus* basis adjustment, if applied in the manner set forth in the *Regulations*, would shift the basis adjustment from property that would produce an ordinary loss to capital assets or depreciable property. Either way the partnership suffers unwarranted tax consequences because in the former situation, the sale by the partnership of its inventory results in a higher ordinary gain and, in the latter, a justifiable ordinary loss is denied. The statutory language of section 755 does not call for such a result. It seems that the more appropriate means of allocating the adjustment to basis of partnership assets is the method employed upon the transfer of a partnership interest. As it now stands, the method adopted by the *Regulations* may lead to invidious results

[174] INT. REV. CODE of 1954, § 755(a)(1).

[175] Treas. Reg. § 1.755-1(b)(1)(ii) (1956).

based entirely on the form (by the partners or by the partnership) by which the outgoing partner's interest is purchased. Unlike the effect of other provisions of subchapter K,[176] this is not a matter of the partners determining *inter se* the tax consequences of a transaction, since the present allocation rule has no effect upon the distributee.

Where the transaction that gives rise to the special basis adjustment is a distribution of property, the *Regulations* provide that the special basis adjustment is to be "allocated to remaining partnership property . . . with respect to which the adjustment arose."[177] This method appears to suffer from an infirmity similar to the one just discussed. The character of the property distributed is the basis for classifying the special basis adjustment, rather than the character of the property with respect to which the distributee has relinquished his interest. The method for allocating the special basis adjustment among the properties within the classes would be the same as, in the case of allocation as a result of a transfer, steps 3 and 4 *supra* page 377.

The allocation procedures prescribed by the *Code* and *Regulations* are deficient because of the use of two factors — the classification procedure and the use of net increase or net decrease amounts — at two different levels — the classified group of assets and at the individual asset level. The reasoning behind the allocation procedure appears to be a desire to prevent the procedure from becoming a tax avoidance tool and to achieve simplicity. The one is justifiable, the other, in the opinion of the author, is not.[178]

At the class level, a significant net increase for one class, used for making the allocation, may be partially, or completely, offset by a net decrease in the other class.[179] Since the *Regulations'* procedure does not provide for an increasing allocation to one class and a decreasing allocation to the other class, only the net increase or net decrease is used for allocation purposes. As between the two classes, the result of the method may be to only minimally affect the basis of the net increase class with no change in the net decrease class. To illustrate, assume that the net increases to "all other property" is $4,000 and the net decrease to capital assets and section

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[176] *See* INT. REV. CODE of 1954, § 736 and the text accompanying note 44 *supra*.

[177] Treas. Reg. § 1.755-1(b)(1)(i) (1956).

[178] Little, if anything, contained in subchapter K, other than the effective date provision, is, in fact, simple. Even the effective date provision involved some room for confusion in 1954. *See* Jackson, Johnson, Surrey, Tenen & Warren, *The Internal Revenue Code* of 1954: *Partnerships,* 54 COLUM. L. REV. 1183, 1235 n.100 (1954). In the single-asset partnership, the allocation procedures are no doubt effective. But where the assets are numerous and have varying fair market values and bases, "simplicity" may work inequity.

[179] *See* WILLIS, *supra* note 155, at 242.

1231(b) property is $3,000. The existing allocation method would require the allocation of the special basis adjustment of $1,000 (assuming net increase also represents the difference between the cost of the partnership interest and the transferee's proportionate share of the adjusted basis of partnership property) to "all other assets." But an increased basis in the amount of $1,000 is not a true reflection of the transaction. Rather, an increase of $4,000 to the basis of "all other property" and a decrease of $3,000 in the basis of capital assets and section 1231(b) property would produce an accurate accounting. If "all other assets" are sold, the sale would produce a $4,000 gain allocable to the transferee, in the case of a transfer, or to the partnership, in the case of a distribution, yet only $1,000 of the gain is offset by the allocated special basis adjustment. Capital assets and section 1231(b) property would continue to have an adjusted basis that is $3,000 in excess of its fair market value. This same situation may occur at the individual asset level of the allocation method.

An alternative to the allocation method prescribed by the *Code* and *Regulations* does exist. The *Regulations* provide that the partnership may file an application with the district director for permission to use another method and the district director is permitted to allow increases to the bases of some properties and decreases to others, so long as such increases and decreases reduce the difference between the fair market value and the adjusted basis of the partnership property.[180] Permission to adopt a different method is conditioned upon a "satisfactory showing" of the values used by the parties to the transaction, or in the case of transfer as a result of death, the fair market value at the relevant date. Perhaps the matter of most significance is the deadline for submitting the application. That deadline is 30 days after the close of the partnership year in which the special basis adjustment was created. Therefore, for the first year to which the election under section 755[181] to adjust the basis of partnership assets pursuant to sections 734(b) and 743(b) applies, application to adopt a different method of allocation will precede the election to make the basis adjustments.

The question of whether the special basis adjustment allocable to a single item of partnership property may exceed its fair market value has been answered in the affirmative in *United States v. Cornish*.[182] Relying upon the legislative history, the court concluded

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[180] Treas. Reg. § 1.755-1(a)(2) (1956).

[181] The question of when the section 755 election must be filed is discussed in section V *infra*. The *Regulations* provide that the section 755 election must be filed with the partnership income tax return for the first taxable year to which it applies. Treas. Reg. § 1.754-1(b) (1956).

[182] 348 F.2d 175 (9th Cir. 1965).

that the fair market value concept was not intended to establish a limitation but rather to be used for allocation purposes.[183] The statutory phraseology, "reducing the difference" was found to mean "that where there are several classes of depreciable partnership properties, the percentage of difference between the fair market value and the adjusted basis of each shall be maintained in allocating the total amount of the increase in the adjusted basis attributable to depreciable assets."[184] The decision has the effect of nullifying two provisions in the *Regulations* that considered fair market value as a limitation.[185]

The *Regulations* require a portion of the special basis adjustment to "be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014 . . . ."[186] "Going concern value"[187] has been held to be an intangible partnership asset and the subject of an allocation of a special basis adjustment.[188]

The *Cornish* case, concerned an interesting allocation question. The court found that the purchase price of a partnership interest represented: (1) the fair market value of the tangible partnership assets, (2) "going concern" value as an intangible partnership asset, and (3) an overvaluation of the partnership interest. The purchasing partners had, in effect, paid more for their interests than they were worth. The government argued that the overvaluation must be treated as if it was an intangible partnership property. Instead, the court held that the overvaluation should be prorated between tangible assets and "going concern value" on the rationale, previously mentioned, that the adjusted basis of partnership property after the allocation of the special basis adjustment could exceed the fair market value of the property.

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[183] *Id.* at 186 n.17.

[184] *Id.* at 186. This same problem of overvaluation appears to have been present in the facts of *Victor G. Mushro,* 50 T.C. 43 (1968), where a buy-sell agreement between the partners, funded with life insurance, resulted in the payment to a deceased partner's widow of an amount approximately 1.4 times the fair market value of the interest at his death. However, no suggestion is made in the case that the buying partners had attempted to allocate the overpayment to tangible partnership property.

[185] Treas. Reg. § 1.755-1(a)(ii,iii) (1956).

[186] *Id.* § 1.755-1(a)(iv).

[187] *See* Los Angeles Gas & Elec. Corp. v. Railroad Comm'n., 289 U.S. 287 (1933), wherein the Supreme Court distinguished going concern value and goodwill. Going concern value is present where " 'there is an element of value in an assembled . . . plant, doing business and earning money, over one not thus advanced . . . .' " Goodwill, on the other hand is that " 'element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business . . . .' " *Id.* at 313.

[188] United States v. Cornish, 348 F.2d 175, 185 (9th Cir. 1965).

B. *Shifting Basis Adjustments*

The *Code* and *Regulations* contain two curious concepts that may change the income tax consequences of the special basis adjustment. One is the shifting special basis adjustment and the other the special basis adjustment *in nubibus*.[189] The latter may be created by, among other ways, the former.

The special basis adjustment *in nubibus* is the product of a distribution, either current or liquidating, but, logically, not of a transfer of a partnership interest. The special basis adjustment may have existed prior to the distribution, in which case it is the shifting that causes the in abeyance aspect) as is the case of a prior transfer to which section 743(b) applied, or may be created by a distribution. If property is distributed and the partnership does not have like property at the time of the distribution, the special basis adjustment is held in abeyance. The definition of like property, however, appears to vary depending on the distribution. Thus, in the case of property to which a special basis adjustment is allocated for the benefit of a transferee, a distribution of that property to another partner will cause the special basis adjustment to shift away from the distributed property. It will attach to other property of a like kind.[190] For purposes of this particular situation, like property is "property of the same class, that is, stock in trade, property used in a trade or business, capital assets, etc."[191] If property of a like kind is not owned by the partnership, the special basis adjustment is *in nubibus* until it is acquired.

However, in the case of a distribution to which section 734(b) applies, a shift in basis is not involved, and while not entirely free from doubt, it appears that like property is determined by reference to the two classes established in section 755 for the allocation of the special basis adjustment. Under this interpretation, like property is property of the same class, and the two classes are (1) capital assets and section 1231(b) property and (2) all other assets. This reasoning has led one author to conclude that a special basis adjustment *in nubibus* which is created by the distribution of capital assets may be applied to depreciable property, if owned at the time of the distribution or acquired before other capital assets are also

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[189] Literally, "in the clouds." The choice of the Latin designation serves the purpose of a loose analogy to the feudal land law policy that title to land may not be in abeyance. *See* A. KALES, ESTATES, FUTURE-INTERESTS, AND ILLEGAL CONDITIONS AND RESTRAINTS IN ILLINOIS 26 (1920). The present author feels that, although the reasons behind the policy for land law purposes and income tax purposes are, quite naturally, very different, the policy against such a situation should be the same in both contexts. A. Willis refers to this same situation as the "Peter Pan" adjustment.

[190] Treas. Reg. § 1.732-2(b) (example) (1956); *Id.* § 1.743-1(b)(2)(ii) (1956).

[191] *Id.* § 1.743-1(b)(2)(ii) (1956).

acquired, since both types of property are of the same class.[192] In the absence of property to which it attaches, depreciation or depletion on an increasing special basis adjustment would not be available.

The foregoing suggests that attention must be directed to the type of property that is intended to be distributed along with consideration of the type of property that will remain in the partnership after distribution.

V. THE ELECTIONS

A. *The Section 754 Election*

As previously mentioned, an adjustment to the basis of partnership assets occasioned by a distribution within section 734(b) or a transfer of a partnership interest within section 743(b) may be made at the option of the partnership, providing the election required by section 754[193] is properly filed. Since the burden of making the election is imposed upon the partnership, section 754 deserves close scrutiny.

The *Code* provides for the filing of an election "in accordance with regulations prescribed by the Secretary or his delegate . . . ."[194] Pursuant to the statutory command, a regulation has been promulgated stating that the "election . . . shall be made in a written statement filed with the partnership return . . . ."[195] In addition to declaring the election, the written statement must also contain the name and address of the partnership and be signed by one of the partners.[196]

The proper date for filing the election in order to make it applicable is a matter on which there exists a conflict of authority. Neither the specific language of section 754, nor the Senate proceedings[197] at the time of adoption of the election provision, contain any indication of when the election must be filed. The pertinent regulation takes the position that the election must be "filed with the partnership return for the first taxable year to which the election applies . . . ."[198] Some degree of hindsight is clearly allowed the partnership since the Internal Revenue Service has confirmed the

[192] Jordan, *Adjusting the Basis of Partnership Property: When to Elect, How to Determine,* 22 J. TAX. 242 (1965).

[193] INT. REV. CODE of 1954, § 754.

[194] *Id.*

[195] Treas. Reg. § 1.754-1(b) (1956).

[196] *Id.*

[197] S. REP. NO. 1622, 83rd Cong., 2d Sess. 406 (1954).

[198] Treas. Reg. § 1.754-1(b) (1956).

logical conclusion, implicit in the statutory language, that the election need not be filed in anticipation of the election's desired applicability.[199] Nor do the *Regulations* require that the election need be made when the particular transfer or distribution occurs. It therefore seems desirable for the partners to review distributions and any transfers of partnership interests made during the taxable year, along with such other considerations as the effect of the applicability of the election to future distributions and transfers and the apparent difficulty of revoking the election once it has been made, before the partnership return is filed each year. In addition, it seems that a valid election may be made where the partnership has been granted an extension of time for filing its return under section 6081(a) of the 1954 *Code*.[200]

The applicability of an election to a distribution or transfer of a partnership interest made within a taxable year, where the election is not filed within the statutory period for filing the partnership return for that year, is foreclosed by the requirements of the *Regulations*[201] and by a Revenue Ruling. [202] Taxpayers in two cases have sought to avoid these limitations with interesting results. The first test of the validity of the *Regulations* was made in *Neel v. United States*,[203] a district court case. In the *Neel* case, the partnership filed the election approximately two and one-half years after the filing date of its partnership income tax return for the year in which a partnership interest was transferred upon the death of a partner. The deceased partner's estate had, during the period before the partnership filed the election, made an adjustment to the reported distributive share of partnership income to reflect the use of cost depletion. The use of cost depletion by the estate would have been proper only by virtue of an adjustment to the basis of depletable partnership property under section 743(b). The court found the timely filing requirement of the *Regulations* invalid on the grounds that a regulation, in order to be valid, must be reasonable and that "[r]egulation § 1.754-1 adopted by the Commissioner has the effect of imposing a penalty . . . ."[204] The Government did not appeal.

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[199] Rev. Rul. 347, 1957-2 CUM. BULL. 365.

[200] "Presumably, an election is valid if it meets all the requirements [of Treas. Reg. § 1.754-1(b)], even if the election statement accompanies a Form 1065 which is filed on the last day of the maximum extended return-filing period of six months after the statutory due date of the return." Jordan, *Adjusting the Basis of Partnership Property: When to Elect, How to Determine*, 22 J. TAX. 242 (1965) (footnote omitted).

[201] Treas. Reg. § 1.754-1(b) (1956).

[202] Rev. Rul. 347, 1959-2 CUM. BULL. 365.

[203] 266 F. Supp. 7 (N.D. Ga. 1966).

[204] *Id.* at 10.

Dupree v. United States,[205] a court of appeals decision subsequent to *Neel*, held adverse to the taxpayer-partner's contention that the partnership election was timely filed. Dupree and his wife owned a community property interest in a limited partnership. Upon the death of his wife in 1957, Dupree received a stepped-up basis for his one-half of the partnership interest pursuant to section 1014(b) (6). In 1960, the principal asset of the limited partnership, a motel, was sold, the partnership was liquidated, and Dupree's proportionate share of the capital gain realized on the sale was reported on the final partnership return, but not on the taxpayer's individual return. The section 754 election was not filed until 1962. The court found that for a valid election to have been made for 1960 (*the year of the sale of the partnership asset*), it should have been filed with the original partnership return for 1960 or with an amended return filed within the statutory time for filing the original return. The court specifically declined to decide the issue presented in the *Neel* case — whether the election could only be made with the partnership return for the year in which the partnership interest was transferred.[206]

These cases are susceptible of two interpretations. It may be said that the *Neel* decision is not impaired by *Dupree* but that the latter case puts a qualification on the position announced in the former case. Thus, it may be argued that the two cases interpreted together, do not require the section 754 election to be made in the partnership return for the year in which a partnership interest is transferred, but the election must be filed with the partnership return for the year in which the partnership asset (or assets) to which the basis adjustment applies is sold or exchanged. However, this interpretation raises more problems than it solves. First, where the partner, in determining his taxable income, adjusts the reported amount of his distributive share of taxable income to reflect the basis adjustment to partnership assets, the partner rather than the partnership has made the election. This is contrary to the requirement of section 754 that the election, because it potentially affects all the partners, is to be made by the partnership. The effect of allowing a partner to make such adjustments would destroy the purpose of the partnership return. One transferee-partner would make adjustments where it would reduce his taxable income, whereas another transferee-partner would not adjust his taxable income to reflect an adjustment that reduces his proportionate share of the basis of partnership assets, because such an adjustment may increase

[205] F.2d 753 (5th Cir. 1968).
[206] *Id.* at 759.

his taxable income. Moreover, absent the affirmative election initially, there would be no assurance that the partnership would ever make the election.

The second deficiency inherent in this approach is the potential confusion that would result in making the sale or exchange of the partnership asset the transaction that gives rise to the filing requirement. Where the adjustment to basis of partnership assets would result from the transfer of a partnership interest, the adjustment is made to the assets, owned at that time by the partnership, that have appreciated or depreciated in value prior to the transfer of the partnership interest. Where such increase or decrease in value applies to inventory items, the election may be required immediately under this interpretation. Where the increase or decrease applies to investments or fixed assets, it could be years before the election would need to be filed.[207]

Finally, the section 754 election applies to remaining partnership assets after distributions as well as to transfers of partnership interests. The proposed interpretation would allow the partners to determine at the time of the sale of partnership assets, which had appreciated or depreciated in value as of the date of the prior distribution, whether to make the election. The election would become a tool for blatant tax avoidance.

An alternative, and probably more accurate, interpretation of *Neel* and *Dupree* is that *Neel* stands alone in allowing an election to be made after the expiration of the statutory time for filing the partnership return for the year in which the transfer of a partnership interest occurred. It should be noted that the taxpayer's contention in *Dupree* was that the election was in effect for the year of the sale of the partnership asset. The taxpayer did not argue for the application of the election to the date of the transfer of the partnership interest. As a result, the court left the *Neel* issue up in the air.

One clear factor must be considered when it appears desirable for the partnership to make an election attempting to give it retroactive application. The Internal Revenue Service does not agree with the *Neel* decision and can be expected to press their position whenever a taxpayer relies on *Neel*. In *Dupree,* Government council urged the court to overrule the earlier *Neel* holding with no success. It seems doubtful that the issue is, as yet, resolved.

The *Code* provides that "[s]uch an election shall apply with respect to *all* distributions of property by the partnership and to *all* transfers of interests in the partnership during the taxable year

[207] In this regard, compare the section 732(d) election discussed in section VI B *infra*.

with respect to which such election was filed and *all* subsequent taxable years."[208] For the unwary, this provision may create undesirable tax consequences. The election applies to the whole year for which the election is made, and it may encompass distributions of property and transfers of partnership interests that give rise to desirable and undesirable basis adjustments. To illustrate, partners A, B, C, D, and E each own a 20 percent interest in the profits and assets of the partnership. A's interest is liquidated early in the year by the distribution of partnership property with a basis to the partnership which is less than the distributee's partnership interest basis. Later in the taxable year, B sells his partnership interest to F for an amount in excess of B's proportionate adjusted basis in partnership assets. If, through inadvertence or a failure to read the statute thoroughly, the partnership makes the election for F's benefit, the election will require an adjustment reducing the basis of the proportionate assets of the partnership held by each partner to reflect the effect of the earlier distribution. While there is some advantage to F, the election is disadvantageous to the other partners. If these other partners are aware of the tax consequences of the section 754 election, they would probably refuse to make the election. This would, of course, deny F the full tax benefits of the purchase price of his partnership interest.

The *Code's* choice of the partnership year as the device for determining the applicability of the election to adjust the basis of partnership property may be used as a tax planning device with favorable consequences to present and potential partners. In the example of the ABCDE partnership above, B should refrain from making the sale until after the close of the partnership year. An election filed for the next partnership year would give F a stepped-up basis in his portion of the partnership assets without requiring the partnership to reduce its basis in those assets to reflect the distribution to A in the prior year. There are, of course, other circumstances in which downward basis adjustments may be avoided by completing the particular transactions that would cause such adjustments before the year for which the election is made.

Since the election applies to the partnership, the decision to make the election is a matter for collective determination. The election is a matter of potential controversy since its binding, prospective effect on the partnership may cause the decrease of partnership asset basis which could more than offset any immediate benefits. The partners may also hesitate where it appears that the benefits gained may be nullified by the administrative burden that results

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[208] INT. REV. CODE of 1954, § 754 (emphasis added).

from the extra record keeping. Therefore, the proper time for partner consideration of the subject is in the planning stage. The purchaser of a partnership interest will be well advised to determine the positions of the other partners during prepurchase negotiation and to reduce the matter to writing by a statement in the new partnership agreement to the effect that the partnership elects to have section 754 applied. A liquidated damages clause would give the transferee a good measure of security against a later change in heart by the other partners resulting in a failure to file. The internal declaration, at the outset, of the partners' desire to have section 754 made applicable, has the further advantage of providing some insurance against events which occur prior to the formal filing of the election. Short of effecting a dissolution under state law, an intervening event, *e.g.* the insanity of a partner,[209] would not jeopardize the election since the filing of the election statement is a ministerial act and only requires the signature of one partner.

Although there is a lack of direct authority on this point, a refusal to file the election in violation of an express or implied agreement to do so may be such as to sustain a cause of action for damages.[210]

Section 754 provides for revocation of the election "subject to such limitations as may be . . . prescribed by the Secretary or his delegate."[211] The *Regulations*[212] give examples of situations that merit the allowance of the revocation. A change in the nature of partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or increased administrative burden to the partnership because of an increased frequency of retirements or shifts of partnership interests are cited as reasons for revocation. A "primary purpose" test is contained in the regulation to the effect that revocation will be denied where the primary purpose in seeking the revocation is to avoid the decrease in the basis of partnership assets upon a transfer or distribution. It follows that revocation is probably not available when the partnership's adjusted basis in its assets exceed: (1) the market value of the partnership assets for purposes of transfers of partnership interests, or (2) the respective partners' adjusted basis in their partnership interests. The application would, no doubt, also fail if a transfer or distribution resulting in a basis step-down occurred in the year to which revocation, if granted, would be effective.

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209 It does not appear that insanity alone is a reason for dissolution of the partnership. *See,* UNIFORM PARTNERSHIP ACT § 31.

210 *See* Stern & Co. v. State Loan & Finance Corp., 238 F. Supp. 901 (D. Del. 1965).

211 INT. REV. CODE of 1954, § 754.

212 Treas. Reg. § 1.754-1(c) (1956).

B. *The Section 732(d) Election*

Unlike the requirement of section 754, section 732(d) requires the election to be made and filed by the individual partner. Since the partnership is not affected by the election, it need not make a decision on the matter. The *Regulations*[213] provide that the election is to be made by way of a schedule, included in the transferee's income tax return, declaring the election and including a computation of the special basis adjustment and a schedule of the properties to which it is applied. Also, unlike the section 754 election, this election is not stated by the *Regulations* to be a continuing one, so that if within two years of the acquisition of the partnership interest the transferee partner receives distributions to which section 732(d) is applicable in different tax years, separate elections appear to be necessary.

The proper time for filing the election depends upon the type of property distributed. If the property is subject to an allowance for depreciation, depletion, or amortization, the election must be filed in the transferee partner's year of distribution. If other property is distributed, the election must be made "in the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax . . . ."[214]

CONCLUSION

The provisions of the *Code* governing the transfer of a partnership interest and distributions are, indeed, very complex. The tax ramifications of any transaction in this area may span a number of *Code* provisions and identification of what *Code* provisions apply is a difficult task for anyone without an intimate knowledge of the intricacies of subchapter K. Although reform measures have been considered by Congress, to date the provisions of the 1954 draft have gone unchanged.[215]

The Commissioner has not been helpful in interpreting the *Code* provisions. For instance, a person looking for information about a distribution problem must look to not only the *Regulations* covering the distribution provisions of the *Code* but also to the *Regulations* dealing with transfers of a partnership interest to completely cover the problem. Where Congress has directed the Commissioner to promulgate rules, the results often appear to be unduly strict and, sometimes, unworkable.

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[213] *Id.* § 1.732-1(d)(3) (1956).

[214] *Id.* § 1.732-1(d)(2) (1956).

[215] Anderson & Coffee, *supra* note 6, for an analysis of the proposed revisions.

Some of the questions raised by the *Code* and *Regulations* have been answered with clarity by the courts. However, litigation has covered only a small portion of the problems which arise in the area. The confusion which attends distributions and transfers in the *Code* and *Regulations,* in turn breeds case law which reflects an equitable approach rather than an approach based on the statutory policy.[216] This is undesirable, particularly to the litigant whose case is decided by a court which properly finds that equity is not a part of the taxing system. Uniformity is necessary but is by no means furthered by the *Code* provisions discussed herein.

The burden is placed upon the attorney representing one of the parties to the transaction to be, at the least, aware of the pitfalls and traps in this area of partnership income tax law. The outcome of a transfer or a distribution in the absence of an awareness of the *Code's* provisions and the case law may be devastating, costly, and very discouraging to the client.

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[216] In Barnes v. United States, 253 Supp. 116 (S.D. Ill. 1966), the court emphasized the inequity of the statute as applied to the taxpayer.