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W. Lewis Roberts
*University of Kentucky*

# Taxation of Partners and Partnerships Under 1954 Code

By W. LEWIS ROBERTS*

THE 1954 CODE was the first complete revision of our federal tax laws for nearly a hundred years. The House Ways and Means Committee said that its purpose was to "remove inequalities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."[1] For the most part the new law embodies the provisions of the 1939 Act but has also enacted into statutory form much of the case law decided under the 1939 Act. One might assume the result would be greater certainty and clearness. This, however, apparently has not been the case in regard to Subchapter K, which deals in taxation of partners and partnerships, if one is to judge by complaints of lawyers and of writers in our law reviews. As one writer puts it: "The Internal Revenue Code of 1954 contains many innovations in the partnership area. The new rules have deservedly earned a reputation for being among the most complex in the new law."[2] As pointed out by an editor of The Journal of Taxation,[3] "Agreement is widespread that Subchapter K is as tough and uncertain to work with as any in the law." He further tells us that "the Section on Taxation of the American Bar Association has undertaken an exhaustive analysis of the workings of Subchapter K."

It seems worthwhile to consider some of the changes found in Section K of the 1954 Code that have added to a lawyer's burden in working under the new Code. First there are a great number

* Professor of Law, University of Kentucky. A.B., Brown University; A.M., Pennsylvania State University; J.D., University of Chicago; S.J.D., Harvard University.

[1] Lawyers Weekly Report, Prentice-Hall, Inc., August 9, 1954, p. 3.
[2] Douglas D. Dreysdate, 2 The Journal of Taxation 340.
[3] Jackson L. Boughner, December issue, 1956, p. 360.

of elections allowed partners and partnerships in certain situations. Section 703(b) contains the first provision in regard to elections. It states that "Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under section 901, relating to taxes of foreign countries and possessions of the United States, shall be made by each partner separately."

As pointed out in the report of the Congressional Committees,[4] this includes elections as to methods of accounting, computing depreciation, use of installment sales, etc., and the elections bind all the partners equally.

A provision carried over from the 1939 Code allows a partnership to elect to be taxed as a domestic corporation.[5] There are certain conditions; the partnership must not consist of more than fifty members; no member shall have more than a ten per cent interest in the profits or capital, nor be a nonresident alien or a foreign partnership. The election is irrevocable except as provided in subsection (f), which deals with a change of ownership. In defining the term "partnership," the 1954 Code includes "a syndicate, group, pool, joint venture, or other unincorporated organization through or by which any business, financial operation, or venture is carried on, and which is not within the meaning of this title, a corporation, or a trust or estate."[6]

The 1954 Code[7] makes provision for an adjustment of the basis of partnership property at the option of the partnership. This election is allowed where property is distributed to a partner under Section 734, permitting an optional adjustment allowed under that section, if in effect, with respect to such partnership. On the death of a partner, the surviving partners are also allowed to elect to adjust the basis of the partnership property. Such an election is subject to revocation by the partnership under limitations laid down by the Secretary of the Treasury or his delegate. A special rule for allocation of the basis of partnership property sets out the property subject to adjustment and that the basis shall not be reduced below zero.[8] The optional adjustment is

[4] Prentice-Hall—Official Explanation of IRC, 1954, Sec. 24, 412.
[5] Sec. 1361, IRC.
[6] Section 761.
[7] Section 754.
[8] Section 755 (b) (1), (2).

allowed not only where there is a transfer of an interest in a partnership by sale or exchange but also on the death of a partner. Under Section 732 (d) an election is allowed a transference of partnership property other than money within two years after the transfer under regulations made by the Secretary or his delegate, and where the fair market value of the property is in excess of 110 per cent of the adjusted basis of the partnership, the Secretary, or his delegate, may require that the provisions of this subsection be applied.

In computing the taxable income of a partnership, the partnership is to make any election, as mentioned above, affecting the computation, with the exception of the election under Section 901 regarding taxes of foreign countries and possessions of the United States.[9]

Where property is contributed to the partnership by a partner, an election is allowed the partnership as to how gains, losses, depreciations or depletions are to be allocated among the partners in the absence of a provision in the partnership agreement covering the question. Section 704 (c) gives three different rules from which the partnership may choose. The first permits allocation to be made in the same manner as if the property had been purchased by the partnership. The second takes into consideration "the variation between the basis of the property to the partnership and its fair market value at the time of contribution." The third provides for determination "as though such undivided interests had not been contributed to the partnership." The partnership may elect to apply one rule to depreciation or depletion and another to gain or loss.

An election is allowed a partnership to increase the basis of its partnership property that remains in its hands upon making a distribution of property to a partner, but not in complete liquidation of his interest, and the basis of his partnership interest is thereby reduced to zero. The 1939 Code allowed distributions in cash to be made tax-free. The new law allows property distributed in kind also to be made free.[10]

As has been pointed out, an election once made "applies to all transactions during the taxable year and subsequent years, unless

[9] Section 703 (b).
[10] See Sections 732 (a) (1), 736 (b), and 751.

later revoked."[11] The Senate Finance Committee pointed out that an election may be revoked if the partnership can "show that the nature of its business has changed in such a manner that the advantage of the optional adjustment is outweighed by an increased administrative burden to the partnership. . . ."[12]

A contributor to The Journal of Taxation[13] says:

> However, the elections afforded by the 1954 Code to deviate from these general rules are extremely significant, particularly those applicable to changes in the partner's capital. The elective rules will often ease the client's tax burden, and awareness of their existence is, therefore, compulsory. This was one of the more significant areas of partnership taxation which was inadequately treated by the 1939 Code and regulations.

Another radical change in the taxation of partners and partnerships brought about by the new Code is taking into account "unrealized receivables" and "substantially appreciated inventory" in computing a partner's gain or loss on a sale and liquidation of his interest in the partnership as a part thereof. Gain or loss from the sale or exchange of such assets is to be treated as ordinary income.[14] Section 751 (c) states that the term "unrealized receivables" includes 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."

Inventory items belonging to the partnership are considered as substantially appreciated "if their fair market value exceeds—

"(A) 120 per cent of the adjusted basis to the partnership of such property, and

"(B) 10 per cent of the fair market value of all partnership property other than money."[15]

The 1954 Code follows the earlier law in regard to the gain or loss from the sale or exchange of an interest in a partnership; namely, that it is regarded as a capital gain or loss with the exception of "unrealized receivables" and "substantially appreciated inventory."

[11] 13 Institute on Federal Taxation 877. By Loyal E. Keir.
[12] S. Rep. No. 1622, 83d Cong. 2d Sess. 406 (1954).
[13] Paul A. Phillips, Vol. 2, p. 262.
[14] IRC 1954, Section 735 (a) (1), (2).
[15] IRC 1954, Section 751 (c).

This breaking down partnership assets into the two groups, namely, group (A), unrealized receivables and substantially appreciated inventory items, and (B) all other partnership property including money, with the exceptions of a distribution of property that the distributor contributed to the partnership and "payments to a retiring partner or successor in interest of a deceased partner,"[16] prevents tax avoidance by use of a collapsible partnership where gain on the sale is of an interest in a partnership having a substantial increase in value from its unrealized receivables and inventory. Such a sale would have the effect of turning an ordinary gain into a capital gain.[17]

Under the 1954 Code an interest in a partnership continues to be a capital asset under Section 741 "except as otherwise provided in section 751," which has just been considered, "unrealized receivables" and "substantially appreciated inventory." In the case of *Roe* v. *United States*,[18] a lower federal court recently went even further than this when it held that an agreement between the taxpayer's parents and a manufacturer constituted, for income tax purposes, as assignment of patent rights rather than a mere license agreement and payments amounted to a sale of capital assets rather than ordinary income. In another case the appellate court ruled in liquidation proceedings that the proceeds from the sale of pipe that came into the hands of the liquidating agents as capital assets, were subject to capital gains tax and not ordinary income tax.[19]

Cases decided under the 1939 Code made it clear that the sale of a partnership interest was a sale of a capital asset whatever the nature of the partnership property.[20] Under the new Code it all depends on whether the partners sell their interests; or the partnership sells its assets and dissolves; or the assets are distributed to the partners before the partnership dissolves and they sell the assets. Section 735 contains a provision that if a partner who has received a distribution of firm assets sells or exchanges the same within five years after the distribution, the gain or loss from the sale or exchange shall be "other than a capital gain." In

[16] Section 736 (a).
[17] IRC 1954, Section 751 (b). [18] 138 F. Supp. 567 (1956).
[19] *Greenspon* v. *Commissioner of Internal Revenue*, 229 F. 2d 949 (1956).
[20] *Hatch* v. *Com'r*, 198 F. 2d 26 (9th Cir. 1952), and *Kaiser* v. *Green*, 5 C.C.H. (6th Cir. 1954).

determining the period there shall not be included the period the assets were held by the partnership. While the new Code follows the rule that partnership interest is a capital asset, we find these two exceptions in dealing with unrealized receivables and substantially appreciated inventories.

Another special rule under Section 736 regarding payments in liquidation of the interest of a retiring partner or a deceased partner's estate, or successor thereto, covers the question of payment for good will of the partnership, except where the partnership agreement has provided for the same. The amount may "not exceed the reasonable value of the partner's share of partnership good will."[21] One writer[22] points out that there is doubt whether a professional partnership can be considered as having good will within the meaning of these provisions of the 1954 Code since a number of cases had held to the contrary in the past.[23] Payments for good will are not deductible by the remaining partners whether the partnership agreement provides for such payments or not.[24]

Guaranteed payments to a partner are provided for in Section 707 (c). These may be made for the use of capital or for services rendered the partnership. Such payments are treated as income taxable to the partner receiving the payments and deductible by the partnership insofar as they do not exceed the provisions regarding unreasonable salaries. The partner receiving such payments is treated in respect to them as though he were not a member of the partnership.

In the formation of a partnership it is not uncommon for one to contribute property instead of a cash payment for an interest in the partnership. The basis allowed for the property is usually the basis of the contributing partners at the time the contribution is made. It may also happen that a partner sells property he owns to the firm, in which case the basis will be the same as if the partnership had purchased the property from a third person. A problem may arise where the value of the property at the time it is contributed is more or less than what the partner originally paid for it.[25] In Section 704 (c) provision is made for allocating

[21] Sen. Rep. No. 1622 at p. 395.
[22] Robert M. Musselman, 2 Journal of Taxation 25 (1955).
[23] See Max Swiren (7th Cir., 1950), 183 F. 2d 656.
[24] Section 736 (b) (1).
[25] Sections 721, 722, 723 and 752 (c).

among the partners the "depreciation, depletion, gain or loss" of contributed property "in the same way as if such property had been purchased by the partnership." Of course, the partnership agreement may contain a stipulation as to how such deductions shall be handled.[26] Another provision in the new Code allows a contract provision to be disregarded where it is evident its purpose is tax evasion.[27] No gain or loss chargeable to the partnership itself on contributed property is recognized. It has been so held by the courts.[28] If the partners contribute property in which they hold undivided interests that are identical to their interests in the partnership capital, deductions for depreciation, etc., are to be treated as though such undivided interests had not been contributed to the partnership.[29]

The fourth provision of this section, 704 (d), places a limitation on losses allowed a partner. The limitation is the adjusted basis of a partner's interest in the firm at the end of the partnership year in which the loss occurs. The excess is allowed to be deducted at the end of the partnership year in which such excess is repaid to the partnership.

The authors of a recent article in a leading law review state that

> [T]he most baffling question in the entire muddled field of partnership taxation was the proper tax treatment to be accorded property contributed at a value other than its tax basis. . . . In addition, the policy of non-recognition of gain or loss on the contribution, coupled with the fact that more than one type of solution could be encompassed within either the entity or aggregate approach, made the formulation of rules dealing with contributed property extremely difficult.[30]

The distribution of property other than cash made to a partner but not in liquidation of his interest in the partnership raises problems under the 1954 Code. Of course, in the case of a distribution of cash there is no realization of gain or loss to either the partner or the partnership.[31] If there is an exchange or sale between the

[26] Section 704 (c) (2).
[27] Section 704 (b) (2).
[28] *Helvering* v. *Archbald,* (2d Cir., 1934), 70 F. 2d 720.
[29] Section 704 (c) (3).
[30] The Internal Revenue Code of 1954: Partnerships. By J. Paul Jackson and others, 54 Col. L. Rev. 1184, at 1204 (December, 1954).
[31] Section 731 (b).

partner and the partnership of property and the distributee partner receives unrealized receivables or substantially appreciated inventory, as we have already seen, the partner receives other than a capital gain and will be liable for a tax on the gain at ordinary income rates.[32] The question may arise as to whether Section 751 (a) (2) prevents such a distribution from coming within the provisions of Section 751 (b).[33] Where the distributee partner receives a distribution in kind no gain is recognized to the extent thereof whether the distribution is received in the usual course of the partnership business or in liquidating all or part of the partner's interest.[34] The writer just cited makes the following criticism of Section 751 (b): "Serious doubts are raised as to the wisdom of attempting to apply this section in its present form to any distribution other than those in complete liquidation of a partner's interest, despite the fact that the alternative is to leave a substantial gap in this loophole- closing provision."[35]

Under the entity theory of partnerships a partner can buy from or sell to the partnership just as though he were dealing at arms' length with a stranger. There are, however, two exceptions made in the new Code: a partner owning fifty per cent or more of the partnership is not allowed any loss on a transaction with the partnership.[36] Where such a loss is disallowed on a subsequent sale of the property involved, no gain will be recognized except on the excess over the loss that was earlier disallowed. In the case of a partner owning eighty per cent or more in the partnership, ordinary gain, not capital gain, is assessed.[37]

These two exceptions are in keeping with the efforts made under the 1954 Code to prevent an evasion of taxes by reducing the tax rate on a gain in a transaction from that payable on an ordinary gain to that payable on a capital gain. The rule applies where the partner owns eighty per cent or more, "directly or indirectly," of the capital or profits in either or both of two partnerships involved in the sale or exchange of any property which is not a capital asset.

[32] Section 751 (b).
[33] See Little—Partnership Distribution under 1954 Code, 10 Tax Law Rev. 161, 335, at 348 (1955).
[34] Section 731 (a) (1).
[35] *Supra*, n. 33.
[36] Section 707 (1) (A).
[37] Section 707 (b) (2) (A).

Under the 1939 Code it was possible for one to make use of a partnership as a means for converting ordinary gains into capital gains and thereby reducing the tax on a transaction. This use of the so-called collapsible partnership is no longer allowed under the new Code. By receiving capital assets in liquidating his interest in the partnership, the retiring partner can no longer avoid the ordinary income tax on his interest in unrealized receivables or substantially appreciated inventory items held by the partnership.[38] Of course, if the partnership has neither unrealized receivables nor substantially appreciated inventory items this problem is not involved in the transaction.

A partnership is to be considered as continuing until terminated.[39] Under the 1954 Code it is considered terminated if "(A) no part of any business or venture of a partnership continues to be carried on by any of its partners in a partnership, or (B) within a twelve-month period there is a sale or exchange of fifty per cent or more of the total interest in partnership capital and profits." Where two or more partnerships merge, the statute provides that the consolidating partnerships, the members of which own an interest in the new firm constituting fifty per cent or more of the capital and profits, shall be considered as the continuing partnership. If a division of a going partnership is made, creating two or more partnerships, the Act deems the resulting partnership whose members own fifty per cent or more of the capital and profits of the same shall be considered as the continuation of the original partnership.[40] The tests laid down in the subdivisions of Section 708 are bound to present many problems for future solution. For instance, one writer has suggested that in the case of a merger it must first be determined what is the amount of the interests sold or exchanged by combining the original partnerships involved in the merger; the interests in the non-continuing partnerships; and the application of the twelve-months test to the continuing partnership.[41] Since the statute considers a partnership terminated by "the sale or exchange of fifty per cent or more of the total interest in the partnership" within a twelve-months

[38] Sections 735, 741 and 751 (b).
[39] Section 708.
[40] Section 708 (b) (2) (A) and (B).
[41] Paul Little, 13 Institute on Federal Taxation (N. Y. Univ.) 897 at 917 (1955).

period, it has been suggested that under this provision of the law the partnership is terminated notwithstanding an agreement of the partners to the contrary; and the taxable year of the partnership is closed by such a sale or exchange.[42]

While the decease of a partner is not enumerated in the Code as one of the causes for terminating a partnership, it does present several problems under the tax code that may call for adjustment. The treatment to be given payments for the deceased partner's interest in the firm is one of these. If his interest includes amounts paid for unrealized receivables or for good will in the partnership, except where the partnership agreement has made other provision as to good will, the payments are regarded as ordinary income to the estate.[43]

It has been pointed out by one authority that payment to the deceased partner's estate or successor may be made in three ways: payment of a lump sum, installment payments, or by a complete liquidation of the partnership.[44] By the first method no gain or loss is recognized provided there are no unrealized receivables, appreciated inventory or good will involved. Where installments are made to deceased's estate over a fixed number of years, if there were no unrealized receivables, the payments are treated as distributions under Section 731. Since the basis for the interest of deceased would be taken at the value at the time of his death there would be no gain to be taxed. If the third method be followed and the partnership liquidated, there would probably be taxable partnership income accruing between the time of the partner's death and the liquidation of the partnership. The estate would be responsible for the deceased's portion of the tax assessed on this income. All of these methods of dealing with a deceased partner's interest, when put into practice, are very likely to raise unforeseen difficulties. It is made evident, however, from Section 736 (b) that the payments in liquidation for the interest of a retiring partner or a deceased partner are to be deemed in exchange of such partner's interest in the partnership and not as a distribution of partnership income, and the distributee in such case is liable only for a capital gains tax on the excess of the

[42] Loyal E. Keir, 13 Institute on Federal Taxation, 883 at 884 (1955).
[43] IRC 1954, Sections 736 (a) and 736 (b) (2). See also Section 691.
[44] Partners and Partnerships. By J. Nelson Young. 1955 Volume of Illinois University Law Forum, p. 533, at 581.

amount received over the basis of the partnership interest. Other payments made to a deceased partner's estate or successor, as already pointed out, include deceased's interest in unrealized receivables, payments under mutual insurance policies and those assignable to good will where the partnership agreement has not provided for payment of good will.

As already suggested, a great many problems arise when a partnership distributes property to a partner or the representative of a deceased partner either in partial liquidation or in taking over the partner's or deceased partner's interest in the firm. Of course, if the distributed property is a return to the partner of his investment in the partnership, no gain or loss is recognized until the property received is disposed of by the partner. His basis is that of the partnership provided that basis does not exceed the adjusted basis of the partnership interest of the partner to whom the distribution is made.. If it does, the partner's basis is his basis for the distributed property.[45] Where the property consists of unrealized receivables or greatly appreciated inventory items, the gain or loss is treated as "gain or loss from the sale or exchange of property other than a capital asset."[46] However, in a final liquidation a partner receives taxable income where the cash distribution exceeds his adjusted basis for his interest in the partnership.

The tax problems arising from distributions to partners, in either partial liquidations or total liquidations, are sufficiently varied to lead one to the conclusion that each case depends upon rules of its own. The Revenue Service as well as the several tax services has sought to simplify the problems by the use of examples. To gain some idea of the tax results following from a partial or total distribution of a partner's interest in a partnership, it seems worthwhile to look at some of these examples. The Revenue Service uses the following two examples in illustrating the determination of gain or loss on a distribution to a partner:

> Example 1. In dissolution of his partnership, a partner receives inventory which has a basis to him of $19,000. Within 5 years he sells the merchandise for $24,000. The $5,000 gain is taxed to him as ordinary income. If he held it for more than 5 years, his gain would be capital gain,

[45] Sections 731 (a) (1) and 732 (a) (2).
[46] Sections 735, 751 (c) and 751 (d) (2).

assuming the merchandise was in all other respects a capital asset in his hands.

Example 2. A partner in the dissolution of his law firm received his share of accounts receivable amounting to $17,000. Therefore, the Special Rule did not apply. Since the partnership was on the cash basis the receivables had a basis to the partner of zero. If the receivables are later paid, or if the partner sells them, the amount received would be ordinary income. The 5 year rule, illustrated in Example 1, does not apply.[47]

A more complicated situation is presented in Federal Tax Handbook, 1957.[48] It reads as follows:

Example 8: X is a transferee partner in the XY partnership. The partnership owns, among other assets, A, a depreciated asset with a common basis to the partnership of $1,000 and a special basis adjusted to X of $200, and B, another depreciated asset with a common basis of $800 and a special basis adjusted to X of $300. X and Y agree that X will receive a distribution of A, and Y will receive a distribution of B, with all other property to remain in the partnership. With respect to Y, the partnership basis of property B is $800, the common partnership basis. Property B will, therefore, have a basis of $800 in Y's hands. With respect to X, however, the partnership basis of property A is $1,500, the common partnership basis of $1,000 plus X's special basis adjustment of $200 for property A, plus X's additional special basis adjustment of $300 for property B in which he has relinquished his interest.

In dealing with liquidating distributions the same publishing firm gives the following example, which is helpful in solving these problems:

A's basis for his partnership interest is $100. On liquidation he receives $40 cash, and other property having a basis of $60 and a value of $70. He has, in fact, a $10 gain, but it is not recognized since the cash does not exceed the basis of his interest. The basis of the property to him is $60. If the property consists of inventory with a basis of $20 and a value of $30, and a capital asset with a basis and value of $40, his basis for the inventory is $20 and his basis for the capital asset is $40. Hence, on sale within 5 years of inventory for $30, he realizes $10 ordinary income.[49]

[47] Tax Guide for Small Business, 1956, p. 103. [48] Prentice-Hall, Inc., p. 327.
[49] Prentice-Hall, Inc.: Concise Explanation of the Internal Revenue Code, p. 31, 1954.

Finally, let us consider a problem given by a practicing attorney to illustrate the effect of a partnership exercising its election under the optional adjustment allowed under Section 755. He suggests that

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

These examples show how diversified the problems arising in partnership sales or distributions may be. Nearly every one depends upon the facts involved, so it is very difficult to lay down general rules that may be of help when a case arises.

In conclusion, it may be said that it has been the purpose of the writer of this article to consider briefly some of the more difficult questions that may confront the practitioner in applying the provisions of Subchapter K of the Internal Revenue Code of 1954, which was intended to simplify the taxation of partnerships.

[50] Wallace C. Murchison, Partnerships under the New Revenue Code, 33 North Carolina Law Review, 231, at 247 (1955).