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SOME ASPECTS OF THE TAXATION OF PARTNERS AND PARTNERSHIPS UNDER THE NEW INTERNAL REVENUE CODE

Paul A. Phillips

With the Internal Revenue Code of 1954 not yet three months old, reams have already been written about it, more reams are being written and more will be written. It would be interesting to speculate with the statisticians, the “believe-it-or-not” and the “strange-as-it-seems” boys as to how many times around the globe all the lines written and to be written on that Code would stretch, if laid end to end.

It seems doubtful whether any substantial contribution to the understanding of the partnership provisions of that Code can be contributed by these lines. This is particularly true in view of the fact that the most significant lines have not, at this writing, been drafted. The reference is, of course, to the regulations. And as anyone who has wrestled with the 1939 Code will bear witness, it would have been easier for Theseus to penetrate the Labyrinth without his spool of thread than for us mortals to understand, work with and live with the Code without the regulations. Especially in an area as complex as the taxation of partners and partnerships guidance from regulations is essential. Recognition of this hard fact by Congress is evidenced by the many instances where the “Secretary or his delegate” are called upon by the statutory language of the new Code to fill in the details necessary for the implementation of the congressional policy.

It is with some misgivings, then, that we undertake to explain even so narrow a corner of the new tax law as the manner of its operation upon certain changes in the membership of partnerships.

Before getting down to details, one general observation may be made. The general rules under the 1954 Code for the treatment of partnerships are not, except in a few areas, much different from those of former law and practice. However, the elections afforded by the 1954 Code to deviate from these general rules are extremely significant. Although this makes the lawyer's work more burdensome, the elective rules will often ease the client's tax burden and awareness of their existence is, therefore, compulsory.

This article deals with the rules of the 1954 Code applicable to certain changes in partnership membership. In brief, the fol-
lowing situations will be discussed: (1) The sale of the partner-
ship business; (2) The sale of the interest of a partner; (3) The
retirement (or withdrawal) of a partner. Like the statute, the
article must distinguish between partnerships whose assets in-
clude no “unrealized receivables” or “substantially appreciated in-
ventory” and those whose assets include such items. The latter
may be colloquially referred to as “collapsible partnerships”, the
former as “non-collapsible” partnerships.

I. THE NON-COLLAPSIBLE PARTNERSHIP

A. Sale of Partnership Business

One of the more significant areas of partnership taxation
which were inadequately treated by the 1939 Code and regulations
was the consequences of sale of the partnership business. The
problem manifested itself in the following questions:
(a) Is the sale of a partnership interest the sale of a capital
asset?
(b) If it is the sale of a capital asset, is it such when all
of the partners sell their interests?
(c) If such a sale is a capital transaction and if the partner-
ship sells its assets at a gain and dissolves, should the partners
recognize their distributive share of the partnership gain or should
this be treated the same as a sale of partnership interests?
(d) If the sale of a partnership interest is a capital trans-
action, what of the sale of an interest in a partnership whose
assets consist of large quantities of appreciated inventory, i.e. the
so-called “collapsible” partnership?
(e) What of the purchaser's side of the sale? Having
bought a partnership interest, at a price reflecting the value of
the partnership assets, should the purchaser be required (or per-
mitted) to pick up his distributive share of the partnership gain
(or loss) upon a subsequent sale of the assets by the partnership?

Some of the foregoing questions were answered by the courts
under the old law. Swiren\(^1\) and Hatch\(^2\) made it clear that the sale
of a partnership interest constitutes the sale of a capital asset
even where all the partners sell and regardless of the character
of the partnership assets. Hatch and Williams v. McGowan\(^3\) made
it clear that the sale of assets by the partnership followed by dis-
solution of the partnership results in the recognition of gain to

\(^1\) Swiren v. Commissioner, 183 F.2d 656 (7th Cir. 1950).
\(^2\) Hatch v. Commissioner, 198 F.2d 26 (9th Cir. 1952). Kaiser v. Glenn,
\(^3\) 3152 F.2d 570 (2d Cir. 1945).
the partnership and the partners are required to recognize their
distributive share of partnership gain. As to the purchaser, it
was conceded on all sides that payment of the purchase price
merely gave him a basis for his acquired partnership interest and
he was not to be treated differently from any other partner so
far as distributive share of partnership gain was concerned.

The new Code provides better answers than the old Code to
those questions to which it addresses itself. However, it does
leave the area of the *Hatch* controversy open, for different results
will follow depending on whether the partners sell their interests,
or the partnership sells its assets and dissolves, or if it dissolves
and the partners sell, or if a current distribution precedes dis-
solution. To illustrate, let us assume a partnership consisting of
Nim, Bardoff & Pistol, doing business as N.B.P. Co., has the fol-
lowing assets:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$90</td>
</tr>
<tr>
<td>Depreciable Property Used in Business Held for More Than 6 Months</td>
<td>100</td>
</tr>
<tr>
<td>Securities</td>
<td>80</td>
</tr>
<tr>
<td>Cash</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td><strong>$360</strong></td>
</tr>
</tbody>
</table>

Nim, Bardoff and Pistol all have a basis of $120 for their
respective interests. All share equally in capital and profit.

*Situation 1:* Nim, Bardoff and Pistol desire to dispose of the
business. They have the following alternatives: (a) The part-
nership can sell the assets and distribute the proceeds to the part-
ners; (b) The partners can sell the assets after distribution there-
of by the partnership and (c) The partners can sell their partner-
ship interests.

If alternative (a), sale of the assets by the partnership, is
chosen the partnership will recognize ordinary gain of $10, a Sec-
section 1231* (Section 117 (j)* gain of $20 and a capital gain of $30.
Section 702 requires that Nim, Bardoff and Pistol each recognize:

| Ordinary Gain | $ 3.33 |
| Section 1231 Gain (Capital) | 6.67 |
| Capital Gain   | 10.00 |
| **Total Gain** | **$20.00 ($3.33 ordinary)** |

* Refers to old code.
If alternative (b), dissolution of the partnership and sale of the assets by the partnership, is chosen, no gain will be recognized on the dissolution under Section 731. Each partner will under Section 732 take the assets at an aggregate basis equal to his partnership interest basis or $120. Section 732(c) requires this aggregate basis to be allocated in the following manner: first, the inventory received by the partner must be given a basis equal to its basis in the partnership's hands ($30) and the cash be given a value basis ($30). The remaining $60 of basis is allocated in accordance with partnership basis for the assets—$33.33 to the Section 1223 assets and $26.67 to the securities. Sale of these assets by the partners would result in the following:

<table>
<thead>
<tr>
<th>Category</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Gain</td>
<td>$3.33</td>
</tr>
<tr>
<td>Section 1223 Gain (Capital)</td>
<td>6.67</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>10.00</td>
</tr>
<tr>
<td><strong>Total Gain</strong></td>
<td><strong>$20.00</strong></td>
</tr>
</tbody>
</table>

Thus the same result will occur whether the partnership sells or dissolves and the partners sell.

If, however, the partners sell their partnership interests, the $20 gain realized by each would all be capital gain. Section 741 so provides.7

Thus it is clear that where there are no “unrealized receivables” as defined in Section 751(c) (2) nor “substantially appreciated” inventory as defined in Section 751(d), the partners' choice as to the method of disposing of the partnership business can make a significant difference even where there is no attempt to manipulate.

The new Code presents some narrow area for manipulation which may enable the limited conversion of ordinary income into capital gain. To illustrate, let us assume that Nim is in a lower tax bracket than Bardoff and Pistol. The three have been advised that sale of their partnership interests would be more advantageous tax wise than sale of the partnership assets. However, the purchaser doesn’t see the sense of buying three partnership interests—all he wants are the assets, not a partnership. Since realization of ordinary income is anathema to Bardoff and Pistol, although not to Nim, the following is suggested: the partnership should dissolve, distributing to Nim the inventory and $40 cash, to Bardoff the depreciable property used in the business and $20

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6 Section 735 requires the same character of gain or loss to be recognized by the distributee partner as the partnership would have recognized.

7 Where inventory appreciation is substantial, ordinary gain will result with respect to the inventory items. See discussion infra.
cash, to Pistol the securities and $30 cash. Then the individual distributees should sell to the purchaser the assets received by them in kind. The following results:

Bardoff, who under Section 732(b) would take the depreciable property at a basis of $120 (partnership interest basis) less $20 (cash received) or $100, would recognize $20 capital gain on his sale of the property at $120 (Section 735).

Pistol, who under Section 732(b) would take the securities at a basis of $120 (partnership interest basis) less $30 (cash received) or $90, would recognize $20 capital gain on his sale of the securities at $110 (Section 735).

Thus the high bracket taxpayers would recognize only capital gain—just as they would have on a sale of their partnership interests. So far so good. But Nim would recognize $20 ordinary gain although there was only $10 appreciation in the inventory on the sale of the inventory (Section 735). For Nim to recognize more ordinary gain than the partnership would have recognized if it had sold the inventory seems an odd result. But how it occurs can be explained:

Section 732(b) states that the basis of property received in kind upon the liquidation of a partner’s interest in the partnership should be the partner’s basis for his partnership interest less the cash received. In Nim’s case this would be $120 less $40 or $80. If he sells the inventory at $100, his gain is $20—all ordinary gain because Section 735 provides that the character of gain or loss on sale of inventory within five years of its distribution by the partnership is gain or loss from the sale of property other than a capital asset. Furthermore, Section 731(a)(1) provides that no gain shall be recognized on dissolution except to the extent cash received exceeds the distributee’s basis for his partnership interest. Hence a basis in Nim’s hands lower than the part-

8 Section 731(a)(2) provides for recognition of capital loss where only inventory and cash is received and the basis thereof to the partnership is less than the distributee’s partnership interest basis. This is necessary because the partner’s basis for inventory received severally may not be greater than the partnership’s basis (section 732(c)). Thus if N.B.P. Co.’s basis for the inventory were $70, Nim would recognize a $10 capital loss on the dissolution and would recognize a $30 ordinary gain on the sale of the inventory (the same gain the partnership would have recognized)—resulting in the correct net gain of $20. If there were a comparable provision on the gain side, that is a provision requiring the basis of inventory to carry over to the distributee partner and a recognition of capital gain on dissolution to the extent the basis of the inventory so determined exceeds the partner’s partnership interest basis less cash received, Nim would take the inventory at a $90 basis, recognize $10 capital gain on the dissolution and $10 ordinary gain on sale of the inventory.
nership's basis for the inventory is required.

Although the presumably equitable result would be a $10 ordinary gain and $10 capital gain to Nim, perhaps, it might be argued that making his entire $20 gain ordinary is the correct price to require for permitting Bardoff and Pistol to recognize capital gain only.

The argument cannot hold water because not only could all the partners have achieved capital gain treatment had their partnership interests been sold, but the pitfall of excessive ordinary gain can also be avoided in the following manner:

The inventory is distributed to Nim but not "in liquidation of (his) interest". Under Section 732(a) such a distribution will give Nim a basis of $90 for the inventory, i.e. the same as the partnership's basis. Nim then will sell the inventory for $100, recognizing $10 ordinary gain. Then the partnership will dissolve, distributing $40 cash to Nim, the depreciable property and $20 cash to Bardoff and the securities to Pistol. Bardoff and Pistol proceed to sell the property received and each recognizes his $20 capital gain.

Nim, having received (in a distribution other than in liquidation of his interest) property with a basis of $90, has had his partnership interest basis reduced to $30 (Section 733). Thus when he received $40 cash in dissolution of the partnership, he recognized capital gain of $10 (Section 731(a)(1)).

Thus $10 ordinary gain and $10 capital gain to Nim and $20 capital gain each to Bardoff and Pistol would be recognized.

Although the area in which different results will occur depending on which route is followed is small, the existence of this potential may raise again the question of whether the partnership sold its assets or the partners' their interest—just as it arose in Hatch under the old law. Actually, the question itself is a silly one for in substance the transaction was the sale of the partnership business and the route followed should be immaterial. If solely capital gain treatment would result if one route were followed, then solely capital gain treatment should result no matter what the route.

Situation 2: Let us assume that Nim wishes to sell to Jones his interest in N.B.P. Co. He does so for $140, the value of his interest in the partnership assets. As previously noted, Nim will recognize gain of $20, all capital (Section 741). Jones will have a cost basis of $140 for his partnership interest (Section 742).

Under the 1939 Code this transfer of a partnership interest could have no effect on the basis of the partnership assets. Thus, for instance, a sale by the partnership of its inventory for $100
would result in $10 partnership ordinary gain, of which Jones would be required to pick up $3.33. Of course, Jones’ greater partnership interest basis would result in a lesser gain (or greater loss) were all the assets to be sold and the partnership dissolved or would be reflected in an increased basis for any assets distributed to him in kind. However, the day of equalization might never arrive, or, when it did arrive, the lesser gain or greater loss might be capital whereas the gain which Jones had picked up as his distributive share of partnership gain on the inventory’s sale was ordinary gain.

The 1954 Code (Section 743(a)) prescribes as its general rule the 1939 Code rule that transfer of a partnership interest has no effect on partnership asset basis. However, it provides an option in Sections 743(b) and 754 to adjust the partnership asset basis to reflect the cost price to Jones. The adjustment will only benefit Jones and not Bardoff and Pistol.

The operation of the adjustment is as follows: Section 743(b) provides that the basis of the partnership’s assets may be increased by the excess of Jones’ partnership interest basis ($140) over his proportionate share of partnership asset basis. “Proportionate share” of partnership asset basis is determined in accordance with Jones’ interest in partnership capital, here one-third or $120. Thus there is an increase of $20 to be made to the bases of three different assets and that amount must be allocated among those assets. Section 755(a) provides that the allocation be made “in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership property” or any other manner prescribed by regulations. What is meant by reducing the difference between value and basis? What is meant is not an allocation in accordance with basis nor an allocation in accordance with value but an allocation in accordance with relative appreciation of the assets. In the example given, the inventory has an appreciation of $10, the depreciable property of $20 and the securities of $30. Thus

\[
\frac{10}{60} \times 20 = 1/6 \times 20 \text{ (the aggregate adjustment) } = 3.33 \text{ is allocable to the inventory; } \frac{20}{60} \times 20 = 1/3 \times 20 \text{ (depreciable property appreciation) } = 6.67 \text{ allocable to the depreciable property and } 30 \times 20 = 10 \text{ to the securities.}
\]

Consequently, the inventory would have a basis of $93.33, the depreciable property a basis of $106.67 and the securities a basis
of $90—but only so far as Jones is concerned. As for Bardoff and Pistol, the partnership’s basis for its assets is undisturbed. Should the partnership sell the inventory, for instance, for $100, it would recognize a gain of $6.67. However, Jones would pick up none of that gain as his distributive share and Bardoff and Pistol would pick up $3.33 each. If the inventory were sold for $109, Jones would pick up $3 gain and Bardoff and Pistol $6.33 each.

If we assume the depreciable property, whose basis after Jones comes in is $106.67, is to be depreciated at 20%, the total depreciation would be shared as follows: $6.67 to Bardoff and Pistol each, and $8 to Jones.

As can readily be seen, complications may exist in making the basis adjustment and in keeping records as to the basis of the assets with respect to the various partners. In many instances, particularly in large partnerships with many different assets, the complications may be too great and equity will yield to simplicity. The important thing is that the existence of Section 743(b) will make it possible to achieve equity where the partnership finds its achievement practicable.

The election is available with respect to transfers occurring during a partnership year beginning after December 31, 1954. Once the election to adjust asset basis upon a transfer has been made, it is effective for all subsequent transfers. The revocation of the election is subject to such limitations as regulations shall prescribe. Thus if a sale of an interest occurs at a price below that interest’s proportionate share of partnership asset basis, a downward adjustment of asset basis must be made, if a previous election to adjust asset basis has been made—unless the regulations will permit the partnership to adjust basis upward but avoid a downward adjustment.

Before leaving the election to adjust basis on sale of a partnership interest, one more word on the allocation of the adjustment seems necessary. The Senate Finance Committee Report,9 contains a sentence which seems misleading if not incorrect. It reads “...if there is an increase in basis to be allocated to the partnership assets, the entire adjustment must be allocated only to the assets whose values exceed their bases in proportion to the difference between the value and basis of each. No adjustment is to be made to those assets whose bases exceed their values since this would increase, rather than reduce, the difference between

their values and their bases.” Consider the application of this language to the following:

Assume N.B.P. Co. has the following assets:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$90</td>
</tr>
<tr>
<td>Depreciable Property A</td>
<td>110</td>
</tr>
<tr>
<td>Depreciable Property B</td>
<td>70</td>
</tr>
</tbody>
</table>

$270 $300

If Jones buys Nim’s interest for $100, there is a $10 upward basis adjustment to be made. This would be allocated according to the Committee Report, $7.50 to depreciable property B, and $2.50 to the inventory. The basis of depreciable property A would remain unchanged. This result is not completely consonant with the policy of the election—namely to have the purchaser’s cost reflected in his proportionate share of the partnership asset basis so that he will not be taxed with respect to appreciation for which he has paid. On the other hand, and even more important, with respect to depreciable property A, Jones will receive the benefit of a basis higher than the asset’s value at the time he purchased his interest in it.

Obviously, as Sections 743(b) and 755 are written and as the Committee Report interprets them, the adjustment formula will work out properly only where all of the assets have a value equal to or greater than their bases. Where some assets have a basis in excess of value, although the aggregate asset values are greater than the aggregate asset basis, the formula does not achieve the desired results.

The proper result in the example given would be a downward adjustment of $3.33 to the basis of depreciable property A, an upward adjustment of $3.33 to the inventory and a $10 upward adjustment to depreciable property B—a net upward adjustment of $10. It is hoped there will be room in the regulations to correct the defect. The remedy is simple—the regulations need only prescribe that the basis of those assets whose basis exceeds their value shall be reduced by the transferee’s proportionate share of that excess and the basis of those assets whose value exceed their basis shall then be increased by the transferee’s proportionate share of that excess.10

10 Where a partner has died, the same election is afforded the partnership with respect to the decedent’s successor in interest as with respect to the purchaser. The date of death (or optional valuation date) is of course the basis for the successor’s partnership interest value and serves as the measure of the adjustment.
Situation 3: The provisions dealing with the withdrawal of a partner, although complicated, are readily understood if considered in the light of the provisions dealing with the sale of an interest.

Let us assume the same partners, Nim, Bardoff, and Pistol in the same partnership N.B.P. Co., with the same assets:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$90</td>
<td>$100</td>
</tr>
<tr>
<td>Depreciable Property</td>
<td>100</td>
<td>120</td>
</tr>
<tr>
<td>Securities</td>
<td>80</td>
<td>110</td>
</tr>
<tr>
<td>Cash</td>
<td>90</td>
<td>90</td>
</tr>
</tbody>
</table>

$360 $420

and the same basis for their partnership interests—$120. Let us assume that the partnership agreement provides, in effect, that upon withdrawal of a partner he shall be paid either in cash or kind his proportionate share of the value of the partnership assets. Let us assume that Nim withdraws. He takes the $90 partnership cash and Bardoff and Pistol each pays $25 to him—a total of $140. There has been a distribution in partial liquidation of Nim’s interest and a sale to Bardoff and Pistol of the balance of his interest. His basis for the balance of his interest being $30, he realized a gain of $20 on the sale.

The optional basis adjustment rule of Section 743(b) may be applied to increase the basis of the partnership assets in an aggregate amount of $20, representing the excess of $50 (the cash paid by Bardoff and Pistol for Nim’s interest) over $30 (the proportionate share of the asset basis allocable to the interest acquired).

The transaction may also be considered as a contribution to the partnership of $25 each by Bardoff and Pistol and a distribution in termination of Nim’s interest of $140, resulting in a $20 recognized gain to Nim. This could bring into operation the “Optional Adjustment to Basis of Undistributed Partnership Property” rules contained in Sections 734 and 754.

Section 734(a) states the general rule that the basis of partnership assets shall not be adjusted upon distribution of property to a partner unless the election provided in Section 754 is in effect. The method of adjustment where such election is in effect is set forth in Section 734(b).

The adjustment provided for is an increase in basis to the extent gain is recognized to the distributee and to the extent the
property's basis in the partnership's hands exceeds its basis in the distributee's hands.

In the situation under discussion, there is no property whose basis in the partnership's hands exceeds its basis in the distributee's hands—since only cash was distributed. The situation would call for an upward adjustment of partnership asset basis since a $20 gain was recognized by Nim.

The method of allocation of the increase is the same as that discussed in connection with the sale of an interest. The result of the allocation will be to eliminate Nim's proportionate share of the asset appreciation, that is: the inventory will have a basis of $93.33; the depreciable property a basis of $106.67; and the securities a basis of $90. Thus, a later sale of these assets will find Bardoff and Pistol picking up only their own shares of the asset appreciation and not the appreciation which occurred while Nim was in the firm and for which Bardoff and Pistol paid when they bought Nim's interest upon which Nim paid taxes.

Having discussed the situation where Nim received cash to the value of his interest in the partnership, we can turn to the situation where Nim receives property in kind. Assume the assets are the same as above set forth:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$90</td>
<td>$100</td>
</tr>
<tr>
<td>Depreciable Property</td>
<td>100</td>
<td>120</td>
</tr>
<tr>
<td>Securities</td>
<td>80</td>
<td>110</td>
</tr>
<tr>
<td>Cash</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>$360</td>
<td>$420</td>
</tr>
</tbody>
</table>

Assume the same basis for the partnership interest—$120 each. Nim wishes to withdraw. The partners agree that Nim is to receive the inventory basis $90, value $100 and $40 cash. Under Section 731 no gain is recognized to Nim on the distribution. Under Section 732(b) Nim's basis for the inventory is equal to his partnership interest basis, $120 less cash received $40 or $80. Since the partnership basis for the inventory was $10 greater than the basis in the hands of the distributee, Nim, the election would produce a $10 upward adjustment to the basis of the partnership assets.

It is difficult to grasp the theory of this "optional basis adjustment" upon withdrawal of a partner from the statutory language. Where only cash is distributed, adjustment to the extent of recognized gain or loss is not an unfamiliar concept. But an
adjustment by the amount of the excess of basis to the partnership over its basis in the hands of the partner sounds strange.

It can be expressed as an increase to reflect the cost to the surviving partners of the interest of the withdrawing partner in the remaining partnership assets. The amount of the adjustment may be expressed as the excess of that cost over the proportionate share of the partnership's basis for those assets attributable to the interest of the withdrawing partner, reduced by the amount of gain realized by but not recognized to the surviving partners on the distribution.

In our example, Bardoff's and Pistol's cost for Nim's interest was the following:

\[
\begin{align*}
2/3 \text{ of the inventory} & \quad \text{-- value --} \quad $66.67 \\
2/3 \text{ of } $40 \text{ cash} & \quad \text{-- value --} \quad $26.66 \\
\hline \\
\text{Total} & \quad \text{--} \quad $93.33
\end{align*}
\]

The remaining assets attributable to Nim's interest were the following:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/3 Depreciable Property</td>
<td>$33.33</td>
</tr>
<tr>
<td>1/3 Securities</td>
<td>26.67</td>
</tr>
<tr>
<td>1/3 $50 Remaining Cash</td>
<td>16.67</td>
</tr>
<tr>
<td></td>
<td>$76.67</td>
</tr>
</tbody>
</table>

Thus Bardoff and Pistol have paid $93.33 value for $76.67 of basis (value-$93.33), an excess of value over basis of $16.67. However, $6.67 of that value constituted Bardoff and Pistol's share of the unrealized appreciation in the inventory—the use of which to buy out Nim did not result in recognition of gain to them. Consequently, it may not be considered an element of cost in determining their cost basis for Nim's interest in the undistributed assets. Reducing the $16.67 of excess of value over the amount of basis attributable to Nim's interest by the $6.67 "unrecognized gain," leaves an adjustment to basis to be made of $10.

Expressed in this way as an adjustment to be made with respect to the remaining partners' cost for the retiring partner's interest in the undistributed partnership assets, the optional adjustment does equity and reaches proper results. However, as expressed in the statute, the results may be inequitable.

Assume the following assets:
Basis  Value

<table>
<thead>
<tr>
<th>Inventory</th>
<th>$90</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciable Property</td>
<td>100</td>
<td>125</td>
</tr>
<tr>
<td>Securities</td>
<td>80</td>
<td>125</td>
</tr>
<tr>
<td>Cash</td>
<td>175</td>
<td>175</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$445</strong></td>
<td><strong>$525</strong></td>
</tr>
</tbody>
</table>

Assume Nim dies and the partnership buys out his interest by the distribution to his estate of the $175 cash. Since the estate’s basis for its interest in the partnership is its date of death value—$175, there is no gain to the estate. Also, of course, there is no excess of basis for the cash in the hands of the partnership over its basis in the hands of the estate. Consequently, no adjustment may be made under Section 734(b) by the partnership. If the statute expressed the adjustment as based on the excess of the value of the interest of the surviving partners in the property distributed (2/3 x 175 = $116.67) over the proportionate share of the basis of the assets attributable to the deceased partner (1/3 x 270) = $90, the proper result could be obtained—an adjustment of $26.67.

Under the Code, as drafted, if alternative methods were used to buy out Nim’s estate, the adjustment could, apparently, be obtained:

Assume the partnership distributes the $175 to the surviving partners who then buy the decedent’s interest in the partnership for that amount. The result would appear to be an elective adjustment to basis under 743(b) of $26.67 (excess of basis of interest in partnership of each partner ($148.33 less $87.50 distributed to him plus $87.50 amount paid for interest of deceased partner) over proportionate share of basis of partnership assets ($135) equals $13.33, multiplied by 2).

Assume the partners make payment out of their own funds to the deceased partner’s estate of $87.50 each. The result would appear to be an elective adjustment to basis under Section 743(b) of $26.67 (excess of basis of partnership interest ($87.50 + $148.33 = $235.83) over proportionate share of basis of partnership assets ($222.50 = $13.33, multiplied by 2). The partnership then, of course, distributes the $87.50 each to the partners.

That such disparate results should occur depending on which way the transaction is shaped seems wrong. If it is a buy-out by the partnership, no adjustment. If it is a buy-out by the other partners with partnership funds or with their own, an adjustment of $26.67.
Thus care in choosing the form of the transaction may be decisive if we assume that no contention will be raised by the government to the effect that a buy-out by the surviving partners was in substance a buy-out by the partnership.

There may be a way out of the dilemma which might produce the same result whether the buy-out is by the partners or by the partnership. This is exercising the election to adjust asset basis upon the death of the partner. No further adjustment need be made upon the distribution to the deceased partner's estate. If in our example upon Nim's death the partnership had elected under Section 743(b) to bring the partnership asset basis attributable to Nim's interest into line with the value basis Nim's estate had for its interest, no further adjustment would be needed upon the distribution to bring the asset basis into line with the cost of buying out the estate. However, the adjustment under Section 743(b) is to be "with respect to the transferee partner only", i.e. Nim's estate. Whether the regulations will permit the adjustment to operate after the estate is bought out so that it will operate with respect to the surviving partners remains to be seen.

The provisions for optional adjustments to basis are only effective with respect to taxable years beginning after December 31, 1954. It will be seen that this can cause considerable embarrassment because the provisions respecting "collapsible" partnerships are effective as of March 9, 1954.

II. THE "COLLAPSIBLE" PARTNERSHIP

Section 751 dealing with "unrealized receivables and inventory items" constitutes a reform long overdue. Since the introduction of Section 117(m) into the 1939 Code, the partnership had become more and more popular as a device for converting ordinary income into capital gain.

Let us take a very simple example. Nim, Bardoff and Pistol are each in the cattle business. They form N.B.P. & Co., the assets of which consist solely of zero basis cattle with a value of $300. They sell their partnership interests to Smith, Jones and Robinson for $100 each. Under the 1939 Code, Nim, Bardoff and Pistol each would have a $100 capital gain. Smith, Jones and Robinson then dissolve N.B.P. & Co. Since each of Smith, Jones and Robinson had a $100 basis for his interest in N.B.P. & Co., each would take his share of the cattle of N.B.P. & Co. at a basis of $100, i.e. value at the time of the purchase.

Section 751 is not only aimed at this type of transaction which is purely tax avoidance motivated, but is also aimed at the going partnership business whose assets are largely ordinary income producing items.
Let us assume Nim, Bardoff and Pistol have been in the cattle feeding business on the cash basis for years as N.B.P. Co. The assets of the partnership consist of the following:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattle</td>
<td>$000</td>
<td>$900</td>
</tr>
<tr>
<td>Ranch</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>Cash</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1800</strong></td>
<td><strong>$2700</strong></td>
</tr>
</tbody>
</table>

Each of the partners has a $600 basis for his interest.

A. Sale of the Partnership Business

Assume Nim, Bardoff and Pistol wish to dispose of the partnership business. Some of the alternative methods are: they can sell their partnership interests; have the partnership sell its assets and dissolve; dissolve the partnership and distribute the assets pro rata and have the partners sell the assets; distribute the cattle pro rata as a non-liquidating distribution to the partners, letting them sell the cattle, and have the partnership sell the ranch; distribute the cattle to one partner as a liquidating distribution to him and have him sell the cattle, the partnership taking care of the disposition of the ranch; dissolve the partnership distributing all the cattle to one partner, the ranch to another and cash to the third.

The results are not identical in all situations although all these methods will result in $900 ordinary gain being recognized. In other words, although the draftsmen of the Code were content to permit different amounts of ordinary gain to result depending on the method of disposition of a partnership business which has no unrealized receivables or whose inventory items contain no substantial appreciation, they, it is believed, intended to require the same results whatever the method of disposition where inventory appreciation is substantial or unrealized receivables exist.

1. Sale of Partnership Interests

If the partners sell their partnership interests, they will each realize $300 ordinary gain. This is because of the operation of Section 751(a) which requires the amount received “attributable to inventory items... which have substantially appreciated in value” to be considered as an amount realized on sale of a non-capital asset.\(^\text{11}\) Obviously to determine the amount of gain, an al-

\(^\text{11}\) Substantial appreciation in value exists when the value of the inventory exceeds 120% of its basis and 10% of the value of all other partnership assets other than cash.
location of partnership interest basis to the various partnership assets is required. The committee report\textsuperscript{12} intimates that the amount of basis to be allocated to the inventory will not exceed the partnership's basis therefor. Consequently, no part of the partner's $600 basis for their interests will be allocated to the inventory and the entire amount realized attributable to the inventory ($300) will be ordinary income.

2. Sale of the Assets by the Partnership and Dissolution of the Partnership

This method results, obviously, in $300 ordinary gain to each partner since each will pick up his distributive share of the $900 partnership ordinary gain.

3. Dissolution with a Distribution Pro Rata to the Partners and Sale by the Partners of the Assets

Under the 1939 Code this method would have reduced the amount of ordinary gain because an allocation of the partnership interest basis to the various assets in accordance with value would have given a basis of $150 to the cattle distributed to each partner. Consequently, each partner would have realized $150 ordinary gain and $150 capital gain on the subsequent sale of assets (assuming the cattle were non-capital assets in the partners' hands).

However, under the 1954 Code, Section 732(c) requires the allocation of the partner's basis for his interest in a method which would require the partner to take the cattle received at its basis in the partnership's hands—$0. Consequently, each partner would realize $300 ordinary gain if this method were followed. Section 735 specifically provides that disposition of inventory by the partners within 5 years of its distribution to them will result in the amount realized on the sale being an amount realized on sale of a non-capital asset.

4. Non-liquidating Distribution of the Cattle Pro Rata to the Partners, Sale by Partnership of the Ranch

If the partnership distributes the cattle to the partners and sells the ranch, each partner will recognize $300 ordinary gain on their sale of the cattle since Section 732(a)(1) would require the partners to take the cattle at its basis in the hands of the partnership—$0. Under the old law, each partner would have had a basis of $200 for the cattle distributed to him. On sale of the ranch, there would be no gain or loss to the partnership, of course.

5. Distribute the Cattle as a Liquidating Distribution to One Partner, the Partnership Selling the Ranch

\textsuperscript{12} Supra note 9, at 401.
Under the old law, if the cattle were to be distributed to Nim, he would have taken it at a basis of $600—his partnership interest basis—and only $300 ordinary gain would have been realized on its sale. Bardoff and Pistol would have realized no gain with respect to the cattle but on dissolution of the partnership after its sale of the ranch, Bardoff and Pistol would each have recognized $300 capital gain.

Under Section 751(b), however, the partnership (as constituted after the distribution) will recognize $600 ordinary gain on the distribution. And Nim will take the inventory at a basis of $600 and recognize $300 gain on sale of the inventory. Upon sale of the ranch for $900 by the partnership, no gain or loss will be realized, of course, and upon dissolution of the partnership and the distribution of $900 to each of Bardoff and Pistol, they will have no further gain for their bases for their partnership interests will have been increased by their distributive shares of partnership ordinary gain recognized when the cattle was distributed to Nim.

Section 751(b) treats the distribution to Nim of the cattle as a sale or exchange between Nim and the partnership of Bardoff and Pistol. Nim exchanges his one-third interest in the cash ($300 value, basis to him $300) and his one-third interest in the ranch ($300 value, basis to him $300) for Bardoff and Pistol's two-thirds undivided interest in the cattle (value $600, basis to it—$0). This ordinary gain of $600 is recognized to the firm of Bardoff and Pistol. Since Nim paid $600 value (basis to him $600) for $600 value, he has had no gain on the exchange. He takes the cattle at a cost basis of $600—when he sells the cattle for $900 he will recognize $300 ordinary gain, being the excess of the value of his own one-third undivided interest over his basis for that one-third undivided interest.

In all of the methods thus far discussed, the ultimate results will be the same—$300 ordinary income to each partner.

6. Partnership Dissolves Distributing All of the Cattle to Nim, the Ranch to Bardoff and the Cash, to Pistol

If this transaction is treated as one subject to Section 751(b), the same results would probably be produced as under 5 above and as under the other methods. But it is difficult to determine whether it will be governed by Section 751(b) or
by the distribution sections, Sections 731 through 735. The doubt is created by the language of Section 751(b) which talks in terms of treating a non-pro rata distribution as "a sale or exchange... between the distributee and the partnership (as constituted after the distribution)." It therefore seems to presuppose the continuation of the partnership after the distribution and does not seem to contemplate distributions in dissolution. Further, it does not treat the transaction as a sale or exchange between the partners of their undivided interests, but as a sale or exchange between the distributee and the partnership.

If this transaction is governed by the distribution sections and not by Section 751(b), the results are the following:

Nim, who received the cattle, takes it at a basis of $0, the partnership basis therefor under Section 732(c). He recognizes a capital loss of $600 on the dissolution under Section 731(a)(2) (i.e., the excess of his partnership interest basis $600 over his basis for the cattle $0) and on sale of the cattle will recognize $900 ordinary gain—to account for his net gain of $300.

Bardoff, who received the ranch, will recognize no gain or loss on the dissolution and take the ranch at a basis of $600 (his partnership interest basis) under Section 732(b). On sale of the ranch he will recognize $300 capital gain.

Pistol, who received $900 cash, will recognize $300 capital gain on the dissolution (Section 731(a)(1)).

Thus, if this situation is governed by the distribution sections, opportunity for manipulation exists. The distribution will depend on the tax bracket of the partners, the existence or non-existence of capital loss carry-overs, and the existence or non-existence of other capital gains.

It would seem that the regulations should make it clear that the intention is to cover all non-pro rata distributions by Section 751(b) including distributions in dissolution.

B. Sale of a Partnership Interest

The consequences of a sale of a partnership interest in a partnership whose assets include "unrealized receivables" or "substantially" appreciated inventory items has been sufficiently considered in A1 above except for the difficulty which may be caused by the effective dates of Section 751(a) and of Section 743(b) (optional basis adjustment on transfer of interest).

Section 751 is applicable to sales of interests after March 9, 1954.

Section 743(b) is effective only with respect to taxable years beginning after December 31, 1954.
Let us assume that on March 15, 1954 N.B.P. Co. had the following assets as in the previous examples.

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattle</td>
<td>$0</td>
<td>$900</td>
</tr>
<tr>
<td>Ranch</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>Cash</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td></td>
<td>$1800</td>
<td>$2700</td>
</tr>
</tbody>
</table>

Nim, Bardoff, and Pistol each had a basis of $600 for his partnership interest. Let us assume that Nim died on that date—March 15, 1954. Let us assume the death of a partner, under the partnership agreement, does not affect the continuation of the partnership and that the partnership interest is freely alienable. Nim’s personal representative sells the partnership interest to Jones for $1,000 on September 16, 1954, assets being the same as above, except that the cattle are now worth $1,200.

Although Nim’s estate has a basis of $900 for its partnership interest, Section 751(a) may require the estate to recognize $400 ordinary income on the sale on which only $1,000 was realized. A $300 capital loss would have to be allowed to the estate in that situation so it will not be taxed on more than its net gain.

Suppose, now, Jones sells on the same day the interest acquired for $1,000—the amount he paid. Section 751(a) might require recognition of $400 ordinary gain to Jones who had no economic gain at all. If so, he must be permitted a $400 capital loss.

The problem lies in the drafting of Section 751(a). This section merely says, “The amount of any money or the fair market value of any property received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to...inventory items of the partnership which have appreciated substantially in value, shall be considered as an amount realized from the sale or exchange of property other than a capital asset...” Although it is simple to determine “the amount realized,” it is difficult to determine the amount of the ordinary gain. For that purpose a portion of the transferor partner’s basis for his interest must be deducted from the “amount realized.” How does one determine that allocable portion of partnership interest basis? The statute is silent. The committee report says, “The amount of basis to be so allocated shall ordinarily be his pro rata share of the partnership basis for such property with appropriate adjustments for any special transferee basis.
with respect to him under Section 743(b).”

Thus the report envisages “ordinarily” a deduction from the amount realized of the transferor partners’ pro rata share of the partnership basis for the inventory. It also allows for special adjustments theretofore made with respect to the transferor. But in our situation there have been no special basis adjustment under Section 743(b) because that section is not yet effective. Furthermore, what would happen when the partnership has declined the election to make special basis adjustment after the effective date of Section 743(b)?

Will the regulations permit the adjustment to be made in effect, upon the transferee’s sale of his interest, even though the partnership had declined the election, by allowing him to allocate to the inventory a basis equal to value at the time he acquired his interest? This is the effect of Section 732(d) which allows a transferee to take inventory items, received in dissolution, at an allocable share of his partnership interest basis (rather than the partnership’s basis for the inventory) when the election to adjust asset basis had not been made by the partnership.

Much depends on whether the intent of Section 751(a) was to treat the partner who sells his interest in an inventory appreciation partnership as he would have been treated if the partnership had sold all its assets and distributed to him an amount of money equal to the amount realized on the sale. If a sale and dissolution had occurred in a partnership which had declined to make the elective asset basis adjustment, the ordinary income-capital loss treatment of the transferee would follow. To accord ordinary income-capital loss treatment of the transferee who sells his interest in such a partnership is the clear intent of Section X760 of the American Law Institute Draft—generally believed to be the prototype of Section 751(a). Although such treatment may be justified where the asset basis adjustment election has been declined, it seems unreasonable to require it where the opportunity to make the election has not existed because the effective dates of Sections 743 and 751 do not coincide.

In the example given above, if Sections 743(b) and 754 were in effect as of March 15, 1954, the partnership might have elected to adjust to value the basis of the partnership assets attributable to Nim’s interest. The estate’s sale of its interest to Jones would then result in only $100 gain. Upon Jones’ purchase, the basis of the assets would automatically be adjusted—the election being in effect—and his subsequent sale would result in no gain or loss.

14 Supra note 9, at 401.
TAXATION OF PARTNERSHIPS UNDER NEW CODE

Some relief must be afforded by the regulations (or the Technical Changes Act of 1955) from the harsh results Section 751 can produce while Section 743(b) is not yet effective.

C. Withdrawal of a Partner

In the course of the discussion of the sale of the partnership business, reference was had to the provisions of Section 751(b) which govern non-pro rata distributions to a partner. Those provisions may be examined further.

Assume N.B.P. Co. has the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattle</td>
<td>$0</td>
<td>$300</td>
</tr>
<tr>
<td>Hogs</td>
<td>0</td>
<td>300</td>
</tr>
<tr>
<td>Ranch</td>
<td>90</td>
<td>300</td>
</tr>
<tr>
<td>Cash</td>
<td>300</td>
<td>300</td>
</tr>
</tbody>
</table>

$390 $1200

Nim, Bardoff and Pistol each has a $130 basis for his interest in the partnership. Nim wants out. The partnership distributes to Nim the cattle and $100. Under Section 751(b), Nim recognizes on the distribution ordinary gain of $100 (his share of the appreciation in the hogs) and $70 of capital gain (his share of the appreciation in the ranch). The partnership recognizes $200 ordinary gain (appreciation in the cattle $300 less Nim's interest therein—$100).

The question is what are the respective bases of Nim for the cattle and the partnership for the hogs and the ranch? There is no specific provision in the partnership sections which will supply the answer. The correct answers would appear to be that Nim has a $200 basis for the cattle that he received and the partnership has a $100 basis for the hogs, and $160 basis for the ranch.

Nim's cost for the cattle is $200. He gave up $100, his interest in the hogs and $100, his interest in the ranch for the undivided interest of Bardoff and Pistol in the cattle. His own one-third undivided interest still has a $0 basis. Presumably the regulations will state that the distributee partner will have a cost basis for the aggregate property received and will set forth the method of allocating that basis to the specific property. Presumably the allocation method will be similar to that prescribed in connection with optional basis adjustments, i.e. in a manner reducing the difference between basis and value or, in other words, in accordance with relative appreciation. The partnership paid
$200 (its interest in the cattle) for Nim's interest in the hogs ($100) and Nim's interest in the ranch ($100), Nim's aggregate basis for those interests was $30. An increase in the basis of the hogs by the amount of ordinary gain recognized to Nim and an increase in the basis of the ranch by the amount of capital gain recognized to Nim seems appropriate. Such an increase would produce the respective bases indicated above.

These are basically the rules for allocation of the adjustment of bases provided by Section 755 with respect to optional adjustments provided for in Section 734(b) and Section 743(b). It would seem appropriate for the regulations to adapt them to distributions considered sales or exchanges under Section 751(b).

CONCLUSION

The partnership provisions of the new Code, as can be seem from the above brief discussion, are complicated and leave many questions to be resolved by the regulations. However, few will question the fact that they promise to constitute a great improvement over the uncertainties, inequities and ambiguities of the taxation of partners and partnerships under the 1939 Code.