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Abandoning Partnership Interests: Ordinary versus Capital Loss

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Comment

Abandoning Partnership Interests: Ordinary Versus Capital Loss

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I. INTRODUCTION

Partnership arrangements and associations are seldom perpetual and the time arrives when most partners have a desire to disassociate themselves from the partnership. There are numerous reasons for leaving which include, major disagreements as to management policy, "cross-over"[1] of a tax shelter partnership, or lack

1. A partnership "crosses-over" when it produces taxable income in excess of cash flow. For example, a typical real estate tax shelter partnership produces losses through leveraging and accelerated depreciation in its early years of existence. In later years, as the nondeductible principal portion of debt payments increase and depreciation deductions decline, the investment "crosses over," *i.e.*, taxable income exceeds cash flow. Before the "cross-over" point is

of economic incentive to continue the partnership. For whatever reason, the partner looks for a way to "bail-out" of the venture.

There are several ways that a partner can withdraw from the partnership, each possessing its own unique tax results. It is quite common to see a partner sell his interest to other partners[2] or to a third party, which usually results in a capital gain or loss to the selling partner.[3] Similarly, the withdrawing partner's interest may

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reached, cash flow from the investment has exceeded taxable income. After crossing-over, the taxpayer must use other dollars to pay taxes imposed on income earned from the crossed-over investment asset. The "paper" losses become "paper" profits. For a discussion of techniques to alleviate the harshness of this problem, see note 28 *infra*.

See also 2 W. McKee, W. Nelson & R. Whitmore, Federal Taxation of Partnerships and Partners, ¶ 18 (1977 with supplements to date) [hereinafter cited as McKee]; Ginsburg, *The Leaky Tax Shelter*, 53 Taxes 719 (1975); Goldstein, *Equipment Leasing After the 1969 Act*, 29 Inst. on Fed. Tax'n 1589, 1622 (1971); Scheff, *Recasting and Terminating the Shelter; Getting Out Gracefully, Economically, and Alive*, 29 Inst. on Fed. Tax'n 1631 (1971); Winokur & Stoppello, *Getting Out of a Real Estate Tax Shelter*, 31 Inst. on Fed. Tax'n 1817 (1973); Note, *The Tax Shelter Dilemma: Disposition of a Crossover Limited Partnership Interest*, 43 U. Cin. L. Rev. 349 (1974).

2. It is often difficult to distinguish a pro rata sale to remaining partners from payments made by the partnership in liquidation of the withdrawing partner's interest. There is little economic difference between a pro rata purchase by continuing partners and a liquidation. Either way the remaining partners bear the cost and accordingly receive a larger interest in the partnership. When this situation arises the partners have the flexibility to structure the transaction as either a sale or liquidation. *See generally* 2 McKee, *supra* note 1, at ¶ 15.02. The intent of the parties and the form, rather than substance, of the transaction will govern. *See* Cooney v. Commissioner, 65 T.C. 101 (1975); Foxman v. Commissioner, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

   Courts will focus on the language in the withdrawal documents. Purchase and sale language indicates a sale. *See* Emory v. United States, 374 F. Supp. 1051 (E.D. Tenn. 1972), *aff'd*, 490 F.2d 208 (6th Cir. 1974). Liquidation and retirement language indicates a liquidation. *See* Miller v. United States, 181 Ct. Cl. 331 (1967); Cooney v. Commissioner, 65 T.C. 101 (1975).

3. Gain or loss realized on the sale of a partnership interest is generally treated as gain or loss from the sale of a capital asset under I.R.C. § 741 (CCH August 1, 1982) [All subsequent citations to the I.R.C. will be made to this publication unless otherwise designated.]. The only major exception to this approach which treats transfers of partnership interests as transfers of entities, rather than assets, is the "hot asset" provision, § 751. I.R.C. § 751 treats the transfer of a partnership interest as a transfer of the underlying partnership property to the extent that the money received by the transferor partner is in exchange for the partner's proportionate share of "§ 751 property."

   I.R.C. § 751 property can broadly be defined as "ordinary income" assets, that is, assets which generate ordinary income upon their sale. More precisely, § 751 property is defined as unrealized receivables, and substantially appreciated inventory and recapture items. I.R.C. § 751(c). The provision is designed to prevent the conversion of ordinary income into capital gain through a transfer of a partnership interest.

   To the extent that money or other property is received by the transferor be liquidated with the usual result being capital gain or loss.[4] Another alternative is simply to abandon the partnership interest, receiving nothing in return.[5] This latter alternative may provide an interesting and often advantageous tax consequence: the opportunity to generate ordinary gain or loss.[6]

This ordinary gain or loss opportunity is contingent upon a finding that no sale or exchange has occurred in the abandonment.[7] The rationale supporting a conclusion that no sale or exchange has occurred, is that by abandonment, the partner has received no consideration whatsoever[8] for the partnership interest and considera-

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partner in exchange for "hot assets," it is considered an amount realized from the sale of a non-capital asset and is afforded ordinary income treatment. *See generally* 2 McKEE, *supra* note 1, at ch. 16; Crumbley and Orbach, *Unraveling a Collapsible Partnership*, 9 TAX ADVISER 47 (1978).

The inherent complexity in determining and calculating the amount of the purchase price which is in exchange for "hot assets" can be lessened by the use of an "allocation agreement," a usual concomitant to the partnership agreement. Treas. Reg. 1.751-1(a)(2) (CCH July 1, 1982) [All subsequent citations to the Treasury Regulations will be made to this publication unless otherwise designated.].

4. The Code affords considerable flexibility in structuring the tax consequences of payments made in liquidation of a partnership. Payments for a withdrawing partner's interest in partnership property are governed by § 736(b) and generally result in capital gain or loss under §§ 731(a) and 741. In determining the value of the withdrawing partner's interest in partnership property the regulations provide that "[g]enerally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct." Treas. Reg. § 1.736-1(b)(1). All other payments are taxed under § 736(a), as either distributive shares of partnership income under § 736(a)(1), or guaranteed payments under § 736(a)(2). I.R.C. §§ 736(a)(1) and 736(a)(2) generally result in ordinary income to the withdrawing partner and a deduction against ordinary income of the partnership. *See* Treas. Reg. § 1.736-1(a)(4).
5. For a discussion of how a partner effectuates an abandonment, see *infra* text accompanying notes 78-85.
6. Another possibility to create ordinary losses for the partner occurs when the partnership owns "§ 1231 assets" which have a fair market value that is less than their basis. The partnership could sell the assets, recognize the § 1231 loss, and then pass the loss through to the partners under § 702(a)(3). The partnership is required to separately state the partner's distributive share of § 1231 losses under § 702(a)(3). The partner must then include his distributive share of partnership § 1231 losses in his personal § 1231 "hotchpot" to determine the aggregate amount of § 1231 gains and losses realized during the taxable year. If the result is a net gain, the gain is treated as a long term capital gain. If the result is a net § 1231 loss, the loss is deductible as an ordinary loss.
7. *See, e.g.*, Rev. Rul. 57-503, 1957-2 C.B. 139.
8. For a discussion as to whether or not the relief from liabilities is deemed to be consideration which triggers a sale or exchange, see *infra* text accompanying notes 71-77.

tion is the distinguishing feature of a sale or exchange.[9] Therefore, the loss is deductible from gross income[10] and is not restricted by the capital loss limitations of section 165(f),[11] because section 165(f) specifically states that the limitations apply only to "sales or exchanges." Additionally, the limitation section, section 1211, applies only to losses from "sales or exchanges" of capital assets.[12]

The ordinary gain or loss treatment which can result from abandonment is advantageous only when losses are experienced.[13] Ordinary losses are deductible in full from a taxpayer's gross

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9. Leh v. Commissioner, 260 F.2d 489 (9th Cir. 1958); Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir. 1958); *see, e.g.*, Rev. Rul. 57-503, 1957-2 C.B. 139.

   In *Leh* and *Pittston*, the taxpayers argued for sale or exchange treatment of a gain from payments received for cancellation of contracts. This placed the IRS in the awkward and unusual position of arguing no sale or exchange. Unlike *Leh* and *Pittston*, the sale or exchange controversy cases normally deal with loss situations: the taxpayer claims an ordinary loss contending there has been no sale or exchange, while the Service argues that a capital loss has resulted from a sale or exchange. But, in both the *Leh* and *Pittston* cases, the courts accepted the Service's argument that no sale or exchange occurred upon cancellation of the contracts where the rights of the taxpayers were extinguished. *See also infra* text accompanying notes 36, 68-70.
10. I.R.C. § 165(a) provides that in the case of an individual, "[t]here shall be allowed a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise."
11. I.R.C. § 165(f) provides that "[l]osses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212." For a discussion of the § 1211 and § 1212 limitations, see *infra* text accompanying notes 12, 16-17.
12. I.R.C. § 1211(b) provides in pertinent part:

    (b) OTHER TAXPAYERS—

    (1) IN GENERAL—In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges plus (if such losses exceed such gains) whichever of the following is smallest:

    (A) the taxable income for the taxable year *reduced (but not below zero) by the zero bracket amount*,

    (B) the applicable amount, or

    (C) the sum of—

    (i) the excess of the net short-term capital loss over the net long-term capital gain, and

    (ii) one-half of the excess of the net long-term capital loss over the net short-term capital gain.

    (2) APPLICABLE AMOUNT—For purposes of paragraph (1)(B), the term "applicable amount" means—

    (A) $2,000 in the case of any taxable year beginning in 1977; and

    (B) $3,000 in the case of any taxable year beginning after 1977.

    (emphasis added).
13. The taxpayer will prefer capital gain rather than ordinary gain because there is a 60% deduction from gross income for net capital gains under § 1202. This assumes, of course, that the partner is not a corporation.

income,[14] whereas there are substantial restrictions on the deductibility of capital losses from ordinary income.[15] The major restrictions are: (1) It takes two dollars of long-term capital loss to offset one dollar of ordinary income,[16] and (2) only a maximum of $3,000 of ordinary income can be offset by capital losses in any one taxable year.[17]

Notwithstanding the tax advantages of abandonment, the decision to abandon cannot be made without also evaluating economic realities. In a true abandonment, a partner voluntarily surrenders the partnership interest and receives nothing in return.[18] Therefore, this alternative is usually only feasible for those partners who would have received little or nothing anyway from a sale or liquidation.[19]

As abandonment is advantageous only in potential loss situations,[20] it is necessary to determine whether the partner will incur gain or loss. Under section 1001, the gain or loss to be realized by the abandoning partner is equal to the difference between the amount realized on the abandonment and the partner's adjusted basis in the partnership interest at the time of the sale.[21] The amount realized is the sum of any money and the fair market value of any property received,[22] plus the partner's share of partnership liabilities.[23] The partner's adjusted basis is his initial basis[24] ad-

14. I.R.C. § 165. I.R.C. § 165(c) limits the deductible losses to those losses which are incurred in a trade or business or in a transaction entered into for profit. It is assumed in this Comment that the partner acquired the partnership interest with a profit motive.
15. *See supra* note 11.
16. I.R.C. § 1211(b)(1).
17. I.R.C. § 1211(b)(2). The excess or unused capital loss is not lost but can be carried forward indefinitely under § 1212.
18. For a discussion of how to abandon a partnership interest, see *infra* text accompanying notes 78-85. Often a partner unknowingly receives something of value: the relief from liabilities. For a discussion of the effect this has on tax liability, see *infra* text accompanying notes 123-131.
19. It is possible for it to be more advantageous to a partner to abandon an interest rather than selling or liquidating the interest for its value. If the tax savings which result from receiving an ordinary loss deduction in an abandonment as opposed to a capital loss deduction on a sale or liquidation are greater than the consideration the partner would receive on the sale or liquidation, the partner should consider foregoing the consideration and abandoning the interest. *See supra* text accompanying notes 14-17.
20. *See supra* note 13.
21. I.R.C. § 1001(a).
22. I.R.C. § 1001(b).
23. I.R.C. § 752. *See infra* text accompanying note 75.
24. I.R.C. § 705(a). If the partnership interest is acquired through contributions, the initial basis is the sum of the amount of money plus the contributing partner's adjusted basis in property contributed. I.R.C. § 722. If the partnership interest is acquired in any other way, the general cost basis rules of § 1012

justed for partnership income, losses, and distributions.[25]

Since a partner in a potential gain situation[26] will find it more advantageous to have a capital gain rather than ordinary gain,[27] this Comment will be limited to an analysis of the inherent risks in abandoning partnership property, and of how to structure an abandonment in the potential loss situation.[28] This Comment begins with a general overview of abandonments in order to permit comparison of the tax treatment of abandoned property generally, with the abandonment of a partnership interest. Indeed, at the outset, it will be noted that the general rules regarding abandonment have been modified by statute[29] for partnership interests.

II. ABANDONMENTS IN GENERAL

A. What Constitutes an Abandonment

Since the Code does not refer to an "abandonment loss," but instead allows the loss through its general loss provision,[30] it likewise has provided no definition of abandonment. To determine

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apply. These rules state generally that the cost is the amount paid for the property in cash or the fair market value of other property. Treas. Reg. § 1.1012-1. Partnership interests acquired from a decedent receive a basis equal to the fair market value of the property on the date of decedent's death. I.R.C. § 1014. Partnership interests acquired by gift receive a basis equal to the donor's basis plus gift taxes paid. I.R.C. § 1015. *See* I.R.C. § 742.

Additionally, a partner's adjusted basis is increased if his share of partnership liabilities increases or if he assumes partnership liabilities. I.R.C. § 752(a).

25. I.R.C. § 705(a). For a discussion of these main adjustments and other adjustments to basis, see generally, 1 McKEE, *supra* note 1, at ch. 6.
26. For a discussion of how to determine if the partner is in a potential gain or loss situation, see *supra* text accompanying notes 20-25.
27. For a discussion of the advantages of capital gains over ordinary gains, see *supra* note 13.
28. Abandonment is not a feasible alternative for most partners in real estate tax shelters. The combination of high leveraging, accelerated depreciation, and long-term mortgage loans with level monthly payments, is likely to result in a gain upon disposition of the interest because the partner's basis in the property will generally be much lower than the amount of the outstanding loan obligations which would be relieved by abandonment. For a discussion of relief from liabilities as constituting an "amount realized," see *infra* text accompanying note 75. Some authors have suggested that partners in this situation should consider: (1) transferring the partnership interest to charity, (2) incorporating, (3) selling the property using the installment sale method, or (4) exchanging the interest for a like kind partnership interest in a nonrecognition transaction. For an excellent discussion of these planning techniques, see Scheff, *supra* note 1; Winokur & Stoppello, *supra* note 1.
29. The major changes created by statute come from §§ 752(b) and 752(d). *See infra* text accompanying notes 92-98, 132-55.
30. I.R.C. § 165(a) provides that there shall be a deduction for "any" loss sustained during the tax year.

what losses qualify for the deduction will be a question of fact[31] to be determined only after a thorough analysis of the prior case law.

The courts have consistently held that whether or not the taxpayer has abandoned property depends on the intention of the taxpayer in conjunction with an act of abandonment.[32] Thus, the mere intention to abandon or ceasing to use the property is not enough.[33] There must be some act of surrender, an act relinquishing control of all incidents of ownership.[34] However, the retention of title by the taxpayer does not prevent a finding that real estate is worthless and that an actual abandonment has occurred.[35] Finally, the courts have determined that if the taxpayer receives any consideration, even nominal, in return for the property, abandonment does not result and the transaction is deemed to be a sale or exchange.[36]

B. Timing the Abandonment Loss Deduction

Since the abandonment loss is not triggered by a sale, exchange, or other dispositive transaction like most losses,[37] but rather by an "abandonment," it is often difficult to determine the year in which the deduction is to be allowed.[38] When the loss is actually sustained is a factual question,[39] to be ascertained from all the pertinent facts and circumstances.[40] The taxpayer will always

31. Burke v. Commissioner, 283 F.2d 487 (9th Cir. 1960); Finley v. Commissioner, T.C. MEM. DEC. 1974-229, 33 T.C.M. 1012 (CCH 1974); Boston Elevated Railway Co. v. Commissioner, 16 T.C. 1084 (1951), *nonacq.*, 1951-2 C.B. 5, *aff'd*, 196 F.2d 923 (1st Cir. 1952).
32. Talache Mines, Inc. v. United States, 218 F.2d 491 (9th Cir. 1954), *cert. denied*, 350 U.S. 824 (1955); Empire Dist. Elec. Co. v. Commissioner, 4 T.C. 925 (1945), *acq.*, 1945 C.B. 3.
33. Hazeltine Corp. v. United States, 170 F. Supp. 615 (Ct. Cl. 1959); Ewald Iron Co. v. Commissioner, 37 B.T.A. 798 (1938) (the storing of unused machinery is not sufficient).
34. Hazeltine Corp. v. United States, 170 F. Supp. 615 (Ct. Cl. 1959); Dezendorf v. Commissioner, T.C. MEM. DEC. 1961-280, 20 T.C.M. 1480 (CCH 1961), *aff'd*, 312 F.2d 95 (5th Cir. 1963); *see also* Boesel v. Commissioner, 11 T.C.M. 950 (CCH 1952), *aff'd*, 208 F.2d 817 (2d Cir. 1954) (taxpayer has burden of proving an overt act of abandonment).
35. Helvering v. Gordon, 134 F.2d 685 (4th Cir. 1943).
36. Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941); Wilkinson v. United States, 177 F. Supp. 101 (S.D. Ala. 1959).
37. For a discussion of what constitutes an abandonment, see *supra* text accompanying notes 30-36.
38. The analysis of this question involves essentially the same considerations as the question of what constitutes an abandonment. *See supra* text accompanying notes 30-36.
39. Burke v. Commissioner, 283 F.2d 487 (9th Cir. 1960); C-O-Two Fire Equipment Co. v. Commissioner, 219 F.2d 57 (3d Cir. 1955); Coors Porcelain Co. v. Commissioner, 52 T.C. 682 (1969), *aff'd*, 429 F.2d 1 (10th Cir. 1970).
40. Boston Elevated Railway Co. v. Commissioner, 16 T.C. 1084, 1108 (1951),

have the burden of proving that the loss occurred in the taxable year in which the deduction was taken.[41]

There is a question as to whether the deduction is taken at the time when the abandoned property no longer has any useful value, so that the property is actually worthless,[42] or in the alternative, when the overt act of abandonment by the taxpayer takes place.[43] The regulations are conflicting and only add to the uncertainty.[44]

In *Dezendorf v. Commissioner*,[45] the court held the loss to be deductible in the taxable year in which the *physical* abandonment of the asset took place.[46] However, if this were the only test, it would give taxpayers the flexibility to postpone the deduction to a more advantageous year, by simply not undertaking the overt act of physical abandonment. Accordingly, the Internal Revenue Service adopted a position to prevent taxpayers from manipulating

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nonacq., 1951-2 C.B. 5 *aff'd*, 196 F.2d 923 (1st Cir. 1952); *see also* Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220, 225 (1972), *acq.*, 1973-2 C.B. 2.

41. Boehm v. Commissioner, 326 U.S. 287 (1945).

42. Treas Reg. § 1.165-2(a) provides:

> A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is *actually sustained*. For this purpose, the taxable year in which the loss is sustained is *not necessarily the taxable year in which the overt act of abandonment*, or the loss of title to the property occurs.

(emphasis added).

43. Treas. Reg. § 1.165-1(d)(1) provides:

> A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is *sustained*. For this purpose, a loss shall be treated as *sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions* and as fixed by identifiable events occurring in such taxable year.

(emphasis added).

44. Although both regulations provide that the deduction shall be allowed in the taxable year in which the loss was sustained, Treas. Reg. § 1.165-1(d)(1) emphasizes that there be a completed transaction or event evidencing the loss, whereas Treas. Reg. § 1-165-2(a), places less emphasis on a completed transaction by rejecting the notion that the abandonment loss always is sustained in the year the overt act or event occurs.

45. T.C. MEM. DEC. 1961-280, 20 T.C.M. 1480 (CCH 1961), *aff'd*, 312 F.2d 95 (5th Cir. 1963).

46. The *Dezendorf* court sated:

> Losses resulting from abandonment are sustained during the year of abandoned [sic] and, if deductible at all, are deductible for the taxable year in which the abandonment occurs. Ordinarily there must be an intention to abandon, evidenced by some act, and such intention and act are to be ascertained from the facts and surrounding circumstances. Non-use alone is not sufficient.

20 T.C.M. at 1482.

the timing of the loss. In Revenue Ruling 54-581,[47] the Service stated its position:

> [A]n abandonment loss is deductible only in the taxable year in which it is actually sustained. An abandonment loss which was actually sustained in a taxable year prior to the year in which the overt act of abandonment took place is not allowable as a deduction in the latter taxable year.[48]

In *Finley v. Commissioner*,[49] the Tax Court synthesized the two alternative views and stated what appears to be the current law on the subject:

> The rule to be deducted from the "abandonment" cases, we think, is that a deduction should be permitted where there is not merely a shrinkage of value, but instead, a complete elimination of all value, and the recognition by the owner that his property no longer has any utility or worth to him, by means of a specific act proving his abandonment of all interest in it, which act of abandonment must take place in the year in which the value has actually been extinguished.[50]

C. Income Tax Consequences

1. Prerequisites to the Abandonment Deduction

The Internal Revenue Code does not specifically refer to a deduction for losses due to the abandonment of property. The authorization for the abandonment loss is based upon the general loss rule of section 165(a) and the regulations thereunder. For an individual taxpayer, the section 165 abandonment loss deduction is limited to losses resulting from the abandonment of property used in the taxpayer's trade or business[51] or property used in a transaction entered into for profit,[52] but will not be allowed for the abandonment of property held for personal use.[53] The loss must be

47. 1954-2 C.B. 112.

Likewise in Superior Coal Co. v. Commissioner, 2 T.C.M. 984, 986 (CCH 1943), *aff'd*, 145 F.2d 597 (7th Cir. 1944), *cert. denied*, 324 U.S. 864 (1944), the court held:

> It is well settled that the retention of bare legal title to property does not prevent a taxpayer from taking a deduction in the year in which the property becomes worthless. . . . It is equally well settled that a taxpayer may not be permitted to postpone the taking of a deduction for a loss actually sustained until a year in which the deduction will result in a larger saving in tax.

2 T.C.M. at 986.

48. Rev. Rul. 54-581, 1954-2 C.B. 112, 113.

49. T.C. MEM. DEC. 1974-229, 33 T.C.M. 1012 (CCH 1974).

50. *Id.* at 1016.

51. I.R.C. § 165(c)(1).

52. I.R.C. § 165(c)(2).

53. The taxpayer is allowed to deduct losses of personal property if the loss arises from fires, storms, shipwreck, theft or other casualty under § 165(c)(3). However, the loss must exceed a $100 floor for each casualty. *Id.*

sustained in a closed transaction during the taxable year.[54] The abandonment loss deduction is also limited to the taxpayer's adjusted basis in the abandoned property.[55] Proving that an asset had an adjusted basis and that it is currently worthless is not enough; a loss of useful value in the property must be shown.[56] The burden of proving such losses is on the taxpayer.[57]

The loss deduction is allowed for all types of abandoned property, whether real[58] or personal,[59] tangible or intangible,[60] capital or non-capital.[61] The regulations, however, draw a distinction between depreciable and non-depreciable property prohibiting the abandonment loss for the former.[62]

2. Income Tax Effect

Abandonment losses, like other losses, produce a deduction for the taxpayer under section 165(a). This section treats a loss as a deduction in full,[63] *i.e.*, ordinary loss, unless the capital loss limitations apply.[64] These limitations do not apply in connection with property that is not "sold or exchanged"[65] or, notwithstanding a

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54. Treas. Reg. §§ 1.165-1(b), 1.165-1(d)(1). *See also* Bouchard v. United States, 143 F. Supp. 5 (E.D. Wis. 1956); Langdon-Warren Mines, Inc. v. Reynolds, 52 F. Supp. 512 (Minn. 1943); Thomas Worcester, Inc. v. Commissioner, T.C. MEM. DEC. 1956-199, 24 T.C.M. 1021 (CCH 1965).
55. I.R.C. § 165(b); Treas. Reg. § 1.165-1(c). I.R.C. § 165(b) is merely a limitation provision which provides that the loss shall not exceed the adjusted basis of the property as determined under § 1011.
56. In Virtue Brothers Mfg. Co. v. Commissioner, T.C. MEM. DEC. 1960-256, 19 T.C.M. 1448 (CCH 1960), the Tax Court denied an abandonment deduction when the asset abandoned by the taxpayer was worthless when acquired and therefore no loss of useful value was suffered. *See* Treas. Reg. § 1.165-1(b).
57. Boehm v. Commissioner, 326 U.S. 287 (1945); Commissioner v. Houston, 283 U.S. 223 (1931).
58. Enid Ice and Fuel Co. v. United States, 142 F. Supp. 486 (W.D. Okla. 1956) (land).
59. Tanforan Co. v. United States, 462 F.2d 605 (9th Cir. 1972) (buildings, improvements, and equipment).
60. Maine Steel, Inc. v. United States, 174 F. Supp. 702 (D. Me. 1959) (patent).
61. A partnership interest is a prime example of a capital asset that can be abandoned. Abandonment of a partnership interest will be discussed in section III of this Comment, *infra*.
62. Treas. Reg. § 1.165-2. The allowable deduction is for depreciation, and not for an abandonment loss. But there is a loss allowance for the abnormal retirement of depreciable property under Treas. Reg. § 1.167(a)(8), and for the obsolescence of depreciable property under Treas. Reg. § 1.167(a)(9).
63. I.R.C. §§ 165(a), 165(b); Treas. Reg. § 1.165-1(c)(2). For a discussion of how to figure gain or loss, see *supra* text accompanying notes 20-25.
64. I.R.C. § 165(f). Treas. Reg. § 1.165-2(b) states: "The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section."
65. The words sale or exchange must be given their ordinary meaning. *See* Gannon v. Commissioner, 16 T.C. 1134, 1139 (1931), *acq.*, 1951-2 C.B. 2. If there is in

sale or exchange, is not a "capital asset."[66]

Taxpayers seeking an ordinary loss deduction through abandonment will probably rely on the absence of a sale or exchange, since they can structure the disposition of the asset more easily than arguing that their abandoned asset was not a "capital asset."[67] As long as the taxpayer who abandons his property receives no consideration in return,[68] there will be no sale or exchange, and the taxpayer will be allowed to treat his loss as an

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fact no consideration received, then even the transfer of title is not a sale or exchange. Commonwealth, Inc. v. Commissioner, 36 B.T.A. 850 (1937), *acq.*, 1941-2 C.B. 3.

66. Both I.R.C. §§ 165(f) and 1211 require sales or exchanges of "capital assets." The definition of a capital asset is found in § 1221. It generally states that "all" assets are capital assets unless specifically excluded by § 1221, regardless of the holding period. *See* Treas. Reg. § 1.1221-1(a). The major exclusions are: (1) inventory, § 1221(1); (2) property used in a trade or business, § 1221(2); and (3) accounts and notes receivable acquired from services or the sale of inventory, § 1221(4).

A partnership interest has consistently been held to be a capital asset. *See* O'Brien v. Commissioner, 77 T.C. 113 (1981); Pieitz v. Commissioner, 59 T.C. 207 (1972); Goldfield v. Commissioner, T.C. MEM. DEC. 1967-129, 26 T.C.M. 575 (CCH 1967); Rev. Rul. 59-109, 1959-1 C.B. 168.

In Pollack v. Commissioner, 69 T.C. 142 (1977), the taxpayer contended that his investment in a limited partnership was "integrally related" to his consulting business and, thus, the partnership interest which was sold was not a capital asset under the rule established in Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955). In general, the *Corn Products* doctrine removes capital assets which are used in a trade or business from § 1221 classification, allowing or requiring the recognition of ordinary gain or loss. In the *Corn Products* case, the Supreme Court said that it was the intent of Congress that "profits and losses arising from everyday operation of business be considered as ordinary income or loss rather than capital gain or loss." 350 U.S. at 52.

The *Pollack* court ruled against the taxpayer holding that the loss from sale of the partnership interest was capital in nature, irrespective of the seller's motivation for acquiring the interest. Furthermore, the court stated that § 741 operates independently of § 1221. I.R.C. § 741 is the partnership tax provision dealing with "sales or exchanges" of partnership interests and accordingly would not apply to abandonments.

For an excellent critique of the Tax Court's decision in *Pollack*, see Battaglia, *Section 741 and Corn Products: A Logical Extension*, 31 U. Fla. L. Rev. 90 (1978).

67. Basically, an asset is either specifically excluded from capital asset treatment or it is a capital asset. One exception is the *Corn Products* rule. *See supra* note 66. But this doctrine provides few after the fact planning opportunities, since it focuses on the capital asset's relationship to the taxpayer's business throughout the period the asset was held.

68. Even nominal consideration will create a sale. *See, e.g.*, Blum v. Commissioner, 133 F.2d 444 (2d Cir. 1943); Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941); Wilkinson v. United States, 177 F. Supp. 101 (S.D. Ala. 1959).

ordinary loss.[69] The Internal Revenue Service has taken the same position.[70]

3. Encumbered Property

If the abandoned property is encumbered by a liability for which the taxpayer is personally responsible (recourse), the transaction will be considered a sale by the taxpayer on the theory that the taxpayer's relief from the obligation is consideration.[71] The finding of a sale or exchange necessitates a capital loss as opposed to ordinary loss[72] and will be subject to the undesirable capital loss limitations.[73]

A much more controversial issue is whether or not a sale or exchange takes place upon the taxpayer's abandonment of property which is subject to non-recourse liabilities, that is, liabilities for which the taxpayer is not personally liable. Several older cases hold that abandoning property encumbered by non-recourse liabilities does not result in a sale or exchange because no consideration is received by the transferor/taxpayer who abandons. The taxpayer receives no consideration because he has not been relieved of any personal liabilities.[74]

The Supreme Court, in its landmark decision, *Crane v. Commis-*

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69. For a discussion of the advantages of an ordinary loss over a capital loss, see *supra* text accompanying notes 13-17.
70. *See, e.g.*, Rev. Rul. 57-503, 1957-2 C.B. 139 (taxpayer corporation abandoned all the assets used in a line of business receiving nothing in return).
71. In Commissioner v. Hammel, 311 U.S. 504 (1941), the Supreme Court held that a capital loss results from a foreclosure sale of property which was subject to a mortgage upon which the mortgagor was personally liable. *See also* Stamler v. Commissioner, 145 F.2d 37 (3d Cir. 1944) (voluntary conveyance to mortgagee for release of liability held to be a sale or exchange); Kaufman v. Commissioner, 119 F.2d 901 (9th Cir. 1941) (cancellation of a contract to purchase land for release of taxpayer's obligation to pay the balance of the purchase price held to be a sale or exchange resulting in a capital loss); Rogers v. Commissioner, 103 F.2d 790 (9th Cir. 1939), *cert. denied*, 308 U.S. 580 (1939) (conveyance of land back to the seller upon cancellation and surrender of personal note held to be a sale or exchange and capital loss).
72. For a discussion of why a sale or exchange creates a capital loss, see *supra* text accompanying notes 10-12, 63-66.
73. For a discussion of the capital loss limitations and why they are undesirable, see *supra* text accompanying notes 15-17.
74. Polin v. Commissioner, 114 F.2d 174 (3d Cir. 1940); Commonwealth, Inc. v. Commissioner, 36 B.T.A. 850 (1937), *acq.*, 1941-2 C.B. 3.

    See also Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941) (voluntary conveyance of property back to the mortgagee who had given a non-recourse mortgage resulted in no sale or exchange); Jamison v. Commissioner, 8 T.C. 173 (1947), *acq.*, 1947-1 C.B. 2 (voluntary grant of a quitclaim deed to the taxing authorities which relieved the taxpayer of non-recourse property taxes *sioner*,[75] left unanswered the question of whether relief from a non-recourse liability constituted consideration to the taxpayer for purposes of determining the presence of a sale or exchange. It did, however, hold that debt relief constitutes an amount realized under section 1001(b). Similarly, recent case law[76] and IRS interpretations[77] indicate a view toward treating the abandonment of

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resulted in no sale or exchange); *but see infra* note 76 (questioning the continued authority of these two cases).

Reconveyance may be a necessary overt act of abandonment. *See* Treas. Reg. § 1.165-1(d)(1) and *supra* text accompanying notes 42-50, 54.

75. 331 U.S. 1 (1947). The pertinent facts of *Crane* involved the sale of property subject to a non-recourse mortgage by a taxpayer to a third party for $2,500 cash. There was no issue as to whether or not a sale had taken place. The question was whether the unpaid principal of the debt should be included in the "amount realized" from the sale of the property by the taxpayer.

The Supreme Court's famous footnote in *Crane*, reproduced below, hints that abandonment of property subject to non-recourse debt is quite possible and might merit different tax treatment than in the case of a sale or exchange for cash consideration:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

331 U.S. at 14, n.37.

When *Crane* was before the Court of Appeals for the Second Circuit, the court stated in dictum that had the property actually been abandoned, the relief from the non-recourse liability would not have created a sale or exchange. 153 F.2d 504, 506 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947).

76. Freeland v. Commissioner, 74 T.C. 970 (1980); Lenway & Co. v. Commissioner, 69 T.C. 620 (1978); Millar v. Commissioner, 67 T.C. 656 (1977), *aff'd*, 577 F.2d 212 (1979).

In *Lenway*, the Tax Court noted: "[I]t is arguable whether [Stokes v. Commissioner, 124 F.2d 335; and Jamison v. Commissioner, 8 T.C. 173, *acq.*, 1947-1 C.B. 2] continue to have their original vitality in light of the subsequent decision of the Supreme Court in Crane v. Commissioner, 331 U.S. 1 (1947)." 69 T.C. at 628, n.9.

In *Freeland*, the court concluded that Congress did not intend to permit a taxpayer to sustain an ordinary loss by voluntarily conveying the property back to the mortgagee, instead, the transaction should be treated as a capital gain from a mortgagor's foreclosure sale. 75 T.C. at 980-83. The court also said that it would be anomalous to hold that relief from indebtedness constitutes an "amount realized" for § 1001(b), and then hold the relief from indebtedness insufficient to constitute consideration to the taxpayer/transferor for purposes of the sale or exchange requirement under § 1211 and § 165(f). *Id.* at 981-82.

77. Priv. Let. Rul. 7744006, which was subsequently published in Rev. Rul. 78-164, 1978-1 C.B. 264, concluded that a taxpayer's transfer of property, subject to a non-recourse mortgage, back to the mortgagee constituted a "sale" and not an "abandonment." Therefore, a capital loss rather than an ordinary loss resulted. The Service interpreted *Crane* to establish that the proceeds *realized* from the debt relief constituted more than an amount realized under

property subject to non-recourse liabilities as a sale, therefore, the taxpayer should be ready to litigate the issue beyond the Tax Court, if the decision is made to claim the ordinary loss.

III. ABANDONING A PARTNERSHIP INTEREST

A. What Constitutes the Abandonment of a Partnership Interest

The abandonment of a partnership interest will be governed by the same tests that govern the abandonment of other property. The issue focuses upon the intention of the taxpayer to abandon the interest in conjunction with an overt act of abandonment.[78] However, a partnership interest is a unique type of property creating special concerns when it is abandoned. Being intangible, a partnership interest cannot be abandoned like a machine or apartment building simply by deeding the property back to the creditor or taxing authorities.[79] Moreover, the partnership interest is not usually memorialized by a stock certificate like corporate stock.[80] Instead, the partners look to the partnership agreement for their respective rights and obligations. As previously mentioned, the burden of proof will be on the taxpayer to show a total abandonment of his interest and that there was no distribution from the partnership.[81]

It has been held that an automatic termination provision in the partnership agreement, allowing the partner no consideration, is an effective abandonment.[82] An abandonment was also found

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§ 1001(b), but additionally, constituted consideration for purposes of finding a sale or exchange under § 1211 and § 1222.

78. *See generally supra* text accompanying notes 32-41.

79. *See supra* notes 74 & 76.

80. The rights and obligations of a partner in relation to the other partners are governed by the partnership agreement executed between them. *See generally* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP § 65 (2d ed. 1968). Today, though, there are many similarities between an investment in a public limited partnership, which breaks down its partnership interests into units, and an investment in corporate stock. Among the similarities include: (1) the partners are business acquaintances and quite often do not know the identity of the other partners, and (2) the limited partners have limited liability and often have access to a market for immediate disposal of their partnership interest. I.R.C. § 165(g)(1) apparently prohibits the abandonment of worthless securities in order to obtain ordinary loss treatment. But, "partnership interest" is not included in the definition of securities. I.R.C. § 165(g)(2).

81. Boehm v. Commissioner, 326 U.S. 287 (1945); Commissioner v. Houston, 283 U.S. 223 (1931); Rodman v. Commissioner, 542 F.2d 845 (2d Cir. 1976). In *Rodman*, the taxpayer failed to argue to the trial court that there had been an abandonment, thus, the court of appeals ruled that taxpayer had neither proved a total abandonment, nor had the taxpayer proved that he had not received a distribution of property or money from the partnership in return for the abandonment. *See also supra* note 57 and accompanying text.

82. Hutcheson v. Commissioner, 17 T.C. 14 (1951), *acq.*, 1951-2 C.B. 2; Gannon v.

where the withdrawing limited partner sent a letter to the general partner stating that he was abandoning his interest effective immediately.[83] A few courts have simply held that having the partnership interest become worthless is enough in itself to trigger an ordinary loss.[84] However, where the withdrawing partner executed an agreement which transferred all his interest in the partnership to the remaining partner in consideration for ten dollars and assumption of all partnership liabilities by the remaining partner, the court held that there was no abandonment.[85]

B. Tax Considerations

1. Overview

The 1954 Code and regulations thereunder contain no specific provision dealing with the withdrawal, abandonment, or forfeiture of a partnership interest, where the leaving partner receives nothing upon his disassociation from the partnership. The Code does provide for the "sale or exchange" of a partnership interest in section 741,[86] but this provision is inapplicable to an abandonment because an abandonment does not involve a sale or exchange. The Code also provides for the liquidation of a partnership in section 731,[87] but this section does not apply to an abandonment since the

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Commissioner, 16 T.C. 1134 (1951), *acq.*, 1951-2 C.B. 2.. In both cases the partnership agreement provided that if any partner in the law firm voluntarily withdrew and remained in the active practice of law, the withdrawing partner was entitled to no compensation for his interest in the assets of the firm.

83. O'Brien v. Commissioner, 77 T.C. 113 (1981). The letter stated, "I herewith abandon all of my right, title and interest in and to the South Arlington Joint Venture, effective this date."

84. Zeeman v. United States, 275 F. Supp. 235 (S.D.N.Y. 1967), *aff'd*, 395 F.2d 861 (2d Cir. 1968); Webb v. Commissioner, 23 T.C. 1035 (1955), *acq.*, 1955-1 C.B. 7. For a discussion of worthlessness as it relates to abandonment, see *infra* text accompanying notes 156-168.

85. Wilkinson v. United States, 177 F. Supp. 101 (S.D. Ala. 1959); *contra*, Stillwell v. Commissioner, 46 T.C. 247 (1966). In *Stillwell*, the taxpayer entered into an agreement to terminate the partnership with the other partners. The other partners were to receive all the assets and assume all the liabilities. The court held that there was no sale or exchange, but subjected the taxpayer to the liquidating distribution provisions of § 731(a), due to the § 752(b) distribution.

86. I.R.C. § 741 provides:

> In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

For a discussion of why an abandonment does not involve a sale or exchange, see *supra* text accmpanying notes 8-9.

87. I.R.C. § 731 provides in pertinent part:

section requires a distribution before it is applicable, and a true abandonment entails no distribution to the abandoning partner. With the provisions of Subchapter K[88] literally inapplicable, the door is open for the partner to claim a deduction for an abandonment loss under section 165(a) for his unrecovered capital contribution.[89] This loss is ordinary in character as opposed to the unwelcomed capital loss when section 731[90] or section 741[91] apply.

A statutory provision which affects abandonment only when a partnership interest, as opposed to other types of property,[92] is

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(a) PARTNERS.—In the case of a distribution by a partnership to a partner—

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon, a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—

(a) any money distributed, and

(b) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)(2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

For a discussion of relief from liabilities as constituting a distribution, see *infra* text accompanying notes 123-131. *See also* O'Brien v. Commissioner, 77 T.C. 113 (1981); I.R.C. §§ 752(b) and 752(d).

88. Subchapter K includes the provisions relating to partnership taxation, I.R.C. §§ 701-761.
89. For a discussion of how to compute the amount of the loss, see *supra* text accompanying notes 21-25.
90. See the last full paragraph of I.R.C. § 731(a), *supra* note 87.
91. I.R.C. § 741 treats the loss from sale or exchange of a partnership interest as a loss from the sale or exchange of a capital asset. Under § 1001, the loss is equal to the excess of the partner's adjusted basis over the amount realized on the sale. One exception to this capital loss characterization is § 751(a), which provides that money or property received by a partner in exchange for all or part of his partnership interest is to be considered an amount realized from the sale or exchange of noncapital asset to the extent attributable to "unrealized receivables" or substantially appreciated inventory items. This "collapsible partnership" provision was enacted to prevent partnerships holding appreciated ordinary income property from converting ordinary income to capital gain. The otherwise distinct possibility of converting ordinary income into capital gain exists because Subchapter K has adopted the entity approach to taxing transfers of partnership interests, *i.e.*, a transfer of a partnership interest is treated as a transfer of the partnership entity and not as a transfer of co-interests in partnership assets. *See* I.R.C. §§ 731, 741, 751.
92. Outside the partnership tax area, Crane v. Commissioner, 331 U.S. 1 (1947),

foresaken is section 752(b). Specifically, section 752(b) provides that where the effect of the abandonment of a partnership interest is to decrease the partner's share of partnership liabilities, or to decrease a partner's individual liability by having the partnership assume the partner's individual liability, the partner will be deemed to have received a distribution of money from the partnership.[93] Section 752(b) goes further than *Crane's*[94] requirement of increasing the transferor's "amount realized." It, in effect, creates a sale or exchange where it was nonexistent before. This happens because the provision treats the decrease in liabilities as a distribution of money from the partnership to the partner, and once a distribution is deemed to have been made, section 731(a)(2) is triggered. Section 731(a)(2) requires that the loss be recognized and characterized as a loss from the sale or exchange of the partnership interest, which, under section 741, is a capital loss. Thus, not only does the provision reduce the amount of the abandoning partner's loss, it also recharacterizes it from ordinary to capital.[95]

Consequently, it is extremely important to determine when section 752(b) will apply to the abandonment. Surely a partner could abandon his partnership interest when at the time of abandonment the partner's share of liabilities[96] is zero, without triggering § 752(b). A partner's share[97] of liabilities will be zero in two situa-

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and its progeny have established that the relief from liabilities is to be included in the "amount realized" under § 1001(b), and also, such relief is consideration for purposes of triggering a sale or exchange. *See e.g.*, Freeland v. Commissioner, 74 T.C. 970 (1980); *see also supra* text accompanying notes 75-77.

93. I.R.C. § 752(b) provides:

> (b) DECREASE IN PARTNER'S LIABILITIES.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

94. Crane v. Commissioner, 331 U.S. 1 (1947); *see supra* note 92.

95. For instance, suppose that a partner with a $1,000 tax basis in his partnership interest intended to abandon such interest. However, because of his share of partnership liabilities ($500), he will be deemed to have received a money distribution of $500 pursuant to § 752(b). In such case, the partner will have a $500 capital loss, rather than a $1,000 ordinary loss from abandonment, as follows:

Taxpayer's Basis	$1000
Amount Realized	500
Capital Loss	($ 500)

So what was potentially a $1000 ordinary loss from abandonment has been transformed into a $500 capital loss because of § 752(b).

96. For purposes of § 752, a partnership liability includes accounts payable and other accrued expenses, even though the partnership accounting method has not recorded the liability. Rev. Rul. 60-345, 1960-2 C.B. 211.

97. A partner's "share" of liabilities is defined in Treas. Reg. § 1.752-1(e):

tions. The first is when the partnership has no liabilities. The second situation will occur when the abandoning partner is a limited partner in a limited partnership which has only recourse liabilities outstanding to which other general partners are personally liable.[98]

2. No Liabilities

If the abandoning partner is not deemed to have received a distribution of money under section 752(b) for a decrease in his share of liabilities, the partner should be entitled to an ordinary loss equal to his adjusted basis in the abandoned partnership interest. The loss does not arise from a sale or exchange, so neither section 741 nor section 1211(b)(1) is applicable. There is no distribution, so section 731 is not applicable. Therefore section 165(a) should be applicable with the taxpayer being allowed an ordinary loss deduction.

In *Gannon v. Commissioner*,[99] a case decided under the 1939 Code, the Tax Court permitted the taxpayer an ordinary loss deduction upon the forfeiture of his partnership interest. In *Gannon*, the taxpayer, a partner in a large Houston law firm, withdrew from the firm to practice elsewhere. Under the provisions of the partnership agreement, the taxpayer's partnership interest automatically reverted to the firm with the withdrawing partner receiving

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A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.

98. In view of Treas. Reg. § 1.752-1(e), it would seem that a partnership *qua* partnership cannot have non-recourse liabilities because all partners, including limited partners, are responsible for partnership liabilities at least according to their interest in profits. But the partnership also can, and usually does have some recourse liabilities for which a limited partner is not responsible, because recourse liabilities are shared according to the loss ratio and limited partners usually have no responsibility for prospective losses. *See* 1 McKEE, *supra* note 1, at ¶ 8.01. However, some limited partners are obligated under the limited partnership agreement to make additional contributions to capital if the partnership needs additional financing, and if so, will be responsible for a proportionate share of the recourse obligations. *See* Treas. Reg. § 1.752-1(e).

99. 16 T.C. 1134 (1951), *acq.*, 1951-2 C.B. 2.

no compensation whatsoever for his interest in the firm's assets and uncollected fees.[100] The Tax Court held that the taxpayer sustained a loss in the amount of his adjusted cost basis in his partnership interest and such loss was deductible under section 23(e) of the 1939 Code,[101] the predecessor to section 165(c) of the 1954 Code. The Tax Court reasoned that even though the taxpayer had incurred a capital loss, the loss was not subject to the capital loss limitations of section 23(g)[102] and section 117(g)[103] because it was not "occasioned" by a sale or exchange. The court held that the

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100. *Id.* at 1137.

101. I.R.C. § 23(e) (1939) the predecessor to § 165(c) of the 1954 Code, provided in pertinent part:

> In computing net income there shall be allowed as deductions:
>
> (e) Losses By Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—
>
> (1) if incurred in trade or business; or
>
> (2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or
>
> (3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

The Treasury Regulations provided that "[t]he limitations provided in [the 1939 Code] section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets." 26 C.F.R. § 39.23(e)-3(a) (1953).

The Code did not contain the partnership tax provisions of Subchapter K, §§ 701-761, in 1939.

102. I.R.C. § 23(g) (1939) provided:

> In computing net income there shall be allowed as deductions:
>
> (g) Capital Losses.—
>
> (1) Limitation.—Losses from sales or exchanges of capitial assets shall be allowed only to the extent provided in section 117.
>
> (2) Securities Becoming Worthless.—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.
>
> (3) Definition of Securities.—As used in this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

103. I.R.C. § 117(g) (1939), the predecessor of § 1233 of the 1954 Code, provided in pertinent part:

> (g) Gains and Losses from Short Sales, Etc.—For the purpose of this chapter—
>
> (1) gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and
>
> (2) gains or losses attributable to the failure to exercise privi-

words "sale" or "exchange" must be given their ordinary meanings and forfeiture of a partnership interest was not encompassed within the ordinary meaning of those terms.[104] Under almost identical circumstances, in a case dealing with another partner's withdrawal from the same law firm, the Tax Court reached the same conclusion.[105] Some commentators feel the same result should be reached under the 1954 Code.[106] Although the Tax Court has not specifically ruled on this issue under the 1954 Code, it did address the issue in *Stilwell v. Commissioner*,[107] where it expressly abstained from deciding the issue as to whether an "absolute" forfeiture by a partner who does not possess a share of partnership liabilities, amounts to an ordinary loss.[108]

The Internal Revenue Service has taken conflicting positions on the question of whether a taxpayer should be afforded an ordinary loss upon forfeiture, without consideration, of a partnership interest. In Revenue Ruling 70-355,[109] the taxpayer, a limited partner, was allowed an ordinary loss deduction under section 165 for the adjusted basis in his interest.[110] There, the taxpayer had purchased his partnership interest for an amount greater than his share of underlying assets but no section 754 election was made to adjust the basis of partnership property by the partnership.[111] The partnership sustained considerable business losses, became insol-

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leges or options to buy or sell property shall be considered as short-term capital gains or losses.

104. Gannon v. Commissioner, 16 T.C. at 1139. *See also* Commissioner v. Flaccus Oak Leather, 313 U.S. 247, 249 (1940), where the Supreme Court stated that "[g]enerally speaking, the language in the Revenue Act . . . is to be given its ordinary meaning and the words 'sale' or 'exchange' are not to be read any differently."
105. Hutcheson v. Commissioner, 17 T.C. 14 (1951), *acq.*, 1951-2 C.B. 2. While the Tax Court never mentioned whether the withdrawing partners were relieved from liabilities, it seems certain that a large law firm would always have some outstanding liabilities.
106. 2 McKEE, *supra* note 1, at ¶ 15.06[2]; A. WILLIS, PARTNERSHIP TAXATION § 26.02 (2d ed. 1976) [hereinafter cited as WILLIS].
107. 46 T.C. 247 (1966).
108. *Id.* at 252, n.3.
109. 1970-2 C.B. 51.
110. *Id.*
111. I.R.C. § 754 allows the partnership to make an election to adjust the basis of partnership property in the case of a transfer of a partnership interest. Such adjustments to basis affect the transferee partner only, in an amount equal to the difference between the transferee's basis for his partnership interest and his proportionate share of the adjusted basis of the partnership property. I.R.C. § 743(b). *See also* 2 McKEE, *supra* note 1, at ¶¶ 24.01-24.09. I.R.C. § 754 is consistent with the entity approach to taxing transfers of partnership interests, yet also provides a mechanism to take account of the value of partnership property aside from its relation to the value of the partnership interest. *See supra* note 91.

vent, and entered into bankruptcy proceedings. After reducing his basis for his distributive share of the partnership loss,[112] the taxpayer still had some basis remaining. The ruling stated that since "the taxpayer did not receive cash or other consideration in liquidation of his interest," the loss is deductible as an ordinary loss under section 165 of the Code.[113]

In contrast, the Service in Revenue Ruling 76-189,[114] appears to have taken an opposing position. Once again, the taxpayer purchased his interest for an amount greater than his share of partnership assets and again no section 754 election to adjust the basis of partnership property was made. However, in this ruling, the partnership simply terminated at the end of the taxable year, having no assets or liabilities remaining, as opposed to entering bankruptcy. After reducing the taxpayer's basis for partnership losses under section 705, the taxpayer still had an adjusted basis remaining. To support its finding that the taxpayer should be allowed only a capital loss for his unrecovered basis, the Service relied on section 731 of the Code.[115] Reliance upon this section required a preliminary finding that the taxpayer had received a "distribution in liquidation" of his interest. Cognizant of the "distribution" language in section 731, the Service, without citing any authority, took the position that "where a partnership having no assets terminates without distributing property, the provisions of Section 731 apply as if an actual distribution had taken place."[116]

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112. I.R.C. § 705 provides in pertinent part:

> (a) GENERAL RULE.—The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—
>
> (1) increased by the sum of his distributive share for the taxable year and prior taxable years of—
>
> (A) taxable income of the partnership as determined under section 703(a),
>
> (B) income of the partnership exempt from tax under this title, and
>
> (C) the excess of the deductions for depletion over the basis of the property subject to depletion;
>
> (2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable years and prior taxable years of—
>
> (A) losses of the partnership, and
>
> (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account . . . .

113. Rev. Rul. 70-355, 1970-2 C.B. 51.

114. 1976-1 C.B. 181.

115. *Id.*

116. *Id.* at 182. This is a strong position for the Service to take without any authority or analysis. I.R.C. § 731 clearly requires a distribution. There was no ac-

These two revenue rulings appear to be difficult to reconcile.

The state of the law in this area is unsettled. Some commentators feel that the abandonment of a partnership interest, where the partner has not been relieved of liabilities and receives no other consideration, should entitle the taxpayer to an ordinary loss deduction.[117] This would seem to be the preferred interpretation. There appears to be no reason to treat partnership interests any different than other property.[118]

As final points, the taxpayer who is considering the abandonment of a partnership interest should see to it that all the liabilities have been paid at the time of the withdrawal, if at all feasible. The dilemma presented by outstanding liabilities will frequently recur, as it is difficult to imagine an operating partnership which does not have some accounts payable which remain outstanding at the time abandonment is contemplated.[119] Even the smallest partnership debt could prove fatal to the ordinary loss deduction.[120] Furthermore, the taxpayer should be sure to separate the payment of all liabilities from the eventual abandonment, termination, or liquidation of the partnership. Without this segregation, the Service could apply the step-transaction doctrine[121] and treat the payment

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tual distribution here, and the partnership had no liabilities from which the partner was relieved. Thus, it seems equally unlikely that there was a constructive distribution under § 752(b) or § 752(d).

117. 2 McKEE, *supra* note 1, at ¶ 15.06[2]; WILLIS, *supra* note 106, at § 26.02.

118. For a discussion of the tax treatment accorded other property unencumbered by liabilities, see *supra* text accompanying notes 67-70.

119. Watch latent liabilities and purchases for which the partnership has not been billed. *See supra* note 96.

120. *Cf.*, Wilkinson v. United States, 177 F. Supp. 101 (S.D. Ala. 1959) (No abandonment occurred when the transferor of a partnership interest received consideration in the form of relief from personal liability and ten dollars.). For a discussion of relief from liabilities, see *infra* text accompanying notes 123-31.

121. The step-transaction doctrine requires looking to the substance of the overall transaction, as opposed to form, and treating any isolated transaction, which is merely a step in the overall plan, in accordance with its true nature. *See, e.g.*, Pietz v. Commissioner, 59 T.C. 207 (1972). In *Pietz*, a partnership was formed to construct a hotel. Upon deciding that it was going to be a losing venture, the partners wanted to end the partnership. The partnership proceeded to sell the hotel which was the principal asset of the partnership. The purchasers assumed the first mortgage, gave the petitioners cash, and gave the other partner (there were three partners; two were petitioners here) a second mortgage. The petitioners immediately repaid a construction loan with the cash. At this point, the partnership had no assets or liabilities and the petitioners claimed an ordinairy loss deduction for their adjusted basis because they received nothing on liquidation and termination of the partnership. The Tax Court held that the sale of the hotel, payment of the bank debt, and distribution of the second mortgage to the other partners were all integral parts of an agreed plan to liquidate. *Id.* at 216-17. Therefore, the last step was united with the previous transactions, resulting in a plan of liquidation from which emanated a capital, rather than ordinary loss.

of liabilities as a distribution in liquidation which would trigger section 731 and result in a capital loss rather than ordinary loss.[122]

3. *Relief from Liabilities*

The factor which most frequently requires consideration before abandoning a partnership interest is the tax effect of relief from partnership liabilities.[123] Even before the addition of Subchapter K in 1954, it had been held that the abandonment of a partnership interest, where the withdrawing partner was relieved from liability, should be distinguished from the situation where no relief from liability was afforded.[124] The relief from liabilities constitutes the consideration given for the partnership interest. Thus, there is a sale or exchange of a capital asset resulting in a capital gain or loss.[125]

Subchapter K affords the taxpayer some flexibility to structure a withdrawal as either a liquidation of the withdrawing partner's interest or a transfer of that interest to the remaining partners.[126]

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122. *See supra* text accompanying notes 87-90.

123. For a discussion of when a partner will not have a share of liabilities, see *supra* text accompanying notes 96-98.

124. Hutcheson v. Commissioner, 17 T.C. 14 (1951), *acq.*, 1951-2 C.B. 2 (held to be an ordinary loss where, pursuant to the partnership agreement, a partner withdrew, forfeiting his investment for which he received no consideration); Gannon v. Commissioner, 16 T.C. 1134 (1951), *acq.*, 1951-2 C.B. 2 (ordinary loss permitted where a partner withdrew from the partnership and, pursuant to the partnership agreement, he received no consideration).

Hutcheson and *Gannon* were distinguished in Wilkinson v. United States, 177 F. Supp. 101 (S.D. Ala. 1959). In *Wilkinson*, a case decided under the 1939 Code, the withdrawing partner was relieved from personal liability. The court said:

> Whether or not a partnership interest can be abandoned where there is no forfeiture clause [in the partnership agreement] is a novel question, but one which need not be decided here. If there was a sale or exchange of the partnership interest, the loss was a capital one. If there was a sale or exchange of the partnership interest, principles of abandonment are rendered inapplicable. Drawing again from analogous cases involving real property, the rule is that if a mortgagor conveys his interest for a release of liability, or for the slightest monetary consideration, a sale or exchange results. Here, the plaintiff received consideration because he was relieved of personal liability on [a mortgage] . . . and because the [withdrawal] agreement . . . recited a consideration of $10 passing to the plaintiff. It follows that there was a sale or exchange and that under the facts, a case of abandonment does not appear.

Id. at 105 (footnotes omitted).

125. *Id.* at 104.

126. *See* 2 McKEE, *supra* note 1, at ¶ 15.02[3][a]. Since the economic results of a pro rata sale and a liquidation are usually identical and the effect of the abandonment is to increase the interests of the other partners proportionately, the abandonment could be deemed either a sale or a liquidation. The courts have looked to the mutual intent of the parties at the time of the transaction in

Both stratagems entail different tax consequences. It is, therefore, important to determine if the abandonment transaction is a sale, or in the alternative, a liquidation of the abandoning partner's interest.

In the situation where the partner is relieved from liabilities as part of a liquidation of the abandoning partner's interest, the tax consequences are definite. Under section 752(b), the partner is deemed to have received a distribution of money from the partnership, which under sections 731 and 741 triggers a loss from the sale or exchange of a capital asset.[127] The Service has adopted this position.[128]

Alternatively, when the abandonment transaction is structured as a transfer of the partnership interest to the remaining partners or creditors, the tax consequences are not as clear. Of course, if the transfer is an outright sale or exchange, *i.e.*, where the abandoning partner receives consideration in addition to relief from partnership liabilities, section 752(d) will apply with the liabilities being treated as an amount realized.[129] The gain or loss will be characterized as capital under section 741 of the Code. However, in most abandonments, and surely in any planned abandonment where the taxpayer has sought competent tax counsel, the taxpayer will not receive any, not even nominal consideration, other than the relief from liabilities,[130] in return for the transfer (by abandonment) of his partnership interest to the remaining partners or creditors. In this situation there is some disagreement as

classifying the event as a sale or liquidation. In ascertaining a partner's intent, the courts have looked primarily to the language in the legal documents and negotiations. Language like "sell" and "purchase" has resulted in sale treatment. Emory v. United States, 374 F. Supp. 1051, 1053 (E.D. Tenn. 1972), *aff'd*, 490 F.2d 208 (6th Cir. 1974). A liquidation was found when language employing the word, "withdrawal," was used. Cooney v. Commissioner, 65 T.C. 101, 110 (1975). Likewise, when the phrase, "terminate and dissolve," was used, a liquidation was found. Stilwell v. Commissioner, 46 T.C. 247 (1966). In O'Brien v. Commissioner, 77 T.C. 113, 116-17 (1981), the tax court concluded that language employing the word, "abandonment," resulted in a liquidation.

127. Stackhouse v. United States, 441 F.2d 465 (5th Cir. 1971); Pietz v. Commissioner, 59 T.C. 107 (1972); Stilwell v. Commissioner, 46 T.C. 247 (1966). All three of these cases stand for the proposition that the provisions of Subchapter K and in particular, §§ 731(a), 741, and 752 must be read together in determining the character of gains and losses upon liquidation of a partnership.

128. Rev. Rul. 74-40, 1974-1 C.B. 159.

129. I.R.C. § 752(d) does not actually state that liabilities are to be considered as an amount realized, but rather states only that they are to be treated in the same manner as liabilities are treated in connection with non-partnership property. Under the *Crane* doctrine, relief from liabilities is considered as an "amount realized."

130. *See supra* notes 117 & 120 and *infra* notes 142, 145-146, 167, 178 and accompanying text.

to whether section 752(b) or section 752(d) should apply to the transfer.[131]

4. Non-Sale Transfers—752(b) v. 752(d)

Section 752(d) simply extends the *Crane*[132] doctrine to the sale or exchange of partnership interests. In essence, if the relief from liabilities would be an amount realized when the transfer was of property other than a partnership interest, then it also is an amount realized when a partnership interest is transferred.[133] Apparently most commentators,[134] as well as the Service,[135] favor applying section 752(d) rather than section 752(b) in all transfers of partnership interests. However, a major obstacle in applying section 752(d) to a transfer by abandonment is the express language of section 752(d) which states that the section applies "in the case of a sale or exchange."[136] Since an abandonment is not a sale or exchange,[137] a literal reading of section 752(d) would require that it not be employed in the abandonment setting. Therefore, to apply section 752(d) to an abandonment, the literal language of the section must be ignored.[138]

Assuming the literal language of section 752(d) is ignored and the section applies to an abandonment, the question arises as to whether the section must be interpreted as authority requiring that the abandonment be treated as a sale or exchange. Remem-

131. *See* 2 McKEE, *supra* note 1, at ¶¶ 15.06[3][b] and 15.5[1][a] for an excellent discussion of the conflict.
132. Crane v. Commissioner, 331 U.S. 1 (1947). *See supra* text accompanying notes 75-77.
133. I.R.C. § 752(d).
134. *See* 2 McKEE, *supra* note 1, at ¶ 15.05[1][b] (The overall structure of § 752 suggests that § 752(d) should control the treatment of liabilities in all "lateral transfers" because otherwise § 752(d) is statutory surplusage.); S. HORVITZ, *Depreciation Recapture—Partnership Transactions*, TAX MGMT. (BNA) No. 289, at A-65, 66 (1973 with supplements to date); A. SPADA, *Dispositions of Partnership Interests—Gifts, Incorporations, etc.*, TAX MGMT. (BNA) No. 286, at A-6 through A-8 (1973 with supplements to date); Note, *supra* note 1, at 359-364.
135. Rev. Rul. 75-194, 1975-1 C.B. 80. There, the taxpayer contributed his limited partnership interest to a charity. The partnership had liabilities none of which were with recourse against the taxpayer, the other partners, or the partnership. The Service applied § 752(c) and Treas. Reg. § 1.752-1(e) and concluded that the taxpayer was responsible for a "share" of the liabilities. The ruling also required the partner to recognize the liabilities on the transfer under the authority of § 752(d). However, the recognition of liabilities under § 752(d) was not the basis for finding a sale, rather the Service relied on the "bargain sale" doctrine used in transfers of property to charitable organizations. *See* I.R.C. § 1011(b) and § 170, and Treas Reg. 1.170A-4(c)(2)(iii).
136. I.R.C. § 752(d).
137. *See supra* text accompanying notes 8-9.
138. I.R.C. § 752(d).

ber, the primary purpose for a partner electing to abandon his partnership interest was not to prevent the realization of liabilities, but, alternatively, to prevent the characterization of the transfer as a sale or exchange.[139] Consistent with this purpose, there are two arguments against such an interpretation. First, only circular reasoning would permit avoiding a literal reading of section 752(d) in the first instance,[140] and then using the same language to convert a transfer that otherwise is not a sale or exchange into a sale or exchange. Second, since section 752(d) is only a statutory authorization to apply the *Crane* doctrine to transfers of partnership interests,[141] it is not clear that *Crane* also dictates the finding of a sale or exchange,[142] though recent cases[143] have certainly suggested it.

Alternatively, if section 752(b) is applied, the tax consequences will not necessarily differ. One commentator suggests the application of section 752(b) bifurcates the transfer.[144] First, a pretransfer, constructive distribution of money is made from the partnership to the partner in the amount of the decrease in his share of partnership liabilities. This distribution is taxable under section 731, which treats the constructive distribution as a sale or exchange generating a capital gain or loss. Second, a lateral transfer of the balance of the partnership interest is made to the other partners or creditors which is taxable under section 741. If the abandoning partner's share of liabilities exceeds his adjusted basis in his partnership interest, the excess constructive distribution of money will be treated as a capital gain under section 731(a) and section 741, a result identical to that reached when section 752(d) is applied.[145] However, when the abandoning partner's adjusted basis in his partnership interest exceeds his share of liabilities, a different result occurs under section 752(b) than under section 752(d).[146] The constructive distribution of money under section 752(b) will reduce the partner's basis under section 733, but no

139. *See supra* text accompanying notes 6-12.
140. *See supra* text accompanying note 138.
141. *See supra* note 129.
142. One commentator suggests that the "sale or exchange" language in § 752(d) may be viewed as an historical accident by Congress, which was not intended to restrict the application of the *Crane* doctrine. This is due to the fact that when § 752(d) was added to the 1954 Code, the *Crane* doctrine had been applied only to sales and exchanges, and not to other types of transfers like gifts and charitable contributions. *See* 2 McKEE, *supra* note 1, at ¶ 15.05[1][a].
143. Freeland v. Commissioner, 74 T.C. 970 (1980); Lenway & Co. v. Commissioner, 69 T.C. 620 (1978); Millar v. Commissioner, 67 T.C. 656 (1977), *aff'd*, 577 F.2d 212 (1979). *See also* text accompanying notes 75-77 *supra*.
144. *See* 2 McKEE, *supra* note 1, at ¶ 15.06[3][b].
145. *Id.*
146. *Id.*

gain or loss is recognized under section 731(a).[147] Consequently, the abandoning partner transfers his partnership interest, which has some basis remaining, to the other partners or creditors for no consideration. No sale or exchange results and an ordinary loss under section 165(a) and section 165(c)(1) may be taken.[148]

Case law to date has not accepted or even discussed this bifurcation approach. However, in *O'Brien v. Commissioner*,[149] a partner effectively abandoned his partnership interest in a Texas real estate joint venture.[150] Abandonment relieved the partner of substantial nonrecourse liabilities, but not in excess of his basis. The Tax Court held that the taxpayer was to be allowed only a capital loss for his remaining basis.[151] The court based its decision on the interplay of sections 752(b), 741, and 731(a)(2). The Tax Court specifically addressed the petitioners contention that no distribution in liquidation occurred, thus making section § 731(a)(2) inapplicable.[152] The court found the taxpayer to have received a constructive distribution of money under section 752(b) and stated: "[T]his 'distribution' occurred upon the *termination* by abandonment of petitioner's partnership interest. Therefore, petitioner is deemed to have received this distribution in liquidation of his partnership interest. Sec. 761(d); [S]ec. 1.731-1(a)(2), Income Tax Regs."[153]

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147. *Id.* A loss is not recognized because there is no distribution in liquidation, but instead, a transfer to the other partners or creditors. For a discussion of the distribution in liquidation requirement under § 731, see *supra* notes 115-116 & *infra* note 153, and accompanying text. *But see*, O'Brien v. Commissioner, 77 T.C. 113 (1981) (a liquidating distribution occurred as a result of the abandonment of the taxpayer's partnership interest); *see also* I.R.C. § 731(a), *supra* note 87.
148. *See supra* text accompanying notes 7-9.
149. 77 T.C. 113 (1981).
150. It is well settled, and the issue was not in dispute in the *O'Brien* case, that joint ventures are taxable as partnerships. *See* I.R.C. § 761(a) and § 7701(a)(2). However, if the joint venture has many corporate attributes, it risks being taxed as an association. *See* I.R.C. § 7701(a)(3). Corporate attributes which may lead to a joint venture being taxed as a corporation include: limited liability, continuity of life, centralization of management and free transferability of interests. *See* Treas. Reg. § 301.7701-2(a)(1).
151. O'Brien v. Commissioner, 77 T.C. 113, 117. *But see supra* notes 146-47 and accompanying text.
152. *Id.* at 118.
153. *Id.* (emphasis added). Treas. Reg. § 1.731-1(a)(2) states that "[t]he term 'liquidation of a partner's interest,' as defined in section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions." *But cf.* Neubecker v. Commissioner, 65 T.C. 577 (1975). In *Neubecker*, the Tax Court held that there was no distribution in liquidation because the partners who received the distribution continued the partnership's law business by retaining clients and cases. The court said that the partnership did not terminate because under

Regardless of the interpretation given to section 752(b), it does appear that the courts[154] have made this the operative section as opposed to section 752(d), which most commentators, and the Service favor.[155]

5. *Worthlessness ("Practical Abandonment")*

To this point, the analysis has focused strictly on abandoning the partnership interest. However, it is quite possible for the partnership interest to become worthless at a point in time before the partner actually abandons his interest.[156] If the partnership interest is worthless,[157] an "abandonment of property in a practical sense" may occur even before the overt act of abandonment.[158] In *Gordon v. Commissioner*,[159] the court stated the "practical abandonment" rule:

> [T]he logic of the situation requires that if, in the case of either real or personal property, it can be shown that no value whatever remains, a deduction for loss may then be permitted even though a sale, abandonment, or other irrevocable loss of title is postponed to a later period.[160]

This is consistent with prior law. For example, under the 1939 Code, a taxpayer was allowed an ordinary loss when his interest in a joint venture became worthless.[161] In *Zeeman v. United States*,[162] the taxpayer owned a limited partnership interest in a stock brokerage firm. When the firm became totally insolvent, the taxpayer's interest became worthless. The court held that even

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§ 708(b)(1)(a), a complete cessation of partnership business is required to effectuate a termination. Similarly, the court found that no abandonment had occurred. *Id.* at 584. Thus, under *Neubecker*, the continuation of the partnership business prevented any distribution, either actual or through an attempted abandonment, from being characterized as a distribution in liquidation, and, therefore, no loss could be recognized to the partner on the basis of a distribution by the partnership. I.R.C. § 731(a)(2). *Id.* at 584.

154. Neubecker v. Commissioner, 65 T.C. 577 (1975); Pietz v. Commissioner, 59 T.C. 207 (1972); Stilwell v. Commissioner, 46 T.C. 247 (1966).
155. *See supra* notes 134-35.
156. For a discussion of the inherent timing problems, see *supra* notes 37-50.
157. In the analogous corporate situation, § 165(g) provides for sale or exchange treatment of any worthless security which is a capital asset. *See also supra* note 80, for a discussion of the similarities between corporate stock and partnership interests.
158. O'Connor Estate v. Commissioner, 7 T.C.M. 43 (CCH 1948).
159. 46 B.T.A. 1201 (1942), *acq.*, 1951-1 C.B. 2, *aff'd*, 134 F.2d 685 (4th Cir. 1943).
160. *Id.* at 1210.
161. Webb v. Commissioner, 23 T.C. 1035 (1955), *acq.*, 1955-1 C.B. 7. In *Webb*, a case under the 1939 Code, the taxpayer organized an automobile dealership which eventually failed. Although the investment was evidenced by a promisory note, the contract signed between the joint venturers created a partnership and the court held that the taxpayer was allowed an ordinary loss in the year the joint venture became worthless.
162. 275 F. Supp. 235 (S.D.N.Y. 1967), *aff'd*, 395 F.2d 861 (2d Cir. 1968).

though the limited partner's interest in the firm was a "capital asset," the taxpayer's loss was an ordinary loss, because the interest became worthless without a sale or exchange.[163]

In fact, claiming an ordinary loss on the worthlessness of a partnership interest may lead to more favorable results than abandonment. In the Tax Court's recent decision, *O'Brien v. Commissioner*,[164] the taxpayer executed an effective abandonment,[165] but was still only allowed a capital loss because of the relief from partnership liabilities which triggered sections § 752(b), 741, and 731(a).[166] Notwithstanding, the Tax Court left open the possibility of an ordinary loss deduction when the partnership interest becomes worthless under the same facts.[167] This possibility exists for two reasons. First, even though the partnership has liabilities, the partner is not surrendering or abandoning his interest. Therefore, the partner does not experience a decrease in his share of those liabilities and section 752(b) will not be applicable. This, in turn, precludes the application of section 731(a) because money is no longer deemed to have been distributed. Second, even if a section 752(b) distribution of money were to be found, section 731(a) requires the distribution to be in liquidation of the partner's interest.[168] This would not necessarily occur merely because the partnership is worthless.

C. Impact of the Economic Recovery Tax Act

The Economic Recovery Tax Act of 1981 (ERTA)[169] added a new provision to the 1954 Code: section 1234A.[170] Section 1234A provides that any gain or loss resulting from the termination of a right or obligation with respect to a special class of personal property, shall be treated as a gain or loss from the sale of a capital asset.[171] Termination by cancellation, lapse, or expiration is specifically provided for by statute; abandonment appears to be within

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163. 275 F. Supp. at 253.
164. 77 T.C. 113 (1981).
165. *Id.* at 119. The court treated the transfer as an abandonment, but specifically did not decide whether the abandonment constituted a sale or exchange.
166. *Id.*
167. *Id.* at 120. In the last full paragraph of the case the court expressly left open the worthlessness argument contained in *Zeeman*. *See supra* note 162.
168. *See supra* text accompanying notes 115-16, 153.
169. Pub. L. No. 97-34, 95 Stat. 172 (1981).
170. I.R.C. § 1234A provides:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

171. *Id.*

the intendment of the statute, too.[172] Note, however, that the new provision is only applicable to property acquired and positions established after June 13, 1981.[173] Moreover, the new provision applies only to personal property as defined in section 1092(d)(1) which is or upon acquisition would be a capital asset in the hands of the taxpayer.[174] Section 1092(d)(1)[175] limits the definition of personal property to that which is actively traded. The incorporation of this definitional limitation into section 1234A together with the fact that section 1092 is a commodity straddles provision,[176] and not a provision dealing with abandoned partnership property, makes it unlikely that the average partnership would fall within the terms of section 1234A. However, there is a possibility that the Service might try to apply the provision to the abandonment of a publicly-sold, limited partnership interest since these interests are sometimes traded.

IV. CONCLUSION

As long as it remains more desirable to receive an ordinary loss rather than a capital loss,[177] partners will seek to avail themselves of this advantage. The abandonment of a partnership interest provides this opportunity. If the partner is not relieved from any liabilities in the process, an ordinary loss should result. But if the taxpayer is relieved from liability, the loss will probably be considered a capital loss. Notwithstanding, the taxpayer still may have an opportunity to treat the loss as ordinary if he can show that the partnership interest became worthless before the abandonment.[178]

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172. *See* S. REP. No. 144, 97th Cong., 1st Sess. 170, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS, 105, 266, which states that abandonment of property was one of the target abuses § 1234A was intended to correct.
173. Pub. L. No. 97-34, § 507(a), 95 Stat. 333 (1981).
174. I.R.C. § 1234A. The requirement that the property be a capital asset in the hands of the taxpayer allows the taxpayer to make the *Corn Products* argument that the asset is not a capital asset. *See supra* note 66.
175. I.R.C. § 1092(d)(1) is a provision designed to prevent the deferral of income and to prevent conversion of ordinary income and short-term capital gain into long-term capital gain on straddle transactions. It provides in pertinent part:

    (d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

    (1) PERSONAL PROPERTY.—The term 'personal property' means any personal property (other than stock) of a type which is actively traded.
176. *See supra* note 175.
177. *See supra* text accompanying notes 10-12.
178. O'Brien v. Commissioner, 77 T.C. 113 (1981).