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Taxation of the Disposition of Partnership Interests: Time to Repeal I.R.C. Section 736

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Taxation of the Disposition of Partnership Interests: Time to Repeal I.R.C. Section 736

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I. INTRODUCTION

As part of the Internal Revenue Code of 1954 Congress enacted section 736.¹ This section specifies the tax treatment of the various

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1. I.R.C. § 736:

PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.

types of payments that a partnership may make to a withdrawing partner.² It introduced the concept of a liquidation of a partnership interest by the partnership itself, as opposed to the sale³ of that interest to an outsider or to the continuing partners. In some instances it provides tax consequences for continuing and withdrawing partners which are different from those attendant to a sale. It was designed to make the law concerning disposition of partnership interests simpler⁴ and to provide flexibility to the parties in fixing the federal tax consequences thereof.⁵

After over thirty-year's experience with section 736 it is time to acknowledge that it has not worked very well. The creation of the concept of a "liquidation" of a partnership interest, with consequences

(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT.—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP.—

(1) GENERAL RULE.—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) SPECIAL RULES.—For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

2. "Withdrawal" from a partnership shall be used herein to refer to withdrawal by retirement, death or expulsion etc. from a partnership. It shall also be used to describe the sale of a partner's entire partnership interest.

3. Section 741 controls the tax consequences of a sale of a partnership interest for the selling partner. It 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).

I.R.C. § 741.

4. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954).

5. *Foxman v. Commissioner*, 41 T.C. 535, 550 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

that differ from those of a sale, has not simplified the tax law in this area; it has complicated it unnecessarily. Further, while section 736 has provided flexibility to the parties to withdrawals from partnerships, this flexibility has been purchased at the expense of significant federal taxation policy. This Article examines those two propositions and advocates abrogating section 736 and the disparity it created between the tax attributes accompanying liquidations and sales of partnership interests. It proposes that all withdrawals from a partnership, whether accomplished by a sale to outsiders or to the continuing partners on one hand, or by liquidation of the interest by the partnership on the other, be treated similarly for tax purposes.

II. THE CHOICE WHEN A PARTNER WITHDRAWS: SALE OR LIQUIDATION

When a partner wishes to withdraw from a partnership that will continue to exist after his departure⁶ the Code provides him two alternatives: he may sell his interest to an outsider or to some or all of his partners, or he may receive liquidating distributions *from the partnership*. If the interest is sold, section 741 provides generally that gain or loss is treated as capital gain or loss.⁷ Section 751, referred to in section 741, provides that to the extent the sale price represents the value of the partner's share of unrealized receivables⁸ or substantially appreciated inventory,⁹ that portion of the sale price, to the extent it

6. Under § 708 a partnership will terminate for tax purposes if "within a 12 month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." I.R.C. § 708(b)(1)(B). Termination results in a constructive distribution of all partnership assets to the partners, the tax consequences of which are controlled by §§ 731 and 732. See Treas. Reg. § 1.708-1(b)(1)(iv). It is assumed in situations and transactions discussed herein that the parties do not intend to bring about this constructive distribution in structuring withdrawal agreements.

7. As in other contexts, the taxpayer may attempt to resist capital asset treatment if a loss is involved in the transaction. See *Stilwell v. Commissioner*, 46 T.C. 247 (1966).

8. These are defined under I.R.C. § 751(c) as including "to the extent not previously includable in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—

(1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(2) services rendered or to be rendered" *Id.* Under Treas. Reg. § 1.751-1(c)(4)(i), (ii), potential § 1245 or 1250 depreciation recapture income is treated as an unrealized receivable.

9. Inventory items are considered to have appreciated substantially in value under § 751 if their fair market value exceeds—

"(A) 120 percent of the fair market value of all partnership property, other than money, and

(B) 10 percent of the fair market value of all partnership property, other than money" I.R.C. § 751(d)(1).

exceeds the basis of such property to the selling partner,¹⁰ is treated as ordinary income. The purchaser, whether an erstwhile outsider or another partner, is deemed to have made a capital outlay¹¹ and generally takes a cost basis for the partnership interest.¹² In accordance with treatment of capital outlays generally, the purchaser receives no current deduction for the price of a partnership interest, regardless of how the selling partner must characterize the transaction.¹³

The tax treatment of the sale of a partnership interest under the 1954 Code is similar to that developed by the courts before 1954. Section 741 embodies an assumption that a partnership interest represents an asset apart from the underlying assets of the partnership, and further, that this interest is a capital asset. This characterization represents a triumph of the entity theory of partnership, a view that the partnership represents for tax purposes something more than the aggregate of its assets.¹⁴ The entity view was adopted by the courts quite consistently¹⁵ in the face of long-standing opposition by the Bureau of Revenue, which contended that the determination of ordinary income versus capital gain should be made on an asset-by-asset basis.¹⁶ For tax purposes, the sale of a sole proprietorship is treated as a sale of its aggregate assets.¹⁷ Similarly, the asset-by-asset approach views the partnership as an aggregate of sole proprietors. Under the 1939 Code

10. The basis to the selling partner is the same as it would be under § 732 if such property had been distributed to him in a current (i.e., non-liquidating) distribution immediately before the sale. Treas. Reg. § 1.751-1(a)(2). Under § 732 the basis of property to a distributee partner generally is the basis of the property to the partnership immediately before the distribution, unless that basis exceeds the basis of the distributee's partnership interest. In that case, the basis of the distributed property becomes the basis of the distributee's partnership interest reduced by any money distributed in the same transaction.
11. *Cooney v. Commissioner*, 65 T.C. 101, 108 (1975). This was also true under the 1939 Code. See *Pope v. Commissioner*, 39 F.2d 420 (1st Cir. 1930).
12. See I.R.C. § 742, which provides that the basis of a partnership interest is determined under §§ 1011 and following.
13. I.R.C. § 263. The House version of the 1954 Code provided for an exclusion from income for the purchasing partner for amounts a selling partner would be required to include in income under § 751. See H.R. REP. NO. 1337, *supra* note 4, at 71. The Senate did not agree with this portion of the legislation and it was not included in the Code. See S. REP. NO. 1622, 83d Cong., 2d Sess. 99 (1954).
14. See *Anderson & Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX L. REV. 497 (1960).
15. See, e.g., *Commissioner v. Smith*, 173 F.2d 470 (5th Cir.), *cert. denied*, 338 U.S. 818 (1949); *Shapiro v. United States*, 83 F. Supp. 375 (D. Minn.), *aff'd*, 178 F.2d 459 (8th Cir. 1949); *Humphrey v. Commissioner*, 32 B.T.A. 280 (1935). But see *Kessler v. United States*, 124 F.2d 152 (3d Cir. 1941); *City Bank Farmers Trust Co. v. United States*, 47 F. Supp. 98 (Ct. Cl. 1942).
16. This position was taken in G.C.M. 10092, 11-1 C.B. 114 (1932) and was not revoked until G.C.M. 26379, 1950-1 C.B. 58 (1950) in recognition of the position generally taken by the courts.
17. *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

and before, if the courts determined that payments by the partnership to a withdrawing partner represented the value of the partner's interest in partnership receivables, the transaction was not treated as a sale and the withdrawing partner was deemed to have received ordinary income. In determining whether payments received by a withdrawing partner represented his share of receivables, the courts generally examined whether that partner's partnership interest included property *other* than receivables. If the partner's interest consisted exclusively of receivables, payments from the partnership were treated as ordinary income to the withdrawing partner or his estate.¹⁸ Thus, before the 1954 Code, tax treatment of the consideration received by a withdrawing partner depended upon whether the transaction was determined to be a sale of a partnership interest, and that depended upon *what* was being sold.

The judicial framework for analyzing the disposition of a partnership interest developed without specific statutory guidance. The adoption of sections 741 and 736 in the 1954 Code provided that guidance but also made the picture more complex. Section 736 introduced a provision for the "liquidation"¹⁹ of a partnership interest with potential consequences quite distinct from those resulting from a sale. Section 736 provides that payments in liquidation of a partnership interest are to be treated by the recipient either as a distributive share or guaranteed payment of partnership income,²⁰ or as a distribution for an interest in partnership property.²¹ Payments treated as a distributive share or guaranteed payments of partnership income are includable in

18. This may be seen in *Bull v. United States*, 295 U.S. 247 (1935), in which the estate of a deceased member of a partnership, engaged in business as ship brokers, received for one year, pursuant to the partnership agreement, payments from the partnership as if the deceased had remained living. No capital had ever been invested in the partnership by any of the partners. The Court, in treating these payments as ordinary income, held:

Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale It results that the surviving partners are taxable upon firm profits and the estate is not. Here, however, the survivors have purchased nothing belonging to the decedent, who made no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was, therefore, income and not corpus

Id. at 254 (footnote omitted). See also *Black v. Lockhart*, 209 F.2d 308 (8th Cir.), *cert. denied*, 348 U.S. 819 (1954); *Helvering v. Smith*, 90 F.2d 590 (2d Cir. 1937); *Beavers v. Commissioner*, 31 T.C. 336 (1958); *Spicker v. Commissioner*, 26 T.C. 91 (1956); *McAfee v. Commissioner*, 9 T.C. 720 (1947); *Doyle v. Commissioner*, 37 B.T.A. 323 (1938), *aff'd*, 102 F.2d 86 (4th Cir. 1939).

19. A liquidation of a partnership interest is actually defined in § 761(d), as "the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership." I.R.C. § 761(b).

20. I.R.C. § 736(a).

21. I.R.C. § 736(b).

the gross income of the recipient.²² If the withdrawing partner must treat payments from the partnership as a distributive share or as guaranteed payments under section 736(a), the partnership income is reduced.²³

If the payments received from the partnership are treated as distributions for an interest in partnership property, the tax treatment accorded the withdrawing and continuing partners is closer to that incident to a sale. Payments that represent the withdrawing partner's interest in partnership property other than unrealized receivables²⁴ or partnership goodwill, and which are not specifically identified in the agreement pertaining to withdrawals as payments for goodwill,²⁵ are treated as partnership distributions generally. To the extent these payments exceed the basis of the withdrawing partner's interest, they constitute taxable gain.²⁶ Generally this gain is capital gain.²⁷ If distributions of money or property other than substantially appreciated inventory are made with respect to the departing partner's share of substantially appreciated inventory,²⁸ a portion of the distribution is allocated to the value of that inventory. To the extent that the amount of the distribution so allocated exceeds the adjusted basis of the substantially appreciated inventory to the withdrawing partner,²⁹ the resulting gain is ordinary income.³⁰ Section 736 provides no de-

22. A partner, under I.R.C. § 702(a)(1)-(8), reports his distributive share of various items of partnership income in determining his income tax. Under I.R.C. § 707(c) a partner who receives a payment that must be made regardless of the income (or loss) of the partnership includes that payment in his income as ordinary income. Treas. Reg. § 1.707-1(c).

23. Guaranteed payments under § 707(c) are deductible by the partnership. Treas. Reg. § 1.707-1(c). The requirement that a withdrawing partner take his distributive share of partnership income into his individual income reduces the amount of partnership income which must be reported by the continuing partners.

24. Under § 736(b)(2)(A), payments attributable to unrealized receivables are treated as payments under § 736(a).

25. I.R.C. § 736(b)(2)(B).

26. I.R.C. § 731(a)(1).

27. I.R.C. §§ 731(a)(2), 741.

28. I.R.C. § 751(d)(1).

29. See I.R.C. §§ 751(b), 732.

30. Section 736 does not refer to substantially appreciated inventory. Treatment of these payments under § 736(b) as distributions invokes § 731, which itself requires that distributions pertaining to substantially appreciated inventory be treated under § 751(b). See also Treas. Reg. § 1.736-1(b)(6). Under § 751(b), to the extent that a partner is treated as having received money (or any other property) for his share of substantially appreciated inventory, he is deemed to have sold that inventory to the partnership. The gain on the exchange is treated as ordinary income. A partnership may also realize ordinary income if it exchanges substantially appreciated inventory or unrealized receivables for a partner's share of partnership property other than money, Treas. Reg. § 1.751-1(b)(2)(i). But since § 736 appears to contemplate payments of money by the partnership, gain to the partnership would not occur in a transaction under § 736.

duction to the continuing partners or the partnership for section 736(b) payments for partnership property. To the extent that the withdrawing partner realizes gain on the distributions, the continuing partners may adjust the basis of remaining partnerships upward under section 734,³¹ if the partnership has a section 754 election in effect.

If the section 754 election is not in effect, the remaining partners get the worst of both worlds with respect to the section 736(b) payments; they are not deductible and there is no step-up in the basis of the partnership property to reflect the capital outlay in buying the departing partner's interest. To the extent that payments are deemed to fall under section 736, the regulations grant the departing partner an unusual degree of flexibility in reporting his capital gain.³²

Under section 736 the partnership, acting as an entity, is able to obtain tax consequences which the partners as individuals could not. The partnership is permitted a section 736(a) deduction for payments for the value of the withdrawing partner's interest in receivables, or even in some instances for the value of the departing partner's interest in goodwill. Thus, the partnership as an entity is accorded more significance with respect to the disposition of partnership interests than under prior law. While prior law emphasized *what* was sold in determining tax consequences, section 736 sometimes permits the identity of the buyer, if it is the partnership, to be determinative in some cases. While section 736 has created more options with respect to the disposition of partnership interests, it has also created more confusion.

III. THE CHECKERED HISTORY OF SECTIONS 736 AND 741

A. Development of Objective Tests

In codifying a scheme which ostensibly gives partners a choice be-

31. See I.R.C. § 734(b)(1)(A). If § 751(b) is involved, the partnership may adjust the basis of substantially appreciated inventory it is deemed to have purchased to the amount of money exchanged for it. Treas. Reg. § 1.751-1(g) example 2(e).

32. If both § 736(a) and (b) payments are made to a withdrawing partner, the parties are allowed to determine, in an arm's length agreement, the valuation of the partner's interest in partnership property. This valuation, the amount of the § 736(b) payments, will generally be regarded as correct. Treas. Reg. § 1.736-1(b)(1). If the payments to a withdrawing partner are fixed in amount, the portion of the payments each year that bears the same ratio to total payments in the year as § 736(b) payments bear to total payments for the life of the agreement is applied against the basis of the withdrawing partner's partnership interest. This is similar to the installment method of reporting under § 453. Treas. Reg. § 1.736-1(b)(5)(i). If there is no fixed amount of payments, the payments are treated first as § 736(b) payments up to the value of the withdrawing partner's interest in partnership property. Treas. Reg. § 1.736-1(b)(5)(ii). The parties may also agree upon any other method of allocating payments between § 736(a) and (b) as long as the total amount allocated to § 736(b) payments does not exceed the fair market value of the withdrawing partner's interest in partnership property. Treas. Reg. § 1.736-1(b)(5)(iii).

tween the tax consequences of a sale and a liquidation, Congress intended to make the law simpler and its application more predictable.³³ As noted earlier, Congress also intended to provide flexibility to continuing and withdrawing partners in structuring the tax consequences of withdrawal from a partnership. In retrospect it seems odd that Congress would have attempted to secure these objectives through section 736, a section that has proved to be too complex to be administered predictably.³⁴

It does not matter whether the fault for this complexity lies with Congress, as has been suggested by the Tax Court,³⁵ or with taxpayers who do not know what they are doing,³⁶ or with taxpayers who *do* know what they are doing³⁷ or with the courts. The fact is, complexity frustrates the desirable flexibility that would exist if knowledgeable parties were able to sit down under the tension of adverse interests and weigh predictable alternatives. Instead, the regime of sections 736 and 741 is one which exalts "pencil pushing,"³⁸ or an ability to overreach the other party to the agreement. For sections 736 and 741 to work as Congress intended, the parties to withdrawal agreements must clearly state what they intend the tax consequences to be. Very frequently parties to these agreements do not do so. Even when they

33. The House Ways and Means Committee commented: The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate or dissolve a partnership without any assurances as to tax consequences. H.R. REP. NO. 1337, *supra* note 4, at 65.

34. In W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 22.01[4] (abridged ed. 1978) the authors blame the complexity of § 736 on its references to other complex Code sections such as 707, 731 and 751.

35. *Foxman v. Commissioner*, 41 T.C. 535, 551 n.9 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

36. In *Jacobs v. Commissioner*, 33 T.C.M. (CCH) 848, 855 (1974), the court noted, understandingly but perhaps patronizingly, that the taxpayers who negotiated what turned out to be an ambiguous agreement were "medical men." A distressing number of ambiguous agreements have involved lawyers, see *Cooney v. Commissioner*, 65 T.C. 101, 108 (1975), and CPAs, see *Spector v. Commissioner*, 641 F.2d 376 (5th Cir.), *cert. denied*, 454 U.S. 868 (1981), *on remand*, 44 T.C.M. (CCH) 631 (1982); *Karan v. Commissioner*, 319 F.2d 303 (7th Cir. 1963); *Champlin v. Commissioner*, 36 T.C.M. (CCH) 802 (1977); *Coven v. Commissioner*, 66 T.C. 295 (1976); *Kelly v. Commissioner*, 29 T.C.M. (CCH) 1090 (1970); *Wheeling v. Commissioner*, 23 T.C.M. (CCH) 778 (1964).

37. See *Kelly v. Commissioner*, 29 T.C.M. (CCH) 1090 (1970). In upbraiding the parties to a withdrawal agreement for an apparently contrived ambiguity, the court commented:

It is indeed unfortunate where, as here, taxpayers having expertise in the field of Federal taxation abuse the freedom which Congress permits them in determining the tax consequences of business transactions by obscuring such transactions in confusion and ambiguity.

Id. at 1105.

38. Horvitz, *Life Insurance as a Planning Tool: Use of Insurance to Fund Partnership Buy-Sell Agreement*, 33d N.Y.U. INST. ON FED. TAX'N 867, 870 (1975). The author did not appear to have used that term disparagingly.

do, however, their intent is subject to unpredictable second-guessing by the courts. The critical difficulty with the regime of sections 736 and 741 is differentiating a liquidation by the partnership from a sale of a partnership interest to all or some of the remaining partners. There is no problem if the purchasing party is an outsider;³⁹ that transaction is generally capital because of *what* is being sold, a partnership interest. When other partners are acquiring the partnership interest of the withdrawing partner, however, it is necessary to determine whether they are acting for the partnership or as individuals. Although in either case it is a partnership interest which is being sold, the difference in taxes can be quite significant. The parties may usually be expected to assume postures that suit the needs of litigation regardless of what was hammered out earlier in negotiations.⁴⁰ It can sometimes be extremely difficult to determine whether the continuing partners, in paying the withdrawing partner for his interest, are acting for the partnership or as individuals. According such a high degree of significance to the capacity in which the actors are deemed to be acting is particularly remarkable in light of holdings that a partnership making a section 736 acquisition may use individual funds of the partners,⁴¹ and partners acquiring as individuals may use partnership funds.⁴²

The courts have struggled to characterize withdrawal payments as representing a sale or liquidation in accordance with (but sometimes in spite of) the objective circumstances of the withdrawal. A number of objective tests have appeared in the cases. The tests as outlined nearly twenty years ago in a perceptive article by Professor Swihart⁴³ are as follows: 1) the economic consequences test; 2) the basis of payments test; 3) the maker of the payments test; 4) the source of the payments test; 5) the obligation of payments test; and 6) the intention of the parties test.⁴⁴

39. Swihart, *Tax Problems Raised by Liquidations of Partnership Interests*, 44 TEX. L. REV. 1209, 1225 (1966).

40. W. MCKEE, *supra* note 34, at ¶ 15.02(a) states:

The aftermath of incomplete documentation of a withdrawal transaction generally begins to unfold when the withdrawing partner reports payments attributable to his interest in good will as capital gain from the sale of his interest under § 741, and the continuing partners report good will payments as § 736(a) payments.

Unfortunately, this inconsistent reporting occurs even when the intended consequences appear quite clear. See *Spector v. Commissioner*, 641 F.2d 376 (5th Cir.), *cert. denied*, 454 U.S. 868 (1981) and *Boland v. Commissioner*, 31 T.C.M. (CCH) 1145 (1972), *aff'd*, 506 F.2d 1050 (3d Cir. 1974).

41. *Sloan v. Commissioner*, 42 T.C.M. (CCH) 1606 (1981).

42. *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

43. Swihart, *supra* note 39.

44. *Id.* at 1225-26. A similar list of tests, excluding the source and basis of payments tests, is set out in Note, *Tax Consequences of Withdrawal from a Two Man Partnership: Sale or Liquidation?*, 54 CORNELL L. REV. 438, 443 (1969).

Professor Swihart's analysis was undoubtedly insightful since all of his tests, particularly the latter four, have been employed by the courts in distinguishing sales from liquidations. The decisions indicate that they have not been applied with much consistency. The degree of inconsistency strongly indicates that the statutory attempt to treat a liquidation of a partnership as distinct from the sale of a partnership should not be continued.

An additional test that may be decisive in distinguishing a sale from a liquidation is whether the departing "partner" ever became a partner in the partnership that made the acquisition of his partnership interest. Assuming that a sensible construction of the regulations under section 736 requires that the payments be made by the entity of which the withdrawing partner was a member, former membership by the payee in the paying entity would seemingly be a *sine qua non* of liquidation treatment.⁴⁵ Membership status, however, has not always been required. This last factor will be discussed in connection with the last of Prof. Swihart's tests, the intention of the parties.

B. Application of the Objective Tests by the Courts

1. *The Economic Consequences Test*

Under the economic consequences test, a sale by a withdrawing partner to other partners on a pro rata basis is treated as a liquidation.⁴⁶ Although it has not gained acceptance in the cases, this test would eliminate problems such as the need to pick through the entrails of withdrawal agreements, or to scrutinize the source of with-

45. I.R.C. § 761(d) defines a liquidation as termination of a partnership interest by a distribution or distributions "to the partner *by the partnership*" (emphasis added). The regulations under §§ 761 and 736 do not specify whether the partnership making the payments must be the same one to which the withdrawing partner belonged.

The regulations under § 736 appear implicitly to require that the partnership entities be the same by treating the continuing "partner" in a two person partnership from which the other partner has withdrawn as a partner for purposes of § 736. Treas. Reg. § 1.736-1(a)(6).

A House Ways and Means Committee proposal, H.R. 9662, 86th Cong., 2d Sess. (1960) which would have continued § 736(a) treatment for payments by a successor entity even though a partnership goes out of existence or takes another form would also indicate that, under § 736 as enacted in 1954, a partner must have been a member of the same partnership making the payments for § 736 to apply. The proposal was not enacted although it was passed by the House of Representatives. See H.R. REP. NO. 1231, 86th Cong., 2d Sess. 96 (1960) and S. REP. NO. 1616, 86th Cong., 2d Sess. 87-88 (1960).

Leading commentators appear to disagree among themselves. See W. MCKEE, *supra* note 34, at ¶ 22.03[3] (payments made by a corporation or a new partnership are not deductible). But see 2 A. WILLIS, J. PENNELL & P. POSTLEWAITE, *PARTNERSHIP TAXATION* § 144.05 (3d ed. 1984) (trend in private rulings is to allow deduction by a successor entity).

46. Swihart, *supra* note 39, at 1225.

drawal payments. It would also eliminate the need to identify the capacity in which the payors had made withdrawal payments. For a withdrawal (not a sale) of one partner from a two person partnership, the economic consequences test would require that the payments be treated as liquidation payments under section 736.⁴⁷ In 1960 the House of Representatives adopted a provision similar to the economic consequences test.⁴⁸

Although the test is undoubtedly useful, courts have demonstrated an unwillingness to adopt it. In those cases involving the withdrawal of one partner from a two person partnership, the decisions appear to be split evenly.⁴⁹ Unfortunately for the government, one split in authority occurred in two decisions arising out of the same factual situation. In *Phillips v. Commissioner*,⁵⁰ the Tax Court held that a partner who withdrew from a two person partnership had made a sale of his partnership interest and was, therefore, entitled to capital gain treatment. However, the Court of Claims in *Miller v. United States*⁵¹ held that the continuing partner in the same partnership was able to deduct the payments on the basis that they were in liquidation of the withdrawing partner's interest under section 736. The government was whipsawed!

As reported by the Tax Court in *Phillips*, Phillips and Miller formed a two person partnership which represented manufacturers of sporting goods. Miller decided he wanted to terminate the partnership after Phillips had a heart attack. Miller was persuaded by the partnership's principal client to pay Phillips a percentage of the commissions from that client for three years.

In response to the contention by the IRS that the payments were income to Phillips under section 736(a)(1), the court noted:

The Commissioner concedes . . . that this section applies only to payments made by the partnership and not to transactions between the partners. That would seem to end the matter since here the agreement was between the partners, the amounts to be paid Charles were not to be paid by the partnership but were to come only from future earnings of Miller, and were to be paid by him. The partnership earned nothing after March 31, 1958, and ceased to

47. As noted, Treas. Reg. § 1.736-1(a)(6) permits the continuing partner to deduct payments to the withdrawing partner under § 736 despite the anomaly of according partnership status to the remaining sole proprietor. This regulation is effective only if it is determined that liquidation rather than sale treatment is appropriate.

48. H.R. 9662, 86th Cong., 2d Sess. (1960). S. REP. NO. 1616, 86th Cong., 2d Sess. 76 (1960) stated that the provision would "provide uniformity of treatment for these payments regardless of the form in which they are made."

49. See *Boland v. Commissioner*, 31 T.C.M. (CCH) 1145 (1972), *aff'd*, 506 F.2d 1050 (3d Cir. 1974); *Phillips v. Commissioner*, 40 T.C. 157 (1963) (similar transactions found to be sales). Compare *Miller v. United States*, 181 Ct. Cl. 331 (1967); *Stilwell v. Commissioner*, 46 T.C. 247 (1966) (liquidations found).

50. 40 T.C. 157 (1963).

51. 181 Ct. Cl. 331 (1967).

exist.⁵²

If there could be no partnership when one partner left, there could be no liquidation under section 736.⁵³

The Court of Claims, in allowing Miller to deduct the payments to Phillips, noted that the Tax Court had not referred to that portion of the regulations which sanctioned the liquidation of a two person partnership.⁵⁴ Further, the court noted that the agreement providing for the withdrawal did not use any language describing the transaction as a sale.⁵⁵ The court cited *Stilwell v. Commissioner*⁵⁶ for the proposition that unless the language of the agreement supports a finding that a sale was intended, no sale will be found. Obviously this proposition was not considered controlling by the Tax Court in its finding that the same agreement provided for a sale. Neither court, however, found the presence of a pro rata acquisition to be determinative.

The economic consequences test might indeed resolve many disputes as to whether partnership withdrawals constitute sales or liquidations. Unfortunately, its acceptance cannot be compelled in the course of the development of the common law in this area.

2. The Basis of Payment Test

If the basis of the payment for the partnership interest is a percentage of the partnership income, this test treats the transaction as a liquidation.⁵⁷ As with the economic consequences test, adoption of this test as a litmus indicator of liquidation treatment would probably eliminate some controversies. The assumption of liquidation treatment would not completely resolve the tax treatment of the payments since it would still be necessary to determine whether these payments fall under section 736(a) or (b).

Unfortunately, this test has not received complete acceptance either. In *Phillips v. Commissioner*⁵⁸ and *Wheeling v. Commissioner*,⁵⁹ in which payments to the retiring partners were calculated as

52. *Phillips v. Commissioner*, 40 T.C. 157, 161 (1963).

53. The court's holding represented an implicit rejection of regulations that accommodate the liquidations of a two person partnership. Treas. Reg. § 1.736-1(a)(6). Perhaps the court held as it did because the IRS raised the § 736 issue in an amended answer and thus had the procedural incubus usually shouldered by the taxpayer, the burden of proof. The court held that the IRS had not alleged any facts to support its contention that a liquidation rather than a sale had taken place. *Id.* at 160.

54. *Miller v. United States*, 181 Ct. Cl. 331, 343 (1967).

55. *Id.* at 344.

56. 46 T.C. 247 (1966).

57. See Swihart, *supra* note 39, at 1225.

58. 40 T.C. 157 (1963).

59. 23 T.C.M. (CCH) 778 (1964). See also *Kelly v. Commissioner*, 29 T.C.M. (CCH) 1090 (1970).

a percentage of partnership income, the Tax Court ruled that the transactions resulted in a sale and not a liquidation. Again, the development of the common law is not always in the direction of tidiness and simplicity.

3. *Maker of the Payments Test*

Under this test, if payments to a withdrawing partner are made directly by the partnership, the transaction is treated as a liquidation, but if made by the remaining partners, the transaction is treated as a sale.⁶⁰ This test is very formalistic and, if it were the only test consistently applied and if the source of the payments could always be determined with precision, it too would avoid many controversies.

Ostensibly this test is consistent with the regulations under section 736, which provide that liquidation treatment applies only to payments by a partnership,⁶¹ and the regulations under section 741, which provide that the section applies to transactions involving "one or more members of the partnership" or "one or more persons who are not members of the partnership."⁶² In the absence of such a limited construction of the regulations, there are four possible combinations of findings on the issue of whether there is a sale or liquidation based on the maker of the payments. They may be viewed schematically as follows:

| Payments Made By: | Payments Found to Constitute: | |
|-------------------------|-------------------------------|-------------|
| Partnership | Sale | Liquidation |
| Partners as individuals | Sale | Liquidation |

If the regulations under sections 736 and 741 are applied scrupulously, a court should not be permitted to find a sale when payments are made by the partnership or a liquidation when payments are made by partners as individuals. In fact, because at times other factors predominate, the courts have made findings involving all four of the above combinations.

In at least four instances the Tax Court has found a sale when the payments, at least formally, were made by the partnership.⁶³ *Foxman v. Commissioner*,⁶⁴ undoubtedly the most frequently cited decision in this area, perhaps best demonstrates why the identity of the maker of the payments should not always be determinative. In that case one

60. Swihart, *supra* note 39, at 1225.

61. Treas. Reg. § 1.736-1(a)(1).

62. Treas. Reg. § 1.741-1(b).

63. *Coven v. Commissioner*, 66 T.C. 295 (1976); *Kelly v. Commissioner*, 29 T.C.M. (CCH) 1090 (1970); *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965) and *Wheeling v. Commissioner*, 23 T.C.M. (CCH) 778 (1964).

64. 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3rd Cir. 1965).

partner had a falling out with the other two. The partners who were to continue were not able to get a bank loan for the amount sought by the withdrawing partner. Thus, the remaining partners agreed to pay the withdrawing partner in installments, presumably in large part from the earnings of the partnership. Although the court found that the parties had discussed only a sale, the partnership was added as a party to the agreement at the suggestion of counsel for the continuing partners.⁶⁵ The intent of that maneuver is plain. It gave the continuing partners a basis for contending that payments to the withdrawing partner were deductible liquidation payments. The indebtedness to the withdrawing partner was paid by checks with the *partnership* as drawer. Not surprisingly, the parties reported the payments inconsistently; the continuing partners deducted the payments and the withdrawing partner reported them as capital gain.⁶⁶

It is quite clear from the expressed intention of the parties and from the language of the agreement and the presence of consideration other than partnership funds,⁶⁷ that the court's finding of a sale was correct. Nevertheless, in one sense the continuing partners should have been able to rely on the regulations under section 741 which provide that only when the acquisition is made by the *partners*, and not the partnership, may the withdrawing partner receive sale treatment. Since the continuing partners succeeded in making the partnership a party to the withdrawal agreement by securing the withdrawing partner's signature to that agreement, and since the partnership made the payments from partnership funds, their claim to liquidation treatment had some legitimacy.

The decision of the Tax Court in *Kelly v. Commissioner*⁶⁸ is paradoxical as to the effect of the identity of the payor. *Kelly* involved payments by a partnership to two different parties under different circumstances.

Payments made to one McCartan were made by the partnership and were based on a percentage of fees billed to certain clients over eight years. Although the payments were made by the partnership, the court held that McCartan had never been a partner in the partnership making the payments and that the payments were a means for him to sell his accounting practice to the partnership.⁶⁹ Thus, since McCartan had never been a member of the partnership, payments to him could not constitute liquidation of a partnership interest. The

65. *Id.* at 540.

66. *Id.* at 548.

67. The withdrawing partner received stock in a corporation owned by the continuing partners which was not partnership property. *Id.* at 552.

68. 29 T.C.M. (CCH) 1090 (1970).

69. *Id.* at 1104.

identity of the payor thus was irrelevant. The payments were not deductible by the continuing partners.

The partnership also made payments to one Chamberlain when he withdrew from the partnership. One of the bases for the court's finding of a liquidation was that Chamberlain was paid by a check drawn on the partnership.⁷⁰ Thus, within the same decision, the identity of the payor was accorded different treatment.⁷¹ Only the finding that the payments by the partnership to Chamberlain constituted a liquidation was consistent with the regulations under section 741.⁷²

When payments to a withdrawing partner are found to have been made by the continuing partners, liquidation treatment should not be applicable. Indeed, some decisions have based the finding of a sale in part upon a finding that payments were made by a partner or partners.⁷³

A very perplexing case, *Sloan v. Commissioner*,⁷⁴ demonstrates that a court may find a liquidation even though the withdrawal payments were made by the partners. In *Sloan* one member of a three person medical partnership withdrew. The withdrawal agreement provided in part that the remaining partners:

will pay or cause to be paid to [the departing partner] the sum of \$2,000 per month as *retirement pay* for a period of eighteen (18) months It is further agreed that the obligation for said payment shall be One Thousand (\$1,000) Dollars per month for [each partner] . . . and that neither . . . shall be obligated to pay [the withdrawing partner] the other's proportionate part thereof.⁷⁵

The IRS denied the continuing partners a deduction for the payments. The obvious creation of individual liability for the payments⁷⁶ and the

70. *Id.* at 1105. Oddly enough, the court cited *Foxman* as authority for that proposition.

71. In *Coven v. Commissioner*, 66 T.C. 295 (1976), payments to a withdrawing partner were made first by one of his partners and then by another partnership into which the withdrawing partner's partnership later merged. The payments were held to constitute a sale. Obviously, treating the identity of the maker of the payment as decisive might have required recharacterization of the payments in midstream.

72. See also *Cooney v. Commissioner*, 65 T.C. 101 (1975).

73. See, e.g., *Karan v. Commissioner*, 319 F.2d 303 (7th Cir. 1963), and a case arising out of the same factual situation, *Estate of Melnik v. Commissioner*, 20 T.C.M. (CCH) 74 (1961), *aff'd*, 319 F.2d 303 (7th Cir. 1963). See also *Coven v. Commissioner*, 66 T.C. 295 (1976). In *Coven*, the individual partner who made payments deducted them before they were assumed by a successor partnership. Although the court noted that such a deduction was not correct, it regarded the deduction as a revelation of the payor's belief as to the *individual* nature of the contract. *Id.* at 306 n.9.

74. 42 T.C.M. (CCH) 1606 (1981).

75. *Id.* at 1608 (emphasis added).

76. Further, the new partnership of the continuing partners did not assume the obligations of the former partnership. *Id.* at 1609.

designation of the payments created an ambiguity.⁷⁷

In the face of this ambiguity the court applied three tests to the facts: the language of the agreement, the placement of the obligation for the payments, and the intent of the parties.⁷⁸ The court found conflicting signals in its review of the three factors. The agreement did not employ the terminology that would normally accompany a sale. The disclaimer of joint liability for the payments favored the contention by the IRS that the payments constituted a sale. Turning to the intent of the parties, the court noted that all parties had treated the payments consistently; the continuing partners had deducted them and the withdrawing partner had reported them as ordinary income.

Emphasizing this consistent treatment for tax purposes, the court concluded that "the manifest intent of the parties" was to liquidate the interest of the withdrawing partner.⁷⁹ That finding is probably accurate but it allowed the parties to do what the regulations under section 736 do not appear to permit—to treat payments by *partners* as liquidation payments. No one may have been harmed by what the court did in that particular case, but the decision makes tax planning more unpredictable and difficult.⁸⁰

It is clear that while the regulations place considerable stress on the identity of the maker of the payments to a withdrawing partner, it has not always been a significant factor in court decisions.

4. *Source of Payments Test*

Under this test a liquidation results if payments to a withdrawing partner are made from partnership income or assets.⁸¹ This approach gives a very formalistic emphasis to the entity view as the income or funds of the partnership are usually the products of the exertions or investments of the partners. Taken to its logical extreme, this test would allow the continuing partners to recharacterize sale payments unilaterally by using partnership funds to discharge their individual liabilities.

77. Lamenting this ambiguity the court commented: "The volume of litigation still occurring in this area is, we think, more a testimony to the inadequacy of parties' tax planning than any obscurity in the law." *Id.* at 1610.

78. The court began its analysis with the almost whimsical quotation from *Foxman v. Commissioner*, 41 T.C. 553, 550 (1964): "How do we choose between Tweedledum and Tweedledee?" This reflects the view in both cases that the only significant issue in these cases is how, among themselves, the parties have arranged the tax consequences.

79. *Sloan v. Commissioner*, 42 T.C.M. (CCH) 1606, 1612 (1981).

80. A commentator has indicated that *Sloan* creates a new tension between the wording of an agreement and the intent of the parties as evidenced by other circumstances. Moore, *The Sloan Doctrine — New Twist in the Partnership Interest Sale/Redemption Question?*, 14 TAX ADVISER 613, 615 (1983).

81. Swihart, *supra* note 39, at 1225-26.

This test was rejected by the court in *Foxman*.⁸² As discussed earlier,⁸³ the continuing partners made the partnership a party to their agreement to purchase the withdrawing partner's interest. The partnership gave promissory notes for the deferred purchase price. The continuing partners argued that this demonstrated that the payments constituted a liquidation. The court rejected this position commenting: "The fact that they utilized partnership resources to discharge their own individual liability in such manner can hardly convert into a section 736 'liquidation' what would otherwise qualify as a section 741 'sale.'"⁸⁴

This test does not appear to have played any role in cases in which it has been necessary to distinguish between a sale and a liquidation.

5. *Obligation of Payments Test*

Under the obligation of payments test, if the primary obligation to make withdrawal payments is placed upon the continuing partners individually, a sale results. If it is placed upon the partnership, a liquidation occurs.⁸⁵ This test obviously involves considerations of greater substance than the maker of payments or the source of payments tests. It has not been applied as a litmus test either. While the results under this test probably do not vary as widely as those under the maker of payments test, they do not provide much reliable guidance to drafters of agreements. This is not only because of the lack of complete consistency in the results, but also because of some of the intricacy of the reasoning employed in court decisions.

The test appeared to have been dispositive in *Champlin v. Commissioner*.⁸⁶ In *Champlin* the taxpayer received monthly installments following his withdrawal from an accounting partnership, which he contended resulted from the sale of his partnership interest. The IRS contended that the monthly installments were liquidation payments. The court noted that the withdrawal agreement was between the taxpayer and "the continuing partnership"⁸⁷ and that the three continuing partners signed the agreement in their representative rather than their individual capacities. Noting that the continuing partners did not obligate themselves personally to pay the taxpayer,⁸⁸ the court found that the payments constituted a liquidation and were income to the taxpayer.

82. *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3rd Cir. 1965).

83. See *supra* notes 64-69 and accompanying text.

84. *Foxman v. Commissioner*, 41 T.C. 535, 553 (1964), *aff'd*, 352 F.2d 466 (3rd Cir. 1965).

85. Swihart, *supra* note 39, at 1226.

86. 36 T.C.M. (CCH) 802 (1977).

87. *Id.* at 808.

88. *Id.*

The result is consistent with the factual findings and the obligation to make payments test, but one must question the significance of a distinction based upon whether partners sign in an individual or partnership capacity and whether they claim to be individually liable for a partnership debt.⁸⁹

While such formalisms supported application of the test in *Champlin*, they were disregarded in *Foxman*, in which the continuing partners shared the obligation to make the payments.⁹⁰ The continuing partners signed checks and notes to the withdrawing partner on behalf of the partnership. Those formalities notwithstanding, the obligation to make the payments was held to be upon the continuing partners. As in *Champlin*, the result was consistent with the maker of the payments test, but the court in *Foxman*, in applying the test, viewed similar facts very differently.

In *Cooney v. Commissioner*,⁹¹ the court also addressed the issue of the obligation to make payments to withdrawing partners, though the outcome turned largely on the intent of the parties as expressed in their agreement. The withdrawing partners, who urged that their withdrawal constituted a sale of their interests, argued that the agreement was signed by one of the continuing partners "[i]ndividually, for and on behalf of the surviving partners."⁹² The withdrawing partners also argued that the continuing partners signed the notes to the withdrawing partners.

The court deflected these contentions noting that the partnership agreement provided that no partner could make commercial paper without consent of all the partners.⁹³ Promissory notes to the withdrawing partners could be given only by an amendment to the partnership agreement or by having all of the partners sign. The continuing partners thus signed to bind the partnership and not themselves. Citing Georgia law, however, the court conceded that an obligation undertaken by all members of a partnership, within the scope of its business, binds the partners individually as well as the partnership.⁹⁴

Although the placement of the obligation to make the payments is highly relevant to the requirement in the regulations that liquidation

89. UNIF. PARTNERSHIP ACT § 15 provides that all partners are jointly liable for all debts and obligations of the partnership. Under § 42 a retiring partner is treated as an ordinary creditor of the partnership with respect to the value of his interest if the partnership business continues.

90. *Supra* note 83.

91. 65 T.C. 101 (1975).

92. *Id.* at 111.

93. *Id.*

94. *Id.* at 112 (citing GA. CODE ANN. § 75-302 (1973)). See also *In Re R.P. Brown & Co.*, 8 F.2d 53 (S.D. Ga. 1925) and *Swygert Bros. v. Bank of Haralson*, 13 Ga. App. 640, 79 S.E. 759 (1913).

payments be made by the partnership, the same factors, particularly in a general partnership, may evidence that both the partners and the partnership are obligated to make the payments. In *Sloan*,⁹⁵ the court found a liquidation even though the evidence indicated a clear attempt by the continuing partners to avoid joint and several liability as members of the partnership for their individual shares of payments to the withdrawing partner. The reasoning in the cases, centering on the obligation to make payments, does not provide very reliable guidance to drafters of withdrawal agreements.

6. *Intention of the Parties Test*

Under this test the court must determine whether the parties intended a withdrawal transaction to be a sale or a liquidation.⁹⁶ This test was the determining factor in *Sloan*. A commentator has referred to its use in *Sloan* as "a curious subemphasis on substance within the primary dominance of form."⁹⁷ It involves a determination of whether a sale or a liquidation was intended, often in the absence of (but sometimes in spite of) a designation in the withdrawal agreement. The intention is discerned from the agreement itself, the negotiations between the parties, and from other surrounding circumstances.

The primary hazard entailed in such an analysis is that the parties to withdrawal agreements do not always consider tax consequences in a coherent fashion,⁹⁸ and even when they do, the language may be hopelessly ambiguous.⁹⁹ Nevertheless, the cases which have turned on the language used by the parties have, with some exceptions, provided the best guidance to drafters of withdrawal agreements.

Several cases have employed a "magic words" approach to agreements. If the parties use the term "sale," the transaction is so regarded; if it is referred to as a "liquidation," or something other than a sale, it is treated as a liquidation.

The rationale for this approach was set out most clearly in *Emory v. United States*,¹⁰⁰ in which the continuing partner in a two-person partnership attempted to deduct payments made to the estate of the deceased partner. The IRS contended that the transaction constituted a sale. The pertinent portion of the partnership agreement provided that upon the death of a partner, "the deceased partner's interest in

95. See notes 74-80 and accompanying text.

96. Swihart, *supra* note 39, at 1226.

97. Moore, *supra* note 80, at 615.

98. See *Emory v. United States*, 374 F. Supp. 1051 (E.D. Tenn. 1972), *aff'd*, 490 F.2d 208 (6th Cir. 1974).

99. In *Commissioner v. Jackson Inv. Co.*, 346 F.2d 187, 190 (9th Cir. 1965), for instance, the agreement provided that the payment to a withdrawing partner was "a guaranteed payment, or a payment for good will." Whether it was one or the other would make a great difference under § 736.

100. 374 F. Supp. 1051 (E.D. Tenn. 1972), *aff'd*, 490 F.2d 208 (6th Cir. 1974).

said partnership shall be sold to and purchased by the surviving partner."¹⁰¹

The court made a rare judicial attempt to distinguish between a sale and a liquidation in economic terms.¹⁰² In upholding the IRS' contention of a sale, the court determined that the sale language of the agreement should be strictly construed, regardless of whether the parties were aware of the tax consequences of that language. It held:

A strong reason for strictly construing terms such as "sale", "exchange", "buy", "purchase", and "sell" as denoting a § 741 transaction and terms like "liquidation", "winding up", "account", "liquidate", "settle", and "adjust" as denoting a § 736 transaction is the public need for certainty in the tax law. Liberal construction of these terms will create unnecessary litigation and confusion as conflicting case law evolves.¹⁰³

Other cases have found section 741 applicable where the withdrawal agreement used sale terminology.¹⁰⁴ On the other hand, the finding of a liquidation in *Cooney v. Commissioner*¹⁰⁵ was based in part upon a clause in the withdrawal agreement which referred to payments "in liquidation of [the withdrawing partner's] partnership interest."¹⁰⁶

At least a couple of decisions have found a liquidation largely on the basis of the absence of terminology indicating a sale.¹⁰⁷ This presumption is remarkable since the finding of a liquidation results in a deduction for the continuing partners.¹⁰⁸

Discerning the parties' intent strictly from the terminology in the agreement presents the possibility for injustice or overreaching in instances where the language used does not reflect the intent or agree-

101. *Id.* at 1052-53 (emphasis in original).

102. The court held:

A sale is a bilateral act of parties acting at arms' length which concludes with a property exchange. Inherent in a sale is a fixed or readily ascertainable amount of money, which is traded for something of value. In contrast, a liquidation is the process of reducing assets to cash, discharging liabilities and dividing surplus or loss. If the business continues, surplus or loss is determined by an accounting; and, the remaining partners pay the withdrawing partners for their interests. Thus, in a liquidation the amount received is contingent upon the financial condition of the business at the time of dissolution.

Id. at 1055. On appeal this reasoning was approved by the Sixth Circuit.

103. *Id.* at 1054-55.

104. See *Boland v. Commissioner*, 31 T.C.M. (CCH) 1145 (1972), *aff'd*, 506 F.2d 1050 (3d Cir. 1974); *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965); *Atkinson v. Commissioner*, 23 T.C.M. (CCH) 834 (1964) and *Wheeling v. Commissioner*, 23 T.C.M. (CCH) 778 (1964).

105. 65 T.C. 101 (1975).

106. *Id.* at 110.

107. *Miller v. United States*, 181 Ct. Cl. 331 (1967); *Stilwell v. Commissioner*, 46 T.C. 247 (1966).

108. See *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-49 (1974); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943) (holding that deductions, as a matter of legislative grace, are construed strictly).

ment of the parties or the economic reality of the transaction. Just how far a court may go beyond the words of the agreement in determining the intent of the parties is unclear. The two decisions which address that issue explicitly are not consistent with each other. In *Coven v. Commissioner*,¹⁰⁹ the taxpayer, following his withdrawal from a partnership, was to receive payments of \$25,000 per year from 1966 to 1990. The agreement was designated a "Consultant Contract." The IRS argued that the payments were liquidation payments under section 736 or, in the alternative, compensation for services under section 61. Although the court found that the agreement provided that the payments were compensation for services, it upheld the withdrawing partner's position that the transaction was a sale.

With respect to the Commissioner's argument that the payments constituted compensation for services, the court found that the taxpayer presented "strong proof" that the form of the contract did not reflect its substance.¹¹⁰ In making this finding the court referred to evidence indicating, among other things, that the payments could have continued long after the death of the taxpayer, that the taxpayer had not been called upon formally to render services under the contract, and that the taxpayer did not expect to render consulting services when the agreement was executed. In disregarding the terms of the agreement to characterize the payments as a sale, the court cited *Ullman v. Commissioner*¹¹¹ and *Schmitz v. Commissioner*.¹¹² Neither *Ullman* nor *Schmitz* purport to require the degree of "strong proof" required in another leading case, *Commissioner v. Danielson*,¹¹³ to overcome the effects of the express terms of an agreement.

Danielson involved taxpayers who had sold stock in a corporation. The sales agreements allocated well over half of the purchase price to covenants not to compete. The allocation was made by the purchaser, and the sellers were not informed that this allocation would result in much of their gain being treated as ordinary income. The taxpayers reported their gain as capital gain and the Tax Court, despite the allocation in the agreement, found for the taxpayers.¹¹⁴

The Tax Court's decision was based on the ultimate finding that the allocation to the covenant not to compete had no relationship to business reality.¹¹⁵ One of the factual findings upon which that conclusion was based was that the agreement left the sellers free to set up

109. 66 T.C. 295 (1976).

110. *Id.* at 304.

111. 264 F.2d 305 (2d Cir. 1959).

112. 51 T.C. 306 (1968), *aff'd sub nom.* *Thronsdon v. Commissioner*, 457 F.2d 1022 (9th Cir. 1972).

113. 378 F.2d 771 (3d Cir.) (en banc), *cert. denied*, 389 U.S. 858 (1967).

114. *Comissioner v. Danielson*, 44 T.C. 549 (1965), *rev'd*, 378 F.2d 771 (3d Cir.) (en banc), *cert. denied*, 389 U.S. 858 (1967).

115. *Id.* at 556.

a business which could compete with the buyer.¹¹⁶ The court also noted that there were no separate negotiations concerning the covenant not to compete.

The Third Circuit reversed the Tax Court. It accepted the Commissioner's argument that permitting a taxpayer to attack an explicit allocation to a covenant not to compete "would encourage parties unjustifiably to risk litigation after consummation of a transaction in order to avoid the tax consequences of their agreements."¹¹⁷ The court held that the "strong proof" necessary to overcome the consequences of the terms of an agreement is that which "would be admissible to alter [its] construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."¹¹⁸

The holding of the Tax Court in *Coven* is obviously not consistent with the Third Circuit's decision in *Danielson*. *Coven* allows a court considerably more flexibility in looking behind the terms of an agreement to determine the intent of the parties.

The *caveat vendor* approach of *Danielson* was applied by the Fifth Circuit in *Spector v. Commissioner*.¹¹⁹ In that case the taxpayer, a member of an accounting partnership, wished to sell his practice to another firm. The purchasing firm agreed to buy the taxpayer's practice for \$96,000, payable in four annual installments of \$24,000. The agreement provided that these payments were to be "for services or for the use of capital as a 'guaranteed payment' . . ."¹²⁰

The agreement also appears to have very clearly outlined the tax consequences intended by the parties. It specifically stated that the meaning of guaranteed payments shall be "the definition provided for such term in Section 707 of the Internal Revenue Code of 1954 and Regulation Section 1.707-1(c)."¹²¹ The IRS required the taxpayer to report the entire amount of the payments as ordinary income.

The Tax Court, notwithstanding the terms of the withdrawal agreement, ruled in favor of the taxpayer, holding that he had adduced strong proof that the agreement did not reflect the economic reality of the transaction.¹²² The Tax Court found that although there had been a merger of the taxpayer's practice with the partnership which made the payments, the taxpayer withdrew from the surviving partnership two days following the merger. Consequently, the court found that the taxpayer never entered into a partnership with mem-

116. *Id.*

117. *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir.) (en banc), cert. denied, 389 U.S. 858 (1967).

118. *Id.*

119. 641 F.2d 376 (5th Cir. 1981), on remand, 44 T.C.M. (CCH) 631 (1982).

120. *Id.* at 378.

121. *Id.*

122. *Spector v. Commissioner*, 71 T.C. 1017, 1022 (1979), rev'd, 641 F.2d 376 (5th Cir. 1981).

bers of the surviving partnership.¹²³ This was based on a finding that the taxpayer did not intend to contribute services or capital to the merged partnership.¹²⁴ Concluding that section 736 can apply only to payments made by a partnership to one of its partners, the court held that the transaction constituted a sale of the taxpayer's share of his partnership goodwill to the surviving partnership.

The Tax Court conceded the difficulties involved in permitting a taxpayer to attack the form of a transaction when tax consequences of a third party may be involved. The court held, however, that the possibility of a "whipsaw" of the government did not preclude a taxpayer's resort to the "strong proof" rule. The court cited *Coven* and *Schmitz* rather than *Danielson* as setting forth the strong proof rule.

In reversing the Tax Court, the Fifth Circuit held, in effect, that the "strong proof" test applied by the Tax Court allowed a party too much latitude in avoiding the tax consequences mandated by the form of the transaction. It adopted the more stringent *Danielson* approach and remanded the case for a determination of whether the taxpayer had adduced proof of mistake, fraud, undue influence or any other ground that would be sufficient to set aside the agreement, or whether the payments were for goodwill.¹²⁵ The Fifth Circuit, noting that there is little difference, in an economic sense, between a sale under section 741 and a liquidation under section 736, denigrated the Tax Court's inquiry into whether the agreement comported with economic reality.¹²⁶

The court's analysis missed the point of the Tax Court's holding, however. The Tax Court held that the taxpayer could not realistically have been viewed as ever having been a partner in the surviving partnership. Thus, section 736 could not possibly have been applicable regardless of the form of the agreement. In its insistence on making the taxpayer live with the words of the agreement, the Fifth Circuit overlooked the requirement of the regulations that payments, if they are to be within the ambit of section 736, must be made by a partnership to a partner.

The Tax Court in *Kelly v. Commissioner*¹²⁷ had previously held that section 736 could not apply to payments by a partnership to an individual who had never become a member of the surviving partnership at any time. While the Fifth Circuit, with its restrictive view of

123. *Id.* at 1024.

124. In making the determination, the court relied on the familiar test of *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949), which examines whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

125. *Spector v. Commissioner*, 641 F.2d 376, 386 (5th Cir. 1981).

126. *Id.* at 383-84.

127. 29 T.C.M. (CCH) 1090 (1970).

the strong proof rule, appears to have limited the choices in this context to sections 736 and 741, decisions such as *Coven* and *Kelly* may provide a basis for avoidance of section 736 treatment in other circuits.

Thus, while the application of the intent of the parties test by the courts may provide the drafters of withdrawal agreements some guidance, it is not entirely clear what factors the courts will examine in order to determine this intent. A review of the tests outlined by Professor Swihart indicates that in over thirty years the courts have been unable to articulate a method for distinguishing Tweedledum from Tweedledee with sufficient certainty to give drafters of agreements the reliable flexibility that was purportedly the aim of Subchapter K.

IV. THE "ADVANTAGES" OF SECTION 736 FROM A POLICY STANDPOINT: ARE THEY APPROPRIATE?

The advantages most often attributed to the statutory scheme for partnership withdrawals are predictability and flexibility. As the previous section indicates, the factors which differentiate sections 736 and 741 have not been applied very predictably. Assuming, for purposes of discussion, that the parties to a withdrawal agreement are able to set out the tax consequences in a manner which the courts will regard as controlling, the very fact that the partners have a range of choices available to them under section 736 raises significant tax policy questions. These questions arise because the "flexibility" embodied in section 736 provides partners the ability to shift income in relation to the income tax brackets of the parties, to deduct payments which represent the cost of a capital outlay, and to deduct payments which represent the cost of mutual insurance. Although in some respects these advantages are unique to the partnership area, there is really no justification for them from a policy point of view.¹²⁸

The first two benefits which spring from the flexibility of section 736, the ability to shift income among taxpayers by agreement and the deductibility of payments which constitute a capital outlay, are obviously not touted by the House or Senate reports for Subchapter K.¹²⁹ Both stem largely from section 736(b)(2)(B), which treats payments for partnership goodwill as payments for partnership property only if the withdrawal agreement specifically indicates that they are for good-

128. A major impetus for the Administration's proposal for tax reform generally is a desire to eliminate unique advantages for particular taxpayers. As the summary of President Reagan's May, 1985 proposal states: "[Americans] can't understand the logic or equity of people in seemingly similar situations paying dramatically different amounts of tax." *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* 1 (May 1985), reprinted in *FED. TAXES (P-H)* ¶ 59,605 (Bulletin 25 EXTRA) (May 30, 1985).

129. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954) and S. REP. NO. 1622, 83d Cong., 2d Sess. (1954).

will. If a portion of the payments to a withdrawing partner are allocated to goodwill by the withdrawal agreement, the payments are not income to the recipient or deductible by the continuing partners. The statute, as indicated in the regulations, does not purport to provide an ability to characterize payments as allocable to goodwill beyond the reasonable value of partnership goodwill.¹³⁰ A valuation placed upon goodwill by an arm's length agreement, however, is presumptively reasonable.

The statute and the regulations, of course, permit the partners to allocate none of the consideration to goodwill even in instances where a substantial portion of a withdrawing partner's interest is indisputably attributable to goodwill. By providing such an unfettered ability to treat payments for goodwill as payments under section 736(a), the statute permits deduction of payments which represent the cost of a capital asset.¹³¹ Even if this flexibility is limited to goodwill, it is considerable nonetheless, particularly in service partnerships where goodwill and receivables constitute most of the assets.¹³² In actuality, however, the flexibility of valuation is not limited to goodwill, since the regulations provide that the arm's length valuation placed upon a partner's interest in property other than goodwill is also presumed correct.¹³³

The flexibility to value goodwill may be justified on the basis that

130. Treas. Reg. § 1.736-1(b)(3) provides:

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

131. This flexibility is somewhat akin to that possessed by the buyers and sellers of a business with respect to allocation of consideration between good will and a covenant not to compete. Allocation of consideration to a covenant not to compete permits the buyer to deduct such portion which, at the same time, becomes ordinary gain to the seller. See *supra* notes 113-18 and accompanying text. The assignment of value to the covenant not to compete is not controlling in the same manner as the failure to designate payments in a partnership as good will. Courts are still free to test the allocation to the covenant not to compete for its economic substantiality. 2 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 51.9.3 (1981).

132. Martin, *Liquidation and Sale of a Partnership Interest*, 25 S. CAL. TAX INST. 433, 447 (1972).

133. Treas. Reg. § 1.736-1(b)(1).

it is relatively difficult to assign a value to an essentially evanescent commodity.¹³⁴ Nevertheless, the Tax Court has at times demonstrated an ability to calculate the value of goodwill involved in the transfer of a partnership interest.¹³⁵

A. Trading of Tax Benefits

The ease with which section 736(a) permits the payments to a withdrawing partner, particularly those for goodwill, to be characterized as deductible or non-deductible, enables the parties to a withdrawal agreement to negotiate tax benefits and price without regard to economic realities. The lure of this opportunity has not been lost on commentators. For instance, two advise:

A planning device in this area is to adjust the portion allocated to goodwill depending upon the effective tax brackets of the retiring and remaining partners. As a rule of thumb, there is less overall tax to the group when no allocation is made to goodwill under Section 736(b) if the retiring partner's tax rate is less than one and two-thirds the effective tax rate savings to the remaining partners.¹³⁶

There is a generalized resistance in the law of taxation to giving tax effect to transactions with no economic consequences other than tax avoidance.¹³⁷ In the recent past, Congress has taken dramatic steps to reduce naked trading of tax advantages in the partnership area.¹³⁸ The courts,¹³⁹ and now the Reagan Administration,¹⁴⁰ have manifested an intention to prevent shifting of income among taxpay-

134. 6 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 35.89 (1985).

135. See, e.g., *Rudd v. Commissioner*, 79 T.C. 225 (1982); *Brooks v. Commissioner*, 36 T.C. 1128 (1961); *Horton v. Commissioner*, 13 T.C. 143 (1949), *appeal dismissed*, 180 F.2d 354 (10th Cir. 1950). In *Rudd* the taxpayer sought to deduct a loss upon the abandonment of his interest in the firm name. The Tax Court found that 20% of the good will of the firm was allocable to the partnership name. That a court may so specifically make an allocation of basis to a particular item of good will makes it strange that Congress in § 736(b)(2)(B) should have permitted partners to disregard entirely the value of good will.

136. Morgan and Larason, *Tax Effects of Partners' Departure Can be Tailored to Meet Parties' Needs*, 12 TAX. FOR LAW. 132, 137 (1983) (footnote omitted). See also Moore, *supra* note 80, in which the author provides a complicated formula to enable a party to benefit from a trade of price for tax benefits.

137. See *Knetsch v. United States*, 364 U.S. 361 (1960); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Boyter v. Commissioner*, 668 F.2d 1382 (4th Cir. 1981).

138. As a result of the Tax Reform Act of 1976, P.L. No. 94-455, 90 Stat. 1548 (I.R.C. § 704(b)), allocations of partnership items of income and loss must possess substantial economic effect. Under § 465, also part of the 1976 Tax Reform Act and which was strengthened by the Revenue Act of 1978, P.L. No. 95-600, 92 Stat. 2814, a partner is generally permitted to deduct losses only to the extent he is at risk in the venture. Section 183, which is designed to limit losses from activities not engaged in for profit, is being used with considerable success in attacking deductions and losses in activities where there appears little chance of economic success. See *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984); *Fuchs v. Commissioner*, 83 T.C. 79 (1984); *Dean v. Commissioner*, 83 T.C. 56 (1984) (ventures to

ers to minimize taxes. Curiously, however, section 736 permits trading and shifting of income akin to that available between the parties to a divorce under section 71.¹⁴¹

This flexibility is not available upon the *sale* of a partnership interest. Under section 741, except where section 751 is applicable, the amount received by a withdrawing partner in excess of the basis of his interest is capital gain. If the partnership interest involves an interest in unrealized receivables or substantially appreciated inventory, it is clear in the regulations that the seller must allocate to this property a portion of the amount realized equal to the market value of the property.¹⁴² The regulations provide that an arm's length allocation of a portion of the consideration to unrealized receivables or substantially appreciated inventory will be regarded as correct.¹⁴³ The temptation to resort to trading on the basis of tax brackets or shifting of income is not as great as with section 736, since under section 741 the consideration paid to the withdrawing partner, regardless of the nature of the assets involved in the partnership, is regarded as a capital outlay and is not currently deductible by the purchaser.¹⁴⁴

When a sale of a partnership interest is involved, a court is not precluded from finding that a portion of the sale price in excess of the fair market value of other partnership assets is allocable to goodwill, even though the parties to the agreement have made no such allocation. Thus, when a sale is involved, a court has greater freedom to

exploit books held not for profit); *Brannen v. Commissioner*, 78 T.C. 471 (1982) (same, venture to exploit a film).

139. See, e.g., *Schulz v. Commissioner*, 686 F.2d 490 (7th Cir. 1982); *Estate of Margita Applestein v. Commissioner*, 80 T.C. 331 (1983).

140. In articulating the rationale for its provisions to curb income shifting within the family, the report on the President's tax proposals states: "[i]ncome shifting undermines the progressive rate structure, and results in unequal treatment of taxpayers with the same ability to pay tax." *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity*, *supra* note 128, at 84.

141. The justification for allowing the paying spouse to shift, in some circumstances, taxation on alimony payments to the recipient was that denial of a deduction to the paying spouse was increasingly leaving such spouses without enough money to pay their taxes. 88 CONG. REC. 6575 (1942) (remarks of Rep. Disney). No such justification has ever been advanced for § 736.

142. Treas. Reg. § 1.751-1(g) example 1. The seller's basis for such property is the basis he would take under § 732 if the property were distributed to him in a current distribution. Treas. Reg. § 1.751-1(a)(2). Generally, this is the basis of the partnership in such property to the extent it does not exceed the distributee's basis in his partnership interest.

143. Treas. Reg. § 1.751-1(a)(2).

144. See *supra* notes 11-12 and accompanying text. Concededly, if there is an election under § 754 in effect, there may be an incentive for the continuing partners to have as much of the consideration as possible allocated to § 751 property so as to have as high a basis as possible for the partnership for property the disposition of which generates ordinary income.

scrutinize the economic substance of the transaction, to examine *what* is being sold.

Commentators differ as to the degree to which drafters of agreements may, practically speaking, disregard economic reality in allocating the value of a partnership interest to deductible or nondeductible payments. One advises caution in situations in which dealings among the parties are not at arm's length.¹⁴⁵ Another, however, opines that even with respect to allocations between payments that represent the value of assets other than goodwill, whether non-deductible under section 736(b) or deductible under section 736(a), "it is unlikely that [an] agreed allocation would be challenged."¹⁴⁶

To the extent that liquidation payments are attributable to the value of a withdrawing partner's share of partnership receivables, treatment under section 736(a) is not particularly troublesome. The withdrawing partner would report these amounts as income if he remained in the partnership and received them as a distributive share. When the total amount of withdrawal payments is in excess of the value of the withdrawing partner's share of the receivables, the inescapable conclusion is that the continuing partners are buying something other than the withdrawing partner's share of the receivables. Allowing a deduction for these excess amounts is troublesome indeed. Yet section 736(b)(2)(B) effectively allows the partners that deduction. To the extent that the continuing partners receive deductions for amounts paid to the withdrawing partner in excess of the withdrawing partner's share of the receivables, ordinary income is being shifted from the continuing partners to the withdrawing partner.

Case law demonstrates the degree to which parties to withdrawal agreements are free to shift this income. In *Smith v. Commissioner*,¹⁴⁷ the taxpayer was expelled from a partnership by vote of the other partners. For his interest, which had a book value of \$53,264.61, the taxpayer received a payment of \$77,000.¹⁴⁸ He reported the

145. Nash, *How to Evaluate the Tax Consequences When a Partner Retires or Sells His Interest*, 4 TAX. FOR LAW. 28, 32 (1975).

146. Solomon, *How Use of Section 736 Enhances Planning in Liquidating Partnership Interests*, 51 J. TAX. 347, 348 (1979).

147. 37 T.C. 1033 (1962), *aff'd*, 313 F.2d 16 (10th Cir. 1962).

148. Book value was defined under the partnership agreement as follows:

The amounts of capital contributed by each partner and the amounts of his share of the earnings left in the business, his accrued salary, and of advances to him by way of loan or against future anticipated distributions shall be kept in one or more separate accounts as the partners find convenient. The net balance of these accounts standing as a credit of a partner shall be considered as the book value of his interest in the partnership as carried on the books of the partnership. In determining the value or the book value of a deceased or a retiring partner's interest, no value shall be assigned to good will, to the right to use the firm name, or to office records such as, but not limited to, lists of clients, files, or statistical data.

\$23,735.39 difference as capital gain. The withdrawal agreement did not provide that any of the payment was attributable to goodwill. Under section 736, therefore, the portion of the payment which exceeded the book value of the taxpayer's interest could not be regarded as section 736(b) payments for property; it had to be treated as a payment under section 736(a). Since the partnership used the accrual method of reporting, none of the value of the payments should have been attributable to *unrealized* receivables under section 736(b). To the extent the taxpayer would be required to take these payments attributable to receivables into income because of section 736(a), he would be required to report income with respect to these items a second time. Correspondingly, the continuing partners would receive a deduction for amounts which would not have represented ordinary income to the withdrawing partner if he had remained in the partnership and received the payments as distributions.

Although the premium paid by the partnership clearly appeared to represent goodwill, the Tax Court followed section 736(b)(2)(B) and refused to characterize it as such. In language that must give solace to commentators who claim that section 736 gives considerable latitude to draftsmen seeking to avoid economic reality, the court held:

A requirement that in every case courts search for the intent of partners or attempt their own characterization of premiums provided for in partnership agreements would substantially eliminate the aspect of certainty and simplicity sought for by Congress. We cannot say that such a search is never appropriate under the present statutory language. However, we see nothing in the record and briefs before us that justifies an interpretation of the statute requiring or permitting us to do other than ascertain whether the partnership agreement refers to the premium in question as goodwill.¹⁴⁹

The court was unconcerned with exactly *what* the premium represented, as long as it was not specifically identified as attributable to goodwill. The IRS, in arguing that it was something other than goodwill, suggested that it was "in the nature of a mutual insurance or deterrent to hasty decisions to expel a partner."¹⁵⁰ In urging that the withdrawing partner be required to report the payment as ordinary income because of section 736, the IRS essentially advocated allowing the continuing partners a deduction. It is surprising that the IRS would urge deductibility of a payment which, even if it is to deter expulsion of a partner, is made in connection with the acquisition of his interest¹⁵¹ or constitutes insurance.¹⁵² The court required the taxpayer to treat the premium as ordinary income.

Id. at 1034.

149. *Id.* at 1037 (footnote omitted).

150. *Id.* at 1036.

151. As a general proposition, amounts paid with respect to the acquisition of property are not deductible under § 263. See *Woodward v. Commissioner*, 397 U.S. 572 (1970). Payments remarkably similar to those in *Smith* were held to be capital in a case involving the 1939 Code. *Kenworthy v. Commissioner*, 11 T.C.M. (CCH)

A similar result occurred in *Cooney v. Commissioner*,¹⁵³ in which the IRS sought to deny deductions for payments by continuing partners to withdrawing partners. As discussed earlier, the Tax Court found that the transaction was a liquidation rather than a sale. In *Cooney*, the IRS, echoing the argument of the taxpayer in *Smith*, contended that while a value of \$271,214.88 had been assigned to the receivables by the partnership agreement, their value did not exceed \$75,000. The IRS argued that the difference between those figures represented goodwill. The court regarded itself as precluded by section 736(b)(2)(B) from making that finding. Although the court stated that it did not intend to hold "that partners are free to disregard objective facts in structuring their liquidation agreements,"¹⁵⁴ it is difficult to imagine circumstances under which the Tax Court would require an allocation of value to goodwill when none has been made in the agreement.¹⁵⁵

If the partners do make an allocation of liquidation payments to goodwill, the amount of the payments so allocated is controlled by section 736(b). To the extent that that allocation results in undervaluation of the withdrawing partner's share of the receivables, his share of ordinary income is shifted to the continuing partners. As noted earlier, commentators on section 736 differ as to the degree of latitude the parties have in allocating the value of the withdrawing partner's interest between 736(a) and 736(b) payments. The regulations provide that the allocation to goodwill must be a "reasonable payment."¹⁵⁶

The case law also provides conflicting signals as to the degree of latitude partners have in allocating payments between deductible section 736(a) payments and payments for partnership property other than goodwill. In *Jacobs v. Commissioner*,¹⁵⁷ the taxpayer was paid \$35,000 by the partnership upon his withdrawal. In asserting that the taxpayer should report this as ordinary income, the IRS argued that

60, *aff'd*, 197 F.2d 525 (3d Cir. 1952). See also *Sperling v. Commissioner*, 20 T.C. 1014 (1953); *Davis v. Commissioner*, 26 B.T.A. 218 (1932).

152. Section 264 denies deduction of amounts paid in connection with certain life insurance contracts and Treas. Reg. § 1.264-1(b) extends this to life insurance purchased by a partnership for the benefit of partners. Payments made in *Smith*, if made upon death or retirement of a partner, might easily be seen as a substitute for life insurance.

153. 65 T.C. 101 (1975).

154. *Id.* at 112.

155. In *Spector* the Fifth Circuit, after holding that the Tax Court had incorrectly applied the strong proof rule in holding for the taxpayer, specified that the Tax Court might consider whether the payments were for good will. The court determined that it was precluded from making such a finding by § 736(b)(2)(B) because none of the documents pertaining to the taxpayer's withdrawal contained any indication that the payments were for good will.

156. Treas. Reg. § 1.736-1(b)(3).

157. 33 T.C.M. (CCH) 848 (1974).

the taxpayer's interest in the firm's receivables at the time of his withdrawal was \$61,622.24.¹⁵⁸ The court noted, however, that under the partnership agreement the taxpayer forfeited his interest in the receivables by his withdrawal.¹⁵⁹ It was apparently very clear from the record that the parties agreed to allocate the consideration paid the taxpayer to goodwill rather than to receivables. Accordingly, the court upheld the allocation to goodwill.

The allocation agreement upheld in *Jacobs*, however, flies in the face of section 736(b)(2)(A), which provides that payments for unrealized receivables are to be regarded as section 736(a) payments. It does not seem appropriate to permit partners to disregard over \$62,000 of receivables through a legerdemain in a partnership agreement. Concededly, the remaining partners in *Jacobs* would have to reckon with the ordinary income involved in the taxpayer's share of the receivables. The tax law, however, does not generally allow such a high degree of flexibility in deciding where the burden of taxation will fall.¹⁶⁰

Not all courts have been unwilling to examine economic substance when confronted with allocations between section 736(a) and (b) payments to a withdrawing partner.¹⁶¹ Nevertheless, the opportunity to

158. The taxpayer received no other payment which might be regarded as having been attributable to the receivables.

159. *Jacobs v. Commissioner*, 33 T.C.M. (CCH) 848, 856 (1974).

160. See *Helvering v. Horst*, 311 U.S. 112 (1940). In *Trousdale v. Commissioner*, 16 T.C. 1056, 1065 (1951), *aff'd*, 219 F.2d 563 (9th Cir. 1955), a case involving the 1939 Code, the Tax Court held: "The fundamental principle in all income tax statutes is to tax income to those who earn or otherwise create the right to receive it."

161. In *Hale v. Commissioner*, 24 T.C.M. (CCH) 1497 (1965), the continuing members of a partnership wished to treat payments to withdrawing partners as deductible § 736(a) payments. The Tax Court appropriately placed the burden upon the continuing partners seeking a deduction:

Petitioners have not adduced any evidence showing that the total liquidating payments made by [the partnership to the withdrawing partners] were in excess of the reasonable or fair market value of their partnership interests . . . when such payments were made . . .

Id. at 1509.

In *Frankfort v. Commissioner*, 52 T.C. 163 (1969) the taxpayer, the surviving member of a two person partnership, sought to deduct payments that were made pursuant to the partnership agreement to his mother, widow of his deceased partner. The Commissioner denied the taxpayer's deduction of such payments on the basis, in part, that they were nondeductible personal expenses. The Tax Court upheld the taxpayer on the basis that most of the assets of the partnership consisted of receivables and that such payments were allocable to the receivables. Highlighting the possibility of income shifting without regard to economic substance the court stated:

In so holding, we wish to make clear that we are not passing upon the question whether partners may effectively spell out in their agreement to what payments, *if any*, the unrealized receivables may or may not be allocated and thus fix as among themselves their respective tax liabilities upon the liquidation or sale of a partnership interest.

Id. at 170 (emphasis added).

shift ordinary income under section 736 is not justified by the purported certainty that that section is designed to facilitate. As discussed earlier, that certainty does not really exist.

B. Deductibility of Payments That Constitute Capital Expenditures

Payments not specifically identified as goodwill are not deductible to continuing partners because these expenditures meet the requirements of deductibility under some other section of the Code (such as section 162 business expenses). Deductibility is provided on the basis of meeting the formality of section 736(b)(2)(B). The flexibility permitted in the allocation of consideration between payments for partnership property and those not for partnership property creates considerable latitude to provide deductibility for payments which truly represent to the continuing partners the purchase price of an additional partnership interest. If the ability under section 736 to shift income attributable to receivables is questionable from a tax policy standpoint, the ability to deduct the purchase price of a partnership interest is even more questionable. One commentator on section 736 indicates: "If one were to suggest to a tax practitioner that a current deduction could be obtained for a large portion of the purchase price of a depreciable asset, it would be greeted by skepticism at best. However, Section 736 does provide this opportunity."¹⁶²

This suggestion may be illustrated by the following example. Assume that the ABC Partnership is composed of three equal partners, A, B, and C, and that the value of each partner's interest is \$30,000. Assume also that A's interest consists of \$10,000 of receivables, \$10,000 of tangible property other than receivables and \$10,000 of partnership goodwill. On A's withdrawal, B and C agree to make payments to him of \$30,000. If section 741 were applied to this transaction, all of the payments would be nondeductible to B and C, even those representing the value of the receivables.¹⁶³ That is because the acquisition of an additional partnership interest is treated as a capital transaction¹⁶⁴ and is reckoned with by the acquiring partners as any other property acquisitions, in adjustments to basis.¹⁶⁵ If section 736 were applied, and the parties do not allocate \$10,000 of the consideration to goodwill, the continuing partners (B and C) will be able to deduct payments to that extent. And to the extent that the parties agree to allocate less than \$10,000 of the consideration to partnership property other than

162. Solomon, *supra* note 146, at 349.

163. 3 B. BITTKER, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶ 87.13 n.30 (1981).

164. Kenworthy v. Commissioner, 197 F.2d 525 (3d Cir. 1952); Lehman v. Commissioner, 7 T.C. 1088 (1946), *aff'd*, 165 F.2d 383 (2d Cir.), *cert. denied*, 334 U.S. 819 (1948).

165. I.R.C. § 742.

goodwill and receivables, the continuing partners receive deductions for payments which clearly constitute a capital outlay. This clearly should not occur under section 736(b) but, as discussed earlier, commentators have indicated that it can occur because the regulations provide that an arm's length agreement will be controlling.¹⁶⁶

As a general rule of federal income taxation, the cost of acquisition of a capital asset is not deductible.¹⁶⁷ There is no justification for allowing a partnership *as an entity* to deduct acquisition costs that taxpayers generally cannot deduct, and that even partners *individually*, purchasing a partnership interest when section 741 is applicable, cannot deduct. This is particularly so in light of the fact that the partners would, except to the extent section 751 is applicable, receive capital gains treatment on any gain recognized from the sale of the interest purchased.

C. Deduction of Payments That Amount to Mutual Insurance Among Partners

In enacting Subchapter K, Congress recognized that provisions for retirement or liquidation payments in partnership agreements are often in the nature of mutual insurance. Payments to a withdrawing partner or his estate may be a substitute for a pension or life insurance rather than payments for partnership property. To the extent section 736(a) is applicable to these payments, it provides a deduction for payments which are clearly for a personal purpose. This, of course, is not generally permitted under section 262. Individuals are not permitted to deduct life insurance premiums,¹⁶⁸ and deductions for pension contributions are allowed only in carefully delineated circumstances.¹⁶⁹ If the members of a partnership purchase life insurance or make pension contributions individually, they are subject to these same limitations.

A commentator has provided an example of how section 736 payments may serve as a substitute for life insurance to the benefit of the continuing partners.¹⁷⁰ The example assumes that the partners desire to provide \$100,000, net of tax, to the estate of any deceased partner. If they arrange to do so through payments under section 736(a), and the estate is in the 30% income tax bracket, they must pay \$144,000 to the estate. If the surviving partners are in the 50% bracket, their cost will

166. See *supra* note 143 and accompanying text.

167. See *supra* note 151.

168. I.R.C. § 264.

169. Contributions to and distributions from individual retirement accounts are carefully regulated under § 219. The same is true for plans for employees and self-employed individuals. See I.R.C. §§ 72, 402, 403, 415.

170. See Horvitz, *supra* note 38, at 868-70.

be only \$72,000. The Treasury will be a co-insurer of the withdrawing partner in the amount of \$28,000.

Again, the partnership as an entity is permitted a deduction which would not be allowed the partners as individuals. There is no difference between the partnership as an entity and as an aggregate which justifies this cost to the Treasury.¹⁷¹

To the extent that a deduction is allowed for payments to a retired partner (the equivalent of a pension), section 736 is a means by which a business organization, a partnership, may provide for pensions completely outside the antidiscrimination and minimum standards applicable to deductible pension contributions generally.¹⁷² Thus, a partnership is permitted to discriminate between principals and employees and to deduct excess pension payments in a manner not permitted any other business organization. This advantage to a partnership is both inequitable and unjustified.

V. A PROPOSAL FOR CHANGE

The confusion involved in distinguishing between a sale and a liquidation has frustrated Congress' attempt to bring some certainty to the law of partnership withdrawals. Yet no analytical approach appears to resolve this confusion. The concept of a section 736 liquidation rests upon an emphasis on the partnership as an entity. There is no principled reason that simple compliance with a statutory formality should create such a dramatic difference in tax consequences between a liquidation and a sale. Further, the deduction provided in the context of section 736 liquidations creates undesirable consequences in terms of tax policy. Section 736 should be repealed and section 741 amended to add at the end of that section the following sentence:

A liquidation of a partner's interest, as defined in section 761(d), shall be considered as the sale or exchange of an interest in a partnership.¹⁷³

171. Although it is true that an employer may deduct the cost of life insurance policies on the lives of employees under § 162 if it can be shown that (1) the payments are in the nature of additional compensation, (2) the total amount of all compensation, including insurance, is not unreasonable, and (3) the employer is not directly or indirectly a beneficiary under the policy, see Rev. Rul. 58-90, 1958-1 C.B. 88, it is quite clear that the relationship among parties is not regarded as an employer-employee relationship, which would permit deduction. Congress recognized this in 1982 when it extended the partnership rules to 2% shareholders in S corporations. See I.R.C. § 1372.

172. See I.R.C. §§ 401, 410, 411.

173. Thus, § 741 would read as follows:

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). *A liquidation of a partner's interest, as defined in section 761(d),*

Section 731 would still generally control recognition of gain or loss.¹⁷⁴

Modification of other statutory provisions would facilitate the above change. Section 708(b)(1)(B),¹⁷⁵ which provides that a partnership terminates upon the sale or exchange of fifty percent or more of the total interest in partnership capital and profits, should be repealed. The regulations now provide that it does not apply to liquidations,¹⁷⁶ but in view of the discussion above, there is often so little difference between sales and liquidations that it is not rational to let one result in termination and not the other.¹⁷⁷

Congress should also repeal the section 754 election whereby the basis of partnership property is adjusted to reflect the cost of partnership interests upon a transfer under section 743(b),¹⁷⁸ or to reflect the gain or loss to a distributee in partnership distributions under section 734(b).¹⁷⁹ The repeal of this election provision is essential to ensure that basis adjustments always serve the role of the deduction now provided continuing partners under section 736(a). To the extent that a withdrawing partner has recognized ordinary income because part of his gain is attributable to unrealized receivables, the continuing partners should receive a step-up in basis for that ordinary income prop-

shall be considered as the sale or exchange of an interest in a partnership. (amended portion emphasized).

174. Under § 731 gain is recognized on a distribution by a partnership to a partner only to the extent that money distributed exceeds the distributee's adjusted basis of his partnership interest immediately before the distribution. No loss is recognized on a distribution to a partner unless such distribution is in liquidation of the partner's interest and the distributee receives only money, unrealized receivables or inventory and the amount of money or the basis to the distributee of the unrealized receivables or inventory is less than the adjusted basis of the distributee's partnership interest.
175. I.R.C. § 708(b)(1)(B).
176. Treas. Reg. § 1.708-1(b)(1)(ii).
177. Termination of the partnership may often be disadvantageous. It may result in loss of the partnership's taxable year, see, 2 A. WILLIS, J. PENNELL & P. POSTLEWAITE, *supra* note 45, at § 132.02 and in recognition of gain in a constructive disposition of the partnership's assets. *Id.* at § 132.03. Treas. Reg. § 1.708-1(b)(1)(iv).
178. Under § 743(b), when the election under § 754 is in effect, if a partner, upon the acquisition of a partnership interest pays more than the aggregate of the adjusted bases of his proportionate share of partnership properties to the partnership, the bases of such properties for the partner are adjusted upward to reflect his purchase price. If such partner pays less than the bases of such property to the partnership they are adjusted downward to reflect that.
179. Under § 734(b), if the election under § 754 is in effect, the basis of remaining partnership property is adjusted after distributions as follows: it is adjusted upward to the extent a distributee recognizes gain on a distribution or must decrease the basis of distributed property because it exceeds the basis of his partnership interest; it is adjusted downward to the extent that a distributee recognizes a loss as a distribution or must adjust the basis of distributed property upward because it is less than the adjusted basis of his partnership interest.

erty to offset any gain upon collection.¹⁸⁰

In the absence of section 736, all gain recognized by a withdrawing partner, except that attributable to unrealized receivables or substantially appreciated inventory under section 751, would be capital gain. That is appropriate because the consideration paid upon transfer of a partnership interest which is not attributable to section 751 is necessarily attributable to some other type of partnership property. The acquiring partners, whether as a partnership or as individuals, would not get a deduction for any payments to the withdrawing partner. That is appropriate since in acquiring a partnership interest they are making a capital outlay. The revisions proposed in this article for taxation of the disposition of partnership interests base tax consequences on *what* is being transferred. This regime would yield greater consistency in results than the present provisions which often make tax consequences turn on the crucial determination of whether the partnership as an entity, rather than the partners as individuals, makes the acquisition.

VI. CONCLUSION

The present Code provisions regulating the tax consequences of the disposition of partnership interests provide great flexibility to the parties to a withdrawal agreement. To a considerable extent, the parties to a withdrawal agreement can control the allocation of the burden of taxation. The myriad factors applied by the courts in deciding where the burden has been placed make it difficult for parties to a withdrawal agreement to choose from among the alternatives with assurance that their choices will prevail if challenged. Further, permitting the parties to allocate the tax burden in the manner most advantageous to all raises significant policy questions. Repeal of section 736 and treatment of all dispositions of partnership interest as sales would provide greater certainty and eliminate questionable tax advantages in the partnership area.

180. Such an adjustment would apply to other partnership property as well. The rationale for making the basis adjustments under § 734(b) and § 743(b) elective was that the tax advantages might be outweighed in some partnerships by bookkeeping inconvenience and expense. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 70 (1954). If § 736 were unavailable, however, continuing partners who have purchased the interest of a withdrawing partner should have some assured means of receiving a basis adjustment when they have purchased the interest in unrealized receivables of the withdrawing partner. Otherwise, the Treasury would receive income twice with respect to the same receivables: once when the withdrawing partner transfers his interest under § 751 and a second time when the partnership, upon collection of the receivable, receives more than the basis of the receivable.