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## Perspectives on Discharge or Cancellation of Partnership Indebtedness: *Stackhouse* Revisited and Related Conceptual Problems

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# Perspectives on Discharge or Cancellation of Partnership Indebtedness: *Stackhouse* Revisited and Related Conceptual Problems

## I. INTRODUCTION

When indebtedness of a partnership is discharged or cancelled, difficult conceptual and mechanical problems arise under the Internal Revenue Code of 1954. This is due to an inadequately defined interrelationship between the income tax provisions of Subchapter K regarding partnerships and the general income rules of Subchapter B regarding discharge of indebtedness.<sup>1</sup> These problems are further accentuated by the wavering federal income tax conception of a partnership as an entity for some purposes and as a mere aggregation of individuals for other purposes.<sup>2</sup>

A variety of factual circumstances may give rise to these problems, including the discharge of a partnership in bankruptcy, the cancellation of partnership indebtedness by a third party creditor, and the satisfaction of partnership obligations by payment at less than face value. Although these types of transactions appear to grant relief to partnerships and partners in general, unantici-

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1. Subchapter K of the 1954 Internal Revenue Code was a response to the "confusion" then existing in the tax treatment of partners and partnerships, which was reflected in "inadequate" statutory provisions and "incomplete and frequently contradictory" regulations, rulings, and court decisions for which Congress undertook "the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws." H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65-66, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4091; S. REP. NO. 1622, 83d Cong., 2d Sess. 89-90, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4721-22, *quoted in* *Stackhouse v. United States*, 441 F.2d 465, 467 (5th Cir. 1971). The extent to which the comprehensive 1954 enactment has achieved the intended result of providing certainty in the statutory treatment of partners and partnerships is debatable.

2. *See generally* *United States v. Bayse*, 410 U.S. 441 (1973); notes 36-42 & accompanying text *infra*.

pated adverse tax consequences may befall partners in these circumstances. Although the statutory structure, judicial decisions, and established Internal Revenue Service position clearly fail to adequately define the tax consequences of these transactions, certain established positions appear to be nonetheless available to lend a degree of certainty to the area. However, any attempt to impose general discharge of indebtedness income notions into the partnership income tax context is fraught with pitfalls.

This comment will develop the present state of the law, analyze the prevailing conceptual problems, and attempt to shed a small glimmer of light upon unresolved areas concerning the interrelationship of the partnership income tax provisions of Subchapter K and the general rules regarding discharge of indebtedness income.<sup>3</sup>

## II. THE STATUTORY STRUCTURE

To provide a framework for analysis of the statutory and conceptual problems involved, it is necessary to outline the partnership income tax scheme of Subchapter K in some detail and contrast it to the general rules regarding discharge of indebtedness income of Subchapter B.

### A. Subchapter K: The Section 752(b)—Section 731(a) Gain Recognition Scheme

In Subchapter K, section 752<sup>4</sup> governs the treatment of liabilities generated upon formation, operation, or dissolution of a partnership. The primary significance of the treatment afforded partnership liabilities lies in their inclusion in a partner's basis in his or her partnership interest when a taxable event occurs.<sup>5</sup>

The bedrock provision for determining a partner's basis in his or her partnership interest is section 705,<sup>6</sup> which provides that in

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3. For further development of the issues discussed in this comment, see generally W. McKee, W. Nelson & R. Whitmore, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (1977) [hereinafter cited as McKee]; A. Willis, *PARTNERSHIP TAXATION* (2d ed. 1976) [hereinafter cited as Willis].

4. I.R.C. § 752.

5. "Taxable event" is used in the sense of an event which may give rise to the realization and recognition of income or loss to a taxpayer. With regard to partner-taxpayers, a taxable event occurs upon the sale or exchange of a partnership interest, I.R.C. § 741, or upon certain distributions from a partnership to a partner, I.R.C. § 731.

6. Under I.R.C. § 705 determination of the adjusted basis of a partnership interest is essentially a three-level process. The terms of the statute provide the first two steps: (1) the determination of an initial basis for the interest depending upon whether the interest was acquired by transfer or contribution, and (2) the application of certain positive and negative adjustments to the

determining basis on any given date, the partner's allocable share of partnership liabilities on that date shall be included as part of the basis of the partnership interest.<sup>7</sup> The allocable share of partnership liabilities which is to be included in the basis of the partnership interest depends mainly upon two factors: the nature of the partnership interest and the kind of liability involved. Partnership liabilities may be either recourse or nonrecourse. Typically, only general partners, to whom the loans are recourse, share in recourse partnership liabilities on the basis of their relative loss-sharing ratios. However, both general partners and limited partners share in nonrecourse partnership liabilities on the basis of their relative profit-sharing ratios.<sup>8</sup> Therefore, inclusion of a partner's allocable share of partnership liabilities in the partner's basis in his or her partnership interest under section 705 causes a partner's basis to fluctuate constantly with the level of partnership liabilities.<sup>9</sup> Consequently, when the level of partnership liability is

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initial basis, depending upon and reflecting changes in the "net worth" of the partnership itself. The statute provides:

(a) **GENERAL RULE**—The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)—

- (1) increased by the sum of his distributive share for the taxable year and prior taxable years of—
  - (A) taxable income of the partnership as determined under section 703(a),
  - (B) income of the partnership exempt from tax under this title, and
  - (C) the excess of the deductions for depletion over the basis of the property subject to depletion;
- (2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of—
  - (A) losses of the partnership, and
  - (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and
- (3) decreased (but not below zero), by the amount of the partner's deduction for depletion under section 611 with respect to oil and gas wells.

I.R.C. § 705(a). The third step, established by regulation, provides that as of any given date the basis also includes the partner's allocable share of partnership liabilities as determined under I.R.C. § 752. See Treas. Reg. § 1.752-1(e) (1956).

7. See Treas. Reg. § 1.705-1(a)(4) (1956).

8. *Id.* § 1.752-1(e).

9. However, this constant fluctuation is of no consequence to the individual partners. The relationship of partnership liabilities to the adjusted basis of an interest in a partnership, as provided by I.R.C. §§ 705 and 752, is only significant when a taxable event occurs. See note 5 *supra*.

reduced by discharge or cancellation, the basis of the partnership interest under section 705 will be reduced by the partner's allocable share of the liability reduction, regardless of whatever collateral tax consequences arise from the transaction.<sup>10</sup>

When partnership debt is discharged, the key provision is section 752(b), which provides that any decrease in a partner's share of the liabilities of the partnership or any decrease in a partner's individual liabilities by reason of their assumption by the partnership shall be considered a distribution of money to the partner by the partnership.<sup>11</sup> When a section 752(b) "deemed"<sup>12</sup> distribution occurs, section 733 is invoked. Section 733 provides that in the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis of the partner's interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to the partner.<sup>13</sup> Any further tax impact of a section 752(b) deemed distribution, beyond the section 733 basis reduction, is controlled by section 731(a), which provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to the partner, except to the extent that any money distributed exceeds the adjusted basis of his or her partnership interest immediately before the distribution.<sup>14</sup> Any gain recognized by the distributee partner under section 731(a) is treated as gain from the sale or exchange of his or her partnership interest,<sup>15</sup> and, therefore, is subject to section 741. That section provides that the gain shall be treated as gain 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).<sup>16</sup>

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10. This interlocking of the basis of a partnership interest with the share of partnership liabilities allocable thereto inevitably results in a discharge of partnership indebtedness reducing the partners' bases in their partnership interests under I.R.C. § 705. I.R.C. §§ 752(b), 733, and 705(a) (2) appear to recognize and provide for this inevitable result.

11. I.R.C. § 752(b). See also Treas. Reg. § 1.752-1(b) (1956). On the other hand, I.R.C. § 751(a) provides that any increase in a partner's share of partnership liabilities or any increase in a partner's individual liabilities by reason of the partner assuming the partnership liabilities, shall be considered contribution of money by the partner to the partnership. See also Treas. Reg. § 1.752-1(a) (1956). Therefore, a "deemed" contribution of money by the partner to the partnership results.

12. "Deemed" is used in the sense of a hypothetical or constructive distribution by the partnership to the partner. This is also applicable to "deemed" contributions under I.R.C. § 752(a). See note 11 *supra*.

13. I.R.C. § 733.

14. *Id.* § 731(a) (1).

15. *Id.*

16. *Id.* § 741. The hypothetical sale or exchange treatment afforded partnership distributions under I.R.C. § 731 generally results in capital gain recognition

In summary, when partnership debt is reduced by discharge, cancellation, or other means of satisfaction, Subchapter K provides a gain recognition scheme for the partner under sections 752(b) and 731(a) which operates independently from any other income or gain recognition to the partnership itself which arises from the transaction.<sup>17</sup> Gain recognition to the distributee partner occurs immediately only if the amount of the section 752(b) deemed distribution exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.<sup>18</sup> Because the partner's basis in his or her partnership interest under section 705 includes the partner's allocable share of the liability discharged, the amount of the section 752(b) deemed distribution would exceed the basis in the partnership interest only in those circumstances in which the distributee partner has a negative basis in the partnership interest.<sup>19</sup> However, if immediate gain recognition results, the gain should be accorded capital gain treatment under section 731(a).<sup>20</sup> Whether immediate gain recognition is required or not, to the extent the section 752(b) deemed distribution reduces the basis of a partnership interest under sec-

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unless I.R.C. § 751 is applicable. I.R.C. § 751 will inject an ordinary income element into the distribution to the extent the distribution relates to unrealized receivables and substantially appreciated inventory items. Whether I.R.C. § 751 could be construed to inject an ordinary income element into a transaction in which partnership indebtedness is discharged, thereby resulting in a "deemed" distribution by the partnership to the partner, is as yet unexplored and beyond the scope of this comment.

17. The best example of this proposition is set forth in McKee, *supra* note 3, at 9-36:

Consider, for example, a sale by a partnership of an asset with a basis of \$100 and a value of \$200. The asset is subject to a \$200 liability, which is assumed by the purchaser as the sole consideration in payment for the asset. Clearly, the partnership realizes \$100 of gain (\$200 consideration less \$100 basis) under § 61(a)(3) and the general sale-or-exchange rules of §§ 1001 and 1002. *In addition*, the partners receive a \$200 § 752(b) distribution as a result of the decrease in the partnership's liabilities. The fact that the partners receive a § 752(b) distribution does not preclude the partnership from realizing gain under § 1001.

This underlying proposition is the central basis of this comment, namely, that in partnership debt discharge transactions two independent elements are operative: an ordinary discharge of indebtedness income element and a capital gain distribution element. The only remaining problem is whether the existing statutory scheme will support such a proposition.

18. I.R.C. § 731(a).  
19. This would be the case only if a partner had a negative capital account and a "positive" adjusted basis for the partnership interest as a result of including his or her proportionate share of partnership liabilities in the basis. See WILLIS, *supra* note 3, § 21.05. This generally would occur where partnership losses or partner withdrawals of cash exceeded income generated by the partnership or loans acquired by the partnership over a period of time.  
20. See note 16 *supra*.

tion 733, gain recognition has been deferred until final disposition of the partnership interest by the distributee partner.<sup>21</sup>

### B. Subchapter B: The Section 61(a)(12) Income Recognition Scheme

In Subchapter B, section 61(a)(12) embodies the general principle established by *United States v. Kirby Lumber Co.*,<sup>22</sup> that debtors realize taxable income upon the cancellation or discharge of their debts, by providing that the general definition of gross income includes income from discharge of indebtedness.<sup>23</sup> However, several judicial exceptions to the *Kirby Lumber* doctrine have been developed to alleviate hardship to the debtor and generally modify the section 61(a)(12) provision.<sup>24</sup> Most notable is the insolvency exception under which debtors are deemed to realize no taxable income from discharge of indebtedness if they are insolvent after the discharge. Insolvent is defined in the bankruptcy sense, *i.e.*, liabilities exceed assets.<sup>25</sup> However, if rendered solvent by the discharge, debtors are deemed to realize taxable income to the extent of their solvency.<sup>26</sup> The principles underlying the insolvency exception have been specifically embodied in the regulations promulgated under section 61(a)(12).<sup>27</sup> It should be noted that any income realized under section 61(a)(12) is ordinary income. Therefore, to the extent that a liability is discharged, a taxpayer may realize ordinary income under section 61(a)(12), unless the insolvency exception principles are applicable, in which case part or all of the section 61(a)(12) ordinary income may be shielded from income tax.<sup>28</sup>

In recognition that debt discharge situations generally accom-

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21. See *Stackhouse v. United States*, 441 F.2d 465, 470 n.3 (5th Cir. 1971).

22. 284 U.S. 1 (1931). See generally Donald, Chirelstein & Suwalsky, *Cancellation of Indebtedness*, 88-3rd TAX MNGM'T (BNA) A-12 to -13 (1976).

23. I.R.C. § 61(a)(12). The *Kirby Lumber* doctrine was predicated on the notion that a debtor realizes an economic gain or increase in net worth as a result of a discharge of indebtedness. This doctrine also finds income realization when a taxpayer satisfies obligations at less than face value. See Treas. Reg. § 1.61-12(a) (1957).

24. See McKee, *supra* note 3, at 9-34 n.121.

25. See *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934); *Astoria Marine Constr. Co.*, 12 T.C. 798 (1949); *Madison Rys. Co.*, 36 B.T.A. 1106 (1937).

26. See *Haden Co. v. Commissioner*, 118 F.2d 285 (5th Cir. 1941); *Conestoga Transp. Co.*, 17 T.C. 506 (1951) (acq.); *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

27. Treas. Reg. § 1.61-12(b) (1963). See also Rev. Rul. 58-600, 1958-2 C.B. 29.

28. To the extent that income from discharge of indebtedness is limited by the insolvency exception, tax avoidance is accomplished because no asset basis adjustment is required to defer recognition of the amount excluded. See Donald, Chirelstein & Suwalsky, *supra* note 22, at A-12.

pany financially depressed taxpayers, a deferral mechanism for section 61(a)(12) income has been provided. If a debtor realizes taxable income from discharge of indebtedness under section 61(a)(12), recognition of that income may be deferred by application of sections 108 and 1017.<sup>29</sup> Under section 108, no discharge of indebtedness income must be recognized by the taxpayer if two conditions are met: (1) The indebtedness must have been incurred or assumed by an individual in connection with property used in a trade or business,<sup>30</sup> and (2) the taxpayer must make and file an effective consent to adjustment of the basis of the property under section 1017.<sup>31</sup> The provision for an asset basis reduction in exchange for nonrecognition of ordinary discharge of indebtedness income effectively defers gain recognition until the taxpayer ultimately disposes of the asset.

In summary, when a debt is discharged or cancelled, ordinary income may be realized by the debtor under section 61(a)(12). However, through application of the insolvency exception or section 108, recognition of that ordinary income may be avoided completely or deferred.<sup>32</sup> Nonetheless, in discharge of indebtedness transactions, taxpayers must deal with the possibility of ordinary income recognition under section 61(a)(12).<sup>33</sup>

### C. The Partnership Income Tax System—The Aggregate and Entity Theories

Before any attempt is made to integrate section 61(a)(12) discharge of indebtedness income principles and the partnership in-

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29. I.R.C. §§ 108, 1017.

30. *Id.* § 108. See Treas. Reg. § 1.108-(a)(1) (1956). The Service has apparently conceded the issue of whether a partnership is an "individual" for purposes of this section in Rev. Rul. 72-205, 1972-1 C.B. 37. As to whether a statutory basis exists for this concession, see note 104 & accompanying text *infra*.

31. I.R.C. § 108. See Treas. Reg. § 1.108-(a)(2) (1956). It should be noted that regulations have been promulgated under I.R.C. § 1017 for rules regarding priorities in the adjustment of the bases of different assets.

32. If the deferral provisions of sections 108 and 1017 are resorted to in situations in which the insolvency exception also applies, the taxpayer receives two types of tax benefits: deferral and avoidance. The amount of asset basis reduction called for by section 108 is cast in terms of the "amount excluded" from gross income which would otherwise be recognized under section 61(a)(12). Therefore, the basis reduction does not include that amount excluded from section 61(a)(12) by reason of the insolvency exception. In a situation in which both the insolvency exception and section 108 provide tax relief, the amount of income excluded by the insolvency exception is completely shielded from taxation while recognition of the amount excluded by section 108 is only temporarily deferred.

33. For problems related to discharge of indebtedness income recognition, see generally Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX. L. REV. 225 (1959).



come tax system of Subchapter K, an outline of two competing theories of partnership income taxation embodied in Subchapter K (the entity theory and the aggregate theory) must be set forth.<sup>34</sup> The entity and aggregate theories are of particular importance in determining the appropriate statutory mechanism for bringing the final tax impact of items of income realized by the partnership to bear upon the individual partners. This is a separate and distinct determination from any gain recognition arising from transactions affecting partnership liabilities under the section 752(b)—section 731(a) scheme.<sup>35</sup> If a partnership may indeed realize section 61(a)(12) income from discharge of partnership indebtedness, the proper statutory mechanism to handle this item of partnership income must be determined under existing Subchapter K provisions.

Probably the clearest articulation of the differing conceptions of a partnership for various Subchapter K purposes was set forth in *United States v. Bayse*,<sup>36</sup> in which the Supreme Court commented: "The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares."<sup>37</sup> Under the conduit or aggregate theory,<sup>38</sup> the partnership as a distinct entity is essentially ignored. The partnership is treated as existing solely for the purpose of collecting information to determine partnership income or loss. This income or loss is then distributed to the partners who include it in their taxable income and pay tax on it. Under the aggregate theory, therefore, factors at the partner level which have an impact on the partners' individual tax liability would be consid-

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34. For a helpful discussion, see generally WILLIS, *supra* note 3, §§ 2.01-.04; McKEE, *supra* note 3, ¶ 1.02.

35. See note 17 *supra*.

36. 410 U.S. 441 (1973).

37. *Id.* at 448.

38. The bedrock aggregate concept provision of Subchapter K provides that "[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate and individual capacities." I.R.C. § 701. The aggregate theory is further evidenced in the statutory mechanism for passing through partnership items of income and loss to the partners. See notes 43-45 & accompanying text *infra*. I.R.C. § 752, by including in a partner's basis in his or her partnership interest a pro rata share of partnership liabilities, also adopts an aggregate theory perspective and attempts to obtain in a partnership situation the equivalence of a partner individually owning property subject to an encumbrance under the doctrine of *Crane v. Commissioner*, 331 U.S. 1 (1947).

ered with regard to items of income or loss passed through by the partnership.

On the other hand, under the entity theory,<sup>39</sup> the partnership is viewed as a distinct entity for federal income tax purposes, one which separately holds assets and conducts activities in its own right. Under an entity theory, factors at the partner level would not be considered in relationship to the ultimate tax impact of partnership items of income or loss passed through to the partners.

This persistent aggregate/entity theoretical tension in Subchapter K is manifest in the statutory mechanisms developed to transfer the final tax impact of partnership transactions to the individual partners. It has an important impact on the handling of section 61(a)(12) discharge income in the partnership context, most notably, on the application of the insolvency exception. Sections 702<sup>40</sup> and 703<sup>41</sup> set forth the system for handling partnership items of income, gain, loss, deduction, or credit.<sup>42</sup> On an aggregate theory basis, section 702(a) sets forth specified classes of partnership items of income, gain, loss, deduction, or credit which the partners are to take into account separately in determining their distributive share<sup>43</sup> to be included in their individual tax returns. How-

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39. The impact of the entity theory on Subchapter K is more pronounced than what is made apparent by the *Bayse* articulation. A partnership, as an entity for federal tax purposes, may adopt its own taxable year (I.R.C. § 706), engage in arm's length transactions with a partner (I.R.C. § 707(a)), make elections for the partnership (I.R.C. § 703(b)), and have a basis for property contributed to it (I.R.C. § 723).

40. I.R.C. § 702.

41. *Id.* § 703.

42. For an excellent discussion of the *Bayse* implications on this issue, see Pusey, *The Partnership as an "Entity": Implications of Bayse*, 54 TAXES 143 (1976). As set out in this article, aggregate/entity issues have been addressed by subsequent courts without mention of *Bayse*. See *id.* at 143 n.2.

43. As a general rule under I.R.C. § 702(a), each partner, in determining his or her income tax, shall take into account separately his or her distributive share of the following partnership items:

1. gains and losses from sales or exchanges of capital assets held for not more than 1 year,
2. gains and losses from sales or exchanges of capital assets held for more than 1 year,
3. gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),
4. charitable contributions (as defined in section 170(c)),
5. dividends with respect to which there is provided an exclusion under section 116, or a deduction under part VIII of Subchapter B,
6. taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,
7. other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and

ever, separate items classified under sections 702(a)(1)-(7) as compared to section 702(a)(8) may have different consequences at the partner level based upon an entity theory distinction. Items separately stated under sections 702(a)(1)-(7) are characterized at the partnership level,<sup>44</sup> with each partner taking into account separately his or her distributive share of the item at the partner level. This evidences an aggregate theory of taxation in which the ultimate tax impact to the partner of items separately stated and passed through may be affected by factors at the partner level. On the other hand, an item separately stated as section 702(a)(8) "taxable income or loss," though similarly characterized at the partnership level,<sup>45</sup> is divided into distributive shares at the partnership level and subsequently passed through to the partners. This evidences an entity theory of taxation, in which the ultimate tax impact of the partnership item is unaffected by factors at the partner level.

Therefore, in situations in which the insolvency exception is applicable, whether section 61(a)(12) partnership discharge income is approached under an aggregate theory or an entity theory can have a significant impact on the appropriate statutory mechanism. If, under an aggregate theory, partnership discharge of indebtedness income were to be considered a section 702(a)(7) "other item of income," the insolvency exception would be applicable at the partner level with the post-discharge solvency of the partner serving as a limitation of his or her individual recognition of partnership discharge income.<sup>46</sup> However, if under an entity theory, partnership discharge income were considered a section 702(a)(8) item included in "taxable income or loss," the insolvency exception would be applicable at the partnership level without the post-discharge solvency of the partner serving as an independent limitation of his or her recognition of partnership discharge of indebted-

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8. taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

This is the basic statutory format through which the tax impact of partnership activities is funneled through to the individual partners.

44. I.R.C. § 702(b) provides that the character of an item separately stated under I.R.C. § 702(a)(1)-(7) is determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. By determining the character of items at the partnership level, their character is passed through intact to the partners.
45. This distinction in treatment arises from the omission of I.R.C. § 702(a)(8) items from the character pass-through provision of I.R.C. § 702(b) and the I.R.C. § 703(a) statement that the taxable income of the partnership shall be computed in the same manner as in the case of an individual.
46. See notes 97-100 & accompanying text *infra*.

edness income.<sup>47</sup> If a partnership may realize section 61(a)(12) discharge of indebtedness income, the statutory mechanism for channeling the tax impact of that income to the partners, and in some circumstances the ultimate tax impact, will differ depending upon whether an aggregate or entity theory approach is adopted.

### III. THE STATUTORY AND CONCEPTUAL CONFLICT

The entity/aggregate conflict apparently underlies many of the conceptual problems involved in adapting the partnership income tax model of Subchapter K to differing forms of income realization. One cannot escape the conceptual dilemma that a partnership as an entity realizes income as a consequence of its transactions,<sup>48</sup> yet is liable for the tax impact of that income realization only as an aggregation of individual partners.<sup>49</sup> To the extent that the partnership entity and the aggregate partners of which it is composed cannot be insulated from one another for federal income tax purposes, the conceptual problem will remain.

Any attempt to reconcile the general rules regarding discharge of indebtedness income and the partnership income tax scheme in situations in which partnership debt is cancelled, discharged, or satisfied by payment at less than face value will require analysis of the following conceptual and statutory problems:<sup>50</sup>

1. Whether a solvent partnership realizes section 61(a)(12) income when partnership debt is discharged, or whether the tax consequences are governed solely by the gain recognition rules of sections 752(b) and 731(a). This involves the underlying issue of whether the section 61(a)(12) income recognition aspect and the section 752(b)—section 731(a) gain recognition aspect of a discharge transaction are to be accorded independent significance.
2. Assuming section 61(a)(12) and section 752(b) are accorded independent significance, whether the insolvency exception is applicable and its manner of application.
3. Assuming section 61(a)(12) and section 752(b) are accorded independent significance, whether the deferral provisions of sections 108 and 1017 are applicable and their manner of application.

The remainder of the comment will focus on the analysis of these problems in light of the existing statutory structure, case law, and established Service position.

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47. See note 58 & accompanying text *infra*.

48. See I.R.C. § 703(a).

49. See *id.* § 701.

50. See generally MCKEE, *supra* note 3, at 9-34; WILLIS, *supra* note 3, § 22.09.

## IV. BASIC POSITIONS—STACKHOUSE REVISITED

A. *Stackhouse*: Section 61(a)(12) Income Recognition v. Section 752(b)—Section 731(a) Gain Recognition

The interrelationship of sections 752(b) and 731(a) of Subchapter K and the section 61(a)(12) discharge of indebtedness income rules was explored for the first time in *Stackhouse v. United States*.<sup>51</sup> In 1960, Vincent Stackhouse and Robert Williams formed a successor partnership to a former partnership of which they had been members. The new partnership took over the assets and liabilities of the former partnership, including a liability to an unrelated third party for fees owed, based on a contract for loans in exchange for a percentage of partnership profits. In 1963, Stackhouse rescinded the contract and refused to pay the outstanding indebtedness of \$126,882. During ensuing litigation, the debt was released and settled for \$30,000, thereby discharging the partnership from indebtedness in the amount of \$96,882.<sup>52</sup>

Subsequently, a dispute between the partner-taxpayers and the Internal Revenue Service arose over whether section 61(a)(12) or sections 752(b) and 731(a) controlled the tax impact of a discharge of partnership indebtedness owed to a third party. In particular, the parties stipulated that immediately after and as a result of the settlement, the net worth (solvency) of Williams was \$41,583 and of Stackhouse was \$32,766, based upon an aggregate theory of solvency as to the partners; and that the partnership itself had been rendered solvent to the extent of \$8,854.<sup>53</sup>

In the district court, the Service argued that section 61(a)(12) solely controlled the tax impact of discharge of partnership indebtedness owed to a third party, and that each partner should be assessed ordinary income to the extent of his personal solvency. On

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51. 441 F.2d 465 (5th Cir. 1971), *rev'g and remanding* 27 A.F.T.R.2d 71-414 (W.D. Tex. 1970).

52. *Id.* at 466.

53. *Id.* The Commissioner approached the question of the solvency of the individual partners on an aggregate theory basis. The Commissioner determined that immediately after the settlement, the partnership was rendered solvent to the extent of \$8,854, on the basis that Williams had a positive capital account balance of \$11,927, while Stackhouse had a negative account balance of \$3,073. William's interest in the partnership was valued at \$11,927 while Stackhouse's interest in the partnership was considered a debt owed to the extent of \$3,073. To these values were added each partner's interest in partnership goodwill and the value of each partner's individually owned property to arrive at the net worth amounts. These values were stipulated by the parties. See also *Turney Estate v. Commissioner*, 126 F.2d 712 (5th Cir. 1942); *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937). In determining the solvency of the partnership under an aggregate theory approach, the value of each partner's net worth as a contingent asset of the partnership was not taken into account. See note 98 *infra*.

the other hand, the partner-taxpayers argued that sections 752(b) and 731(a) solely controlled the tax impact of the transaction. Neither party advanced the position that both the section 61(a)(12) income and section 752(b) gain aspects of the discharge transaction should be analyzed. The district court supported the Service's position on the theory that there had been "no distribution"<sup>54</sup> to invoke the sections 752(b) and 731(a) gain recognition scheme. This theory clearly ignored the language and intended effect of section 752(b).

The final tax impact of upholding the Service's position should be noted: The partnership realized section 61(a)(12) discharge of indebtedness income in the amount of \$96,882 (the difference between the amount of the liability and the amount of the settlement) which would be divided equally (\$48,441) between the partners under the partnership agreement. Under an aggregate theory approach, this section 61(a)(12) partnership discharge of indebtedness income would be treated as a section 702(a)(7) "other item of income" which each partner would take into account separately for recognition as ordinary income. However, the Service conceded that because the partnership had been insolvent before the settlement, income to each partner should be recognized only to the extent of his solvency immediately after the settlement. Therefore Williams would only recognize ordinary income of \$41,583; Stackhouse, \$32,765.<sup>55</sup> By applying the insolvency exception on an aggregate theory basis, the partner's post-discharge solvency limited the recognition of the amount of section 61(a)(12) discharge of indebtedness income passed through to the partners as a section 702(a)(7) item.

By applying the insolvency exception in the partnership context to limit the amount of section 61(a)(12) discharge of indebtedness income that must be recognized by a partner, a potential problem develops regarding the partner's basis in his other partnership interest under section 705.<sup>56</sup> Under an aggregate theory approach, the full amount of section 61(a)(12) discharge of indebtedness income is passed through to the partners as a section 702(a)(7) item, with the insolvency exception being applied at the partner level to limit ultimate recognition. This assures that the basis of a partnership interest would be increased by the full amount of the allocable share of partnership discharge of indebt-

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54. The court stated that "there was no distribution here of any partnership assets to a partner, and there was no sale or exchange of partnership assets with the resulting proceeds being distributed to the partners. There was simply a cancellation of a debt which section 61(a)(12) explicitly designates as income." See 27 A.F.T.R.2d at 71-415.

55. 441 F.2d at 466-67.

56. See note 6 *supra*.

edness income passed through, even though ultimate recognition is limited.<sup>57</sup> However, if the insolvency exception is applied under an entity theory approach, so as to limit the amount of income passed through to a partner under the section 702(a) scheme, the amount of increase in the partner's basis in his or her partnership interest would also be limited under section 705, unless the amount of potential section 61(a)(12) discharge of indebtedness income excluded by application of the insolvency exception could be classified under section 705(a)(1)(B) as "income of the partnership exempt from tax."<sup>58</sup> This would provide for a full basis increase under section 705 for the partner's total allocable share of section 61(a)(12) discharge of indebtedness income realized by the partnership. Therefore, the basis of the partnership interest is potentially affected in insolvency exception situations, depending on whether an aggregate or entity theory approach is taken.

Under the Service's essentially aggregate position, the partners immediately recognize ordinary income from discharge of partnership indebtedness. Since the insolvency exception issue is approached under an aggregate theory, each partner receives a full basis increase in his or her partnership interest under section 705, thereby avoiding the possible statutory problem if the issue were approached under an entity theory. Also, to the extent that the accompanying increase in the partner's basis in his or her partnership interest under section 705 creates an artificially high basis,<sup>59</sup> a built-in loss may be created which could only be recognized as a capital loss on complete disposition by the partner of the partnership interest.<sup>60</sup>

On appeal to the Court of Appeals for the Fifth Circuit, the decision of the district court was reversed in favor of the taxpayers.<sup>61</sup> In support of the district court decision, the Service again con-

57. See I.R.C. § 705(a)(1)(A); note 6 *supra*. However, this approach is not without its difficulties because, to the extent the insolvency exception applies, it is arguable that the discharge did not produce "income" to be passed through under I.R.C. § 702(a)(7) as an "item of income." See McKEE, *supra* note 3, at 9-38 n.138.

58. This approach is also not without its difficulties because it is arguable that to the extent the insolvency exception applies, there is no "income" within the meaning of I.R.C. § 705(a)(1)(B) "tax-exempt income" to provide the basis increase. See McKEE, *supra* note 3, at 9-39.

59. The basis of the partnership is artificially high as a practical result of increasing the basis of each partnership interest by the amount of ordinary income realized by each partner on the cancellation of the indebtedness, and then, as an inevitable result, reducing the basis of each partnership interest by the amount of the liability cancelled. See Aronsohn, *The Financially Troubled Partnership*, 34 N.Y.U. INST. FED. TAX. 327, 348 (1976).

60. See I.R.C. §§ 741, 731 (a)(2).

61. 441 F.2d at 465.

tended that section 61(a)(12) solely controls transactions in which partnership indebtedness to a third party is discharged. The "no distribution" rationale was arguably supported by a narrow statutory interpretation of section 752(b) to the effect that the statute deals solely with intra-partner rights and liabilities and does not affect a partner-taxpayer's realization of gain from the discharge of partnership indebtedness owed to a third party.<sup>62</sup>

To the contrary, the partner-taxpayers again argued that the section 752(b)—Section 731(a) gain recognition scheme solely controlled the tax impact of the transaction. Once again, neither party argued that the section 61(a)(12) income and section 752(b)—Section 731(a) gain aspects of the partnership discharge of indebtedness transaction should be analyzed. The court concluded that although the statute could be narrowly construed as applicable only to liabilities resulting from transactions among partners or between individual partners and the partnership, a broader interpretation was required in light of the legislative history and current Treasury Regulations promulgated under section 61(a)(12).<sup>63</sup> Clearly, section 752(b) was intended to cover transactions in which partnership indebtedness to a third party was discharged.<sup>64</sup> Therefore, since a section 752(b) deemed distribution occurred on the settlement of the partnership liability, gain recognition was to be determined under section 731(a).<sup>65</sup>

The final tax impact of upholding the partner-taxpayer's posi-

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62. Compare *J.C. Nichols v. Commissioner*, 42 B.T.A. 618 (1940).

63. 441 F.2d at 468-69. The relevant legislative history provided that "when the liabilities of the partnership are decreased, thereby decreasing each partner's share of such liabilities, the amount of the decrease shall be treated as a pro rata distribution by the partnership, thereby reducing the basis of each partner's interest in the amount of his share of the increase." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A236-37, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4376-77; S. REP. NO. 1622, 83d Cong., 2d Sess. 405, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 5047. The relevant regulation provides:

Where the liabilities of a partnership are decreased, and each partner's share of such liabilities is thereby decreased, the amount of the decrease shall be treated as a distribution of money to the partner by the partnership. For example partnership AB, in which A and B are equal partners, repays an obligation of \$10,000. The repayment reduces each partner's share of partnership liabilities by \$5,000 and is considered a distribution of money which reduces the basis of each partner's interest in the partnership by that amount. For the effect of a discharge of partnership property, see sections 108 and 1017.

Treas. Reg. § 1.752-1(b)(1) (1956).

64. The court explicitly stated that L.R.C. § 752 applies "to those situations in which the liabilities of the partnership itself are decreased, thereby decreasing each partner's share of those liabilities. . . . [A] reduction of liabilities would . . . occur if a partnership obligation were forgiven, or . . . discharged for a lesser amount than the total due." 441 F.2d at 469.

65. See note 92 *infra*.



tion in *Stackhouse* should be noted: A section 752(b) deemed distribution to each partner in the amount of \$63,441 (one-half of the total outstanding indebtedness) occurred on the settlement, reducing each partner's basis in his partnership interest under section 733. The section 752(b) deemed distribution exceeded the stipulated adjusted basis<sup>66</sup> of the partnership interests as to Stackhouse by \$12,029, and as to Williams by \$0.

Under the partner-taxpayer's position, only Stackhouse immediately recognized capital gain as a result of the discharge of partnership indebtedness.<sup>67</sup> Also, to the extent the basis for each partnership interest was reduced under section 733, capital gain recognition was deferred until complete disposition of the partnership interest.<sup>68</sup>

As a result of the *Stackhouse* decisions, the Service and partner-taxpayer have basically adopted polar positions over whether section 61(a)(12) or section 752(b)—section 731(a) are to solely control the tax impact of transactions involving discharge of partnership indebtedness. Under the Service's position, in which the tax impact is solely controlled by section 61(a)(12), the partnership realizes ordinary income. The recognition may be limited by the insolvency exception, calculated under an aggregate theory approach and applied at the partner level. Under the partner-taxpayers' position, supported in *Stackhouse*, in which the tax impact is solely controlled by sections 752(b) and 731(a), the partner-taxpayers recognize capital gain only where the amount of liability deemed distributed exceeds the adjusted bases of their partnership interests.

Several aspects of the *Stackhouse* result should be noted. First, if the tax impact of the transaction is controlled solely by sections 752(b) and 731(a), the section 61(a)(12) insolvency exception principles would appear inapplicable in the Subchapter K context. Consequently, partner-taxpayers could conceivably be required to recognize capital gain in an amount in excess of their net worth (solvency),<sup>69</sup> a disadvantage not suffered by nonpartner-taxpayers. Second, this position provides partner-taxpayers with two significant advantages over nonpartner-taxpayers in the area of

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66. See note 53 *supra*.

67. For any possible ordinary income consequence, see note 16 *supra*.

68. This deferral effect was recognized by the court. See 441 F.2d at 470 n.3. *Compare, Reduction in Partnership Liabilities*, 37 J. TAX. 136 (1972).

69. The *Stackhouse* rationale may prove disadvantageous in situations in which partners who are not rendered solvent by the cancellation will nonetheless be required to recognize gain to the extent their share of the cancelled debt exceeds their bases in the partnership. See Donald, Chirelstein & Suwalsky, *supra* note 22, at A-13. However, this disadvantage to partner-taxpayers was eliminated in Rev. Rul. 71-301, 1971-2 C.B. 257.

discharge of business indebtedness. The primary advantage is the ability to convert immediate ordinary income recognition into deferred or limited-immediate capital gain recognition. Also, non-partners must elect under section 108 to reduce the basis of business property under section 1017 in order to avoid immediate recognition of section 61(a)(12) ordinary income. Partners, on the other hand, can effectively defer or limit immediate gain recognition under section 733 without reducing the basis of partnership business assets. The basis of partnership assets remains intact for purposes of depreciation deductions while the basis of non-partnership assets would be reduced to avoid income recognition.

*Stackhouse* grants partner-taxpayers two important tax advantages solely on the basis of the form of business organization: (1) conversion of ordinary income into capital gain, and (2) deferral of tax consequence without reduction in basis of business assets.<sup>70</sup> Consequently, by failing to develop a theory for analyzing the independent section 61(a)(12) income recognition and section 752(b)—section 731(a) gain recognition aspects of partnership discharge of indebtedness transactions and to equalize the treatment accorded partner-taxpayers and nonpartner-taxpayers, *Stackhouse* did little to settle the controversy in this area.

#### B. Revenue Ruling 71-301—Independent Significance and Insolvency Exception Problems

Without citing *Stackhouse*, but in probable response to that case, the Service issued Revenue Ruling 71-301<sup>71</sup> to clarify problems raised by discharge of indebtedness in the Subchapter K context. In this Ruling, advice was requested regarding the application of sections 752(b) and 731(a) to the partners and the partnership in the following circumstances: A partnership and all its partners were adjudicated bankrupt and discharged from all indebtedness under section 14 of the Bankruptcy Act, with the discharge of indebtedness in bankruptcy rendering neither the partnership nor any of its partners solvent.

The question presented was whether the partners must recognize gain under the section 752(b)—section 731(a) gain recognition scheme. The Service first noted that a section 752(b) deemed distribution occurred upon discharge of the partnership indebtedness, and that gain recognition under section 731(a) would normally result. However, noting with approval the insolvency exception principles set forth in Treasury Regulations section 1.61-

70. See Moore & Keller, *Discharge of partnership indebtedness: Stackhouse muddies the water*, 6 TAX ADVISER 134, 138 (1975).

71. 1971-2 C.B. 257.

12(b)(1), the Service held that section 731(a), with respect to recognition of gain, was not applicable to the partners under the facts presented. Therefore, a partner would not recognize gain, notwithstanding that the section 752(b) deemed distribution exceeded the adjusted basis of the partnership interest immediately before the distribution, since the discharge in bankruptcy did not make the partner or the partnership solvent.<sup>72</sup>

Several aspects of this Revenue Ruling must be noted in comparison to the positions set forth in *Stackhouse*. First, the Ruling appears to give independent significance to the section 61(a)(12) and sections 752(b) and 731(a) aspects of the discharge of partnership indebtedness, in conflict with *Stackhouse*. However, this conflict is more apparent than real because the particular facts in the Ruling do not generate section 61(a)(12) income to the partnership.<sup>73</sup> Because neither the partnership nor any partners were rendered solvent by the discharge, the potential for recognition of section 61(a)(12) income by the partnership, which arose in *Stackhouse*, was not applicable in the Ruling. Second, and most important, the principles of the section 61(a)(12) insolvency exception were injected into the section 752(b)—section 731(a) gain recognition scheme to preempt section 731(a) gain recognition by the insolvent partners. The Service's unusual extension of the insolvency exception into the partnership context to preempt capital gain recognition by an insolvent partner under section 731(a) is unsupported by either the statutes or the case law.<sup>74</sup> However, this result is arguably justifiable on the hardship and net worth principles underlying the insolvency exception. Third, the Ruling is consistent with the Service's position in *Stackhouse* that section 61(a)(12) controls the tax impact of the discharge of indebtedness transaction although the Service apparently concedes that a section 752(b) deemed distribution will inevitably occur when partnership debt is discharged.<sup>75</sup> Fourth, the Ruling leaves the Service's approach to the insolvency exception unclear. In *Stackhouse*, the Service assumed a pure aggregate theory ap-

72. *Id.*

73. See also MCKEE, *supra* note 3, at 9-38.

74. No clear statutory basis for injecting the insolvency exception into the I.R.C. § 731(a) gain context to prevent gain recognition by insolvent partner-taxpayers is apparent. This Service position appears clearly fallible under a statutory construction attack. However, this approach was adopted in Arthur R. Fixel, 33 T.C.M. 857 (1974), in which the taxpayer attempted to inject the insolvency exception into the I.R.C. § 741 context to prevent gain recognition by an insolvent partner on sale of a partnership interest. The issue was not reached because of a proof problem.

75. This evidences a retreat from the Service's litigating position in *Stackhouse* and a recognition of the inevitable basis reduction when liabilities are reduced. See note 10 *supra*.

proach in which section 61(a)(12) income recognition would be limited by the partner's post-discharge of indebtedness solvency.<sup>76</sup> In the Ruling, the Service implies that section 731(a) gain would be recognized by a partner if either the "partner or the partnership"<sup>77</sup> were rendered solvent by the discharge. This appears to leave open the possibility that, under an entity theory approach, an insolvent partner could be required to recognize section 731(a) gain if the partnership were rendered solvent by the discharge of indebtedness. Whether this distinction in possible approaches is based upon whether the section 61(a)(12) or section 731(a) context is involved is unclear and its validity is questionable.<sup>78</sup>

Because of the factual dissimilarity between Revenue Ruling 71-301 and *Stackhouse*, little clarification of problems involved in discharge of partnership indebtedness was achieved. It was not possible for the Service to adopt a position of recognizing the independent significance of the section 61(a)(12) and section 752(b)—section 731(a) aspects of the discharge of indebtedness under the facts presented by the Ruling. Nevertheless, the Service did seize the opportunity to extend the section 61(a)(12) insolvency exception principles into the section 731(a) context to prevent partner-taxpayers from suffering a tax disadvantage not experienced by nonpartner-taxpayers in similar situations.<sup>79</sup> To this extent, then, Revenue Ruling 71-301 eliminated a disadvantageous tax consequence to partner-taxpayers left open by *Stackhouse*.

#### C. Revenue Ruling 72-205—Availability of Sections 108 and 1017 Deferral of Section 61(a)(12) Discharge Income to a Partnership

In further response to problems generated when partnership indebtedness is discharged, the Service issued Revenue Ruling 72-205.<sup>80</sup> The Ruling involved the following factual circumstances: A partnership negotiated the discharge of indebtedness incurred in connection with property used in its trade or business for an amount less than the face amount of the debt and *realized income to that extent*.<sup>81</sup> The Service concluded that the income realized by discharge of indebtedness may be excluded from the gross income of the partnership if the partnership makes timely consent under section 108 to adjustment of basis of partnership assets

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76. See note 53 & accompanying text *supra*.

77. Rev. Rul 71-301, 1971-2 C.B. 257.

78. See note 74 *supra*.

79. See note 69 & accompanying text *supra*.

80. 1972-1 C.B. 37.

81. *Id.*

under section 1017. It also held that a section 752(b) deemed distribution occurred in the amount of the total liability (which included the amount excluded from partnership income under section 108), thereby reducing the basis of each partnership interest under section 733.<sup>82</sup>

Several aspects of this Ruling are of notable importance in comparison to the positions set forth in Revenue Ruling 71-301 and *Stackhouse*. First, and most important, the Service took a position recognizing the independent significance of the section 61(a)(12) income recognition and sections 752(b) and 731(a) gain recognition aspects of the discharge transaction, a position apparently contrary to Revenue Ruling 71-301 and the holding in *Stackhouse*. Second, the Ruling adopted an entity theory approach to section 61(a)(12) income recognition by the partnership and deferral of income recognition under sections 108 and 1017. However, the entity theory approach, rather than an aggregate theory approach, may be justifiable in situations in which insolvency exception problems are not present.<sup>83</sup> Third, the Service took the position that a section 108 election is available to a partnership, a proposition arguably unsupported by the statutory scheme.<sup>84</sup> Fourth, the Service left unanswered the question whether a partner would be required to recognize section 731(a) gain if the section 752(b) deemed distribution exceeded the basis of his or her partnership interest immediately before the distribution, where the partnership also realizes section 61(a)(12) discharge of indebtedness income, whether or not sections 108 and 1017 are applicable. The Ruling left this issue unsettled because it assumed that only a section 733 basis reduction resulted from the section 752(b) deemed distribution.<sup>85</sup>

## V. GENERALIZATIONS, UNRESOLVED PROBLEMS, AND POSSIBLE APPROACHES

It should be readily apparent that *Stackhouse* and Revenue Rulings 71-301 and 72-205 are less than adequate to define with the necessary degree of certainty the tax impact of discharge of partnership indebtedness transactions. The extent to which *Stackhouse* should be relied upon by partner-taxpayers is unclear because of several logical fallacies in the *Stackhouse* rationale which may make its continuing viability questionable. However, against the logical fallacies of the *Stackhouse* rationale and the clear tax advantage afforded partner-taxpayers must be balanced

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82. *Id.*

83. See notes 97-99 & accompanying text *infra*.

84. See note 104 & accompanying text *infra*.

85. See Moore & Keller, *supra* note 70, at 138 n.31.

the glaring failure of the statutory scheme to integrate discharge of indebtedness income notions into the partnership income tax provisions of Subchapter K. For partner-taxpayers willing to assume the inevitable hazards of litigation to gain the tax advantages of the *Stackhouse* rationale, a strong statutory construction argument is available to promote the theory that the discharge of indebtedness income provisions were not intended to be integrated with the partnership income taxation scheme of Subchapter K. This theory would undercut any Service arguments to the contrary under Revenue Ruling 71-301 or Revenue Ruling 72-205.

The initial premise is that the general discharge of indebtedness provisions were available to the drafters when the specific partnership income tax provisions of Subchapter K were developed in the Internal Revenue Code of 1954. The absence of any Subchapter K provision dealing with partnership discharge income arguably supports the proposition that the later, specific statutory scheme of Subchapter K was not intended to integrate the earlier, general discharge of indebtedness provisions. The only attempted integration of the two statutory schemes appears in Treasury Regulations section 1.752-1(b)(1) which provides, in what appears to be an after-thought of the drafters: "For the effect of a discharge of indebtedness on the basis of partnership property, see sections 108 and 1017."<sup>86</sup> Apparently, the drafters of this regulation anticipated some interrelationship between section 752 and the general discharge of indebtedness provisions.<sup>87</sup> However, examination of the statutory schemes themselves reveals no attempted integration thus leaving the statutory basis for this regulation, at best, unclear. The basic statutory scheme itself arguably supports the proposition that discharge of indebtedness provisions are inapplicable in the Subchapter K context, as the Court effectively held in *Stackhouse*,<sup>88</sup> on the theory that a later specific statute controls an earlier general statute.

Revenue Rulings 71-301 and 72-205 evidence a marked shift in the Service's position since *Stackhouse*, and appear to be an attempt by the Service to eliminate the tax advantages and disadvantages accruing solely to partner-taxpayers under the *Stackhouse* rationale. However, the statutory basis for this shift in Service position evidenced in Revenue Rulings 71-301 and 72-205 is anything but substantial due to the statutory failure to integrate

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86. Treas. Reg. § 1.752-1(b)(1) (1956).

87. See Moore & Keller, *supra* note 70, at 138.

88. Although this is not the explicit holding in *Stackhouse*, it is clear that the result was solely controlled by the Subchapter K provisions, despite intimations by the court to the contrary. See note 90 & accompanying text *infra*.

Subchapter K and the general discharge of indebtedness provisions.

Although many problems remain, a certain degree of predictability is available regarding the treatment of partnership discharge of indebtedness transactions in light of the Service's positions in Revenue Rulings 71-301 and 72-205 and the *Stackhouse* rationale. The remainder of this comment will attempt to articulate what generalizations may be made, what problems remain unsolved, and to suggest some possible approaches.

### A. The Independent Significance Issue

Although both the Service and partner-taxpayer positions advanced in *Stackhouse* failed to afford the distinct section 61(a)(12) income recognition and section 752(b)—section 731(a) gain recognition schemes independent significance, the *Stackhouse* rationale developed by the court is arguably unsupportable both in logic and theory. This rationale, whereby the tax impact of partnership debt discharge transactions is solely controlled by the sections 752(b) and 731(a) gain recognition scheme has been subject to criticism on several grounds.<sup>89</sup>

First, in *Stackhouse* the court stated that “[i]n a sense then we are giving effect to both sections of the Code,”<sup>90</sup> referring to sections 61(a)(12) and 752(b). This assertion is questionable because the tax impact of the transaction was determined solely under the gain recognition provisions of sections 752(b) and 731(a). It is true that the amount of section 731(a) capital gain recognized by the partners was less than the amount otherwise recognizable by the partners under a section 61(a)(12) theory and, therefore, the result reached is not in conflict with insolvency exception principles. However, the crucial issue is whether under the *Stackhouse* rationale a different result would have been reached if the principles of the section 61(a)(12) insolvency exception would have been violated by the amount of gain otherwise recognizable under section 731(a). This is precisely the issue raised in Revenue Ruling 71-301 from which it is clear that a *Stackhouse* rationale would have required a contrary result. Therefore, the statement that the *Stackhouse* rationale, whereby the tax impact is solely controlled by sections 752(b) and 731(a), “[gives] effect to both sections of the Code”<sup>91</sup> is of doubtful validity.

Furthermore, the court stated that since a section 752(b) distribution had been found, it “necessarily” followed that the *gain* rec-

89. See generally MCKEE, *supra* note 3, at 9-37 to -38.

90. 441 F.2d at 470.

91. *Id.*

ognized by the partner-taxpayers must be determined under section 731(a).<sup>92</sup> This statement is unquestionably true within the sections 752(b) and 731(a) gain recognition context. But in conjunction with the statement previously considered, it evidences the fallacy of failing to independently consider the income recognition aspects to the partnership of liability affecting transactions. Clearly, the statutory scheme contemplates that income recognition to the partnership will operate independently from gain recognition to the partner-taxpayers which arises from the same partnership transaction. Therefore, when liability affecting transactions occur, two independent tax effects need be considered: (1) the income recognition at the partnership level to be passed through to the partner-taxpayers under the section 702 provisions, and (2) the gain recognition at the partner level under sections 752(b) and 731(a). Transactions involving partnership liabilities clearly may independently generate both ordinary income and capital gain recognition by the partner-taxpayers.<sup>93</sup> Therefore, on the basis of these logical flaws in the *Stackhouse* rationale, its continuing viability to confer distinct tax advantages upon partner-taxpayers is subject to question.

The Service position in *Stackhouse*, however, also lacks justification for the same reasons. The Service's post-*Stackhouse* position appears to have evolved to the point of a general recognition that partnership debt discharge transactions may indeed contain both a section 61(a)(12) discharge of indebtedness income element and a section 752(b)—section 731(a) gain element. Revenue Ruling 72-205 clearly adopted this position in a situation in which no insolvency exception issue was presented. However, in Revenue Ruling 71-301, in which the insolvency exception issue was presented, the facts of the Ruling precluded the Service from adopting a position in direct conflict with *Stackhouse*. Whether a logical basis exists to justify a difference in position depending upon whether the insolvency exception issue is presented is unclear. In addition, Revenue Ruling 71-301 did inject section 61(a)(12) insolvency exception principles into the section 731(a) context so as to preempt section 731(a) gain recognition by insolvent partners, thereby eliminating a disparate tax impact solely befalling partner-taxpayers under the *Stackhouse* rationale. However, this result did not recognize the independent section 61(a)(12) and section 752(b) aspects of the debt discharge transaction.

Given this general development of the independent significance issue, the following generalizations appear supportable:

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92. *Id.*

93. See note 17 & accompanying text *supra*.



1. In situations not involving an insolvency exception issue, the Service will give independent effect to the section 61(a)(12) and 752(8) aspects of the discharge transaction under Revenue Ruling 72-205. Any partner-taxpayer challenge under *Stackhouse* based on a statutory construction theory must overcome the logical fallacies of the *Stackhouse* rationale. If Revenue Ruling 72-205 was upheld, the tax advantages available under the *Stackhouse* rationale to partner-taxpayers would be eliminated.
2. In situations involving the insolvency exception, where no section 61(a)(12) discharge of indebtedness income is realized by the partnership, insolvency exception principles will also prevent section 731(a) gain recognition by insolvent partners under Revenue Ruling 71-301. This result should hardly be subject to challenge by partner-taxpayers relieved of a tax disadvantage resulting solely to partner-taxpayers under the *Stackhouse* rationale.
3. In situations involving the insolvency exception, where section 61(a)(12) discharge income would be realized by the partnership if the independent section 61(a)(12) and section 752(b) aspects of the transaction were recognized, the probable result is unclear. This is a *Stackhouse*-type situation in which the Service has failed to clearly establish a contrary position based on the theory of independent significance through Revenue Rulings 71-301 and 72-205.

The *Stackhouse*-type situation is the area in which the issue of independent significance will likely be raised and ultimately settled.<sup>94</sup> Partner-taxpayers, arguing *Stackhouse* and a statutory construction theory, would be met by the Service's assertion of the logical fallacies of the *Stackhouse* rationale and the logic of according the section 61(a)(12) income aspect and section 752(b) gain aspect of partnership debt discharge transactions independent significance. Ultimately, the conflict will probably be settled on the basis of whether partner-taxpayers and nonpartner-taxpayers should receive similar tax treatment in discharge of indebtedness situations.

## B. The Insolvency Exception Issue

Assuming sections 61(a)(12) and 752(b) are accorded independent significance, so that a partnership may indeed realize section 61(a)(12) discharge income when partnership indebted-

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94. See *Austin v. United States*, 461 F.2d 733 (10th Cir. 1972), in which the *Stackhouse* issue was raised but avoided by the court for failure to properly raise the issue in the pleadings.

ness is discharged, the fundamental question of how the insolvency exception is to be applied in the partnership context must be resolved. Resolution of this issue involves overcoming the aggregate/entity theoretical conflict in deciding whether to apply the insolvency exception at the partnership or partner level. At present, this issue is totally unresolved by the courts.<sup>95</sup>

Under the aggregate theory, the amount of section 61(a)(12) income realized by the partnership is limited by the partner's post-discharge of indebtedness solvency. The solvency of the partnership itself as a result of the discharge is not relevant to the issue of section 61(a)(12) income recognition, except to the extent it is a part of the individual partner's post-discharge solvency. This theory of applying the insolvency exception is integrated with the existing statutory scheme only if section 61(a)(12) partnership discharge of indebtedness income is passed through separately as a section 702(a)(7) "other item of income" and the insolvency exception is applied at the partner level.<sup>96</sup> This is basically the approach utilized by the Service in *Stackhouse* and Revenue Ruling 71-301.<sup>97</sup>

Under the entity theory, however, the amount of section 61(a)(12) income realized by the partnership is not limited by the partner's post-discharge of indebtedness solvency but only by the post-discharge solvency of the partnership itself. Although under a pure entity theory analysis, the partner's post-discharge of indebtedness solvency would be totally irrelevant to partnership realization of section 61(a)(12) income, it is unclear whether consideration should be given to the partner's post-discharge solvency in determining the solvency of the partnership itself.<sup>98</sup> This theory of applying the insolvency exception is integrated with the existing statutory scheme only if section 61(a)(12) partnership discharge of indebtedness income is passed through as a section 702(a)(8) item of "taxable income" after the insolvency exception has been applied at the partnership level.<sup>99</sup>

It should be noted that neither of the above theories is beyond

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95. The district court in *Stackhouse* took the partner's post-discharge solvency into account in limiting recognition of partnership discharge income. See *Stackhouse v. United States*, 27 A.F.T.R.2d 71-414 (W.D. Tex. 1970), *rev'd and remanded*, 441 F.2d 465 (5th Cir. 1971).

96. See McKEE, *supra* note 3, at 9-38.

97. This is a pure aggregate approach. See note 53 *supra*.

98. The problem with this pure entity theory is that it ignores the fact that general partners are personally liable for partnership obligations. To this extent, the assets of general partners are contingent partnership assets and are relevant to determine the post-discharge of indebtedness solvency of the partnership. See McKEE, *supra* note 3, at 9-39 n.140.

99. See *id.* at 9-39.

challenge under the present statutory scheme and any other coherent alternative theories available should be considered as well.

As discussed previously, a major impact of the choice between applying an aggregate theory or entity theory approach to the insolvency exception may lie in a possible significant difference in the partner's post-discharge of indebtedness basis in his or her partnership interest.<sup>100</sup> Under the aggregate theory, partnership discharge of indebtedness income is passed through as a section 702(a)(7) item with the insolvency exception applied at the partner level. Therefore, partners are assured a full basis increase for their partnership interests under section 705 regardless of the fact that a portion of the discharge of indebtedness income is not recognized by application of the insolvency exception. Under the entity theory, however, the assurance of a full basis increase for a partnership interest is less clear because the partnership discharge of indebtedness income is treated as a section 702(a)(8) item, with the insolvency exception applied at the partnership level, thereby excluding a portion of the discharge of indebtedness income from the section 702(a)(8) pass through and resultant section 705 basis increase. In order to achieve a full basis increase under section 705, the amount excluded by the insolvency exception at the partnership level must be classed as tax-exempt income under section 705(a)(1)(B), an approach not without its technical statutory difficulties.<sup>101</sup>

If the goal in partnership taxation is to preserve the equality between the basis of partnership assets ("inside" basis) and the aggregate bases of the partners in their partnership interests ("outside" basis) the statutory language must be interpreted to allow for a full basis increase for partnership interests under section 705, regardless of the theory adopted in insolvency exception situations. Furthermore, this would bring about parity with non-insolvency exception situations in which no basis distinction is generated.

Whatever approach to application of the insolvency exception in the partnership context is finally determined by the courts, the aggregate theory approach adopted by the Service should be seriously considered. The aggregate theory approach appears favorable for two reasons. First, under a state law conception of a partnership and its composite partners, an insular perspective on the liability issue is unavailable.<sup>102</sup> Second, under the federal tax law conception of a partnership, the ultimate tax impact of part-

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100. See notes 56-58 & accompanying text *supra*.

101. See note 58 *supra*.

102. For liability purposes, general partners and the partnership are inseparable due to the fact that general partners are jointly and severally liable for all

nership discharge of indebtedness transactions upon a partnership cannot be separated from the impact on the composite partners.<sup>103</sup> Therefore, an aggregate theory approach seems to more clearly consider the interrelationship of a partnership and its partners in insolvency exception situations.

Finally, it must be remembered that the insolvency exception issue is only relevant insofar as the underlying assumption that a partnership may realize section 61(a)(12) discharge of indebtedness income holds true, a proposition not entirely free from doubt in light of the existing statutory scheme and the *Stackhouse* holding. The utilization of the insolvency exception in Revenue Ruling 71-301 must be distinguished as applicable only in the section 731(a) context and not in the context of the general partnership income mechanism of section 702. Therefore, if a partnership may indeed realize section 61(a)(12) discharge of indebtedness income, a coherent theory for applying the insolvency exception is yet to be developed.

### C. The Section 108—Section 1017 Deferral Issue

Two factual predicates must exist before the application of the section 108—section 1017 deferral mechanism will arise in the partnership context. First, the section 61(a)(12) and section 752(b) aspects of the partnership debt discharge transaction must be accorded independent significance so that the partnership may realize section 61(a)(12) discharge of indebtedness income. Second, the amount of section 61(a)(12) discharge of indebtedness income realized in the transaction must exceed the amount of such income excluded from recognition by application of the insolvency exception.

If these two factual predicates exist, the Service apparently concedes in Revenue Ruling 72-205 that the section 108—section 1017 deferral mechanism is available to a partnership. Two aspects of this concession need be examined. First, making a section 108 election available to a partnership is arguably contrary to the clear requirement in section 108 that an "individual" make the election. To the extent a partnership is not an "individual" for purposes of section 108, the concession in Revenue Ruling 72-205 would lack statutory support.<sup>104</sup> Second, by holding that the partnership realized section 61(a)(12) discharge of indebtedness income, in arguable conflict with *Stackhouse*, the Service was forced to make the

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partnership debts. See Uniform Partnership Act, NEB. REV. STAT. § 67-315 (Reissue 1976).

103. See I.R.C. § 701.

104. No statutory support under I.R.C. § 108 exists for making the election available to a partnership.

section 108 election available to the partnership to avoid partner-taxpayers being treated differently than nonpartner-taxpayers in debt discharge situations. This would effectively avoid similar criticisms that were directed at the *Stackhouse* rationale and soften the impact of holding that a partnership realizes section 61(a)(12) income. In spite of the Service's concession in Revenue Ruling 72-205, the issue of the threshold applicability of section 108 to a partnership could clearly be challenged on a statutory construction theory by partner-taxpayers relying on *Stackhouse*.

Assuming the section 108—section 1017 deferral privilege is available to a partnership, a further unsettled issue must be resolved relating to the manner of applying the deferral mechanism in light of the aggregate/entity theoretical tension. With no insolvency exception issue presented by the facts of Revenue Ruling 72-205, the Service adopted an entity theory approach by holding that the partnership makes the section 108 election to adjust the bases of partnership assets. This appears to be somewhat contrary to the aggregate theory approach generally adopted by the Service in *Stackhouse* and Revenue Ruling 71-301.

Under an aggregate theory approach, the section 108 election should be available to the individual partners to adjust the bases of the partner's assets under section 1017.

The entity theory approach of Revenue Ruling 72-205 is arguably justified because no insolvency exception situation was presented. Although contrary to the Service's position in *Stackhouse* and Revenue Ruling 71-301, in which the insolvency exception situation was presented, the entity theory approach recognizes that a viable partnership entity with tangible assets exists for purposes of making the section 108 election and section 1017 basis adjustment. However, in insolvency exception situations, in which no viable partnership entity with tangible assets exists, the aggregate theory approach should vitiate against application of Revenue Ruling 72-205 so as to prevent loss of the deferral privilege simply because no assets are available at the partnership level.<sup>105</sup> Whether an entity theory or aggregate theory approach is finally adopted, in the interests of consistency both the application of the insolvency exception and the section 108—section 1017 deferral mechanism should be approached on the same theoretical basis.

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105. Under an aggregate theory approach, a priority rule could be developed which would first require basis reductions to the extent assets remained at the partnership level and then allow partners to adjust the basis of individual assets.

## VI. CONCLUSION

It should be apparent that the issues generated in exploring the interrelationship of the general rules regarding discharge of indebtedness income of Subchapter B and the partnership income tax provisions of Subchapter K are difficult and far from settled. Due to a failure by the drafters to clearly indicate the extent to which the statutory schemes were intended to be integrated, the positions established by the *Stackhouse* decision and Revenue Rulings 71-301 and 72-205 cannot be supported by a clear showing of statutory authority.

For partner-taxpayers willing to seek the distinct tax advantages flowing from the *Stackhouse* rationale, a strong statutory construction theory is available to counter a contrary Service position based upon Revenue Rulings 71-301 and 72-205 and the logical deficiencies of the *Stackhouse* decision. Given the proper stakes to provide an incentive for tax gamesmanship, the controversy involving the interrelationship of the general rules regarding discharge of indebtedness income and the partnership income tax provisions of Subchapter K will likely arise again.

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