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# Income Tax Consequences of Partnership Agreements Under the 1954 Internal Revenue Code

By EARLE B. FOWLER and JAMES T. CAREY*

The Internal Revenue Code of 1954 contains twenty-seven sections under the heading "Subchapter K, Partners and Partnerships,"[1] in lieu of the nine basic sections on that subject in the old Code. Important elections are available to the partners, if made at the right time and in the right manner. The lawyer who drafts the partnership agreement, or amendments thereto, must assume responsibility for tax consequences which are dependent upon such agreements, and the accountant who establishes or reviews the partnership records or prepares the partnership's income tax return must be prepared to apply the statutory rules of tax accounting where no partnership agreement has been drafted, or to suggest to the partners that they obtain legal counsel and have an appropriate agreement drafted. It is important to note that the new law applies to already existing partnerships, as well as to those formed after passage of the 1954 Internal Revenue Code.

### *Theoretical Background*

There is no provision in the new Code setting forth a general rule as to whether the aggregate or entity theory of partnerships is to be applied in areas not specifically covered by statutory provisions. However, for purposes of imposition of tax liability on partnership income, a partnership is regarded as nothing other than an *aggregate* of individuals who are individually liable for tax on their respective shares of partnership income, whereas in matters involving the sale or other transfer of a partnership in-

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[1] INT. REV. CODE OF 1954, secs. 701-771.

terest, or the contribution of property to the partnership, the new Code generally views the partnership as a separate *entity,* with special provisions as to the extent of recognition of gain or loss.[2]

*Determination of Income of Partnership*

With respect to a partner's distributive share of the aggregate income of the firm, the provisions of the partnership agreement control as heretofore, with two main exceptions: (1) where "the principal purpose of any provision . . . is the avoidance or evasion of . . . tax," and (2) where the amount of a partnership loss (including capital loss) distributed to a partner would be greater than the adjusted basis of the partner's interest.[3] The excess loss is deductible only when paid to the partnership by the partner to whom the loss applies under the terms of the agreement. There is a question as to whether the giving of a note by the partner to the partnership would constitute "payment". The Senate Committee Report says, "Your committee has revised subsection (d) of the House bill to provide that any loss in excess of the basis of a partner's partnership interest may be allowed as a deduction only at the end of the partnership year in which the loss is repaid, either directly, or out of future profits."[4]

Special provision is made for allocation to each partner of his distributive share of depreciation, depletion or basis for determination of gain or loss on property other than cash *contributed* to the partnership.[5] The partnership agreement may fix the conditions precedent to distribution among the partners of the amount by which the fair market value at the time of contribution exceeds or fails to equal the contributor's basis. If the partnership agreement makes no provision for allocation of depreciation, depletion or basis for determination of gain or loss on contributed property, the contributor or contributing partners must recognize gain or loss, or claim a deduction for depreciation or depletion in accordance with the division of partnership income and losses generally. The use in a partnership agreement of special provisions

[2] See Official Explanation of the Internal Revenue Code of 1954 (Prentice-Hall) par. 24,086.
[3] INT. REV. CODE OF 1954, sec. 704.
[4] See Official Explanation of the Internal Revenue Code of 1954 (Prentice Hall), par. 24,417.
[5] INT. REV. CODE OF 1954, sec. 704(c).

based upon the "credited-value" or "allocated-value" principle may be extremely important in particular cases; it is obvious that the circumstances of every partnership involving contributions of property other than cash should be carefully appraised and the partners advised as to the elections available to them.

Whether or not a partner's "salary" is *guaranteed* under the agreement is now important from a tax standpoint, since a "guaranteed salary" to a partner is deductible as a firm expense and reportable by the partner as income.[6] The same principle applies to interest allowed on invested capital.

### *Determination of Gain or Loss of Partners*

With respect to the recognition of a partner's gain or loss when partnership property is distributed, sold, or otherwise transferred, the partnership agreement may control the tax results to some extent, according to the business purposes of the partners as expressed therein. Such control may be exercised by the use of the "credited value" principle, with respect to contributed assets (as outlined above). The possibilities for control are extended, rather vaguely for the present, by a provision requiring the issuance of regulations permitting the determination of the adjusted basis of a partner's interest "by reference to his proportionate share of the adjusted basis of partnership property" at termination.[7]

Under the new Code all dealings between a partnership and a partner acting otherwise than in his capacity as such are to be treated as though the partner were an outside party;[8] however, a 50% ownership interest precludes recognition of a loss from the sale or exchange of property, and an 80% ownership interest converts what otherwise might be a capital gain into ordinary income, with respect to the partner owning such 50% or 80% interest, either directly or through members of his family.[9]

The contribution of property to a partnership does not result in recognition of gain or loss to the contributing partner.[10] However, the transfer of property by the partnership to a partner,

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[6] *Id.*, sec. 707(c).
[7] *Id.*, sec. 705(b).
[8] *Id.*, sec. 707(a).
[9] *Id.*, sec. 707(b).
[10] *Id.*, sec. 721.

during the continuance of the partnership, may give rise to gain or loss, depending upon whether such transfer is an *exchange* or a *distribution*.[11] But in transactions between partner and partnership and also in transactions of the partnership with outside parties, the vital factor in determination of gain or loss of the partner is the *basis* of the property distributed, sold or otherwise transferred. The new Code establishes new rules for the determination and adjustment of a partner's basis for his partnership interest, which rules may trap the unwary partner or his adviser.

Under prior law a proportionate part of the partner's basis of his partnership interest generally had to be allocated to each distributed asset, in accordance with the market value of such asset.[12] Now, on the other hand, the partner's basis for a distributed asset may be to some extent the basis established under the law and regulations by agreement of the partners, unless the partnership's basis for the distributed property exceeds the adjusted basis of the partnership interest of the distributee partner, in which case the partner's share of the partnership's basis for the distributed property is limited to his own adjusted basis.[13] The difference may be taken into account by an adjustment to the basis of the remaining property of the partnership, if an election is properly made.[14]

*Death or Retirement Payments*

In the past the Commissioner of Internal Revenue has challenged the taxpayer's contention in some cases that payments to a retiring partner or to the executor or heirs of a deceased partner were distributions of profit, not payments of the purchase price for the capital investment of the retiring or deceased partner, including goodwill. The presence or absence of an element of goodwill in such payments in the future can be controlled by appropriate specifications in the partnership agreement including a provision that no part of such payments shall be attributable to goodwill.[15] Of course such a provision should be inserted only

[11] *Id.*, secs. 731-735.
[12] For a discussion of the prior law as to basis in partner's hands of distributed property, see Little, Federal Income Taxation of Partnerships (Little Brown, 1952) Chapter VIII, Secs. 8.2, 8.3, 8.4.
[13] INT. REV. CODE OF 1954, sec. 732.
[14] *Id.*, sec. 734.
[15] *Id.*, sec. 736.

if the overall plan for such payments is mutually satisfactory to all partners, taking into account both tax and non-tax considerations.

### *Transfers to a Withdrawing Partner*

Transfers of property to a withdrawing partner, or by a withdrawing partner to the remaining partners, may constitute an exchange of property for a partnership interest in other property, in which event gain or loss will be recognized to the transferor partner so disposing of his property interest.[16] In particular cases the choice of the asset or assets to be transferred, and the terms of the partnership agreement, may cause, or prevent, the recognition of gain or of loss, depending upon the basis of the transferred property in the hands of the partnership, or upon the basis of the partner's interest.

Generally, the basis of partnership property is not to be adjusted as the result of a transfer of an interest in a partnership by sale or exchange, or on the death of a partner. However, after a transfer has occurred, the partnership may elect to adjust the basis of partnership property by the amount of the difference between the basis of the transferee partner's interest and his proportionate share of the adjusted basis of all partnership property.[17]

This article is intended to call to the attention of lawyers the fact that they are necessarily burdened with some responsibility for the tax consequences of instruments pertaining to partnerships which they draft, and to point out to lawyers and accountants the importance of the elections permitted to the partnership, including the filing of an election to adjust the basis of partnership property when a distribution or transfer of partnership interests has taken place during the taxable year. If this article has stimulated the reader to recognize his responsibility for the tax consequences resulting from his advice to his client, then it has served its purpose.

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[16] *Id.*, sec. 741-743.
[17] *Id.*, sec. 743.