

January 1957

Income Tax Aspects of Partnership Formation

Francis J. Butler

Guest Speaker, Fourth Annual Tax School

Follow this and additional works at: <https://scholarship.law.umt.edu/mlr>



Part of the [Law Commons](#)

Recommended Citation

Francis J. Butler, *Income Tax Aspects of Partnership Formation*, 18 Mont. L. Rev. 142 (1956).

Available at: <https://scholarship.law.umt.edu/mlr/vol18/iss2/2>

This Article is brought to you for free and open access by The Scholarly Forum @ Montana Law. It has been accepted for inclusion in Montana Law Review by an authorized editor of The Scholarly Forum @ Montana Law.

Income Tax Aspects of Partnership Formation†

By FRANCIS J. BUTLER*

INTRODUCTION

Importance of Partnership Taxation

The partnership form of doing business is extremely popular because most small businesses readily lend themselves to it. As a result the tax provisions relating to partnerships are of vital importance. It should be remembered that although a partnership is not itself a tax-paying entity, many income tax consequences flow from the use of the partnership form of doing business which will directly affect the individual partners.

1939 Code Provisions

The 1939 Internal Revenue Code had few provisions governing the taxation of partnerships, although the partnership is one of the most widespread forms of business association. The statutory guides were skimpy, the Commissioner's Regulations were inadequate and the rulings (government interpretation and case law) were in most areas confused, chaotic and voluminous. Although the partnership is at least as complicated as the corporation, the lack of adequate guides existed until the enactment of the Internal Revenue Code of 1954. This problem was well recognized, and the reports of both the House and Senate which accompanied the Internal Revenue Code of 1954 showed an understanding of the problem.¹

The confusion and uncertainty in the old law arose chiefly because of the conflict in the cases and rulings between the "aggregate" theory and the "entity" theory. Under the aggregate theory the partnership was viewed merely as a collection of individuals doing business jointly, each having an undivided interest in the partnership property. The entity approach treats the partnership as a business entity, separate and apart from the members of the partnership. Under this theory, a partner holds an interest in the partnership as distinguished from an undivided interest in the partnership property. The new law adopts neither the aggregate theory nor the entity theory to the exclusion of the other, *i.e.*, the partnership remains only an information reporting medium for the taxation of the individual partners, but treatment of the partner-partnership transactions is based upon the recognition of the partnership as a separate entity. In addition, the new

†This article was originally delivered orally at the Fourth Annual Tax School presented by the School of Law at Montana State University in December, 1956, and is reprinted from *ESTATE PLANNING AND INCOME TAXATION*, the report of the proceedings of the school.

*Associated with Paul Castoldi, Spokane, Wash. Member of the Montana and Oregon Bars. A.B., LL.B., Montana State University, LL.M. (Taxation) New York University.

¹"The existing tax treatments of partners and partnerships is among the most confused in the entire Income Tax field. . . . As a result, partners today cannot form, operate or dissolve a partnership with any assurance as to the tax consequences.

"Because of the vital need for clarification, the House and your Committee have undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the Income Tax Laws. In establishing a broad pattern applicable to partnerships generally, the principal objectives have been simplicity, flexibility and equity as between the partners." S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954). See also H.R. Rep. No. 1337, 83d Cong. 2d Sess. 65 (1954).

Code contains a series of elections in which the individual partners can achieve equity among themselves through an aggregate treatment.

1954 Code Provisions

The provisions of the Internal Revenue Code of 1954 pertaining to the taxation of partnerships² were amplified and clarified in many ways by the Commissioner's interpretation of them promulgated in final form on May 23, 1956, in the Treasury Regulation.³ The new provisions in the Code are generally applicable to partnership taxable years beginning after December 31, 1954. Earlier dates were prescribed in the law for certain loop-hole-closing provisions which will be discussed below.

GENERAL RESUME OF PARTNERSHIP TAXATION

Definition of Partnership of Tax Purposes

The Internal Revenue Code defines a partnership in a negative manner. The Code states that the term "partnership" includes a syndicate, group, pool, joint venture or other incorporated organization through or by means of which any business, financial operation or venture is carried on, which is not, within the meaning of the Internal Revenue Code, a corporation, or a trust or estate.⁴ The definition of a partnership, as can be seen, is much broader in scope for tax purposes than the common law meaning.⁵

Under the law and Regulations, certain groups can elect not to come within the provisions of the partnership tax law. These groups are certain investing partnerships and operating agreement partnerships. The Regulations set out in detail the conditions which must be met before the elections can be made.⁶

The Commissioner's Regulations attempt in some manner to set out what is and what is not a partnership. They provide as follows:

A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Merely co-ownership of property which is maintained, kept in repair and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.⁷

In each instance, you will have to look to the agreement to ascertain whether you come within the provisions of sub-chapter K of the Code. Remember, also, that certain partners can elect to be treated as corporations;⁸

²INT. REV. CODE OF 1954, c. 1, subchapter K, §§ 701-771.

³U.S. Treas. Reg. §§ 1.701-1 to 1.771-1 (1956).

⁴INT. REV. CODE OF 1954, § 761(a).

⁵U.S. Treas. Reg. § 1.761-1 (1956).

⁶*Ibid.*

⁷*Ibid.*

⁸INT. REV. CODE OF 1954, § 1361.

conversely, the partnership may, if it resembles a corporation, be taxed as such.⁹

If an organization is a partnership for tax purposes and does not file a partnership return, it is likely that some dire consequences could flow to the members of the partnership in their individual capacity. As will be seen, any election which has to be made concerning the tax laws must be made by the partnership in the partnership return.¹⁰ Failure of the partnership to make an election could result in the loss of a favorable tax consequence flowing from the election, *e.g.*, the election to treat a sale on the installment basis.

Aggregate Theory

As under prior law, the partnership is a reporting entity and not itself a taxpayer. A partnership, as such, is not subject to the income tax imposed, but persons carrying on businesses as partners are liable for the income tax in their separate and individual capacities.¹¹ The partnership files a partnership return and the individual partners then take into account their distributive shares of the partnership income computed according to the method of accounting employed by the partnership. The partnership return filed on Form 1065 shows the names and addresses of the partners and the partnership and lists the partners' distributive shares of income or loss. The partners are liable to report on their individual returns their distributive shares of the partnership income or loss whether or not distributed to them. There is little change under the new law in the basic principle of taxing partners but it should be noted that under the estimated tax provisions, a partner must take into account the partnership income at each installment date. Therefore, a partner, for this purpose, will be treated as though he received his share of the partnership income directly.¹²

Character of Partnership Income

The basic tax computation involves two fundamental steps: (1) determination of the partnership's own items of income and deduction, and (2) the inclusion of such items in the individual returns of the partners. However, in arriving at this computation many factors have to be considered. Under the 1939 law, there was no mechanism whereby certain items of income were assured the same character in the hands of the individual partner that they had in the hands of the partnership, *e.g.*, capital gains. Section 702 of the Internal Revenue Code of 1954 takes care of this and provides that, in addition to the regular partnership profit and loss, certain items are to be separately stated by the partnership and taken into account separately on the partnership return. The partners then pick up their individual share of these separately stated items, which are as follows:

- (1) Long-term capital gain.
- (2) Short-term capital gain.
- (3) Section 1231 capital gains and losses.
- (4) Charitable contributions.
- (5) Dividends.

⁹*Morrissey v. Commissioner*, 296 U.S. 344 (1935).

¹⁰INT. REV. CODE OF 1954, § 703 (b).

¹¹*Id.* § 701.

¹²See S. Rep. No. 1662, 83d Cong., 2d Sess. 89 (1954).

- (6) Taxes paid or accrued to foreign countries.
- (7) Partially tax-exempt interest on obligations of the United States.

In addition to these items, section 702(a) (8) serves as a catchall section and confers discretion on the Commissioner to require segregation of any item which is not treated separately in numbers 1 to 7 above. The Regulations set forth a great many items in addition to the above. It is probably safe to say that any items which affect the computation of the partner's personal income tax must be segregated and separately stated.¹²

Wherever an item is separately computed, the Code requires that the character of the item shall be determined as if it were realized directly by the partner.¹⁴ The partners are treated as if each received his distributive share of partnership gross income for all computations relative to individual partners, *e.g.*, to determine the necessity of filing a return or to determine the applicability of the six-year period of limitation on assessment and collection provided for in section 6501(e) of the Code.¹⁵

The effect of this provision may be illustrated as follows:

The partnership has a section 1231 gain. Partner *A* has a section 1231 loss. In determining whether the section 1231 gains exceed the section 1231 losses, partner *A* is considered as having received his distributive share of section 1231 gain of the partnership. It is treated by him as a section 1231 gain. The netting of the section 1231 gains and losses is made on the partner's level.

Partnership Computation of Income

After the partnership has segregated the items required to be separately stated and has included the other partnership items of income or loss not required to be segregated, the partnership income is determined in the same manner as that of an individual, except that the partnership does not get certain deductions, *i.e.*, charitable contributions, net operating losses, capital gains and losses, the standard deduction and itemized deductions.¹⁶

Any election affecting the computation of income derived from a partnership shall be made by the partnership, *e.g.*, elections as to methods of accounting, computation of depreciation, or use of installment sale provision.¹⁷ The election should be made in accordance with the provisions of the partnership agreement. If the agreement does not provide who is to make these elections and how they are to be made, the authorization of one or more of the partners to file a return on behalf of the partnership may be considered the right to make the elections on behalf of the partnership.¹⁸ This is a carry-over from the case law and rulings under the Internal Revenue Code of 1939.

The only exception to the election provision above is the election affecting foreign taxes paid or accrued. Individual partners in this case may elect separately whether to claim deduction or credit against the tax.

In connection with the deductions which are not allowed a partnership, it must be remembered that the individual partner does not lose these deduc-

¹²U.S. Treas. Reg. § 1.702-1(a) (8), (9) (1956).

¹⁴INT. REV. CODE OF 1954, § 702(b).

¹⁵*Id.* § 702(c).

¹⁶*Id.* § 703(a).

¹⁷*Id.* § 703(b).

¹⁸*Ibid.*

tions, but takes them on his own return in computing his individual income tax.

PARTNER'S DISTRIBUTIVE SHARE

Allocation by Agreement

In the introductory material, the term "partnership distributive share" was used. The 1939 Code failed to define distributive share as such. If *A*, *B* and *C* form a partnership to share profits and losses equally, the allocation of distributive shares is automatic. Each partner would report one-third of everything. Unusual business exigencies, however, can create some difficult problems, and the ingenuity of the taxpayer could, and often did, create further difficulties. The 1954 Code attempts to supply the omission of the prior law and does define distributive share. In so doing, it recognizes that certain exigencies may well arise as to the allocation of certain items between the taxpaying partners, and it provides the machinery to quash exigencies which are created purely through taxpayer ingenuity.

A partner's distributive share of the income, gain, loss, deduction or credit will be determined by the partnership agreement.¹⁹ If the partnership agreement is silent, the general profit and loss ratio will govern as to any item. The general profit and loss ratio also governs if the partnership agreement contains a provision on distributive share, where such provision has as its principal purpose the avoidance or evasion of tax.²⁰ In determining the general profit and loss, the Regulations state:

The manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss.²¹

As noted, if the partnership agreement contains something on distributive share and the principal purpose is tax avoidance, the agreement would be disregarded. This will cause much litigation. The illusiveness of the words "tax avoidance or evasion" is shown in many other fields of the tax law, and this undoubtedly will be no exception. Remember that the partnership agreement is defined in section 761(c) as follows:

[A] partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year . . . which are agreed to by all of the partners or which are adopted in such other manner as may be provided by the partnership agreement.

This means that the agreement can be modified subsequent to the close of the partnership taxable year. This language will give the taxpayer and the taxpayer's representatives an opportunity to reflect back on the prior year.

¹⁹*Id.* § 704(a).

²⁰*Id.* § 704(b).

²¹U.S. Treas. Reg. § 1.704-1(b) (1) (1956).

Section 1.704-1(b) (2) of the Regulations sets out guides²² and cites some examples²³ of what would be considered tax avoidance or tax evasion, the importance of which cannot be overlooked by the astute tax planner.

As some of the text writers have pointed out, this is the first time in the history of the tax laws that taxpayers are permitted to agree on the incidence of tax, *i.e.*, to agree as to which of several co-owners shall be entitled to specific items of income, deductions and credits. The possibilities are most flexible. For example, the owner of an undeveloped oil or gas lease might will be able to raise capital by agreeing that the investor alone would be entitled to amortization, depreciation or depletion allowances.

There is bound to be a lot of litigation on the evasion or avoidance feature. It is important to remember that the agreement can be modified up until the time for filing the return, and the agreement can be either oral or in writing. If the agreement is silent on any matter, the provisions of local law will be considered as constituting a part of the agreement.²⁴

Allocation of Specific Items

When property is contributed to a partnership, the new law recognizes the inequity that might result from the variation between the basis of the property to the partnership and its fair market value at the time of its con-

²²"In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect," that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation." U.S. Treas. Reg. § 1.704-1(b) (2) (1956).

²³Example (1). The provisions of a partnership agreement for a year in which the partnership incurs losses on the sale of depreciable property used in the trade or business are amended to allocate such losses to one partner who has no such gains individually. An equivalent amount of partnership loss or deduction of a different character is allocated to other partners who individually have gains from the sale of depreciable property used in the trade or business. Since the purpose and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting the shares of partnership income, such allocation will not be recognized. Under section 704(b) (2), those items will be allocated to all the partners in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (3). Rather than impair the credit standing of the AB partnership by distribution, the partners agree to invest surplus partnership funds in an equal dollar amount of municipal bonds and corporate stock. The partners further agree that A is to receive all the interest income and gain or loss from tax-exempt bonds and B is to receive all the dividend income and gain or loss from corporate stock. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion. On the other hand, under an agreement with respect to partnership CD, it is provided that C's distributive share of income shall be the first \$10,000 of tax-exempt income, and D's distributive share of income shall be the first \$10,000 of dividend income, the balances to be divided equally. Since the principal purpose of this provision is to allocate tax-exempt interest to C, who is in a higher income tax bracket than D, it will be disregarded. Each partner's distributive share of such interest and dividends will then be allocated in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

²⁴U.S. Treas. Reg. § 1.761-1(c) (1956).

tribution. For example, *A* contributes property with a fair market value of \$20,000 and a basis of \$50,000. *B* contributes \$20,000 cash. Is it fair that *A* and *B* should then share the depreciation on a fifty-fifty basis? The new law recognizes that the parties might want to take care of this disparity and arrange depreciation, depletion or gain or loss among themselves.

The law provides that, as a general rule, depreciation, depletion or gain or loss shall be allocated among the partners as if the property had been purchased by the partnership.²⁵ However, this is subject to an exception. Section 704(c) (2) says that if the partnership agreement so provides, depreciation, depletion, or gain or loss shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution. The property, to come within this rule, must be property which has actually been contributed to the partnership—not merely property subject to the claims of partnership creditors. The rules set forth above do not apply to property owned by one partner who only permits the partnership to use it.

A few examples might best illustrate the operation of this section. Assume first that the partnership agreement is silent. *A* owns machinery with a basis of \$50,000 and a present fair market value of \$20,000. *A* and *B* (who is in a high tax bracket) form a fifty-fifty partnership, with *B* putting up \$20,000 cash. The machinery is subsequently sold at a \$30,000 loss. \$40,000 is used to buy new equipment. *B* gets a \$15,000 loss for income tax purposes, though he has sustained no economic loss. *A* has sacrificed a loss of \$15,000.

Assume now that the partnership agreement is not silent. *A* contributes \$10,000 in cash at the formation of the partnership and *B* contributes non-depreciable property with a basis of \$4,000 and a value of \$10,000. The property is sold for \$10,000 and there is a gain of \$6,000. In the absence of anything in the agreement, the gain would be split fifty-fifty, but the agreement can provide that *B*, who contributed the property sold, is to pick up any gain realized by the partnership on the difference between the basis of the property contributed and the fair market value of the property at the time of its contribution. Therefore, the taxable gain would be included by *B*. Obviously, if this is to be taken into consideration, the partnership agreement should contain a provision which would allocate the gain to *B*.

In addition to the possibilities set out here for securing equity as between the partners, thought should be given in any partnership formation to other alternatives, for example, a sale of depreciable property by a partner so that the partnership might thereby receive a stepped up basis.²⁶ There are many other possibilities, such as leasing property to a partnership.

Another example might be found where *A* has depreciable property with a value of \$10,000, but a zero basis. *B*, on the other hand, has \$10,000 cash. If *A* should contribute this property to the partnership, the partnership will have (as will be seen later) a zero basis. Perhaps if the tax brackets are right, *A* should sell the property to *B* for \$10,000 prior to the formation of the partnership. The partnership might then get a \$10,000 basis for the property. Of course, *A* would have a \$10,000 capital gain. However, under certain circumstances, this might well be advisable.

²⁵INT. REV. CODE OF 1954, § 704(c) (1).

²⁶See, however, the limitation set out in INT. REV. CODE OF 1954, § 707.

The new law also contains a special provision as to the contribution to a partnership of undivided interests.²⁷ It states that if the partnership agreement does not provide otherwise, depreciation, depletion or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. The section applies only if all the partners had undivided interests in such property prior to the contribution and their interests in the capital and profits of the partnership correspond with such undivided interests. The effect of this provision is illustrated as follows:

A and *B* are tenants in common, owing one-half interests in a factory building. They each contributed their respective share to the partnership in which profits and losses are shared equally. *A* has a basis for his interest of \$3,000 and *B* has a basis for his interest of \$7,000. The partnership agreement contains no provisions as to the allocation of depreciation. The annual depreciation on the factory is \$500 (*i.e.*, five per cent of \$10,000). Under the operation of this section, *A* would get five per cent of \$3,000 or \$150, as his share of the depreciation, and *B* would get five per cent of \$7,000, or \$350, as his distributive share.

Limitation on Allowance of Losses

Section 704 contains one other important sub-section which provides for a limitation on the allowance of partnership losses.²⁸ Partnership basis problems will be discussed below, but suffice it to say that a partner's distributive share of the partnership loss is allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the year in which the loss occurs. The excess, if any, of loss over basis is allowed as a deduction at the end of the partnership year in which the excess is repaid to the partnership. For example, at the end of the partnership taxable year 1956, partnership *AB* had a loss of \$20,000. Partner *A*'s distributive share of this loss is \$10,000. At the end of the year *A*'s adjusted basis for his interest in the partnership is \$6,000. Therefore, *A*'s distributive share of the partnership loss is allowed to him only to the extent of his basis of \$6,000. This \$6,000 loss allowed for 1956 decreases the adjusted basis of *A*'s partnership interest to zero. Assume that at the end of the partnership taxable year 1957, *A*'s share of the partnership income has increased the adjusted basis of *A*'s interest in the partnership to \$3,000. Of the \$4,000 loss disallowed for the partnership taxable year 1956, \$3,000 is allowed *A* in the partnership taxable year 1957, thus again decreasing his adjusted basis to zero. If at the end of the taxable year 1958 *A* has an adjusted basis of his interest of at least \$1,000, he will be allowed the additional \$1,000 loss previously disallowed.²⁹

The limitation of the loss may be obviated if the partnership borrows money and the partner is bound to repay. Section 752(a), as will be seen below, says that a partner increases his basis by any increase in the partnership liabilities. The Regulations seem to distinguish between "losses" and "deductions." The Regulations have made reference to charitable contributions and taxes paid to foreign countries. This would seem to imply that these items are allowed regardless of the lack of basis.

²⁷*Id.* § 704(c) (3).

²⁸*Id.* § 704(d).

²⁹See U.S. Treas. Reg. § 1.704-1(d) (4) (1956).

CONTRIBUTIONS TO PARTNERSHIP

Gain or Loss Upon Contribution

We come now to a little different problem, *i.e.*, that of organizing the partnership. In the absence of anything to the contrary in the statute, an exchange of property for a partnership interest could, under certain circumstances, be a taxable transaction and result in gain to the contributing partner. Section 721 of the Internal Revenue Code of 1954, however, provides that no gain or loss shall be recognized to a partner or a partnership if property is contributed to a partnership in exchange for an interest in the partnership. This section is new in the Code, but represents a codification of prior case law. The regulations under section 721 further amplify the section by saying that the non-recognition provision contained in it applies to a contribution of property, including installment obligations. The rule applies to a contribution made to a partnership in the process of formation and to a partnership which is already formed and operating.

As has already been mentioned, partners sometimes wish to deal with a partnership in a capacity other than as a partner. Section 707 of the new Code permits this. The regulations under section 721 recognize that this situation might well arise. They provide that if, rather than contributing property to a partnership, a partner sells property or retains the ownership of the property and allows the partnership to use it, substance will control rather than form.³⁰ Here, again, is a fertile field for litigation. For example, the regulations say that if *A* sells to a partnership and gets money or a promissory obligation fixed in amount and time, this would result in a sale. If, however, the compensation to be received upon this sale was on a percentage basis, then the regulations indicate that this would not be permissible. The effect of a sale, of course, could be to turn ordinary income into capital gain.

There are two danger points to watch. Section 721 only applies to a contribution of property in exchange for an interest in the partnership. To the extent that a contribution is not in property or is not in exchange for a partnership interest, gain or loss may be recognized under general principles of tax law. For example, if *A* contributes \$8,000 and *B* contributes \$2,000 to form a partnership with a total capital of \$10,000, and *A* and *B* each have a fifty per cent interest in the partnership capital, the \$3,000 additional contributed by *A* may constitute payment to *B* for services. If so, *B* would appear to be taxable on \$3,000 of ordinary income at the time of acquiring the capital interest. *B*'s capital interest to the extent of \$3,000 has not been acquired by a contribution of property to the partnership, hence the non-recognition provisions of section 721 are probably not applicable. The mere fact that a portion of *B*'s interest was acquired by a contribution to partnership capital would not seem to change the result.

There is one other situation that bears mention. If the property contributed to a partnership is subject to a liability or if the partnership assumes a liability of the partner in connection with the contribution of property, the rules of section 752 are applicable. A partner contributing such property is deemed to have received a distribution of money to the extent the liabilities are considered transferred to the other partners. The distribu-

³⁰*Id.* § 1.721-1.

tion of money reduces the basis of the contributing partner's partnership interest and any excess over the basis of his interest may result in gain. For example, *A* contributes appreciated property to the *AB* partnership in exchange for his interest. The property is worth \$10,000 with the basis to *A* of \$1,000 and the property is subject to a liability of \$5,000. *A*'s basis, as we shall see under section 722, is \$1,000, *i.e.*, the basis of the contributed property. Under section 752, however, *A* is treated as receiving a distribution of money in the amount of \$2,500, *i.e.*, the amount of the liability transferred to partner *B*. *A*'s basis is therefore reduced to zero and *A* is taxable on \$1,500 (the amount of the distribution exceeding the basis of his interest).

The Regulations point out one other possibility of gain upon the formation of a partnership.³¹ Under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership, whether made at the formation of the partnership or subsequent thereto. To the extent that either partner gives up any part of his right to be repaid his contributions as distinguished from the share in the partnership profits in favor of another partner as compensation for services, the Regulations say that the non-recognition provision of section 721 does not apply. Thus, the partner who receives credit for the additional contribution either for services or in satisfaction of an obligation will receive taxable income at that point. The income will be *measured* by the value of the transferred interest in capital, and the *time* of reporting the income will depend upon all the circumstances, *i.e.*, restrictions on the partner's right to withdraw or otherwise dispose of his interest. This payment may represent a guaranteed payment to the partner and therefore may be deductible by the partnership depending upon all the circumstances. An interest in future profits does not qualify for this section so that *A* could be given a ten per cent interest without a capital contribution and would not get income at that point. He would, of course, have a zero basis for his partnership basis and would receive income when it was distributed to him from the partnership.

Basis of Partnership Interest

In the preceding material the problem of basis has been discussed as it has arisen. Basis involves both section 722 of the Internal Revenue Code which covers basis of the contributing partner's interest, and section 723, which concerns the basis of property contributed to the partnership. These two sections cover generally the basis with respect to property contributed to the partnership. This basis, however, is subject to adjustment. Section 705 provides for the adjusted basis of a partnership interest. Section 752 also has to be considered, since it concerns the treatment of certain liabilities which directly affect the computation of basis.

Section 722 provides that the basis to a partner of a partnership interest acquired by a contribution of property, including money, is the amount of money contributed plus the adjusted basis of the property contributed. If the acquisition of a partnership interest in partnership capital results in income to a partner, such income results in an addition to the basis of the partner's interest.³²

³¹*Id.* § 1.721-1(b) (1).

³²This is the income that can result as illustrated in the example above from U.S. Treas. Reg. § 1.721-1(b) (1956), p. 244.

If the contributed property is subject to an indebtedness, or liabilities are assumed by the partnership, the basis of the contributing partner's interest is reduced by the portion of indebtedness assumed by the other partners, since such assumption is treated as a distribution of money to the partner under the provisions of section 752. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. For example, if A acquires a twenty per cent interest in the partnership by contributing property with a fair market value of \$10,000 and an adjusted basis to him of \$4,000, and the property is subject to a \$2,000 mortgage, which is assumed by the partnership, A's basis is \$2,400, *i.e.*, the adjusted basis of \$4,000 is reduced by the mortgage assumed by the other partners, which is eighty per cent of \$2,000, or \$1,600. If the mortgage was \$6,000, A's basis would be zero, since the \$4,000 would be reduced by eighty per cent of \$6,000, or \$4,800, leaving a minus \$800 basis but basis cannot be less than zero.³³

Basis for Partnership of Contributed Property

Section 723 of the Internal Revenue Code and the Regulations promulgated thereunder³⁴ provide that the basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution.

Since the property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of the property for the partnership includes the period during which it was held by the partner.³⁵

Adjustments to Basis of Partnership Interest

As we have seen, a partner who contributes property to a partnership gets an initial basis under section 722. In addition, section 742, entitled "Basis of Transferee Partner's Interest," provides for a partner's basis if he acquired the property other than by contribution. If he acquired the property by gift or upon the death of a decedent, this section provides that the initial basis shall be governed by the general basis provisions contained in sections 1011 to 1022. We might refer to a basis acquired under sections 722 and 742 as "the original basis."

Section 705 provides the adjustments that have to be made to the original basis. A computation of basis is important only if a partner retires, or sells his partnership interest, or if the partnership dissolves. As mentioned earlier, a partner's basis is also important in determining whether he can deduct his distributive share of partnership loss under section 704(d).

The 1939 law had no provision for the determination of a partner's basis. The Regulations under the old Code, however, did cover the subject, but were inadequate. For example, under the old law, a partner got no credit for his distributive share of non-taxable income. Since his basis was not increased by these amounts, if he later sold his partnership interest, the gain to him might include tax-exempt interest or life insurance proceeds. In addition, under the old law, the method set up in the Regulations for computing adjusted basis was complex and often impossible.

³³*Id.* § 1.722-1.

³⁴*Id.* § 1.723-1.

³⁵INT. REV. CODE OF 1954, § 1223(2).

Section 705 of the new law provides that the *original basis* must be *increased* by (1) any further contributions to the partnership, and (2) the partner's distributive share for the taxable and prior taxable years of (a) taxable income of the partnership, (b) tax-exempt receipts of the partnership and (c) the excess of the deductions for depletion over the basis of the depletable property.

Section 705 then provides that the *original basis* shall be *decreased*, but in no event below zero, by distributions from the partnership and by the sum of the partner's distributable share for the taxable year and prior taxable years of (1) partnership losses (including capital losses) and (2) partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures. In addition, as mentioned before, certain adjustments to basis are made where liabilities are assumed by the partnership.³⁶

Remember that *A* might contribute property with an adjusted basis of \$4,000 and a fair market value of \$10,000, while *B* contributes \$10,000 cash. Their capital accounts might well be \$10,000 each, but the adjusted basis at that point for *A*'s partnership interest is \$4,000 and for *B*'s interest \$10,000. The adjusted basis is determined without regard to any amount shown on the partnership books as capital, equity or a similar account.

In addition to covering some of the items such as tax-exempt income, the new law also provides an alternative rule where a computation would be too complex. Remember that in computing the adjusted basis under section 705, it would be necessary to go back to the original inception of the partnership.³⁷ If circumstances are such that a partner cannot practicably apply the general rule and the Commissioner concludes that the result will not be substantially different from that of the general rule, then the regulations promulgated under section 705 provide that the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon the termination of the partnership. The alternative rule works as follows: The *ABC* partnership of which *A*, *B* and *C* are equal partners owns various properties with a total adjusted basis of \$15,000 and has earned and retained an additional \$15,000. The total adjusted basis of the partnership property is thus \$30,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or \$10,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest and therefore, each partner would have an adjusted basis of \$10,000.

SALARIES AND INTEREST PAID TO PARTNERS

Treated as if Paid to a Non-Partner for Certain Purposes

The new law, as will be seen, applies the entity theory to a partner's transactions with his partnership when he is not acting in his capacity as a partner, and section 707(c) adopts the entity theory with regard to guaranteed annual payments of salary and interest. This section provides that payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent

³⁶*Id.* § 752.

³⁷*Id.* § 705(b) and U.S. Treas. Reg. § 1.705-1(b) (1956).

that such payments are determined without regard to the income of the partnership. These payments are termed "guaranteed payments." The partnership is allowed a deduction for these payments and the partner includes the payment in his gross income as ordinary income. The partner includes the guaranteed payments in his income tax for the taxable year with or within which the partnership year in which the payment was made or accrued ends.³⁸

Treated as a Partner's Share of Income for Certain Purposes

A guaranteed payment is viewed as made to an outsider only for the purposes of gross income and deductible business expenses. For other tax purposes, the guaranteed payments are treated as a partner's share of ordinary income. For example, payment of a guaranteed sum while a partner is sick would not qualify such payment for the exclusion as to sick payment, and, in addition, the amounts are not subject to withholding.³⁹

Advantages of 1954 Code Treatment

The treatment accorded guaranteed payments under the new law seems to apply to two situations. The first is where partnership income is insufficient to cover the guaranteed payment. Assume that in the *AB* partnership *A* is entitled to \$5,000 annually for his services without regard to partnership profits and the partnership has no taxable income. The \$5,000 constitutes a deduction to the partnership which produces a loss distributable to the partners. *A* therefore has income of \$5,000 but he is also entitled to his proportionate share of the partnership loss which is distributed to the partners.

The guaranteed payment provisions are also important where the partnership has a special type of income (*e.g.*, capital gain), but not sufficient ordinary income to cover the guaranteed payment. Suppose the *AB* partnership has a capital gain of \$5,000 and partner *A* receives his \$5,000 guaranteed salary. *A* is taxable on the \$5,000 as ordinary income and the payment creates an operating loss of \$5,000. The capital gain is distributable to the partners according to their profit ratio. The recipient of the guaranteed payment is treated as receiving ordinary income, and the capital gains are distributable to the partners as mentioned according to their profit ratios.

It appears that guaranteed payments would not reduce special items of income. Thus, the partnership agreement gives partner *A* a salary of \$10,000 plus thirty per cent of the income or loss of the partnership. For the taxable year, the partnership has only a capital gain of \$30,000. The breakdown as to partner *A* under this example would be as follows: Partner *A* would include \$10,000 (the guaranteed payment) as ordinary income; he would include capital gain of \$9,000 (thirty per cent of \$30,000); he would also have an ordinary loss of \$3,000 (thirty per cent of the \$10,000).⁴⁰

³⁸Example: Partnership *AB* is on a fiscal year basis ending May 31st, and Partner *A* is on a calendar year basis. Partner *A* receives a guaranteed payment for services of \$1,200. \$700 of this amount was earned between June and December, 1955. *A* reports the entire \$1,200 received for income tax purposes in 1956.

³⁹U.S. Treas. Reg. § 1.707-1(c) (1956).

⁴⁰*Id.* § 1.701-1(c), Example 4.

TAXABLE YEAR OF PARTNERS AND PARTNERSHIPS

Prior Law—Adoption of Partnership Taxable Year

As under prior law, each partner reports his distributive share of the partnership income for the partnership taxable year ending with or within his own taxable year.⁴¹ Several difficult problems can arise, however, by reason of the fact that the partnership's taxable year might differ from that of some or all of its partners.

Under prior law, a partner could minimize his first year's taxes by having the partnership on a taxable year different from his own. For example, if a partner on a calendar year basis had his partnership adopt a fiscal year ending on January 31, 1956, the partner's distributive share of partnership income for the first year would not be included in his income until the calendar year ending on December 31, 1956. This would postpone the inclusion of the income for a year, but could result in a bunching of income upon the termination of the partnership.

1954 Code—Adoption or Change of Partnership Taxable Year

To curb this postponement of income, the new law⁴² provides that a partnership may not change to or adopt a taxable year other than that of all of its principal partners unless it establishes a business purpose to the satisfaction of the secretary. Similarly, a principal partner may not, without the approval of the secretary, change to a taxable year other than that of his partnership.⁴³ A principal partner is defined as a partner having a five per cent interest or more in the partnership profits or capital.

A newly formed partnership may adopt, without securing prior approval from the Commissioner, a taxable year which is the same as the taxable year of all of its principal partners, or a calendar year if all of its principal partners are not on the same taxable year. In any other case, a duly formed partnership must secure prior approval from the Commissioner for the adoption of its taxable year. An existing partnership may not change its taxable year without securing prior approval from the Commissioner unless all its principal partners have the same taxable year to which the partnership changes or unless all its principal partners concurrently change to such taxable year.

It should be noted that the partnership's automatic right to adopt the calendar year when the principal partners themselves have different taxable years is an administrative solution to a dilemma posed by the statute. The alternative in such a situation would have been to require the Commissioner's approval before the partnership could adopt any taxable year. On the other hand, the Regulations thwart an interpretation of the statute which would have enabled any partner automatically to change his own taxable year to conform with that of his partnership. Under such an interpretation, individuals could form an insignificant partnership as a justification for a change in taxable year in order to obtain deferment with respect to income of their major partnership. Although both of these administrative solutions involve debatable statutory interpretation, they appear to be a reasonable implementation of legislative intent.⁴⁴

⁴¹INT. REV. CODE OF 1954, § 706(a).

⁴²*Id.* § 706(b).

⁴³*Id.* § 706(b) (2).

⁴⁴U.S. Treas. Reg. § 1.706-1(b) (1) (1956).

1954 Code—Change of Partner's Taxable Year

As noted above, a principal partner may not change his taxable year without first securing prior approval from the Commissioner and a principal partner is a partner having an interest of five per cent or more in the profits or capital. The Regulations set forth in detail the method to file application for approval, either in adopting a new year or changing a prior partnership taxable year.

It should be noted that the statute again uses the words "business purpose." This will cause much litigation. The Regulations give an example: Partnership *AB*, which is on a calendar year, is engaging in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its taxable year coincide with such natural business year constitutes a sufficient business purpose.⁴⁵

Section 706(b) applies to any partnership which adopts or changes to a taxable year beginning after April 1, 1954.⁴⁶

1954 Code—Termination of Partnership Taxable Year

Just as the difference in taxable years of a partnership and its partners may result in a postponement of the income upon the adoption of the fiscal year, so it may result in the bunching of income upon the closing of a fiscal year. Thus, if a calendar year partner of a January 31 fiscal year partnership dies on December 31, 1956, and the partnership's taxable year terminated with respect to him on the date of his death, his final return would have to include not only his distributive share of partnership income during the twelve-month period from February 1, 1955 to January 31, 1956, but also his distributive share of the partnership income earned during the eleven-month period beginning on February 1, 1956, and ending on December 31, 1956. On the other hand, if the partnership's taxable year remained open until January 31, 1957, his final return would include only his distributive share of the partnership income for the year ending January 31, 1956, while his estate would be taxed on his distributive share of the partnership income earned from February 1, 1956.

This bunching of income might also occur upon the sale of a partnership interest or the retirement of a partner if the partnership's taxable year closed with respect to the selling or retiring partner on the date of sale or retirement. However, the date is not too important here because the partner can generally choose the date of his severance from the partnership in the light of the tax consequences of his action.

The effect of death upon a partnership has been the subject of much controversy in the courts. There has been a definite conflict. The Supreme Court has held that the death of a partner has the same effect as dissolution and that the deceased partner's final return was consequently required to report the decedent's distributive share of the partnership income for the year ending within his taxable year and for the short year terminated by his death.⁴⁷ However, there was some conflict since the Court of Appeals for the Third Circuit did not follow this and allowed the partnership's tax-

⁴⁵*Id.* § 1.706-1(b) (4) (iii).

⁴⁶INT. REV. CODE OF 1954, § 771(b) (1) and U.S. Treas. Reg. § 1.706-1(b) (6) (1956).

⁴⁷*Guaranty Trust Co. v. Commissioner*, 303 U.S. 493 (1933).

able year to remain open where the partnership agreement provided that the partnership was to continue after the death of the partner.⁴⁸ The answer to this important question was not certain therefore until the enactment of the 1954 Code. The Code explicitly sets forth rules for the closing of a partnership's taxable year with respect to a withdrawing, selling or deceased partner.

Section 706(c) provides that the closing of a partnership taxable year or a termination of a partnership for federal income tax purposes is not governed by the dissolution or liquidation of a partnership under state or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's entire interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

However, a partnership taxable year does close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. But the partnership taxable year with respect to a partner who dies shall not close prior to the end of such taxable year or the time when such partner's interest (held by his estate or other successor) is liquidated, sold or exchanged, whichever is earlier.⁴⁹

When a partner dies, the partnership year doesn't close as to him, nor does it close with respect to the other partners. In a two-man partnership, the partnership is not terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership.⁵⁰

The last return of a decedent partner includes only his share of partnership income for the year ending within his last taxable year, (which ends on the date of his death). The partner's distributive share of partnership income for the period ending after the decedent's last taxable year, is included in the return of the estate. For example, if the partnership has a fiscal year ending March 31st, and partner A, on a calendar year, dies May 3d, and his estate continues as a partner until November 30th (the estate, a new taxpayer, adopts as the taxable year a calendar year), A, on his last return, would include his share of the partnership earnings for the fiscal year ending March 31st preceding his death. No part of the income from April 1st to his death would be included in his last return. The estate's return would be for the period May 3d to December 31st since it had adopted a calendar year. It would therefore include A's share of the partnership income from April 1st to May 3d, and its own share of the partnership income from May 3d through November 30th.

Since the partnership year does not close, the decedent may have no income in his last return (*i.e.*, the income for the time he was alive might be taxable to his estate). This, of course, could hurt a great deal, since the estate cannot split the income with his wife or take all the deductions decedent could if he were alive. The Regulations, however, show the way out by providing that if a partner or a retiring partner, in accordance with the terms of a partnership agreement, designates a person to succeed to his

⁴⁸Girard Trust Co. v. U.S., 182 F.2d 921 (3d Cir. 1950).

⁴⁹U.S. Treas. Reg. § 1.706-1(c) (1) and (2) (1956).

⁵⁰*Id.* 1.708-1(b) (1) (a).

partnership interest after death, such designated person is regarded as his successor in interest. Thus, if a partner specifies that his widow is to be his successor in interest, the share of the partnership income for the partnership year ending within or with her taxable year may be included in a joint return.⁵¹

If there is a buy and sell agreement in force which provides for the sale or exchange of the partner's interest at the date of death, then the taxable year of the partnership with respect to the deceased partner closes upon the date of death. This is an exception to the general rule that the taxable year of the partnership does not end with death, but it is an exception specifically provided for in the Regulations.⁵²

CONCLUSION

As can be seen from the foregoing, the formation of a partnership can involve some very difficult considerations. The 1954 Revenue Act and the Regulations promulgated thereunder attempt to provide a taxpayer with a working set of ground rules. In some areas the rules are still complex and difficult, but the Internal Revenue Service in its Regulations has made an honest attempt to clarify certain areas. In some areas, clarity can only come after years of extended litigation and unfortunately there are a number of sections in the new law which appear to call for extended litigation. This result is inevitable when an attempt is made to codify something as complex as the taxation of partnerships.

In any event, taxpayers and their counsel no longer need scurry through a maze of conflicting case law to determine most partnership tax consequences. Most of the desired answers can be found in the Law and Regulations. It is only hoped that this notice points up the necessity of finding the desired answers at the time the partnership is formed and not later at the expense of the taxpaying partners.

⁵¹*Id.* § 1.706-1(c) (3) (iii).

⁵²*Id.* § 1.706-1(c) (3) (iv).