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Tax Aspects of Partnership Distributions and Transfers of Partnership Interests, Taxing Statutes

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TAX ASPECTS OF PARTNERSHIP DISTRIBUTIONS AND TRANSFERS OF PARTNERSHIP INTERESTS

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While ideally the process of imposing taxes should be simple, direct, and easily understood by the taxpayer, the interposition of traditional forms of business organization between the taxpayer and property in which he has an interest appears to make this objective extremely difficult of attainment, if not impossible. This article deals with some of the complexities resulting from such a situation—the taxation under the federal income tax of income generated in the partnership form of organization. It should be observed at the outset that while some criticism[1] of the approach of Subchapter K of the Internal Revenue Code of 1954 in dealing with these complexities can be made, a substantial case can be developed for the proposition that Subchapter K is, for the most part, a commendable attack upon a very difficult tax problem. One point, however, seems certain: a system of taxation cannot at one and the same time adapt itself to the intricacies of a variety of business, legal, and economic concepts and institutions and remain a model of simplicity. If taxing statutes are, in the modern complexity of affairs, to serve the objectives of fairness and minimal interference with traditional forms of business organization and operation, they will involve complexities far beyond the layman's capacity to deal with. The choice—if one still remains—may be between the continued development of expert and specialized tax counsel assisting both the government and the taxpayer in the application of intricate laws on the one hand, and, on the other, the indiscriminate impact on entities and forms of doing business of a statute designed primarily to be simple. As noted above, this article deals particularly with some of the more intricate aspects of the application of the federal income tax to those who have associated themselves in a general partnership. More specifically, the areas for consideration are tax aspects of transfers of partnership interests and distributions by a partnership to its partners.

Before consideration may be directed to these areas, it is desirable to point out certain fundamental propositions with respect to the impact

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1. Hauser, *Partners and Partnership: Contributions, Distributions and Transfers Under the 1954 Code,* 32 TAXES 954 (1954). Paper presented at the Seventh Annual Federal Tax Conference of the University of Chicago, October 27-29, 1954. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION (1957).

of the taxing statute on income derived from or related to partnerships. While these propositions do not deal specifically with the transfer of partnership interests or with distributions by a partnership to its partners they are a necessary preliminary to understanding in these areas. The first of these is contained in section 721 of the Internal Revenue Code of 1954:[2]

> No gain or loss shall be recognized to the partner on the transfer to the partnership of money or property in exchange for *an interest in the partnership.* (Emphasis added.)

Whatever may be the fine subtleties of the ownership interest of a partner in partnership property, the above quoted provision seems clearly to indicate that for purposes of the Internal Revenue Code, the partner acquires, in exchange for his property, *an interest in the partnership,* and ownership of the contributed property passes to the partnership. This is analogous to the acquisition of an interest in a corporation in exchange for property transferred thereto. The proposition—to the effect that the partner holds an *interest in the partnership* as distinct from an interest in the partnership property—seems to have been well established in pre-1954 cases.[3] Certain correlative propositions follow from the basic conclusion. First, the basis of the property in the hands of the partner must carry over to the partnership;[4] second, no gain or loss is recognized to the partnership;[5] and, finally, the tax basis of the partner's interest in the partnership resulting from the exchange is the basis to him, immediately before the exchange, of the transferred property.[6]

Capital and Basis

At this point it seems appropriate to make a slight digression from the principal topic in order to comment on certain business or economic interrelationships of the partners and their partnership as they affect the tax problems under consideration. It appears that the *basis* of a partner's interest in the partnership resulting from an exchange of property for such interest has no necessary exact correspondence to his economic, or legal interest in the firm. Some of the difficulties in understanding tax

2. All references to statutes herein are to the Internal Revenue Code of 1954 unless otherwise indicated.

3. Kessler v. United States, 124 F.2d 152 (3d Cir. 1941); Gartling v. Commissioner, 6 CCH Tax Ct. Mem. 879 (1947), *aff'd per curiam,* 170 F.2d 73 (9th Cir. 1948); Lehman v. Commissioner, 7 T.C. 1088 (1946), *aff'd,* 165 F.2d 383 (2d Cir. 1948); Thornley v. Commissioner, 147 F.2d 416 (3d Cir. 1945), *reversing* 2 T.C. 220 (1943); Robert E. Ford, 6 T.C. 499 (1946), *acq.,* 1946-2 CUM. BULL. 2.

4. INT. REV. CODE OF 1954, § 723.

5. INT. REV. CODE OF 1954, § 721.

6. INT. REV. CODE OF 1954, § 722.

aspects of partnership distributions and transfers of partnership interests arise from confusion about a partner's capital in the partnership and the basis of a partner's interest in the partnership. Capital is the contribution of money or property to the partnership by the partner which represents his stake in the business and his share of the money or property with which the partnership is to carry on its activities.[7] In order to express the capital relationship among the partners in a meaningful way it seems almost always necessary that the partners' capitals should be stated in money terms.[8]

If there is to be an equitable arrangement among the partners, it is hardly debatable that property contributed to a partnership by a partner must be valued for purposes of establishing his capital at its fair market value at the time of its contribution to the partnership.

Under the carryover basis provisions of the Code, the basis of the contributed property to the partnership and the basis of the contributing partner's interest in the partnership may vary substantially from the partner's capital.

This divergence between capital and the basis of the partner's interest in the partnership may not only cause difficulties in the allocation of taxable income among the partners in a manner differing from their shares of the net profits,[9] but it causes complications in connection with transfers of interests and distributions. In the following illustration it is assumed that A, B and C have transferred the kinds of property indicated, as capital, to their partnership under an agreement whereby each partner is to contribute an equal capital.

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7. "The capital of the partnership is the amount specified in the agreement of the partners, which is to be considered by the partners for the purpose of initiating and operating the partnership business." BARRETT AND SEAGL, PARTNERSHIPS LAW AND TAXATION § 3.1 (1956).

8. See MILROY, WALDEN, AND SEAWELL, ACCOUNTING THEORY AND PRACTICE ADVANCED (1961).

9. A contributes $20,000 cash and B contributes land with a fair market value of $20,000 to their equal partnership. But B's land, at the time of contribution to the partnership, had a basis to him, and hence to the partnership of, only $5,000. If the land is sold by the partnership for $20,000, from an accounting point of view, the partnership realizes no gain or loss if, on the initiation of the partnership, the partners were credited with equal capitals and the land was entered at its fair market value. From a tax standpoint, however, the partnership has a recognized gain of $15,000, and the question is to whom this gain is to be allocated for tax purposes. Section 704(c)(1) provides that the gain is to be allocated between the partners "as if such property had been purchased by the partnership." Assuming that the partnership is equal as to division of profits, A and B would each report $7,500 of taxable gain. Section 704(c)(2) permits the allocation of the entire gain to B "if the partnership agreement so provides." The equitable handling of situations involving variations between the basis and fair market value of contributed property becomes more complex if the contributed property is subject to depreciation or depletion. See WILLIS, HANDBOOK OF PARTNERSHIP TAXATION ch. 7 (1957) for alternative methods of handling situations of this kind.

Partner	Kind of Property	Capital; Fair Market Value of Property	Basis of Property to Contributing Partner and Partnership and Basis of Interest in Partnership
A	Money	$100,000	$100,000
B	Property	100,000	80,000
C	Property	100,000	125,000
		$300,000	$305,000

While A, B and C have equal capitals, as required by the partnership agreement, they do not have equal bases for their interests in the partnership nor is the basis of the contributed property uniform to the partnership. It is highly desirable in any consideration of tax problems relating to partnerships to avoid confusion of such terms as capital, basis of a partner's interest, and basis of partnership property.

Transfers of Partnership Interests

It is well established that a partner may transfer his interest in the partnership to another.[10] Because of the contractual basis of the partnership relation, the consent of the other partners and the consummation of a new contractual relationship will be required if the enterprise is to continue with the transferee becoming actively engaged in the business. Since the subject of major interest here is the tax problems flowing from such a transfer, no consideration will be given to other aspects of this kind of transaction.

The first, and perhaps the dominant tax aspect of such a transfer, appears to lie in the recognition in the Code that this is a transfer of an *interest in the partnership.*[11] It is strongly analogous to the sale of a stock interest in a corporation. Furthermore, the general rule, again analogous to the general rule applicable in the sale of a stock interest in a corporation, is that the transaction is the sale of a capital asset resulting in a capital gain or loss.[12] But, as will be noted at a later point, while the partner may sell an *interest* in the partnership, the character of the underlying partnership assets may sift through the partnership "interest" to color the character of the gain or loss resulting from the sale. But before this aspect of the transaction may be dealt with properly, attention must be directed to additional reasons why the value of a partnership interest may vary substantially from the tax basis of that interest.

10. UNIFORM PARTNERSHIP ACT § 27.
11. INT. REV. CODE OF 1954, § 741.
12. INT. REV. CODE OF 1954, § 741. See, with reference to the Int. Rev. Code of 1939, GCM 26379, 1950-1 CUM. BULL. 58; United States v. Shapiro, 178 F.2d 459 (9th Cir. 1949); Commissioner v. Lehman, 165 F.2d 383 (2d Cir. 1947), *cert. denied,* 334 U.S. 819 (1947).

It has already been shown that this variation may be due to a divergence of the value of the partnership property and its basis to the contributing partner at the time of contribution to the partnership. Another reason for this divergence would obviously be general appreciation in the value of the underlying partnership assets after their contribution. Still a third and very important reason is found in the method of accounting employed by the partnership. For example, if the partnership is a service business and employs the cash receipts and disbursements method of accounting, as is frequently the case, it may have accounts receivable which belong to the partnership but which have not been taken into taxable income and hence are not reflected in the basis of the partner's interest in the partnership. A final reason may be noted. Under generally accepted methods of accounting, income is not considered to be realized until sales have actually been made of the product held for sale. A firm may have an inventory, valued at cost for accounting purposes, with substantial profit potential; this increment in value will not be reflected in cash or accounts receivable and hence not in the partner's interest until sales have actually been made. To illustrate the effect of the divergence between the value of the underlying partnership assts and the basis of the partnership interest, consider the following partnership balance sheet which includes an item of unrealized receivables.

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' Interests:		
Cash	$27,000	$27,000	A	$30,000	$19,000
Accounts receivable	24,000	0	B	30,000	19,000
Capital assets	39,000	30,000	C	30,000	19,000
	$90,000	$57,000		$90,000	$57,000

If partner A sells his interest in the partnership to a new partner, X, for its fair market value of $30,000, what does X get as a result of this transaction? He has acquired an *interest* in the partnership and, under the general rules with respect to basis of property acquired by purchase, his basis for the partnership interest will be its purchase price.[13] But it is to be noted that while X has paid an amount for the acquired partnership interest which reflects the value of the underlying assets, and while the basis of his interest is a like amount, he will be subjected to tax at ordinary rates on the realization by the partnership of the accounts receivable and to gain on the sale of the capital assets.[14] But here the stat-

13. INT. REV. CODE OF 1954, § 1012.

14. It is elementary that a partnership as such pays no tax, and the partners "carrying on a business as partners shall be liable for income tax only in their separate or individual capacities." INT. REV. CODE OF 1954, § 701.

ute, in sharp contrast to that applicable to acquisition of an interest in a corporation, provides that the acquiring partner may transmute a part of the purchase price of his interest to his share of the underlying partnership assets. Section 743 provides *inter alia*:

> In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall—
>
> (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property . . .

While this election to transmute the excess of the basis of the partnership *interest* over the basis *to the partnership* of the corresponding property requires allocation among categories of partnership property and to specific items within categories, in the simple illustration presented above, it is clear that partner X would be entitled to a special basis adjustment with respect to the partnership accounts receivable and the capital assets. The firm balance sheet reflecting these adjustments is shown below:

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' Interests:		
Cash	$27,000	$27,000	X	$30,000	$30,000
Accounts receivable	24,000	8,000	B	30,000	19,000
Capital assets	39,000	33,000	C	30,000	19,000
	$90,000	$68,000		$90,000	$68,000

On collection of the receivables and assuming the sale of the capital assets at fair market value, B and C would each report taxable income of $11,000 divided between ordinary income and capital gain while X's share of the collections on accounts receivable ($8,000) and capital gain ($3,000) would represent a mere recovery of basis. Of course the basis of B's interest and C's interest in the partnership would be increased to $30,000 as a result of the allocation to them of their share of the ordinary income and capital gain. If the total realized income of $33,000 were distributed, each partner, including X, would thereupon have a basis for his interest of $19,000. Incidentally, it is important to note that the portion of Section 743 quoted above makes specific reference to the acquisition of a partnership interest "upon the death of a partner." To vary the foregoing example, it may be assumed that A died owning his partnership interest. The implications of the Code seem clear to the effect that A's estate acquires only a *partnership interest* with, of course, a basis equal to its fair market value of \$30,000. If the election above referred to is not in effect, the estate would realize \$8,000 of ordinary income upon the collection of the receivables and \$3,000 of capital gain on the sale of the capital asset. On the other hand, if the election is in effect, the fair market value basis for the partnership interest acquired by A's estate would, in part, be transmuted to the unrealized receivables and capital assets in a manner similar to that already illustrated in the case of a sale of the partnership interest.[15] Since the Code's definition of unrealized

15. The general rule relating to the allocation of basis is that whatever the amount of adjustment which is to be made to property in the hands of the partnership, it must have the effect of reducing the difference between the fair market value of partnership property and the basis of such property in the hands of the partnership. There are two specific rules in implementing this requirement. The first is that the allocation must be made between categories of property and the second is that any amount allocated to a category must be re-allocated to assets within that category. Section 755(b) designates two classes of assets making up those in Category 1, viz., capital assets and section 1231 assets. Category 2 embraces all other kinds of assets. In the illustration below it is assumed that a new partner has purchased a 1/4 interest in the partnership for \$37,500 and the basis to the partnership of his share of the underlying assets is \$30,000. The difference of \$7,500 must be allocated to categories on the basis of the relative difference between the fair market value of the assets in the category and their adjusted basis to the partnership. In the illustration below the total of this variation is \$30,000 with \$10,000 applicable to Category No. 1 and \$20,000 to Category No. 2. Further allocation among the assets in Category No. 1 results in \$1,250 being allocated to Assets A and C. Note that no part of the basis allocation is made to Asset B in Category No. 1. This is because the regulations prohibit allocation of any part of the adjustment to an asset where such allocation would increase the disparity between the basis and the fair market value of the asset. It should be noted that the excess of the basis of the partnership interest over the transferee partner's share of the partnership assets may be due to the presence of good will in which case it would appear that some part of the excess must be allocated to this asset.

	Basis	FMV	Allocation to Categories	Allocation Within Categories	Basis New Partner
Assets:					
Category No. 1:					
Asset A	\$ 20,000	\$ 30,000		10/20* = \$1,250	\$ 6,250
Asset B	20,000	10,000			5,000
Asset C	20,000	30,000		10/20* = 1,250	6,250
	\$ 60,000	\$ 70,000	10/30 x \$7,500	\$2,500	\$17,500
Category No. 2:					
Asset D	\$ 20,000	\$ 40,000		20/20 = \$5,000	\$10,000
Asset E	20,000	20,000			5,000
Asset F	20,000	20,000			5,000
	\$ 60,000	\$ 80,000	20/30 x \$7,500	= \$5,000	\$20,000
	\$120,000	\$150,000		\$7,500	\$37,500

*The total variation between basis and fair market value in Category No. 1 is \$20,000 when Asset B is disregarded, with \$10,000 assignable to Asset A and \$10,000 to Asset C, hence the allocation is 10/20 to each asset. In Category No. 2 the total variation is \$20,000 all of which is assignable to asset D.

receivables is broad enough to include such items as "work-in-progress" in professional partnerships reporting on the cash basis, it would appear reasonable to give serious consideration to the adoption of the election referred to above.[16]

The foregoing illustration has dealt with adjustment to the basis of unrealized receivables and capital assets by one acquiring a partnership interest, but these are not the only kinds of partnership property to which such adjustments may be applicable. The transmutation of additional basis to depreciable property, to non-depreciable assets, such as land, whether used in the business or held for sale, will have a similar effect. In this connection attention should be given at this point to a relatively new statutory concept. This is the recapture of depreciation provided for in section 1245 and section 1250 of the Code. Essentially these sections provide that where the amount realized upon the disposition of depreciable chattels or depreciable real estate is in excess of the adjusted basis of the asset, the gain which otherwise would be considered capital gain must be treated as ordinary income to the extent of the lesser of the gain or the depreciation taken on the property since 1961 in the case of chattels and 1963 in the case of real property. The ability of a new partner to have the excess of the basis of his partnership interest over the basis to the partnership of his share of the underlying assets reflected in section 1245 and section 1250 property will depend upon whether the partnership has elected the optional adjustment to the basis of underlying assets upon acquisition of his interest in the partnership. This may be illustrated by considering a hypothetical firm. It is assumed in the illustration that the partnership acquired depreciable property January 1, 1954, at a cost of $15,000 and that depreciation has been claimed each year based on a 20 year life without regard to salvage value. At December 31, 1965, the situation will be as follows:

Basis of asset	$15,000
Less depreciation deductions claimed (12 years x $15,000/20)	9,000
Adjusted basis at December 31, 1965	$ 6,000

It may be further assumed that the asset has a fair market value of $9,300

16. Certain other points are to be noted in connection with the election: (1) the election must be made by the partnership and is not available generally to the partner on a unilateral basis; this is subject to a limited qualification contained in section 732(d) discussed *infra* in the text; (2) once the election is made, it applies to adjustments arising in connection with the transfer of partnership interests and also in connection with certain distributions discussed *infra* in the text; (3) once the election is in effect, it requires downward adjustment of underlying partnership property where the basis of the transferee partner's interest is less than the basis to the partnership of his share of partnership property. For possibilities with respect to revocation of the election, see Treas. Reg. § 1.754-1(c) (1956).

or $3,300 in excess of its adjusted basis. Since section 1245 has application only to the recovery of depreciation taken since 1961, it is necessary to divide the excess of fair market value over adjusted basis between capital gain (section 1231) and ordinary income. The section 1245 gain is computed as the difference between the adjusted basis of the asset and the lesser of the amount realized on the disposal of the asset or the recomputed basis.[17] In the illustration below the fair market value assignable to the section 1245 asset exceeds the recomputed basis and therefore the situation involves both potential section 1245 gain and potential capital gain.

Fair market value of asset		$9,300
Adjusted basis		6,000
Potential gain to be allocated		$3,300
Adjusted basis of asset	$6,000	
Depreciation claimed since 12-31-61 (4 years x $750)	3,000	
Recomputed basis	$9,000	

17. When a depreciable asset is sold at an amount in excess of its adjusted basis the total selling price, if large enough, may be broken down into the following elements: (1) recovery of adjusted basis, (2) recovery of depreciation claimed prior to 1962, (3) recovery of depreciation claimed subsequent to 1961, (4) pure gain. If an asset having an adjusted basis of $6,000 was sold for $9,500 before 1962 the entire $3,500 would have been considered gain without regard to "recoveries." Since 1961, however, the selling price is, in effect, allocated as follows:

(1) First to recovery of adjusted basis	$6,000
(2) Next, to recovery of depreciation claimed since 1961	1,000
(3) Next, to recovery of depreciation claimed prior to 1962	3,000
(4) Next, to pure gain	500
	$9,500

Under section 1245, elements of recovery, (2) and (3), as well as pure gain, (4), are still considered gain, but element (2) is considered to be ordinary income rather than gain under section 1231. Of course, if the asset is sold for an amount not greater than $7,000, the total selling price will include recovery of elements (1) and (2) only, and the entire gain will be ordinary income. Where an asset is disposed of other than by sale the amount realized (generally the fair market value of what is received in exchange) is the measure of the various elements of recovery and gain. The Code [section 1245(a)(2)] prescribes the measure of ordinary income realization as the lower of the amount realized or the "recomputed basis." In the present illustration, the recomputed basis is the sum of the recovery elements (1) and (2). Since to the extent depreciation taken since 1961 is recovered (element (2) in the present illustration), the seller of the asset is in effect recovering payment for value that has no tax basis. The adjusted basis of the section 1231 asset for computation of capital gain becomes, in effect, the recomputed basis, that is, the true adjusted basis plus depreciation taken since 1961; in other words, the sum of recovery elements (1) and (2) in the present illustration. Section 1250 relates to recovery of depreciation on a disposition of real property. The section provides for recovery only to the amount of the excess of the depreciation allowed since 1963 over the amount that would have been allowed if the taxpayer had used the straight line method of computation. Even this excess is considered "recovery" only to the extent of a percentage determined by reducing 100 per cent by 1 percent for every month in excess of 20 the property has been held; thus, there is no "recovery" if the property has been held 10 years.

Adjusted basis	6,000	
Section 1245 gain		3,000
Section 1231 gain		$ 300

In the application of the excess of the basis of a partnership interest acquired by purchase over the adjusted basis of the partner's share of underlying assets, the allocation may be determined as follows:

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' Interests:		
Cash	$27,000	$27,000	A	$22,100	$21,000
Sec. 1231 asset	6,300	6,000	B	22,100	21,000
Sec. 1245 potential	3,000	0	C	22,100	21,000
Other assets	30,000	30,000			
	$66,300	$63,000		$66,300	$63,000

If X pays partner A $22,100 for his partnership interest, X would be entitled to an adjustment to the basis of underlying partnership property of $1,100 which would be allocated as follows:

	Fair Market Value	Basis	Excess		X's Share		Adjustment
Section 1231 asset	$6,300	$6,000	$ 300	x	1/3	=	$ 100
Section 1245 gain	3,000	0	3,000	x	1/3	=	1,000

The partnership balance sheet would then appear:

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' interests:		
Cash	$27,000	$27,000	X	$22,100	$22,100
Sec. 1231 asset	6,300	6,100	B	22,100	21,000
Sec. 1245 asset	3,000	1,000	C	22,100	21,000
Other assets	30,000	30,000			
	$66,300	$64,100		$66,300	$64,100

For purposes of depreciation and gain on subsequent sale, the basis of the section 1231 asset and the section 1245 asset have been adjusted, with respect to partner X, to reflect the effect of the election to transmute the excess of the purchase price of his partnership interest over the adjusted basis of his share of partnership property.

The conclusion to be reached from the above discussion is obviously that one acquiring a partnership interest by purchase or as the result of the death of a partner may have an adjustment to the underlying partnership property. Thus it seems clear that while the Code contemplates that the partner owns an interest in the partnership and the partnership in turn owns the underlying assets, there is still the opportunity, through the exercise of the election referred to above, to place the owner of the interest in a relationship with the underlying assets that bridges over the strict concept of ownership. The uniqueness of this relationship is apparent if it is compared with the situation of the owner of corporate stock and his relationship with the underlying corporate assets. It is true in certain situations that gain characteristics of the corporate assets may be attributed to the shareholder's stock,[18] but there appears to be no opportunity to transmute the basis of the stock itself to property owned by the corporation.

It has seemed necessary to approach consideration of the tax aspects relating to the transfer of partnership interests by noting the opportunity available to a transferee to reflect the basis of his interest in the underlying partnership property. The necessity for this preliminary approach lies in the fact that if one acquiring a partnership interest by purchase or by reason of the death of a previous owner is to have an opportunity to transmute to the underlying assets the excess of the basis of his interest over the basis to the partnership of such assets, a door is opened for tax manipulation which is incompatible with the general concepts of the tax law. This relates to conversion of ordinary income into capital gain. The following propositions are pertinent:

1. basically a partnership interest is a capital asset, and hence the general rule must be that the gain on its sale is a capital gain;
2. one purchasing a partnership interest or acquiring such interest by reason of the death of another may preclude the recognition in his hands of any appreciation in the value of the underlying assets by election to adjust the basis of his share of such assets;
3. it follows that if the gain on a disposal of an interest is capital gain and the person acquiring such interest, when the relevant election is in effect, avoids any realization of gain due to appreciation in the value of the underlying assets or as a result of the partnership method of accounting, then any potential ordinary income has been converted to capital gain.

On the other hand, it should be apparent that if it were not for the opportunity to adjust the basis of partnership property on the transfer of a partnership interest, potential gain would be taxed twice—once when the partnership interest was sold, and once upon the subsequent sale by the partnership of the underlying property.[19] While avoidance of this

18. See INT. REV. CODE OF 1954, § 341, with respect to stock of collapsible corporation.

19. INT. REV. CODE OF 1954, § 702. Theoretically, at least except for the time element, failure to obtain adjustment upward of the basis of underlying partnership property does not work to the disadvantage of a transferee partner. The reasoning is: the transferee recognizes his share of gain, which could have been avoided by upward ad-

kind of double recognition of gain has not been provided for in other instances,[20] the possibility of avoidance of the second recognition by election has been uniquely provided for in connection with partnership interests.[21] Similarly, the election may prevent the recognition as taxable income of realized appreciation where the statute provides a stepped up basis for a partnership interest received as the result of the death of a partner.

Provision for avoiding a second recognition of gain by the purchaser of a partnership interest or the realization of gain by an estate or heir requires protection of the government's interest against the conversion of potential ordinary income into capital gain through the sale of a partnership interest which is, under the general rule, a capital asset. To meet this problem, the law provides for the fragmentation of the gain realized on the sale of such an interest. It should be observed that while the right to adjust the basis of underlying partnership property is available only by election, the fragmentation of gain on sale of such an interest as between capital gain and ordinary income is mandatory.

> Section 751(a) of the Code provides:
> Sale or Exchange of Interest in Partnership.—The amount of money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—
> (1) unrealized receivables of the partnership, or

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justment of basis, on the sale of the partnership property; but this recognition increases the basis of his partnership interest under section 705; ultimately, therefore, on the liquidation or sale of his interest he will match the proceeds of sale or liquidation against a higher basis than otherwise would have been the case.

The benefits of the opportunity to adjust basis upward on the transfer of a partnership interest are, of course, not limited to situations where the adjusted property is sold. The special adjustment applicable to the transferee partner will, in the case of depreciable property, provide a larger depreciation deduction in computing the transferee partner's share of partnership taxable income.

The election by the partnership under section 754 to adjust the basis of underlying property "casts the die" with respect to four possible situations: (1) adjustment upward where the basis of the transferee partner's interest in the partnership exceeds the basis of his share of the underlying property; (2) adjustment downward where the basis to the transferee of his partnership interest is less than the basis to the partnership of underlying property; (3) and (4) similar adjustments upward and downward with respect to distributions which are discussed above.

Section 754 provides that the election to adjust basis may be revoked by the partnership, subject to such limitations as are prescribed by the Secretary or his delegate. A general statement as to these limitations is contained in Treas. Reg. § 1.754-1(c) (1956).

20. There is apparently no possibility of the transmutation of the gain realized by the seller of corporate stock to the underlying corporate property even though the purchaser has paid a price for the stock that reflects the appreciation above basis of the underlying corporate property.

21. INT. REV. CODE OF 1954, §§ 742, 743(c).

(2) inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Section 751(c) provides definitions for unrealized receivables, appreciated inventory, and, by cross reference, sections 1245 and 1250 property.

The regulations provide with respect to the allocation of the sale price of the partnership interest: "Generally, the portion of the total amount realized which the seller and purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct."[22] But, it should be observed, the selling partner is also required to make an allocation of the total basis of his partnership interest to the section 751 property disposed of. The regulations provide that the adjusted basis of the partnership interest to be allocated to section 751 property shall be determined under section 732. This section deals with the basis of property to a partner upon a distribution to him by the partnership. Thus in allocating a part of the total basis of his partnership interest to section 751 property, the partner, in effect, must assume a *current* distribution to him by the partnership of such property.[23] The general rule of section 732 is that in a current distribution the basis to the distributee partner of property distributed to him is the same as the adjusted basis of such property to the partnership just prior to the distribution—a carryover basis. This general rule is subject to some qualification. In the first place, if the partner selling his partnership interest had contributed section 751 property (*e.g.*, substantially appreciated inventory under an agreement under section 704(c)(2)[24]) by virtue of which all gain on the sale of such property is, for tax purposes, to be allocated to him, it would appear that the phrase in the regulations[25]—"Such basis should reflect . . . any agreement under section 704(c)(2)"—would require attribution to the selling partner of the inventory property which he had contributed to the partnership and not just his share as represented by his fractional interest in the partnership.

The allocation of basis to section 751 property also requires that effect be given to any election made by the partner under section 732(d). This subsection provides that a transferee of a partnership interest may

22. Treas. Reg. § 1.751-1(a)(2) (1956).

23. A current distribution is to be contrasted with a distribution in complete termination of the partner's interest in the partnership.

24. See note 9 *supra*.

25. Treas. Reg. § 1.751-1(a)(2) (1956).

invoke a special basis adjustment for his share of the underlying partnership property to reflect variation between the basis of his partnership interest and such property even though no election has been made by the partnership, providing a distribution of such property is made to him within two years of the acquisition of his interest.[26] It would appear, therefore, that where one sells his partnership interest within two years of its acquisition, he may adjust the basis of underlying property as if he had received a distribution thereof since the tenor of the Code seems to be that in determining the part of the basis of his interest to be allocated to section 751 property, he is to presume a distribution to him of the underlying partnership property although, of course, such a distribution is not actually made.

26. Section 732(d) provides that the Secretary or his delegate may by regulations require the application of this subsection in the case of a distribution to a transferee partner, whether or not made within two years after the transfer, if at the time of the transfer, the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership. The regulations [§ 1.732(d)(4) (1956)] require the application of the subsection in cases of a distribution whether or not made within two years if (1) the fair market value of all partnership property, other than money, exceeds 110 percent of its adjusted basis to the partnership, (2) an allocation of gain under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such allowance, and (3) a special basis adjustment under section 734(b) would change the basis to the transferee partner of the property actually distributed. This rule is designed to prevent the following development noted in the regulations:

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' Interests:		
Land	$165,000	$ 15,000	A	$105,000	$ 55,000
Depreciable property	150,000	150,000	B	105,000	55,000
			C	105,000	55,000
	$315,000	$165,000		$315,000	$165,000

If D purchases A's interest for $105,000 when the election is not in effect and subsequently receives a distribution of one-third of the land and one-third of the depreciable property, under the general rule of basis allocation [without regard to section 732(d)] the following result would obtain:

Land: $\frac{\text{Basis } 5{,}000}{\text{Total basis } 55{,}000} \times \$105{,}000 = \$\ 9{,}545$

Depreciable property: $\frac{\text{Basis } 50{,}000}{\text{Total basis } 55{,}000} \times \$105{,}000 = \$95{,}455$

Obviously, a part of the appreciation in the value of the land which was reflected in D's purchase price for his partnership interest, has been transferred from the basis of the land (a non-depreciable asset) to the basis of the depreciable property. Under section 732(d), requiring D to treat the adjustment to basis as if section 743(b) had been in effect, all of the excess of the purchase price would have been transmuted to the basis of the land.

Another complication in allocating the basis of the selling partner's partnership interest to the underlying partnership property, relates to the limitation imposed by the rule of section 732(a)(2), to the effect that even in a current distribution the total basis of the distributed property may not exceed the basis of the partner's interest in the partnership, and this is true despite the fact that the basis of the distributed property to the partnership exceeds the basis of the partnership interest.

It seems clear from the application of the various relevant sections of the Code that one selling his partnership interest may have gain as well as loss on the same transaction. In the following example, it may be assumed that A sells his partnership interest for $25,000.

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' Interests:		
Cash	$27,000	$27,000	A	$30,000	$19,000
Unrealized receivables	24,000	0	B	30,000	19,000
Capital assets	39,000	30,000	C	30,000	19,000
	$90,000	$57,000		$90,000	$57,000

Under the regulations his gain and loss would be computed as follows:

Total selling price		$25,000	
Allocated to unrealized receivables		8,000	$8,000
		$17,000	
Basis allocated to interests sold:			
Total basis	$19,000		
To unrealized receivables	0		0
To capital assets		19,000	
Ordinary income			$8,000
Capital loss		$ 2,000	

An Evaluation

It appears that the Code provisions dealing with transfers of partnership interests constitute an integrated system to provide for the following reasonable objectives:

1. To allow a purchasing partner, or one acquiring a partnership interest because of the death of a previous owner, to avoid taxation on the realization of appreciation which has occurred at the time of the acquisition of his interest and which is reflected in the basis of his partnership interest, but not in the basis of the underlying partnership assets.
2. To prevent the conversion of ordinary income into capital gain by requiring the gain on the sale of a partnership interest to be fragmented with ordinary gain and capital gain being allocated

to the sale in the same manner as if those assets which would have produced the particular kind of gain had been sold by the partner without the interposition of the partnership between the partner and the actual property.

Partnership Distributions

There are two fundamental questions involving partnership distributions. The first of these relates to the recognition of gain or loss and the second to the basis to the distributee partner of property distributed by the partnership, and, sometimes, to the basis to the continuing partnership of undistributed property.

With respect to the first question—that dealing with recognition of gain incident to a distribution—the Code provides that no gain may be realized to a distributee partner "except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution."[27]

On the other hand, loss may be recognized by a distributee partner only where *all* three of the following conditions are met:[28]

1. no property other than money or unrealized receivables or inventory items is distributed,
2. the distribution is in liquidation of the partner's interest in the partnership, and
3. the adjusted basis of the partner's interest in the partnership exceeds the amount of money distributed plus the basis to the distributee partner of any property distributed.

With respect to the realization of gain on a distribution by a partnership to a partner, it would appear that such an event is not likely to arise with any great frequency in the normal course of a continuing partnership operation. The prerequisite for such recognition is a money distribution in excess of the basis of the partner's interest in the partnership. Since the partner's basis for his interest includes not only the money he has contributed to the partnership, but also the basis to him of any property contributed, plus his share of partnership liabilities, plus his distributive share of partnership net income, it would appear that any money distributions would, in the usual situation, have to be substantial in order to exceed the basis of his interest.[29]

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27. INT. REV. CODE OF 1954, § 731(a).
28. INT. REV. CODE OF 1954, § 731(b).
29. INT. REV. CODE OF 1954, § 705. The basis of the partnership interest is also adjusted upward for exempt income of the partnership, and the excess of the deduction for depletion over the basis of the property subject to depletion. The basis of the partnership interest is also adjusted downward for distributions, the partner's share of losses

Despite the improbability of the development of a situation where gain would be recognized upon a distribution in the usual operation of the partnership, it is, of course, not impossible that a combination of circumstances will produce recognition of gain upon a distribution. In the example submitted below, it must be remembered that where a partner contributes property to a partnership, the basis of his interest in the partnership reflects the adjusted basis to him of the contributed property prior to the contribution. The following schedule, similar to one already presented, will serve as a basis for discussion of this point:

Partner	Kind of Property	Fair Market Value	Basis of Contributed Property to Partner and Partnership and Basis of Partner's Interest
A	Money	$100,000	$100,000
B	Property	100,000	40,000
C	Property	100,000	100,000
		$300,000	$240,000

In order to isolate the problem with respect to distributions it may be assumed that during its first year the partnership had net income of $30,000, and each partner received a distribution of that amount. Thus the basis of each partner's interest would have been increased by $10,000 as a result of his share of the net income and reduced by a like amount as a result of the withdrawal, leaving the capital and basis situation exactly as they were at the inception of the partnership. At this point it may be assumed that partner B wishes to reduce his partnership capital to $50,000 and the partnership agreement is amended to give effect to this capital modification. The agreed upon reduction in B's capital is effected by a distribution of $50,000 cash to him. He has a recognized gain of $10,000 upon the distribution since this is the amount by which the money distribution exceeds the basis of his interest. It should be noted, however, that B would still have a capital of $50,000 in the partnership although the basis for his partnership interest is reduced to zero.

Since the basis of a partner's interest in the partnership is obviously a critical element in determining gain or loss upon a distribution, a slight digression is necessary in order to consider the matter of partnership liabilities which have a particularly significant effect in determining the basis of a partner's interest in the partnership. A partner's share of partnership liabilities is considered as making up a part of the basis of

of the partnership and expenditures of the partnership that are neither deductible in computing taxable income nor properly chargeable to capital account.

his partnership interest.[30] At first glance, in the situation depicted below, one would be inclined to the conclusion that each partner's basis was the amount of his contribution:

Assets	$51,000	Liabilities		$21,000
		Partners' interests (created by cash contributions):		
		A	$10,000	
		B	10,000	
		C	10,000	30,000
	$51,000			$51,000

But this is not the case; the basis of each partner's interest is $17,000 and not $10,000. The rationale of this treatment of partnership liabilities may be developed along the following lines. It is clear beyond question that where an individual purchases property, his basis is the total purchase price despite the fact that there may be debt standing against the property. Furthermore, if he disposes of the property before the debt has been discharged, receiving in cash only the difference between the sale price and the debt, the amount received for tax purposes is measured by the cash plus the debt against the transferred property. In the partnership situation, because of the liability of partners for partnership debts, in contrast to the usual stockholder-corporation relationship, it would appear that the interposition of the partnership "entity" between the partner and the property owned by the partnership does not nullify the result that would obtain if the partner owned his share of partnership property personally. The concept of liabilities as constituting a part of the basis of a partner's interest in the partnership may, perhaps, be thought of by reference to the partnership balance sheet structured in a form differing somewhat from the conventional presentation.

30. Section 752 is a codification with respect to partnership interests of the holding in Crane v. Commissioner, 331 U.S. 1 (1947) to the effect that the basis of property is not the equity of the owner in excess of the debt against the property, but rather the basis applicable to the property itself without regard to debt against it or the manner in which its acquisition or retention has been financed. Consistent with this holding is the conclusion reached in the case that the sale of the property whereby the purchaser assumes, or takes the property subject to, the debt, results in realization of gross income not only in the amount of money received but also in the amount of debt. While the holdings in the *Crane* case are well recognized where an individual taxpayer is involved, the concept of partnership capital as an equity interest somewhat analogous to that of a stockholder in a corporation seems to cause some difficulty. But the analogy with the stockholder-corporation situation does not appear proper since the partnership agreement may be drawn or modified so as to limit or vary the partner's share of firm liabilities, at least among the partners. Such could hardly be the case in the shareholder-corporation relationship. See also M. Pauline Casey v. Commissioner, 38 T.C. 357, 372 (1962).

Assets acquired with partners' contributions	$30,000	Bases of partners' interests:		
Assets acquired by use of partners' credit	$39,000	A:		
		Basis acquired by contribution	$10,000	
		Basis acquired by use of A's credit	13,000	$23,000
		B:		
		Basis acquired by contribution	$10,000	
		Basis acquired by use of B's credit	13,000	23,000
		C:		
		Basis acquired by contribution	$10,000	
		Basis acquired by use of C's credit	13,000	23,000
	$69,000			$69,000

The regulations provide that the allocation of partnership liabilities among the partners for the purpose of determining the basis of each partner's interest shall be made in the partnership loss ratio.[31] But if there is a modification of the partnership agreement so as to relieve a particular partner of his obligation as to partnership liabilities, he will, to this extent, have a reduction in the basis of his interest. The reduction of a share of partnership liabilities is treated as a distribution of cash to the partner while an increase in a partner's share of the liabilities is treated as an additional cash contribution by the partner to the partnership. By way of illustration it may be assumed, in the above illustration, that the partnership agreement is modified so as to relieve A of any responsibility for partnership liabilities. A will be considered as having received a distribution of $13,000 in cash. B and C will each be considered to have made an additional cash contribution to the partnership of $6,500. The basis of A's interest is reduced to $10,000 and A's and B's interests will have been increased to $29,500 each, or a total of $59,000.

Since gain can only result from a distribution of money to the distributee partner, the question is raised as to the effect of a distribution of property having a partnership basis in excess of the basis of the distributee partner's interest. In this discussion it would appear better to postpone consideration of this matter until after an examination of the recognition of losses resulting from distributions.

In the first place, recognition of a loss may not result in any event unless the distribution is in termination of the partner's interest in the

31. The regulations in this respect are criticized by WILLIS, HANDBOOK OF PARTNERSHIP TAXATION § 16.04 (1957).

partnership. The reason for this rule appears to lie in the concurrent operation of two other rules:

1. If the basis of the distributee partner's interest in the partnership is greater than the basis to the partnership of the distributed property, then the general rule that the partnership basis carries over applies.
2. If the basis of the partner's interest in the partnership is less than the basis of the distributed property to the partnership immediately before the distribution, then the distributed property in the hands of the distributee takes the basis of the partner's interest, and this is true even though the basis of the interest is zero. This will result in a loss or shrinkage of basis, a problem to be dealt with *infra*.

The operation of these rules may be traced through Subchapter K as follows. Section 705 provides that the basis of the partner's interest will be reduced (but not below zero) by distributions by the partnership as provided in section 733. The latter section indicates that the basis of the partner's interest is to be reduced by a distribution (other than in liquidation of the partner's interest) by the amount of the basis to the distributee partner of the distributed property as determined under section 732. Section 732 provides, in effect, that in a current distribution the basis of the distributed property to the distributee partner shall be the lesser of the basis of such property to the partnership immediately before the distribution or the basis of the distributee partner's interest in the partnership reduced by any money distributed in the same transaction.

These rules avoid the possibility that the basis of the partner's interest in the partnership could be reduced to a negative figure, but they also may bring about, as already noted, a sort of evaporation of basis. The recapture of this lost basis will be considered *infra*.

While it is clear that the distributee partner cannot realize a loss as the result of a *current* distribution, such a result may not be the case with a distribution in termination of his interest in the partnership. If the distribution consists solely of money and unrealized receivables and inventory, or unrealized receivables and/or inventory alone, loss may be realized. The test for loss determination is whether the basis of the unrealized receivables and inventory distributed to the distributee partner is less than the basis of his interest in the partnership reduced by the amount of money distributed in the same transaction. If the basis of such property to the partnership is equal to or greater than the basis of the distributee partner's interest, there can be no recognition of loss since the basis of such property will take on the basis of the interest. But to prevent the stepping up of the basis of the distributed unrealized receivables and inventory, where their basis to the partnership is less than the basis of the distributee partner's interest, section 732(c)(1) provides for a carryover basis from the partnership to the partner. The difference between this carried over basis and the basis of the distributee partner's interest in the partnership becomes a recognized capital loss.

Gain or loss resulting from distributions may be illustrated by again having reference to the relationship between the partners' capital interests in the partnership and the bases of their interests. The following situation may be assumed:

Partner	Kind of Property	Capital; Fair Market Value of Property	Basis of property to contributing partner and partnership and basis of partner's interest
A	Cash	$100,000	$100,000
B	Property X	100,000	80,000
C	Property Y	100,000	100,000
		$300,000	$280,000

If B accepts cash in liquidation of his interest in the partnership in the amount of his capital, $100,000, he will of course recognize a gain of $20,000. If the partnership subsequently sells the property contributed to the partnership by B another $20,000 gain will be recognized. Thus two $20,000 gains become taxable, both of which are brought about by the same fact—the property contributed by B had a basis to him and the partnership less than its fair market value and less than B's capital in the partnership.

The double taxation of the potential gain arising from the basis "deficiency" of B's contributed property may be avoided. Section 734 provides an "escape" feature under the section caption of "Optional adjustment to basis of undistributed partnership property." The impact of this section is that the partnership is entitled to adjust the basis of property retained by the partnership upward, thus making possible avoidance of a second recognition of gain. In the simple illustration given above the partnership would be entitled to adjust the basis of the property contributed by B (and still retained by it) to $100,000. On subsequent sale at fair market value, no gain would be realized.

The realization of gain on the part of a distributee partner is not the only situation giving rise to the option to adjust the basis of undistributed property. Consider, in the foregoing example, that B received a distribution of the property contributed by C in liquidation of B's interest in the partnership. In this situation, assuming that property Y is not unrealized receivables or inventory items, no loss will be recognized and since no money is distributed, gain cannot be recognized. The answer of section 732(a)(2) in this situation is that there is a loss of basis of $20,000 since, under the limitation of this subsection, the basis of the distributed property must take on the basis of the distributee partner's interest in the partnership as it stood immediately before the distribution. In this situation there is a loss or, so to speak, an evaporation of basis. If B, having received a distribution of Y property which thereupon has a basis of $80,000 to him, sells the same for its fair market value of $100,000 he will realize a gain of $20,000. But if the partnership sells the property contributed by B (and still retained by it) for its fair market value, there will be a second recognized gain of $20,000. Both of these gains stem from the same cause—the deficiency in basis in the property contributed by B. Here again, however, the Code provides an optional method of escape from the second recognition of gain. Under section 734 the partnership may elect to adjust the basis of undistributed property upward, thus preventing the possibility of a recognition of a second gain. Clearly, the adjustment would be applied to Property X. This is a sort of recapture of basis.

The option to adjust the basis of undistributed partnership property is not a one way street. Once the election has been made it must be applied in situations where a reduction in basis of undistributed property is called for. Such a situation may be indicated under the following circumstances:

Partner	Kind of Property	Capital; Fair Market Value of Property	Basis of property to contributing partner and partnership and basis of interest
A	Cash	$100,000	$100,000
B	Property D	100,000	100,000
C	Property E	100,000	120,000
		$300,000	$320,000

If C retires from the partnership and receives a cash distribution equal to his capital, $100,000, he will recognize a loss of $20,000. Assuming the partnership has elected to adjust the basis of undistributed partnership property, a reduction in the basis of Property E is required. This prevents the double recognition of loss—once on the distribution to C, and again in the event Property E is sold by the partnership.

If Property D is distributed to Partner C either in a current distribution or in liquidation of his interest, assuming this property is not unrealized receivables or inventory items, no gain or loss will be recognized. Nevertheless, property D will assume a basis in the hands of

C if the distribution is in liquidation of his interest of his basis in the partnership, that is, $120,000. Of course, if C sells the property for its fair market value of $100,000 loss will be recognized. But the partnership may also recognize a loss of $20,000 on the subsequent sale of E property. Thus two losses would be recognized because the basis of the property contributed by C exceeded its fair market value and the amount of C's partnership capital. If the partnership has elected the optional adjustment to basis of undistributed partnership property the possibility of the double recognition of loss will not occur since, upon the expansion of the basis of D property on its distribution to C, the partnership will be required to adjust the basis of E property downward by the $20,000, that is, by the amount of the expansion of basis of D property in the hands of C.

Distributions Relating to Section 751 Property

One of the areas where the usual effects of the interposition of an entity between one devoting property to an enterprise and the property itself are disregarded is in connection with distributions classified as section 751 property. This approach is necessary to prevent opening two possible avenues of undesirable tax manipulation. The first of these is the possibility of conversion of ordinary income into capital gain. Consider the following service partnership to which A, B and C have each contributed $4,000 cash as capital. The partnership reports on the cash receipts and disbursements method of accounting.

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partners' Interests:		
Cash	$12,000	$12,000	A	$11,000	$ 4,000
Accounts receivable	21,000	0	B	11,000	4,000
			C	11,000	4,000
	$33,000	$12,000		$33,000	$12,000

Assume A withdraws from the partnership and receives a distribution of $11,000 in cash; under the general rule he would recognize a capital gain.[32] Under the general rule with respect to optional adjustment to basis of undistributed partnership property B and C would be entitled to adjust the basis of accounts receivable upward by $7,000 and on subsequent collection of all of the receivables only $14,000 would represent taxable income. While there does not appear to be any provision of the Code which specifically blocks the result indicated, the Regulations under Code section 755 provide that the adjustment to undistributed partner-

32. INT. REV. CODE OF 1954, § 731.

ship property becoming available because of a gain recognized on a distribution must be made to capital assets or section 1231 assets. Even if the election to adjust the basis of undistributed partnership property were not in effect, A would, under the general rule, be allowed a capital gain of $7,000 on the distribution of $11,000 cash to him; recognition of ordinary income would be shifted from him to B and C.

The approach of Subchapter K to block these avenues of manipulation is, in effect, to consider that certain sales or exchanges take place in the various partners' interests in the partnership assets prior to actual distribution.[33] In the example above it may be assumed that a shift of interests in partnership assets took place through a sale by A of his interest in receivables for a part of B's and C's interests in the cash. After this sale, the interests of the partners in partnership assets would appear as shown below:

	A	B	C
Interests in cash before distribution	$ 4,000	$ 4,000	$ 4,000
Effect of purchase by B and C of A's interest in accounts receivable	7,000	-3,500	-3,500
	$11,000	$ 500	$ 500
Accounts receivable before sale	$ 7,000	$ 7,000	$ 7,000
Effect of sale to B and C of A's interest in accounts receivable	-7,000	+3,500	+3,500
	$ 0	$10,500	$10,500

It should be apparent that B and C have given up part of their interests in the cash for all of A's interest in the accounts receivable. Since A received cash for his interest in the accounts receivable having a zero basis, and since his interest in the receivables is an ordinary asset, he will have realized an ordinary gain of $7,000. B and C have each, in effect, purchased $3,500 of A's interest in the accounts receivable for which they now have a basis by purchase of $7,000. The shifts of interests in the various partnership assets may be somewhat complicated in more involved situations. Prior to noting one of these, attention must be directed to a more detailed consideration of the nature of partnership assets. For the purpose at hand, partnership property may be divided into two classes: (1) section 751 assets, and (2) non-section 751 assets.

The Code includes within the definition of section 751 three kinds of property: (1) unrealized receivables; (2) inventory items which have appreciated substantially in value; and (3) what may be called section 1245 and section 1250 "potential."[34] The term "unrealized receivables"

33. INT. REV. CODE OF 1954, § 751(b).
34. See note 17 *supra*.

seems fairly self-explanatory once it is realized that the items involved generally arise out of the use of a method of accounting which delays the "taking up" of income to a time later than would be the case under a strict accrual method.[35] Substantially appreciated inventory items involve a more complicated definitional problem. In the first place, it is necessary to determine what constitutes "inventory items." Included are inventory items in the usual sense and items held primarily for sale to customers in the ordinary course of a trade or business, but also included are any other assets except capital assets and section 1231 assets.[36] Thus, notes and accounts receivable (including unrealized receivables) arising in the ordinary course of business are within the definition.[37] In addition, "inventory items" includes certain foreign investment stock. Finally, included is any property held by the partnership which, if held by the selling or distributee partner, would be property having the characteristics of "inventory items." But the fact that the partnership possesses inventory items does not necessarily mean that these items constitute section 751 property. Two objective tests must be applied: (1) the fair market value of section 751 property must exceed 10 per cent of the fair market value of all partnership property other than money, and (2) the fair market value of inventory items must exceed 120 per cent of the adjusted basis of such property to the partnership.[38]

Since the purpose of the statutory distinction between section 751 property and other partnership property is to inhibit the conversion of ordinary income into capital gain, it was, with the enactment of sections 1245 and 1250, necessary to relate them to partnership tax problems. The sole purpose of sections 1245 and 1250 is to avoid the "trading" of an ordinary deduction—depreciation—for a capital gain by disposition of the asset under section 1231. The implementation of this concept necessitates that sections 1245 and 1250 potential be considered as section 751 property.[39]

A critical question in connection with any partnership distribution is whether or not it involves a section 751 situation. It would appear that in the great majority of situations section 751 problems are not involved. Actually, a section 751 situation will be involved only if there is an imputed sale or exchange of interests in underlying property among the partners, and even if there has been such a sale or exchange, it may

35. INT. REV. CODE OF 1954, § 751(c).
36. INT. REV. CODE OF 1954, § 751(d)(2).
37. Treas. Reg. § 1.751-1(d)(2) (1956).
38. INT. REV. CODE OF 1954, § 751(d)(1).
39. INT. REV. CODE OF 1954, § 751(c). Actually, the statute considers § 1245 and § 1250 potential to be a form of unrealized receivables.

not have involved the kind of situation with which section 751 deals. In order to analyze a distribution for a possible section 751 problem it is necessary to isolate:

(1) The portion of the distribution that does not involve any sale or exchange among the partners of interests in underlying partnership property, i.e., the distribution consists exclusively of the partner's share of the particular kind of property.

(2) The exchange of interests in property which are "like kind" exchanges in the sense that an interest in section 751 property is exchanged for an interest in other section 751 property or an interest in non-section 751 property is exchanged for an interest in other property falling in the same class.

(3) The exchange of interests in section 751 property for interests in non-section 751 property and *vice versa*.

The following illustration, the data for which have been taken from the regulations,[40] offers a method of isolating the various elements of a distribution by the partnership to its partner. The partnership balance sheet before the distribution is as follows:

	Fair Market Value	Basis		Fair Market Value	Basis
Assets:			Partnership Interests:		
Cash	$ 3,000	$ 3,000	A	$15,000	$10,000
Sec. 1231 property	15,000	9,000	B	15,000	10,000
Land	27,000	18,000	C	15,000	10,000
	$45,000	$30,000		$45,000	$30,000

It is assumed Partner C receives the section 1231 property in termination of his interest in the partnership. It is further assumed that depreciation of the section 1231 asset since 1961 has been $6,000 and, therefore, all of the variation between fair market value and adjusted basis of the property is section 1245 potential. In order to segregate the elements of the distribution, the schedule shown in Table I has been developed. The two elements related to the section 1231 property have been segregated in the schedule.

In the first place, it should be noted that if the distribution to C had been made in the amount representing his share of each asset, no section 751 problem would have been involved. This is true since there would have been no exchange of his interest in some particular partnership assets for a larger interest in others.[41] Actually, C did receive a distribu-

40. Treas. Reg. § 1.751-1(f) (1956), example 6.

41. Where the partnership § 751 assets consist of unrealized receivables and a partner withdraws, a relatively simple procedure might be to assign the partner's share of the receivables to him whereupon he would constitute the partnership his agent for col-

tion representing his share of two assets, the section 1231 asset to the amount of $3,000 and the section 1245 potential in the amount of $2,000.

Since C received amounts greater than his share with respect to two kinds of assets (section 1231 property and section 1245 potential) and less than his share of cash and land, C has given up his interest in the latter two assets in exchange for a greater interest in the section 1231 property and the section 1245 potential. The exchanged amounts are indicated in Table I. Section 751 imposes no penalty upon the exchange of interests in non-section 751 assets for interests in assets of the same class. It seems desirable, therefore, to isolate these innocuous exchanges as "non-section 751 exchanges." In the illustration, C has given up his interest in the cash and part of his interest in the land ($5,000) for a larger interest than his share of the section 1231 asset. It is vital to note that the exchange is of interest in assets of the same class, i.e., non-section 751 property. Finally, the analysis indicates, by a process of elimination, that C has given up part of his interest in land in exchange for an interest in section 1245 potential greater than his share.[42] This is the critical exchange, since it involves an exchange of an interest in non-section 751 property (land) for a greater interest in section 751 assets (section 1245 potential). The Regulations indicate that the distributee partner and the remaining partners may agree as to which assets are being exchanged; apparently A, B, and C could have agreed that C would give up his interest in the cash ($1,000) and $3,000 of his interest in the land for the section 1245 potential in excess of his share.[43]

Once the various elements of the distribution have been isolated, it is necessary to analyze their tax effects. The effect on the distributee partner may be noted first. Here the Regulations indulge in something of a fiction: it is presumed that the distributee partner received a *current* distribution of those assets which he then exchanged with the partnership in the section 751 exchange.[44] The assumption is, therefore, that C received a current distribution of 4,000/9,000 of his interest in the land. Under the general rule with respect to current distributions, the basis to C of this land would be the same as its basis to the partnership, thus:

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lections of *his* receivables. In some appreciated inventory situations, such as those involved in subdivision development, it might be possible to distribute undivided interests in the lots to the withdrawing partner with the partnership constituted as his agent for the sale of the property. Assuming these procedures would be acceptable to the taxing authorities, the withdrawing partner would avoid recognition of ordinary income until such time as realization through collection of receivables or sale of lots had actually taken place.

42. In the illustration it would appear difficult for C not to have taken all of the § 1245 potential since he has taken all of the § 1231 assets to which it relates.

43. Treas. Reg. § 1.751-1(f) (1956).

44. *Ibid.*

$$4/9 \times 1/3 \times \$18{,}000 = \$2{,}667$$

Under section 733 the receipt of the land reduces the basis of C's interest in the partnership to $7,333; see Table II. C has a recognized capital gain on this transaction since he is exchanging a section 1231 asset with a basis of $2,667 for section 1245 potential having a fair market value of $4,000; see Table III.

The remaining basis of C's interest in the partnership, $7,333, will be absorbed by those assets distributed to him that were not involved in the section 751 exchange. The first of these is the section 1245 potential. Since it has a zero basis to the partnership, it will carry over the same basis to C. The remaining basis of the partnership interest—still $7,333—will attach to the section 1231 property, $3,000 of which was C's share and $6,000 of which he received in exchange for his relinquishment of non-section 751 assets—cash ($1,000) and land ($5,000). Note particularly, that this distribution involves a loss, or what has been termed an evaporation of basis, of $1,667 since the 1231 asset had a basis of $9,000 to the partnership and now has only a basis of $7,333 to C; see Table II.

C's situation after the distribution is shown in Table IV. C has a potential gain of $3,667 on the sale of the section 1231 asset at fair market value of $15,000. Of this amount $2,000 would be section 1245 gain which, of course, is C's proper share. A and B recognized their shares—$2,000 each—on the exchange of section 1245 potential for other assets. C's total actual and potential gain makes up the total of $5,000 which was his share of the partnership potential gain before the distribution.

The effect of the distribution to C on the partnership situation is shown in Table V. A and B of course realized ordinary income—$2,000 each—on exchange of their shares in section 1245 potential for a greater interest in the land having a fair market value of $4,000. The basis of the land to A and B will now be $19,333 computed as the total original basis less the basis of the portion assumed to have been distributed to C in a current distribution and plus the $4,000 for which this portion of the land was "bought" back from C at fair market value in exchange for section 1245 potential. As shown in Table V, the partnership recognized gain and potential gain is $11,667—actual gain on the distribution of $4,000 and potential gain on the sale of the land of $7,667. This is, of course, $1,667 more than A and B's share of the potential partnership gain before the distribution. Presumably A and B would be entitled to adjust the basis of undistributed partnership property upward by this amount since C had a shrinkage in basis of $1,667 on the distribution of the section 1231 asset to him. This would require that the partnership had made the proper election. If the election were in effect, presumably the basis of the land could be adjusted to $24,000.

Conclusions

The interposition of an entity, or at least a quasi-entity, between the owner of an interest in property and the property itself creates very complex tax situations and concomitant tax problems, problems which are relatively simple where only an individual owns an interest in property directly—that is, without the interposition of an entity or quasi-entity. Even where the entity is fully recognized as such, as in the case of the interposition of the corporation between one having an interest in property and the property itself, the tax problems seem less difficult. But the answer to these difficulties does not seem to lie in the direction of trying to ignore the partnership as at least a quasi-entity—there is too much in the way of tradition, law, and businessmen's patterns of thought to the contrary. For the most part, a partnership will operate in the conduct of ordinary business operations with no more serious day-to-day tax problems than businessmen are accustomed to live with. It would seem that the answer lies where it does in most tax situations when the unusual transaction or situation is pending: competent counsel must be on hand to guide the enterprise and its partners through the welter of tax complexities and pitfalls.

TABLE I

	Basis	FMV	C's Share	C Received	Exchanged Amounts	Non-Sec. 751 Exchange Received	Non-Sec. 751 Exchange Gave Up	Sec. 751 Exchange Received	Sec. 751 Exchange Gave Up
Cash	$ 3,000	$ 3,000	$ 1,000		$-1,000		$1,000		
Sec. 1231 Asset	9,000	9,000	3,000	$ 9,000	+6,000	$6,000			
Sec. 1245 Potential	0	6,000	2,000	6,000	+4,000			$4,000	
Land	18,000	27,000	9,000		-9,000		5,000		$4,000
	$30,000	$45,000	$15,000	$15,000	$ 0	$6,000	$6,000	$4,000	$4,000

TABLE II

Assume a current distribution to C of his share:	
Basis of interest	$10,000
Basis of 4/9 of C's share of land 4/9 x 6,000 =	2,667
	$ 7,333
Share of Sec. 1245 property	0
Remaining basis and basis of Sec. 1231 asset	$ 7,333

TABLE III

Gain or loss to C:

Sec. 1245 potential received	$4,000
Basis of interest in land exchanged	2,667
Sec. 1231 gain	$1,333

TABLE IV

	Basis	FMV	Gain
C has after distribution:			
Sec. 1231 asset:			
Basis by distribution not under Sec. 751 exchange	$ 7,333	$ 9,000	$1,667
Sec. 1245 potential:			
By distribution	-0-	2,000	2,000
By exchange for cash and land	4,000	4,000	-0-
	$11,333	$15,000	$3,667
Gain recognized in distribution	-1,333		1,333
	$10,000	$15,000	$5,000

TABLE V

Gain or loss to partnership:	
Received for Sec. 1245 potential:	
Land FMV	$ 4,000
Basis of Sec. 1245 property	-0-
Ordinary income	$ 4,000

		Basis	FMV	Gain
Partnership has after distribution:				
Cash		$ 3,000	$ 3,000	
Land:				
Original basis to A and B	$18,000			
Less distribution	2,667			
	$15,333			
Add purchased	4,000			
	$19,333	$19,333	$27,000	$7,667
		$22,333	$30,000	$7,667