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THE DRAFTING OF PARTNERSHIP AGREEMENTS UNDER THE 1954 INTERNAL REVENUE CODE*

ROBERT S. ASHBY† AND ALBERT L. RABB, JR.‡

The impact of the 1954 Internal Revenue Code upon partnerships is two-fold: By codification it makes relatively certain, for the first time, the tax results of many transactions in which a partnership is likely to engage and thereby aids in determining the tax consequences of completed transactions; secondly, and perhaps more important to the lawyer, is the assistance and, to some extent, the obstacles it provides in terms of tax planning in the partnership field. Partnership tax planning normally starts with the drafting or amendment of the partnership agreement. This article will discuss some problems and opportunities presented to the draftsman of a partnership agreement by the new Code.

I. PROVISIONS RELATING TO CONTRIBUTIONS OF PROPERTY TO THE PARTNERSHIP

With the exception of personal service partnerships in which property is relatively unimportant to the production of income, one of the first and most basic decisions to be made in the formation of a partnership relates to the means of making property available for partnership use. The new Code provides for or recognizes a number of possibilities.

1. Contribution of the Use of Property. Under the common law, it is possible for a partner to retain title to an asset and merely grant the use of it to the partnership.[1] Widely used in the past, this method is still available under the new Code. If it is used, there is no change in the ownership of the asset, and there are no problems with respect to basis or depreciation of the asset, either as regards the partner contributing the use of the asset or the partnership. The basis of the asset remains unchanged, and the depreciation allowance accrues in its entirety to the owner of the property; in the event of sale, the gain or loss accrues in its entirety to the owner of the property. Examination of other available

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1. See cases cited in 68 C.J.S., *Partnerships* § 72(e) (1950).

methods will disclose that contribution of the use of an asset, where the contributing partner retains title, has the virtue of simplicity and completely avoids some difficulties which arise under the other techniques.

2. Contribution of Property to the Partnership. If the asset is contributed, that is, title is transferred, to the partnership, a different situation prevails. A partner's contribution to an asset results in no realization of gain or loss.[2] The basis of the contributing partner's interest in the partnership is augmented by the basis of the asset contributed,[3] and the basis of the asset in the hands of the partnership is the same as it was in the hands of the contributing partner.[4]

3. Contribution of Property Having a Tax Basis Different from Its Fair Market Value. If each asset contributed in kind to the partnership has a tax basis which is equal to its fair market value, the above rules are simple of application, and few difficulties tax-wise or between the partners result from such contribution. If the partners desire to contribute property to the partnership, which has a basis for tax purposes below its fair market value, or in excess of its fair market value, the simplicity departs and "leaves not a rack behind."

The disparity between basis and fair market value complicates the problem of equitable treatment between the partners. A partner who contributes an asset having a tax basis in excess of its fair market value is in effect making an additional contribution to the partnership. This contribution takes the form of a tax advantage arising from the abnormally large depreciation allowance available to the partnership by reason of its ownership of such asset. Conversely, the partner who contributes an asset having a basis lower than its fair market value is in effect burdening the partnership with an income tax liability. This liability arises from the inability of the partnership to obtain a depreciation allowance commensurate with the market value of the property, which value is ordinarily used in striking the bargain between the partners.

This problem of an equitable sharing between the partners of tax advantages and disabilities is not new. It existed under the old law and was, for a time, solved by administrative ruling whereby the tax benefit or disability accrued to the contributing partner even though the partners failed to recognize and deal with the problem in their partnership agreement.[5] A different treatment is now provided by statute,[6] and with the

2. INT. REV. CODE OF 1954, § 721. Henceforth references are to sections of the Internal Revenue Code of 1954 unless otherwise indicated.

3. § 722.

4. § 723.

5. See G.C.M. 10092, XI-1 CUM. BULL. 114 (1932).

6. § 704(c).

matter thus highlighted the draftsman can scarcely fail to consider the problem.

(a) Treatment if the Partnership Agreement is Silent. The statute provides that, in the absence of contrary provisions in the partnership agreement, depreciation, depletion, or gain or loss, with respect to property contributed to the partnership by a partner, shall, except as otherwise provided in the statute,[7] be allocated among the partners as if such property had been purchased by the partnership. The consequence of this provision is that the draftsman who ignores this problem will leave the partners burdened with the inequities resulting from the disparity between market value and basis of assets contributed. In effect, depreciation allowances will be distributed among the partners on the same basis in which they participate in profit; the tax advantage or disability which prior to contribution accrued to one partner alone is, after the contribution, shared with other partners.

These inequities may be diminished or eliminated upon dissolution of the partnership. A partner, who has been burdened with a fictitious income resulting from the inadequate depreciation allowance upon property contributed by his partner, will, upon dissolution, realize an offsetting loss. A partner, who has benefited from an abnormally large depreciation allowance resulting from the contribution by his partner of property having a basis in excess of its value, will, upon dissolution, realize an offsetting gain. However, such offsetting gain or loss will be capital gain or loss, and there is no assurance that it will ever be realized or that, if it is realized, the partner will then be able to utilize it. Accordingly, the conscientious draftsman cannot rely upon this possibility as a means of achieving equitable treatment between partners.

(b) Contract Provisions Relating to the Problem. The partners may enter into appropriate contractual arrangements to avoid this inequity. Section 704(c) (2) provides:

> If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

7. This will be discussed in (c) *infra*.

It should be noted that the apparent freedom of contract provided by this section is limited by § 704(b) of the new Code, which provides, in effect, that a contract provision may be disregarded if its principal purpose "is the avoidance or evasion of any tax imposed by this subtitle."

All assets of the partnership need not be treated alike. Particular assets may be made the subject of express and various agreements and accorded different treatment. The various possible contractual arrangements intended to eliminate inequities may be characterized as (1) the transference of basis approach, (2) the credited value approach, and (3) the ceiling approach.[8] None of these methods is simple or free from difficulty, and the draftsman may be led to avoid the problem rather than to attempt to use them to solve it.

(c) Contribution of Undivided Interests. Section 704(c)(3) provides that, in the absence of contrary agreement in the Articles of Partnership, "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." This provision applies only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests. The parties may avoid the operation of this section by inserting an inconsistent provision in the partnership agreement, or they may deliberately procure its application by buying or selling among themselves prior to the contribution of property to a partnership in order to create undivided interests equal to their proportionate interests in the partnership. Although undivided interests in property, contributed to the partnership and governed by this section, may have bases for tax purposes different from their fair market value, such differences will not create inequities between partners since each partner will, under the statute, obtain a depreciation allowance, or realize gain or loss in event of sale, in accordance with the tax basis of the undivided interest which he contributed.

4. Sale of Property to the Partnership by a Partner. The problem arising from disparity between the fair market value and the basis of property which is to become a partnership asset can, of course, be avoided by a sale of the property to the partnership by a partner. A sale will have the result of realization of gain or loss by the selling partner and will

8. For a discussion of the contractual possibilities under § 704(c)(2), the reader is referred to Jackson, Johnson, Surrey, Tenen, Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1204-10 (1954).

bring the market value (represented by the sales price) into line with the tax basis of the property in the hands of the partnership.

Under § 707, if a partner owns 50 per cent or less of the capital interest, or 50 per cent or less of the profits interest in a partnership, he may sell property to such partnership and the transaction will be treated as if it had occurred between strangers.[9] The partnership will thus obtain a stepped-up or reduced basis and the selling partner will realize gain or loss. If § 707(b)(2), relating to transaction between a partnership and a partner with more than an 80 per cent interest, is not applicable, the result is a depreciation allowance which can be offset against ordinary income procured at the relatively small price of a capital gain realized upon the sale. If § 707(b)(2) is applicable, the gain to such partner will be taxed as ordinary income.

5. *Summary of Techniques of Making Property Available to the Partnership.* In planning for the acquisition of property by the partnership, the following possibilities are therefore to be considered:

(a) Retention of title to the asset by the prospective partner so as to make only its use available to the partnership. Tax and other considerations may make this method desirable.

(b) Contribution by the partners of property which has a fair market value equal to its tax basis so that complications are avoided and a sharing of depreciation allowances and gain or loss, in accordance with the sharing of partnership profits, is equitable as between the partners.

(c) Contribution of property to the partnership and allowance under § 704(c)(1) of the sharing of depreciation, gain or loss, in accordance with the sharing of partnership profits. Equity, or a semblance of it, may be attempted by adjusting the participation in profits or other factors to avoid the inequities which normally would result. Section 704(c)(1) may be allowed to operate by deliberate plan so as to shift part of a depreciation allowance from a partner who cannot use it to a partner who can. Such planning will, however, be hampered and compli-

9. It should be noted that this technique is available even though there are two equal partners; it is only if the selling partner has *more* than 50% of the capital interest or *more* than 50% of the profits interest in a partnership that a different result obtains.

In the typical two-man equal partnership, the purchase by the partnership of appreciated property from one of the partners may have the effect of avoiding the complications arising from disparity between market value and tax basis, and it may, at the same time, procure for the partnership a stepped-up basis.

cated by the possibility of offsetting losses or gains upon dissolution of the partnership.

(d) Contribution of property, coupled with rather elaborate contractual provisions, as permitted by § 704(c)(2), for the sharing of depreciation and gain or loss with respect to such assets.

(e) Creation of undivided interests in property prior to contribution to the partnership, and the subsequent contribution of the property to the partnership, so as to make § 704(c)(3) applicable.

(f) Organization of the partnership and subsequent sale of property to it, pursuant to § 707, by a partner having a 50 per cent or less interest in the partnership.

(g) Any combination of (a) through (f) with respect to various assets.

II. Provisions Relating to the Fiscal Year of the Partnership

The former freedom of contract as to the fiscal year of a new partnership no longer exists. The partnership may not adopt (or, in the case of an existing partnership, shift to) a fiscal year other than that of its principal partners.[10] The problem of principal partners with different individual tax years is not solved by the statute. Compliance with the statute in this situation is impossible without shifting the tax years of some or all of the partners,[11] or relying upon the exception provided in § 706(b)(1), *i.e.*, the partnership may change to or adopt a different partnership tax year if it establishes, to the satisfaction of the Secretary, a business purpose therefore.[12]

The effect of these provisions, indeed their avowed and intended purpose, is largely to destroy the old device of adopting a fiscal year for the partnership which will end in a succeeding tax year of the individual partners. Under the old and new law,[13] a partner is deemed to receive his share of partnership income at the end of the partnership's fiscal year. Consequently, selection of a fiscal year for the partnership could delay the receipt of taxable income by individual partners for substantial fractions of a year. Remnants of a planning device of this kind may remain where partners are members of two different partnerships.[14] In the usual

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10. § 706(b)(1). Principal partners are partners having an interest of 5% or more in the profits or capital of the partnership. See § 706(b)(3).

11. § 706(b)(2).

12. Either course may require resort to the Secretary for approval. U.S. Treas. Reg. 118, § 39.46-1 (b) (1953), as amended, T.D. 6099, 1954-2 Cum. Bull. 113.

13. § 706(a).

14. Jackson, *supra* note 8, at 1195.

case, however, any idea of wringing any advantage from selection of a fiscal year now seems doubtful.

Unfortunately, the destruction of free selection of a fiscal year for the partnership has not been accompanied by the elimination of all possibility of bunching of income. The bunched income trap, inherent if the tax years of the partnership and its partners differed, was generally well known under the 1939 Code. If a partner died or a partnership terminated, and there was disparity between the tax year of the partners and the partnership, partnership income for an entire year, plus that for a fractional year, could be included in the income of a partner or partners for a single year. Consider the case of a partner on a calendar year basis and a partnership with a fiscal year ending January 31st. In a given year the partners would have income from such partnership for a twelve-month period ending January 31st. Thereafter, if for some reason the partnership terminated in November, the partner might in the same year have ten months of partnership income, so that in a single individual year he would have to report his share of partnership income for a twenty-two month period.

Under the old law, in the absence of proper precautions by the draftsman, such a bunching of income might occur, both for the deceased and surviving partners, upon the death of a partner. Such a result could be avoided as to the survivors by provisions continuing the partnership after the death of a partner,[15] or as to the deceased by a provision that the estate of the deceased should continue as a partner until the end of the partnership year.[16]

The new law, though an improvement, has not eliminated the possibility of bunched income in the now rarer case of disparate tax years of partners and their partnerships. Section 706(c)(1) provides that, except in the case of a termination of a partnership, the taxable year of a partnership shall not close as the result of the death of a partner; section 706(c)(2)(a)(ii) provides that the taxable year of a partnership shall not close with respect to a partner who dies prior to the end of the partnership taxable year. In the case of a partnership with numerous partners, the death of a partner, as a matter of law, will not result in bunching of income for the deceased or surviving partners if they carry on the business.

A partnership terminates only if no part of the business of the partnership "continues to be carried on by any of its partners *in a part-*

15. Mary D. Walsh, 7 T.C. 205 (1946).

16. Girard Trust Co. v. United States, 182 F.2d 921 (3d Cir. 1950); Commissioner v. Mnookin's Estate, 184 F.2d 89 (8th Cir. 1950).

nership,"[17] or "within a 12-month period there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits."[18] These rules create possible difficulty for the two-man partnership. The death of one partner in a two-man partnership will not, under § 706(c)(1), close the taxable year of the partnership for the survivor or the decedent "except in the case of a termination of a partnership." Since the remaining partner will ordinarily not be carrying on the business "in a partnership,"[19] there is a possibility that the partnership year will close and the partners will have bunched income despite the provisions of § 706(c). In a two-man partnership, bunching of income for the deceased and surviving partner can be avoided by an appropriate provision in the Articles of Partnership that the estate of the deceased shall continue to participate in the partnership until the end of the year. The will of the decedent would empower the executors of the deceased to continue in the partnership.

It will be noted, however, that the sale of a 50 per cent interest in a partnership will terminate the partnership.[20] Then there will be bunched income not only for the withdrawing partner but also for the remaining partners. This result is deliberate and is intended to prevent possible tax avoidance by sale of interests in fiscal year partnerships to individuals having different tax years.[21] The draftsman may argue that this tax penalty of bunched income upon the selling or withdrawing partners may be a sufficient deterrent to protect the partners against a sale which would terminate the partnership. This argument is unsound, however, because the selling partner may have a tax year which coincides with the partnership year, so that he individually is not affected by the bunching of income. The draftsman may consider inserting in the partnership agreement provisions which would penalize any partner who, by his voluntary act, terminated the partnership other than at the end of a partnership year. Such a provision applied to termination of a partnership by reason of death would be unfair, and, as has been pointed out, is unnecessary because termination by reason of death can be avoided. Aimed at voluntary acts of partners terminating the partnership, such a provision might provide a salutary deterrent.

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17. § 708(b)(1)(A). (Emphasis added.)
18. § 708(b)(1)(B).
19. § 708(b)(1)(A).
20. § 708(b)(1)(B).
21. H.R. REP. No. 2543, 83d Cong., 2d Sess. 61 (1954).

III. Provisions Relating to Payment to a Retired Partner or to the Estate of a Deceased Partner

There is a fundamental diversity of interest between a payor who wishes an item to be treated as a deductible expense to him and taxable as ordinary income to the recipient and a recipient who wishes the item to be treated as capital in nature and free of tax or subject only to a capital gains tax. This is nowhere better demonstrated than in the area of payments to a retired or deceased partner.[22] Prior to the enactment of the new Code the courts had some difficulty in determining whether the payors or the recipients were to have the advantage of favorable tax characterization of payments made to retired partners or the estates of deceased partners. The draftsman who sought to achieve a particular result had trouble insuring that his characterization of the payments would be effective for tax purposes.

The assistance in this area provided by the new Revenue Code[23] may be summarized by the following rules:

1. Payments made for "unrealized receivables"[24] will be taxed as ordinary income to the recipient and will have the effect of a tax deduction to the remaining partners.[25]

2. Payments made for an interest in partnership property, excluding good will, will be treated as capital transactions and will not be deductible to the remaining partners.[26]

3. Payments made for good will will be treated as capital transactions and will not be deductible to the remaining partners if the partnership agreement provides for a payment for good will.[27]

4. Payments, measured by income of the partnership, except to the extent they represent payments for an interest in partnership property, as provided in 2 above, will be taxed as ordinary income in the hands of the recipient, and will have the effect of a tax deduction to the remaining partners.[28]

It is immaterial for tax purposes whether the partners choose, upon the death or retirement of a partner, to calculate precisely his interest in accounts receivable and other unrealized receivables and to make payment

22. Sidney Hess, 12 T.C. 773 (1949).
23. § 736.
24. This term is defined in § 751(c).
25. § 736(b)(2)(A).
26. § 736(b)(1).
27. § 736(b)(2)(B).
28. § 736(a)(1).

of that interest in a fixed amount, or elect to recognize his interest in such unrealized receivables by payment of a portion of future income over the period of time during which such unrealized receivables will probably be liquidated. In either event the payments have the effect of a deduction to the surviving partners, and the receipts are taxable as ordinary income to the retired partner or his estate. If the payments are fixed in amount and not measured by income, they are deductible items to the partnership.[29] If they are not fixed in amount and are measured by income, they constitute distributions of partnership income and have the effect of deductions to the remaining partners although they are not technically such.[30]

The retiring partner will perhaps wish to protect himself against a decline in partnership profits by having his interest in unrealized receivables calculated as a fixed sum and paid. The surviving partners may wish to make a distribution of a portion of partnership profits, so as to protect themselves from the possibility that the deduction available to them will accrue at a time when the partnership has no income against which it can be offset. If the partnership remains profitable, however, it will be immaterial to both payor and payee, so far as the income tax is concerned, whether the payments are fixed in amount or measured as a share of partnership income.

To the extent that a partner has an interest in partnership property, it would seem imprudent to attempt to liquidate that interest by payments measured by future income of the partnership. Even if a partner were willing to make the recoupment of his capital dependent upon the future earnings of the partnership, § 736 (b) (1) expressly provides that payments in exchange for an interest in partnership property are not to be treated as distributive shares of partnership income. Regulations to be issued will undoubtedly provide for apportionment of payments measured by income if some of them are in fact in payment for a partner's interest in partnership property. Similarly, payments for a partner's interest in unrealized receivables of the partnership cannot be deprived of their character as ordinary income in the hands of the retired partner or the estate of the deceased partner.[31] And this result cannot be avoided by distribution in kind of capital assets.[32]

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29. § 707(c).
30. § 736(a)(1).
31. § 736(b)(2)(A).
32. § 751(b). See Little, *Partnership Distributions Under the Internal Revenue Code of 1954*, 10 Tax L. Rev. 161, 183 (1955).

With respect, however, to the intangible property of the partnership in the nature of good will, the statute gives partners freedom of contract. By appropriate provision they can procure a deduction to the remaining partners and taxation as ordinary income for the recipient. Or the payments may be rendered not deductible to the payors and taxable on a capital gains basis to the recipients. If the partnership agreement provides for a payment for good will the latter result is achieved. If it provides for the payments measured by income, but does not characterize them, the former result will be achieved.

In the normal case, the surviving partners will be in a higher income tax bracket than the retired partner or the estate of a deceased partner. Accordingly, if distribution made by the surviving partners are treated as distributions of partnership profits, the tax saving to the payors will be greater than the tax burden to the recipients. Within the limits above described, the objective of minimizing taxes can be achieved.

A fair bargain requires that the draftsman and the parties be sure of the characterization of the payments for tax purposes. Provided their limitations are respected, the rules provide much assistance. As a practical matter, the draftsman should first provide for payment for the interest in tangible property of the partnership of a deceased or retired partner. He should assume that such payment will be treated as a capital transaction not having the effect of a deduction to the remaining partners, but taxed on a capital gains basis to the recipient. The arms length agreement by the partners as to the amount of such payment is likely to be more satisfactory than the later arbitrary apportionment of undesignated amounts pursuant to regulations to be issued. Failure to segregate payments made for the interest in partnership property would lead the parties back into the problems existing before the 1954 Code.[33]

The draftsman may provide next for the payment of unrealized receivables of the partnership, either by calculation as a lump sum or on a reasonable approximate basis as a percentage of profits of the continuing partnership for a period of years. It is unavoidable that the liquidation of such unrealized receivables will be taxed as ordinary income to the retired partner or deceased partner's estate. Apportionment by the parties is likely to be more advantageous than ex post facto apportionment by the Treasury.

33. The surviving or remaining partners were contending that payments were distributions of income and therefore in effect deductible to them and taxable to the recipient, while the recipient was contending that such payments were payments for capital interest.

With these preliminary provisions out of the way, the parties will then have complete freedom of contract. By providing in the partnership agreement that payments are to be made for good will or by providing that payments are to be measured by income, but omitting any reference to good will, the tax burden on the remaining payments can be passed to the recipient or left with the remaining partners, as the parties desire. If the first method is used, the transaction will be treated as a purchase of an interest in partnership property—a capital transaction; if the second is used, it will be treated as payment of a distributive share of partnership profits taxable to the recipient as ordinary income. Diverse treatment for different retiring or deceased partners, reflecting their various circumstances, seems to be entirely feasible.

IV. Provisions Relating to Elections

1. Election to Adjust the Basis of Partnership Assets. The Code[34] provides that a partnership may elect to adjust the basis of partnership properties in event of certain distributions of partnership property[35] and certain transfers of partnership interests.[36] The election, once made, is irrevocable except within limits to be prescribed by regulations which were not yet available at the time of writing.

The question immediately arises whether, in the Articles of Partnership, the partners should contract with respect to the exercise or non-exercise of this election. The effect of election is unpredictable. The long-run practical operation can seldom be foreseen, and once the election is made there probably will be no turning back. In various unforseen circumstances election may serve either to increase or decrease the basis of assets held by the partnership. It has been suggested that few partnerships will make such election.[37] If a transaction occurs which would make exercise of the election advantageous, the election may be made in that year.[38] In these circumstances it would seem prudent not to make a provision in the partnership agreement as to the election, but rather to let it be decided by unanimous vote of partners or in the manner provided in the agreement for making business decisions.

2. Election to be Taxed as a Domestic Corporation. Subchapter R of the Internal Revenue Code of 1954 consists of one section, § 1361, which grants to certain partnerships an election to be taxed as a domestic

34. § 754.
35. § 734(b).
36. § 743.
37. Hauser, *Partners and Partnerships: Contributions, Distributions and Transfers Under the 1954 Code,* 32 Taxes 954, 961 (1954).
38. § 754.

corporation. By the terms of the statute, the election is to be made by all the partners.[39] The election is irrevocable,[40] and its use can be extremely hazardous in view of the uncertainties involved. The election is available only if certain qualifications are met with respect to the number of partners (not more than fifty),[41] the non-ownership of interests in other such partnerships taxed as corporations,[42] the nationality of the partners,[43] and capital being a material income producing factor.[44]

The election may be made at any time within sixty days after the end of the taxable year of the partnership.[45] Consequently, there may be retroactive election to be taxed as a corporation. Any such retroactive election would, however, involve difficulties as yet unsolved by the statute or regutations. For example, there is a question whether the retroactive election would involve payment of penalties because of failure to make timely payments of estimated corporate income tax. The character of distributions made to partners during the course of the year might also be altered by a retroactive election. A further deterrent to the election is the present uncertainty as to the consequence of shifts in ownership which would destroy the election[46] and the means of terminating an enterprise which has once made an election. It remains to be seen whether an election, followed by liquidation, will be treated as the dissolution of a corporation and consequently permit the realization of capital gain in lieu of the taxation as ordinary income.[47]

A partnership making the election will be subject to the accumulated earnings tax,[48] the corporate normal tax and surtax,[49] and the alternative tax for capital gains.[50] There will be available to it a deduction for salaries paid to partners for services rendered.[51] The partnership will not be required to pay withholding or unemployment taxes on the salaries of partners.[52] The partners will not be eligible to participate as employees under any pension plan or profit sharing plan of the partnership.[53]

39. § 1361(a).
40. § 1361(e).
41. § 1361(b)(1).
42. § 1361(b)(2).
43. § 1361(b)(3).
44. § 1361(b)(4).
45. § 1361(a).
46. § 1361(f).
47. Jensin, *Elections To Be Taxed as a Corporation or as an Unincorporated Business*, 13 INSTITUTE ON FEDERAL TAXATION (N.Y.U.) 1029, 1051 (1955).
48. § 531.
49. § 11.
50. § 1201.
51. § 1361(j).
52. Jensin, *supra* note 47, at 1033-34.
53. § 1361(d).

It is obvious that the election has far reaching consequences for all partners and that their interests in such election will often be divergent. No contractual provision in the Articles of Partnership is necessary to give each partner a veto power on such election; this is provided by the statute itself.[54] But in the unusual event of a partnership organized with the intention of using this election, a covenant by all parties to elect may be helpful. Failure to join in the election would then constitute a breach of the partnership agreement with such consequences as the partnership agreement may provide.

V. Provisions in Connection With Insured Buy and Sell Agreements

Provisions of the new Code not relating primarily to partnerships provide solutions to some problems arising from agreements for the purchase of the interest of a deceased partner by a surviving partner and the financing of the purchase with insurance. The abolition of the former payment of premiums test has made it possible to exclude from a decedent's estate the proceeds of insurance, paid by reason of the death of the insured, although the decedent may have paid the premiums on the insurance.[56]

The generally preferred form of insured buy and sell agreements between partners contemplates that Partner A will own insurance upon the life of Partner B. The insurance will be payable to A on B's death, and the proceeds will be used to purchase B's interest in the partnership. At the same time B will own insurance upon the life of A, payable to B upon A's death.[57] Draftsmen of such agreements were plagued with the possibility that it would be held that payments made by A on the policy on B's life were in consideration of the payments made by B on the policy on A's life. If so, then by analogy to the reciprocal trust cases,[58] A was *indirectly* paying the premiums on the policy on his own life and B was *indirectly* paying the premiums on the policy on his own life. Each policy would, therefore, be included in the gross estate of the insured although he had no incidents of ownership in the policy. This created the possibility that both the proceeds of the policy and the partnership interest purchased with such proceeds would be included in the decedent's estate.

54. § 1361(a).
55. Int. Rev. Code of 1939, § 811(g)(2), 44 Stat. 71.
56. § 2042.
57. Matthews, *Estate Tax Consequences of Agreements for the Sale of a Partnership Interest Effective at the Partner's Death—An Appraisal of the Status of the Law,* 26 Texas L. Rev. 729 (1948).
58. Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940).

This difficulty is eliminated;[59] even if the deceased partner has directly or indirectly paid the premiums on the policy upon his life it will not be included in his estate *if he has no reversionary interest* in excess of 5 per cent of value immediately before death and has no incidents of ownership. The last two requirements still make it undesirable for the *partnership* to own the policies used in the buy and sell agreement. Such ownership may create incidents of ownership or reversionary interests in the decedent which would bring the policy into the estate. If these possibilities are avoided by placing ownership in a partner or partners individually, the fact that the insured may, directly or indirectly by contract, or indirectly by payment through the partnership, have paid the premiums, will be immaterial, and will not result in inclusion of the policy in the estate of the insured partner.

The second convenience provided by the new law relates to the disposition of A's estate, after A's death, of the policy held on the life of B, a surviving partner. Under former rule,[60] the proceeds of life insurance, which had been assigned for value, were taxed as ordinary income to the extent of the difference between the proceeds and the cost of such policy to the assignee. Sale of the policy to the partnership or partners other than the insured destroyed the tax free character of the proceeds payable on the death of the insured. Under the new Code[61] proceeds of a life insurance policy paid by reason of the death of the insured are excluded from gross income, despite a transfer for value, if the transfer is "to a partner of the insured . . . [or] to a partnership in which the insured is a partner."[62] Disposal of a policy by the estate of a deceased partner to a surviving partner or partnership is greatly facilitated.

VI. The Partnership as a Refuge for Low Basis Property

Many lawyers have pondered the problem of the client with undiversified low basis securities. Stock in the family business is acquired in a tax-free reorganization by a larger concern; the former owners then find themselves with all their eggs in one basket and diversification possible only at the price of realizing a capital gain. The combination of inflation and tax-free organizations has made this problem a frequent occurrence, and a digression from the main theme of this paper to discuss the possibilities of a partnership in providing a solution seems proper.

59. § 2042.

60. Int. Rev. Code of 1939, § 22(b)(2)(A), 52 Stat. 457.

61. § 101(a).

62. § 101(a)(2)(B).

If several persons, in like circumstances, but owning different securities or properties, contributed low basis assets to a partnership, each could obtain a measure of diversification, and the contribution would not result in any realization of gain for tax purposes.[63] It is true that similar tax-free diversification could be obtained by contributions to a corporation in exchange for stock,[64] but the resulting corporation would probably be a personal holding company. In addition, the corporation would ultimately face the problem of the imposition of accumulated earnings tax[65] on the one hand or double taxation of dividends on the other. The additional difficulty and practical impossibility of getting the property, or any property, out of the corporation, without realization of gain or receipt of ordinary income, are well known. In contrast it is believed that the Code visits no tax penalty upon a partnership serving the function of a holding company. So long as the partnership continues, diversification may be achieved without tax additional to that which would be paid by the partners, if the properties contributed to the partnership were held individually.

Not only can the holder of low basis assets obtain tax-free diversification by means of a partnership, but also other important possibilities are open to him. If one of his partners contributes cash, or if one or more of the partners is willing to leave in the partnership cash accruing from current earnings, the partner contributing low basis assets can withdraw cash in an amount not exceeding the basis of his partnership interest without realization of gain.[66] Thus, the partnership form apparently will permit what is in substance a tax-free liquidation of property contributed to the partnership to the extent of the basis of the contributed property.

A third possibility involves distribution of partnership property in kind. The partner who receives diversified property in kind realizes no gain or loss.[67] The property received in kind will have in the hands of the distributee its basis in the hands of the partnership or the remaining basis of his partnership interest, whichever is the smaller, but recognition of gain or loss will be postponed until disposition of the property received by the distributee.[68] This generalization that property may be

63. § 721.
64. INT. REV. CODE OF 1939, § 112(b)(5), 52 STAT. 485 (now INT. REV. CODE OF 1954, § 351).
65. INT. REV. CODE OF 1939, § 102, 52 STAT. 483 (now INT. REV. CODE OF 1954, § 531).
66. § 731(a).
67. § 731(a).
68. § 732(a)(1)(2).

distributed in kind to partners without realization of gain or loss must, of course, be qualified in so far as such distributions constitute a sale or exchange of unrealized receivables and inventory items,[69] or a payment for unrealized receivables to a retiring partner or a deceased partner's successor in interest.[70] Since these rules merely insure that what is in substance ordinary income of the partnership will not, as to any partner, be converted into capital gain, they give no cause for complaint. When ordinary income has been taxed to the partners as ordinary income and distributions are made when the partnership has only capital assets, then those capital assets may be distributed to a partner or partners without recognition of gain or loss. To this extent the movement of property into and out of partnerships is facilitated and made tax free. Such freedom is unusual, if not unique, and the possibilities of its use will warrant consideration. Of course, the running of property into and out of a partnership by pre-arangement will perhaps be subject to attack as a sham and illusory transaction resulting in a taxable exchange of properties which are not of like kind. Nevertheless, a large and legitimate area remains for use of the partnership as a refuge for low basis property.

VII. Conclusion

Generalization as to the effect of the 1954 Code upon the drafting of partnership agreements is difficult and not likely to be profitable. The new Code undoubtedly provides greater certainty than has heretofore prevailed in the income tax consequences of partnership transactions. At the same time it has thrown a greater responsibility on the draftsman to reckon with the new certainties in the preparation of Articles of Partnership.

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69. § 751.
70. § 736.

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