

1992

## Cold Body - Hot Assets: Entity and Aggregate Partnership Theories in Conflict; Treatment of IRC § 751(c) Unrealized Receivables Upon the Death of a Partner

Richard J. Wood

Follow this and additional works at: <https://dsc.duq.edu/dlr>



Part of the [Law Commons](#)

---

### Recommended Citation

Richard J. Wood, *Cold Body - Hot Assets: Entity and Aggregate Partnership Theories in Conflict; Treatment of IRC § 751(c) Unrealized Receivables Upon the Death of a Partner*, 31 Duq. L. Rev. 1 (1992). Available at: <https://dsc.duq.edu/dlr/vol31/iss1/3>

This Article is brought to you for free and open access by Duquesne Scholarship Collection. It has been accepted for inclusion in Duquesne Law Review by an authorized editor of Duquesne Scholarship Collection.

# Duquesne Law Review

Volume 31, Fall 1992, Number 1

## Cold Body—Hot Assets: Entity and Aggregate Partnership Theories in Conflict; Treatment of IRC § 751(c) Unrealized Receivables Upon the Death of a Partner

*Richard J. Wood\**

I.	Introduction	2
II.	The Statutory Web	6
	A. Income In Respect Of A Decedent Generally	6
	B. Partnership Income In Respect Of A Decedent	11
III.	Expansion Of Partnership Income In Respect Of A Decedent Beyond The Code	19
	A. Judicial Interpretation	19
	B. Administrative Interpretation	25
	C. Criticism Of Expansive IRD Theories	27
IV.	Entity And Aggregate Partnership Theories	28
	A. Non-Tax Partnership Theory	28
	B. Partnership Tax Theory	33
	1. Tax Policy And The Primacy Of Income Classification	33
	2. Implementation Of Tax Policy	38
	C. Reconciliation Of Tax And Non-Tax Theories	42

\* Associate Professor of Law, Capital University Law and Graduate Center, Columbus, Ohio; B.A. 1974, University of Kentucky; J.D. 1977, Ohio State University College of Law; LL.M. 1985, Georgetown University Law Center. I am grateful for the intellectual encouragement and financial support for my work on this article, which was provided by Dean Rodney K. Smith and Capital University Law School. Special thanks to Associate Dean Robert Wade and Professors Donald Hughes and Myron Grauer of Capital University Law and Graduate Center and Professor Beverly Moran of the University of Wisconsin Law School for their comments on drafts of this article.

V. Hot Assets: The Scope of Unrealized Receivables . . .	44
A. The Nature Of Hot Assets . . . . .	44
B. Proper Treatment of Hot Assets As Income In Respect Of A Decedent ("IRD") . . . . .	45
VI. Conclusion . . . . .	49

## I. INTRODUCTION

The Internal Revenue Code<sup>1</sup> is a web of complex rules that sometimes ensnares unwary taxpayers and their money. At the web's center lurks a spider whose motto announces its intention to tax income "from whatever source derived."<sup>2</sup> However, because the economy is itself a complex creature of differing business arrangements and transactions, the web, if it is to catch every tax creature, must also be complex.<sup>3</sup>

One of the primary areas of tax code complexity is subchapter K.<sup>4</sup> A partnership, as defined in subchapter K, includes nearly every sort of enterprise organization other than a corporation, trust, or estate.<sup>5</sup> In other words, partnership, as a tax concept, is a

1. Internal Revenue Code of 1986, as amended, will be referred to hereinafter as "IRC" or "Code". References to earlier versions of the Code will be specifically identified as such.

2. IRC § 61(a) (1986) provides:

(a) GENERAL DEFINITION - Except as otherwise provided in this subtitle, gross income means all income from whatever source derived,

IRC § 61(a).

3. Michael D. Rose & John C. Chommie, *Federal Income Taxation*, § 1.05 (West, 3d ed 1988) ("Rose, *Taxation*");

The complexity of the federal income tax law has generated considerable discussion. It has been said that the law is unfair by placing a premium on costly expertise, thereby diverting legal and accounting talent that could otherwise be devoted to more important tasks. Moreover, persons are forced to make and structure personal and business decisions based on the tax laws. Some of the criticisms reflect the complexities of a highly developed society with a federal revenue structure that is a product of the nation's economic, political, and social forces. Other criticism reveals an almost passionate desire for certainty, and some criticism is the result of frustrations with the political system.

Rose, *Taxation* at § 1.05.

4. The partnership provisions of the Code are located in Subtitle A - Income taxes; Chapter 1 - Normal Taxes and Surtaxes; Subchapter K Partners and Partnerships. Subchapter K includes sections 701 through 761.

5. IRC § 761(a) (1986) provides:

(a) PARTNERSHIP. - For purposes of this subtitle, the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of

sort of catch-all term that may be applied to organizations not specifically defined as corporations, trusts or estates. This expansive definition of partnership exists outside the several states' definitions, and is wholly independent of state law.<sup>6</sup> Consequently, a wide array of organizations with many differences and individual idiosyncracies are classed as partnerships under the Code.

The foundation of partnership analysis, in both the tax and the non-tax context, is built upon the aggregate and entity theories of partnership. Both theories have found expression in taxation of partnership problems. Income and losses received by a partnership "pass through" the partnership to the partners, without being taxed at the partnership level.<sup>8</sup> In this respect the partnership may be regarded as an aggregation of individuals.<sup>9</sup> Partnership tax principles also require taxable income to be computed at the partner-

---

this subchapter, if it is availed of -

- (1) for investment purposes only and not for the active conduct of a business,
- (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or
- (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

IRC § 761(a).

6. Rose, *Taxation* at § 9.02 (cited in note 3). This point is illustrated by the authors when they note that:

A partnership is defined in sections 761(a) and 7701(a)(2) as an unincorporated organization, by means of which any business, financial operation, or venture is carried on; it includes a syndicate, group, pool, or joint venture. The foregoing definition considerably expands the meaning of a partnership under state law. Furthermore, any restrictions imposed by state law on the use of the partnership form will not prevent partnership characterization for federal income tax purposes. (citations omitted)

Id.

7. Donald J. Weidner, *The Existence Of State And Tax Partnerships: A Primer*, 11 Fla St U L Rev 1, 27 (1983) ("Weidner, *Primer*"). "Because there is no tax due at the partnership level, the purpose of the partnership return is to indicate how tax results of partnership operation are 'passed through' to the partners and allocated among them by their partnership agreement." (citations omitted). Weidner, *Primer* at 27.

8. IRC §701 (1986) provides:

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

IRC §701.

9. Donald J. Weidner, *A Perspective to Reconsider Partnership Law*, 16 Fla St U L Rev 1, 4 (1988) ("Weidner, *Perspective*"). This article described the traditional common law aggregate approach as "one which declined to recognize the partnership as an organization with a separate legal personality. The aggregate approach viewed the partnership as nothing more than a conduit for the collection of individuals it embraced." Weidner, *Perspective* at 4.

ship level prior to the determination of the individual partner's share of that income.<sup>10</sup> This calculation is reflective of the entity theory of partnership taxation. These two disparate methods of thinking about partnerships illustrate the aggregate and entity principles of partnership theory in partnership taxation.<sup>11</sup>

Together the aggregate and entity theories form the structure upon which the web of partnership Code sections is spun. The two theories meet at a point marked by the death of a partner and defined by those Code sections that address income in respect of a decedent.

Income in respect of a decedent is a concept that evolved<sup>12</sup> to account for items of income that, but for the death of a taxpayer, would have been reportable by the deceased taxpayer.<sup>13</sup> In general, "income in respect of a decedent," or IRD, are amounts to which a decedent is entitled, but which were not properly includible in her<sup>14</sup> income while she was alive.<sup>15</sup> Accordingly, the term includes:

---

10. IRC § 702(b) (1986) provides:

(b) CHARACTER OF ITEMS CONSTITUTING DISTRIBUTIVE SHARE. The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. IRC § 702(b).

11. Weidner, *Perspective* at 4 (cited in note 9). "The law of partnerships has long been characterized by efforts to identify those issues to be resolved in accord with the entity theory of partnerships and those to be resolved in accord with the aggregate theory of partnerships. This dichotomy has long existed under state law, and has more recently come to exist for federal income tax purposes." *Id.*

12. Prior to 1934, income earned but not yet paid was not taxed to the person who earned it or to his successor in interest. In the Revenue Act of 1934 Congress required the accrual of all income owed to the deceased, regardless of the accounting system used by the deceased. See *Helvering v. Estate of Enright*, 312 US 636 (1941). That approach resulted in the bunching of income in the last return of the deceased. To eliminate that bunching problem, Congress enacted the predecessor to the current section 691. See Rose, *Taxation* at § 8.18 (cited in note 3).

13. Rose, *Taxation* at § 8.18 (cited in note 3). "Congress enacted the predecessor of section 691 in 1942 to allocate income and deductions not received or accrued before death in the usual tax sense to the decedent's estate or to other persons receiving such items after the decedent's death." *Id.*

14. For purposes of convenience the author will use the feminine pronoun throughout this article. That decision is based upon the feminine characters described in the hypothetical that is used in the article.

15. Treas Reg § 1.691(a)-1(b) (1965) provides:

In general, the term 'income in respect of a decedent' refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.

accrued income of a cash-basis taxpayer;<sup>16</sup> income of an accrual-basis taxpayer that accrues solely by reason of her death;<sup>17</sup> and income to which the decedent had a contingent claim at the time of her death.<sup>18</sup>

Application of the income in respect of a decedent concept is nowhere more difficult than when the taxpayer is a partner, because income in respect of a decedent principles must be applied through, and reconciled with, subchapter K<sup>19</sup> partnership provisions. The presence of both aggregate and entity theories of partnership taxation in subchapter K appears to clash or merge, depending on your perspective, in their application to IRD of a partner. They clash in that items defined as partnership unrealized receivables,<sup>20</sup> which are not within the purview of income in respect of a decedent outside the partnership context, may be converted into such items by virtue of their inclusion in the partnership entity. And yet they merge in that once the items are determined to be income in respect of a decedent, they may then pass through the partnership to the deceased partner's successor in interest pursuant to an aggregate view of the partnership. In other words, the partnership may be split into part entity and part aggregate based upon the nature of an asset rather than upon any normative principle of taxation. That is either a clash of partnership principles or a merger of complementary characteristics, as this article will explore.

This article will examine the framework upon which the web of partnership taxation has been spun. The purpose of this inquiry is to resolve the tension between aggregate and entity partnership theories as they are applied upon the death of a partner. In the

---

Treas Reg § 1.691(a)-1(b).

16. Treas Reg § 1.691(a)-1(b)(1) (1965). This term includes:

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

Treas Reg § 1.691(a)-1(b)(1).

17. Treas Reg § 1.691(a)-1(b)(2) (1965). This term includes:

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting;

Treas Reg § 1.691(a)-1(b)(2).

18. Treas Reg § 1.691(a)-1(b)(3) (1965). This term includes:

(3) Income to which the decedent had a contingent claim at the time of his death.

Treas Reg § 1.691(a)-1(b)(3).

19. Treas Reg § 1.691(a)-1(b). This regulation further refers the reader to sections 736 and 753 and the regulations thereunder for "income in respect of a decedent" in the case of a deceased partner. Treas Reg § 1.691(a)-1(b).

20. See note 37 for a definition of unrealized receivables.

course of this inquiry it will become apparent that aggregate partnership theory provides the best analysis of income in respect of a decedent upon the death of a partner. However, further examination of specific partnership assets will show that both theories are subordinated to the overarching principles of recognition of income and its corollary, the preservation of basis. In other words, normative principles that guide all substantive tax questions will supersede state law principles of partnership law for the purpose of resolving questions concerning specific assets embedded in the partnership on the death of a partner.

The methodology employed in examining this partnership problem will be to first examine the Code, strictly construing its provisions for income in respect of a decedent. Aggregate and entity partnership theory will then be explored to determine if one or both adequately explains the way in which partnership assets are treated upon the death of a partner. Unrealized receivables, so-called "hot assets," will then become the focus of this inquiry.<sup>21</sup> Aggregate partnership theory, under superior tax principles, will be used to resolve the question of proper treatment of unrealized receivables. Individual hot assets will then be examined under income in respect of a decedent principles as applied through the partnership organization.

## II. THE STATUTORY WEB

### A. *Income In Respect Of A Decedent Generally*

Income in respect of a decedent, or IRD, requires the deceased's successor in interest to include in gross income items received by the successor and not accounted for on any return of the de-

---

21. "Hot assets" are so named because they generate ordinary income upon the disposition of a partnership interest. Section 751 treats the proceeds of such a disposition as ordinary income to the extent that any portion of the proceeds corresponds to an amount received in exchange for the "hot asset". Section 751(c) defines the assets that will generate ordinary income upon the occurrence of any of the events listed in section 751(a) and 751(b).

The ultimate success of such innovative uses of partnerships may depend on the tax planners' ability to avoid the clutches of section 751(a) of the Internal Revenue Code. This section states that a partner will recognize ordinary income whenever he sells or exchanges unrealized receivables or substantially appreciated inventory. These are known as 'hot assets.'

See David Joy, Randall Hahn, and Allan Karnes, *The Problem of Hot Assets in Farm Partnerships*, 1985 SIU L Rev 655, 656 (1985). See also *Rodman v Commissioner*, 542 F2d 845, 856 (2d Cir 1976) which noted that "there could, for example, have been so-called 'hot assets,' namely unrealized receivables or appreciated inventory." *Rodman*, 542 F2d at 856.

ceased.<sup>22</sup> Section 691(a)<sup>23</sup> ensures that items of income which were owed to the deceased taxpayer, but unpaid on the date of her death, will nevertheless be reported as income on the return of the successor in interest to that income.<sup>24</sup>

22. Treas Reg § 1.691(a)-2(a) (1957) provides:

(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of -

- (1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;
- (2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or
- (3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements method.

Treas Reg §1.691(a)-2(a).

23. IRC § 691(a) (1986) provides:

(a) INCLUSION IN GROSS INCOME. -

(1) GENERAL RULE. - The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

- (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;
- (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or
- (C) the person who acquires from the decedent the right to receive the amount by bequest, devise or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

IRC § 691(a).

24. Rose, *Taxation* at § 8.18 (cited in note 3) provides:

Prior to the Revenue Act of 1934, income received after the death of a cash method taxpayer escaped taxation completely. To preclude this, Congress enacted legislation that, in effect, required the accrual at death of all income and deduction items regardless of the accounting method used by the decedent. Accrual was interpreted by the Supreme Court (citation omitted) to embrace any income item capable of valuation whether or not it had accrued in the accounting sense. As a result of this interpretation, a decedent's final return sometimes contained a substantial amount of bunched income that significantly increased the tax liability under the graduated system. To alleviate this bunching in a decedent's final return, Congress enacted the predecessor to section 691 in 1942 to allocate income and deductions not received or accrued before death in the usual tax sense to the decedent's estate or to other persons receiving such items after the decedent's death.

Id.

Section 691 was enacted as an extension of prior law under section 126 of the 1939 Code.<sup>25</sup> Congress wanted to avoid the bunching or upgrading of income in the final return of a decedent but, of course, could not allow the income to escape income taxation. The concept of income in respect of a decedent was added to the law to solve that problem.<sup>26</sup>

There are four primary characteristics of income in respect of a decedent that distinguish it from other forms of income.<sup>27</sup> First, the item of income must have been earned by the taxpayer, or due to the taxpayer because of her status, and but for her death would have been realized by the decedent as gross income without further effort.<sup>28</sup> An example of such an item would be an amount due to a cash basis taxpayer with a solo accounting business. Consider the case of Arachne who earned \$20,000.00 through her business of providing accounting services, \$10,000.00 of which was unpaid on her death. On payment, her successor in interest would include the amount as ordinary income on her return.

The example also illustrates the second characteristic of IRD, that the item of income was not properly includible on the decedent's final tax return.<sup>29</sup> Arachne was a cash method taxpayer, and as such the amounts due from clients, even though earned by her prior to death, were not properly includible on her final return.

The third characteristic of IRD is that the recipient of the right to income must have acquired it solely by reason of the death of

---

25. Beyond the question of inclusion in income of items that were earned but not yet paid to the deceased taxpayer, there is the problem of "bunching" the income on the final return of the deceased. This bunching would force the taxpayer into a higher bracket and tax the item of income at a higher rate than would otherwise necessarily be the case. In solving this problem Congress removed the income from the return of the deceased and placed it on the return of the recipient in the year of receipt. See Finance Committee Report, S Rep No 1622, 83d Cong, 2d Sess 5015 (1954):

[The section 126] provisions were added by the Revenue Act of 1942 and were designed to overcome the preexisting requirement that there be included in the income of a decedent for the taxable period in which his death occurred all the income accrued up to the date of his death. In order to overcome the "bunching" of all such income in the decedent's final return, the 1942 amendments made the income accrued solely by reason of the decedent's death taxable to the actual recipient at the time the income was received.

S Rep No 1622 at 5015.

26. S Rep No 1622 at 5015.

27. Alan S. Acker, 32 *Tax Management, Estates, Gifts, and Trusts Portfolios A-9* (BNA 3d ed 1990) ("Acker, *Tax Management*").

28. Acker, *Tax Management* at A-9 (cited in note 27).

29. *Id.*

the taxpayer who created it.<sup>30</sup> Arachne's successor acquired the right to \$10,000.00 solely by reason of the death of Arachne.

The example also illustrates the fourth characteristic in that the item which passed on the death of the taxpayer was not a property right and therefore not subject to a step up in basis under section 1014.<sup>31</sup> It is this characteristic that will be called into question in the partnership context because an unrealized receivable owed to a partnership may become a right to property when the partnership is viewed as an entity that includes an unrealized receivable. As we will see, an interest in a partnership is treated as a property right of the holder of that interest both under state law and under federal tax law. If the partnership entity is respected, an interest in a partnership may include an IRD component that may be transformed into a property right subject to a step up in basis under section 1014.<sup>32</sup> On the other hand if the partnership entity is ignored pursuant to an aggregate theory of partnership law, the IRD component may retain its characteristic as an item of income rather than a property right.

The interaction of IRD and partnership taxation occurs in three different circumstances, all initiated by the death of a partner. First the deceased partner's interest may remain in the hands of a successor, allowing the continuation of the partnership with the inclusion of the successor as a new partner.<sup>33</sup> Second, there may be a sale of the partnership interest with the firm continuing as an ongoing business. And finally there may be a liquidation of the partnership.<sup>34</sup> The presence of unrealized receivables, as that term

---

30. Id.

31. Id.

32. IRC § 1014 (1986).

33. The Uniform Partnership Act section 31(4) requires the dissolution of the old partnership and the formation of a new partnership under state law upon the death of one partner. It also provides for a continuation of the business under section 42. The Code specifically allows for the continuation of the SAME partnership, even if a partner withdraws or dies. See IRC § 708 (1986) which provides:

(a) GENERAL RULE. - For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION. -

(1) GENERAL RULE. - For purposes of subsection (a), a partnership shall be considered as terminated only if- (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

IRC § 708.

34. See Stephen A. Lind, et al, *Fundamentals of Partnership Taxation* 359 (Founda-

is defined in section 751(c),<sup>35</sup> in each of those three circumstances is the subject of this inquiry.

Most, if not all, cash basis partnerships will maintain an account for unrealized receivables that keeps track of amounts owed to the partnership which have not yet been paid.<sup>36</sup> Section 751(c) defines partnership unrealized receivables to include such amounts and expands upon the simple definition to include whole classes of items, such as farm land, stock in certain foreign corporations, and other items that, but for the Code, would not be considered unrealized receivables.<sup>37</sup>

tion, 3d ed 1992) ("*Lind, Fundamentals*") which noted:

When a partner dies, there is no repose for his partnership interest, which remains in the purgatory that we have come to know as Subchapter K. At the partner's death, his interest in the partnership can: survive and be acquired by his successor in interest; be sold pursuant to a buy-sell agreement taking effect at the partner's death; or be liquidated by the partnership under a preexisting agreement.

*Lind, Fundamentals* at 359.

35. For the definition of unrealized receivables see note 37 and accompanying text.

36. *Lind, Fundamentals* at 241-242 (cited in note 34):

Unrealized receivables generally include rights (contractual and otherwise) to payment for goods and services which have not previously been included in income, provided, in the case of goods, that the sales proceeds would be treated as received from the sale or exchange of non-capital assets.

*Id.*

37. IRC § 751(c) (1986) provides:

(c) UNREALIZED RECEIVABLES.- For purposes of this subchapter, the term 'unrealized receivables' includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for -

(1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(2) services rendered, or to be rendered.

For purposes of this section and sections 731, 736, and 741 such term also includes mining property (as defined in section 617(f)(2)), stock in a DISC (as described in section 992(a)), section 1245 property (as defined in section 1245(a)(3)), stock in certain foreign corporations (as described in section 1248), section 1250 property (as defined in section 1250 (c)), farm land (as defined in section 1252(a)), franchises, trademarks, or trade names (referred to in section 1253(a)), and an oil, gas, or geothermal property (described in section 1254) but only to the extent of the amount which would be treated as gain to which section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1252(a), 1253(a), or 1254(a) would apply if (at the time of the transaction described in this section or sections 731, 736 or 741, as the case may be) such property had been sold by the partnership at its fair market value. For purposes of this section and sections 731, 736, and 741, such term also includes any market discount bond (as defined in section 1278) and any short term obligation (as defined in section 1283) but only to the extent of the amount which would be treated as ordinary income if (at the time of the transaction described in this section or section 731, 736, or 741, as the case may be) such property had been sold by the partnership.

IRC §751(c).

For purposes of illustration, consider the accounting partnership of Arachne and Athene (A and A).<sup>38</sup> The partnership is on the cash basis and was formed on January 1, 1980. Arachne died on April 15, 1990, when there were \$10,000.00 in unpaid fees due from clients of the firm. Additionally, the partnership owned farm land (as described in section 1252)<sup>39</sup> on the date of death. These facts will be applied throughout this article to explain the application of both the law and the theory of income in respect of a decedent in the partnership context.

### B. *Partnership Income In Respect Of A Decedent*

Courts interpreting section 691<sup>40</sup> have said that the first requirement for application of the statute is whether "the decedent had a right to the income."<sup>41</sup> If the decedent had a right to the income at the time of death, later receipt of the income by a successor in interest is included in income of the successor under section 691.<sup>42</sup> In our illustration, if Arachne had been in business on her own, the unpaid fees would clearly be income in respect of a decedent to her estate or heir or other successor in interest. The farm land would not be IRD, because it fails to satisfy the first characteristic of income in respect of a decedent. It is not income that would be realized by the decedent without any further effort. Farm land is not covered by the theory because it is not income, even though it may have appreciated in value over the life of the decedent. It does not

38. The names for this example come from the Greek myth of Arachne and Athena. See Robert Graves, Vol One, *The Greek Myths*, (Penguin Books, 1960) ("*The Greek Myths*"):

Arachne, a princess of the Lydian Colophon - famed for its purple dye - was so skilled in the art of weaving that Athene herself could not compete with her. Shown a cloth into which Arachne had woven illustrations of Olympian love affairs, the goddess searched closely to find fault but, unable to do so, tore it up in a cold, vengeful rage. When the terrified Arachne hanged herself from a rafter, Athene turned her into a spider - the insect she most hates - and rope into a cobweb, up which Arachne climbed to safety.

*The Greek Myths* at 98.

39. IRC § 1252(a)(2) (1986) provides:

(2) FARM LAND - For purposes of this section 'farm land' means any land with respect to which deductions have been allowed under sections 175 (relating to soil and water conservation expenditures) or 182 (relating to expenditures by farmers for clearing land).

IRC § 1252(a)(2).

40. IRC § 691 (1986).

41. *Halliday v US*, 655 F2d 68, 71 (5th Cir 1981). See also *Trust Company of Georgia v Ross*, 392 F2d 694 (5th Cir 1967).

42. IRC § 691 (1986).

constitute an amount of income which the decedent had a right to receive prior to death.

Income in respect of a decedent as applied to partners is specifically addressed in section 691(e).<sup>43</sup> This section directs the reader to subchapter K section 753<sup>44</sup> which defines partnership IRD as amounts includible in the gross income of a successor in interest under section 736(a).<sup>45</sup> That section says that payments made in liquidation of the interest of the deceased partner are to be considered IRD. This purely statutory analysis of a deceased partner's IRD requires the examination of three sections in Subchapter K, each applied in sequence upon the issues raised by application of its predecessor. Judicial interpretation of section 691<sup>46</sup> has taken a more expansive view of the area, and will be explored later in this article.

The cornerstone of this statutory analysis is section 736(a).<sup>47</sup> That section is limited to payments made in liquidation of the interest of a deceased partner. The remaining two possibilities, namely the continuation of the partnership by the successor in interest or the sale of the partnership interest to a third party, are not addressed in section 736(a).<sup>48</sup> Statutorily, no partnership item qualifies as IRD unless it is a section 736(a) payment.<sup>49</sup> There is no

43. IRC § 691(e) (1986) provides:  
(e) CROSS REFERENCE. -

For application of this section to income in respect of a deceased partner, see section 753.

IRC § 691(e).

44. IRC § 753 (1986) provides:

The amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691.

IRC § 753.

45. IRC § 736(a) (1986) provides:

(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT. - Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered -

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or  
(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

IRC § 736(a).

46. IRC § 691 (1986).

47. IRC § 736(a) (text quoted in note 45).

48. *Id.*

49. Lind, *Fundamentals* at 367 (cited in note 34):

Section 753 is a specific statute that is limited to characterizing section 736(a) payments received by a deceased partner's successor in interest as IRD. It does not apply if the partner's interest continues in the hands of a successor or is sold pursuant to a

alternative statutory method for determining IRD. Some commentators have named this seeming statutory dead-end the "exclusivity problem."<sup>50</sup> By its terms, section 736(a)<sup>51</sup> does not apply to either sale of the partnership interest or continuation of the partnership by the successor in interest of the partnership, the only two alternative possible circumstances other than liquidation. A strict construction of the Code, therefore, requires a dead stop at section 736(a),<sup>52</sup> resulting in IRD treatment only for amounts paid in liquidation under that section. Continuation of the partnership or sale of the partnership interest are outside the reach of statutory income in respect of a decedent because there is no Code provision that describes IRD in either of those circumstances.

The A and A partnership illustration, when analyzed under a purely statutory analysis, would generate IRD only if there was a liquidating distribution to Arachne's successor in interest. In other words any payment received in liquidation of Arachne's partnership interest would include Arachne's share of the unrealized receivables. That amount would be treated as IRD under section 736(a).<sup>53</sup> The unpaid fees would be IRD and thus ordinary income to the recipient upon the section 736(a) liquidating payment. The farm land might also be considered IRD because section 736(b)(2) specifically treats all section 751(c)<sup>54</sup> unrealized receivables as within the section 736(a) definition of distributive share of partnership income upon payment to a deceased partner's successor in interest.<sup>55</sup> Farm land is an unrealized receivable under section

pre-existing buy-sell agreement.

Id.

50. Acker, *Tax Management* at A-36 (cited in note 27). The author explains:

b. The Exclusivity Problem

\* \* \*

It can be argued, then, that, except for § 736(a) amounts, there can be no IRD in respect of a deceased partner. This proposition, the acceptance of which would produce results that would be hard to justify, has been rejected by the regulations and the courts.

Id.

51. IRC § 736(a) (text quoted in note 45).

52. Id.

53. Section 736(b)(2)(A) makes it clear that section 736(a) payments are ordinary income to the extent they contain unrealized receivables as defined in section 751(c).

54. IRC § 751(c) (1986) (text quoted in note 37).

55. IRC § 736(b) (1986) provides:

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP

(1) GENERAL RULE. - Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations

751(c) and could theoretically be viewed as IRD if the payment in liquidation of Arachne's interest included a payment for farm land. This analysis will be explored in more detail later in this article.

Continuing with the analysis of the proper treatment of Arachne's interest upon her death when there is a liquidation of her interest under section 736(a), the question now focuses on the fourth characteristic of income in respect of a decedent, namely that it is not a property right subject to a step up in basis. In other words, the question now becomes one of the proper way in which to treat unrealized receivables in computing basis of the partnership interest of the deceased partner.

The passage of the partnership interest from the deceased to her successor in interest permits an adjustment to the basis of partnership property with respect to the transferee partner. The general rule, found in section 743(b),<sup>56</sup> is that the basis of partnership property with respect to the successor in interest is equal to the value of the partnership interest acquired by the successor in interest. The value of the partnership interest acquired on the death of a partner is its value at the date of her death, increased by her estate's or other successor's share of partnership liabilities, and reduced to the extent that such value is attributable to items constituting IRD.<sup>57</sup> Accordingly, it is important to determine the extent

prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) SPECIAL RULES. - For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for -

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

Id.

56. IRC § 743(b) (1986) provides:

(b) ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY. - 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, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

IRC § 736(b).

57. Treas Reg § 1.742-1 (1956) provides:

of IRD in a partnership interest, not only because it is subject to ordinary income treatment by the recipient in a liquidating distribution, but also because the basis of the partnership interest will be computed by subtracting items of IRD.

The capstone of this statutory analysis approach is the application of section 1014(a).<sup>58</sup> That section provides the successor in interest of the deceased partner with a stepped-up basis for the partnership interest acquired from the decedent. The only exception to section 1014<sup>59</sup> that might prevent the operation of the general rule from stepping up the basis of the partnership interest is section 1014(c),<sup>60</sup> which prohibits the application of the general rule to property that is IRD under section 691.<sup>61</sup> Accordingly, the basis provisions of Subchapter K send the taxpayer back into Subchapter J<sup>62</sup> for a brief stop at section 691<sup>63</sup> before returning again to the Subchapter K analysis.

The successor to Arachne's partnership interest will obtain a basis in the partnership interest equal to its fair market value without regard to unrealized receivables. Under section 743,<sup>64</sup> the basis in partnership property may be adjusted to reflect the value of the partnership interest that Arachne's successor acquires. Liquidating distributions paid to the successor will therefore be measured

---

The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of §1.706-1 and paragraph (b) of § 1.753-1) under section 691. See section 1014(c).

Treas Reg § 1.742-1.

58. IRC § 1014(a) (1986) provides:

(a) IN GENERAL. - Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be -

(1) the fair market value of the property at the date of the decedent's death,

IRC § 1014(a).

59. IRC § 1014 (1986).

60. IRC § 1014(c) (1986) provides:

(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT. - This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

IRC § 1014(c).

61. IRC § 691 (1986).

62. IRC Subchapter J concerns estates, trusts, beneficiaries and decedents and covers section 641 through 692.

63. IRC § 691.

64. IRC § 743 (1986).

against that basis for purposes of determining gain. Under section 1014(c),<sup>65</sup> unrealized receivables will not receive any step up in basis, and amounts representing Arachne's share of unrealized receivables will be treated as ordinary income, whether or not they are actually paid to the successor in interest.<sup>66</sup>

Based upon a statutory analysis alone, only those cases of liquidated partnership interests under section 736(a)<sup>67</sup> would contain IRD, and all other cases would be entitled to the step up in basis of the entire partnership interest under section 1014(a),<sup>68</sup> and a subsequent step up in basis for the partnership property under section 743(b).<sup>69</sup> Section 736<sup>70</sup> is the key. There will be no IRD income to a successor in interest under section 753<sup>71</sup> and no denial of a step up in basis under section 1014(c),<sup>72</sup> unless there is a liquidation of interest under section 736(a).<sup>73</sup> Furthermore, payments made in liquidation of interest, and thus considered to be IRD, include payments attributable to unrealized receivables, as defined in section 751(c),<sup>74</sup> and good will.<sup>75</sup>

Without reference, for the moment, to the expansive definition of unrealized receivables contained in the flush language of section

65. IRC § 1014(c) (1986) (text quoted in note 60).

66. Rev Rul 68-215, 1968-1 CB 312 provides:

Where a partner dies before the close of the partnership taxable year and under the partnership agreement his estate, as his 'successor in interest,' is entitled to receive his share of the partnership's profits remaining undistributed at the time of his death, the deceased partner's distributive share of partnership taxable income for the partnership taxable year in which the decedent's last taxable year ended is includible in the return of the decedent's estate. This is the case even though his executor, pursuant to the terms of his will, assigned to the beneficiaries fractional interests in any right which the decedent had to partnership profits realized after the beginning of the year of the decedent's death.

Rev Rul 68-215, 1968-1 CB 312.

67. IRC § 736(a) (1986) (text quoted in note 45).

68. IRC § 1014(a) (1986) (text quoted in note 58).

69. IRC § 743(b) (1986) (text quoted in note 56).

70. IRC § 736 (1986).

71. IRC § 753 (1986) (text quoted in note 44).

72. IRC § 1014(c) (1986) (text quoted in note 60).

73. IRC § 736(a) (1986) (text quoted in note 45).

74. IRC § 751(c) (1986) (text quoted in note 37).

75. IRC § 736(b)(2) (1986) provides:

(2) SPECIAL RULES. - For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for -

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

IRC § 735(b)(2).

751(c),<sup>76</sup> the term refers generally to income which has been earned, but not yet included in income, by the taxpayer.<sup>77</sup> There is no doubt that such an item would be IRD in the hands of an individual under section 691(a).<sup>78</sup> Yet a strict entity interpretation of the Code and of the underlying partnership interest would extinguish the individual components of that interest. Entity theory does not inquire into the components of the entity. It is unconcerned with the constituent bundle of rights and responsibilities that make up the entity. Pure entity theory would consider the partnership interest to be a single, discrete asset regardless of the presence of what would otherwise be IRD outside the partnership.

In the case of the A and A accounting partnership, accounts receivable earned prior to Arachne's death and paid out on liquidation will be IRD to the successor in Arachne's interest. That result would also occur if Arachne had been in business for herself acting as a sole accounting practitioner. Her death would mean that the unrealized receivables would be IRD to the successor in interest when collected.<sup>79</sup>

As a sole practitioner, the unrealized receivables of Arachne's accounting business belong to her personally. However, as a partner in A and A, the unrealized receivables earned by Arachne and Athene belong to the partnership, not Arachne, although she would have gained the benefit of sharing in the receivables of the partnership had she lived. Nevertheless, the item is an asset of the partnership, not of Arachne. The partnership agreement between the two accountants would describe how the proceeds from the business are to be divided. In other words, the accounts receivable are the property of an entity. The benefits flowing from the accounts receivable to the equity holders is determined at the entity level and is not simply a flow through of monies earned separately by the members of the firm.

If the partnership agreement provides for the liquidation of Arachne's interest on her death, then, pursuant to the statutory

---

76. IRC § 751(c) (1986) (text quoted in note 37).

77. Treas Reg § 1.691(a)-1(b) (1965) (text quoted in note 15).

78. IRC § 691(a) (1986) (text quoted in note 23).

79. Treas Reg § 1.691(a)-2(a)(1) (1960) provides:

Inclusion in gross income by recipients. - (a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of -

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

Treas Reg § 1.691(a)-2(a)(1). See also Treas Reg § 1.691(a)-2(b) examples 1 through 5.

analysis contained in section 736(a),<sup>80</sup> liquidating payments to the successor in interest would be IRD through section 753<sup>81</sup> and 691(e).<sup>82</sup> There would be no step up in basis to the successor in interest by virtue of section 1014(c),<sup>83</sup> and the estate would owe income tax on the portion of the liquidating distribution corresponding to the unrealized receivables.

If the partnership agreement provides for the continuation of the partnership or the possible purchase of the partnership interest, then there would be no liquidation of the interest of a deceased partner under section 736(a).<sup>84</sup> Due to the absence of a section 736(a)<sup>85</sup> liquidation, the statutory analysis described above appears to be inapplicable.<sup>86</sup> In our example, the sale of Arachne's interest to a third party or the continuation of the business by the successor to Arachne's interest<sup>87</sup> would not be within the statutory framework of IRD because there would not be a liquidation within the meaning of section 736(a).<sup>88</sup> To the "consternation of strict constructionists,"<sup>89</sup> however, courts have extended IRD treatment

80. IRC § 736(a) (1986).

81. IRC § 753 (1986).

82. IRC § 691(e) (1986).

83. IRC § 1014(c) (1986) (text quoted in note 60).

84. IRC § 736(a) (1986) (text quoted in note 45).

85. IRC § 736(a).

86. Arthur B. Willis, Paul Little and Donald McDonald, *Problems on Death, Retirement or Withdrawal of a Partner*, 17 NYU Institute on Federal Taxation 1033, 1041-1042 (1959) ("Willis, *Problems*). The authors note:

2. A's estate's basis for A's interest is its estate tax value of \$60,000 plus \$500, his share of partnership liabilities, less 'income in respect of a decedent' which apparently varies.

\* \* \*

c. If B and C purchase A's interest, or if A's successor continues as a partner, the values of goodwill and unrealized receivables are not income in respect of a decedent, resulting in an interest basis of \$60,500. This results apparently from a statutory oversight. The Internal Revenue Service may be expected to oppose this result.

Willis, *Problems* at 1041-1042.

87. The example breaks down to some extent at this point because it concerns personal services provided by the partners themselves. I ask the reader to assume that a purchaser or successor would be capable of providing those services and that Athene would agree to continuation of the business with that successor or purchaser.

88. IRC § 736(a) (1986) (text quoted in note 45).

89. Lind, *Fundamentals* at 367 (cited in note 34).

To the consternation of strict constructionists of the code, the Service has contended that section 753 is not the exclusive means of classifying the decedent's interest in partnership assets as IRD. Applying an aggregate theory, the courts have concurred with the Service, in effect creating an additional category of IRD that is not specifically contemplated by section 753. The *Quick Trust* and *Woodhall* cases, below, adopted this approach with respect to a continuation of a partnership interest and a

to cases in which there is a sale or continuation of the partnership interest.<sup>90</sup> This expansion of the IRD concept appears to shatter the partnership entity and is supported instead by an aggregate view of partnership taxation.

### III. EXPANSION OF PARTNERSHIP INCOME IN RESPECT OF A DECEDENT BEYOND THE CODE

#### A. *Judicial Interpretation*

Courts have been very critical of the rigid entity analysis of partnership IRD that a strict statutory approach requires.<sup>91</sup> With some art, they have avoided the seemingly required statutory result in favor of a consistent treatment of simple unrealized receivables in the hands of an individual and in the hands of a partnership.<sup>92</sup> The two cases that recognize a non-statutory approach to IRD in the contexts of a sale of the partnership interest and the continuation of the partnership interest are *Woodhall v Commissioner*<sup>93</sup> and *Quick Trust v Commissioner*,<sup>94</sup> respectively.

In *Quick Trust*, the estate of George E. Quick and its successor to the partnership interest of the decedent, the George Edward Quick Trust, relying upon entity partnership theory, challenged the Service's position that any of the partnership interest contained IRD attributable to the accounts receivable allocable to the deceased partner.<sup>95</sup> The partnership elected<sup>96</sup> under section 754<sup>97</sup>

---

sale situation, respectively.

Id.

90. Id.

91. *George Edward Quick Trust v Commissioner*, 54 Tax Ct 1336, 1343 aff'd 444 F2d 90 (8th Cir 1972). The tax court noted "that petitioner's position [that only payments in liquidation of a partnership interest can be IRD under the Code] has been the subject of extensive legal analysis and that it has some support among the legal pundits." *Quick Trust*, 54 Tax Ct at 1343.

92. See Id at 1343, and *Chrissie H. Woodhall v Commissioner*, 28 Tax Ct Mem Dec 1438, aff'd 454 F2d 226 (9th Cir 1972).

93. *Woodhall*, 28 Tax Ct Mem Dec (CCH) at 1443, Tax Ct Mem Dec (P-H) ¶ 69,279 at 1556-69. (cited in note 92).

94. *Quick Trust*, 54 Tax Ct.at 1343, explained that " the partnership provisions of the 1954 Code are comprehensive in the sense that they are detailed. But this does not mean that they are exclusive, especially where those provisions themselves recognize the interplay with other provisions of the Code." Id.

95. Id at 1342. The petitioner argued "that the partnership provisions of the Internal Revenue Code of 1954 adopted the entity theory of partnership, that the plain meaning of those provisions, insofar as they relate to the question of basis, requires the conclusion that the inherited partnership interest is separate and distinct from the underlying assets of the partnership, and that, therefore, section 691, and consequently section 1014(c), has no application herein." Id.

to adjust the basis of partnership property under section 743(b).<sup>98</sup> Pursuant to those sections the partnership adjusted the taxpayer's basis in the accounts receivable from zero to an amount roughly equal to one half of the fair market value of its accounts receivable at the death of Mr. Quick.<sup>99</sup> Pursuant to this approach, the accounts receivable would generate no ordinary income to the taxpayer on collection, because the taxpayer's basis in the accounts receivables would equal or exceed the amount collected.

The Tax Court analyzed the issue by asking<sup>100</sup> whether the ac-

---

96. Id at 1340.

97. There is no substantial difference between the 1954 version of section 754 and the current 1986 version. See IRC § 754 (1986) which provides:

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent years. Such election may not be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.

IRC § 754.

98. There is no substantial difference between the 1954 version of the code and the 1986 version. See IRC § 743(b) (1986) which provides:

(b) Adjustment to basis of partnership property. - In the case of a transfer of an interest in a partnership by sale or exchange or on 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, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of the partnership property with respect to the transferee partner only.

IRC § 743(b).

99. *Quick Trust*, 54 Tax Ct at 1340-1341. The court observed that "On the facts of this case, the net result of this adjustment was to increase the basis of the accounts receivable to the partnership from zero to an amount slightly less than one-half of their face value." Id.

100. Id at 1341. The court indicated that:

The issue before us is whether the foregoing adjustment to basis was correctly made. Its resolution depends upon the determination of the basis to the estate of its interest in the partnership, since section 743(b)(1) allows only an "increase [in] 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." (emphasis added). This in turn depends upon whether, to the extent that "the basis to the transferee partner" reflects an interest in underlying accounts receivable arising out of personal services of the deceased partner, such

counts receivable component of the partnership interest was IRD under section 691,<sup>101</sup> thereby coming within the exception to the general rule of section 1014(a)<sup>102</sup> found in section 1014(c).<sup>103</sup> Petitioner argued that the Code embodies an entity theory of partnership.<sup>104</sup> Accordingly, the inherited partnership interest is distinct from the assets which compose that interest. Pursuant to such an approach, petitioners argued for the court to apply section 1014(a)<sup>105</sup> and cut off the application of sections 691<sup>106</sup> and 1014(c).<sup>107</sup>

The Service argued in favor of an aggregate approach to partnership basis.<sup>108</sup> In this case, one of the aggregate rights was a right to receive income in respect of a decedent, namely, section 691 IRD.<sup>109</sup> The Service pointed out that had the partnership been on the accrual basis, or if Mr. Quick had been a sole proprietor, or even if the accounts receivable had been those of a corporation, they would certainly have been taxable as ordinary income.<sup>110</sup> Inclusion of the right to receive income in a partnership ought not to change that result, argued the Service.<sup>111</sup>

In reaching its decision, the court noted that although the partnership provisions of the Code are comprehensive, they are not ex-

---

interest constitutes income in respect of a decedent under section 691(a)(1) and (3). In such event, section 1014(c) comes into play and prohibits equating the basis of Quick's partnership interest with the fair market value of that interest at the time of his death under section 1014(a). (emphasis by the court)

Id.

101. There is no substantial difference between the 1954 version and the 1986 version of section 691, other than the redesignation of section 691(f) as section 691(e). See IRC § 691 (1986).

102. IRC § 1014(a) (1954) provides:

(a) IN GENERAL. - Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under section 2032 or section 811(j) of the Internal Revenue Code, of 1939 where the decedent died after October 21, 1942, its value at the applicable date prescribed by those sections.

IRC § 1014(a).

103. There is no difference between the 1954 version and the 1986 version of section 1014(c). See IRC § 1014(c) (1986) (text quoted in note 60).

104. *Quick Trust*, 54 Tax Ct at 1342.

105. IRC § 1014(a) (1954) (text quoted in note 102).

106. IRC § 691 (1954).

107. IRC § 1014(c) (1954).

108. *Quick Trust*, 54 Tax Ct at 1342.

109. IRC § 691 (1954).

110. *Quick Trust*, 54 Tax Ct at 1342.

111. Id.

clusive.<sup>112</sup> Judge Tannenwald described the Code's analysis of income in respect of a decedent in the context of a deceased partner as detailed but not complete,<sup>113</sup> and engaged in a policy analysis that first focused on section 1014,<sup>114</sup> and then moved on to section 691.<sup>115</sup> Differing with "legal pundits,"<sup>116</sup> the court rejected the strict construction of section 691(e)<sup>117</sup> that requires entering a labyrinth at whose end there is only liquidating payments made to a deceased partner under section 736(a).<sup>118</sup> Instead the court directed itself to the predecessor of section 691,<sup>119</sup> section 126<sup>120</sup> of the 1939 Code, and judicial precedent<sup>121</sup> regarding that section.<sup>122</sup> Those cases<sup>123</sup> were interpreted to support the court's view that a general partner's distributive share as received by his successor in interest upon his death, to the extent it contains accounts receivable arising out of the rendition of personal services, constituted income in respect of a decedent under the 1939 Code.<sup>124</sup> The court noted that the legislative history of section 1014(c)<sup>125</sup> included a specific desire to continue the 1939 interpretation of IRD.<sup>126</sup> Legis-

112. *Id.* at 1343.

113. *Id.*

114. IRC § 1014 (1954).

115. *Quick Trust*, 54 Tax Ct at 1343 (cited in note 92).

116. *Id.* at 1343, n 11. The court noted that "[the petitioner's position has been the subject of extensive legal analysis and that it has some support among the legal pundits. See Arthur B. Willis, *Handbook of Partnership Taxation*, 389-395 (1957); M. Carr Ferguson, *Income and Deductions in Respect of Decedents and Related Problems*, 25 Tax L Rev 5, 100 et seq." *Quick Trust* at 1343, n 11.

117. IRC § 691(e) (1986) (text quoted in note 43).

118. IRC § 736(a) (1986) (text quoted in note 45).

119. IRC § 691 (1954).

120. IRC § 126 (1939) provides:

The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of this death or a prior period shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is required by the decedent's estate from the decedent . . . .

IRC § 126.

121. *Mandel v Sturr*, 266 F2d 321, 324 (2d Cir 1959). The *Mandel* court observed that "section 126 of the Internal Revenue Code of 1939 is high on the list of vaguely drafted legislation in a field notoriously complex . . ." *Mandel*, 266 F2d at 324.

122. *Quick Trust*, 54 Tax Ct at 1343.

123. *United States v Ellis*, 264 F2d 325 (2d Cir 1959); *Riegelman's Estate v Commissioner*, 27 Tax Ct 833, *aff'd* 253 F2d 315 (2d Cir 1958).

124. *Quick Trust*, 54 Tax Ct at 1342.

125. IRC § 1014(c) (1954).

126. *Quick Trust*, 54 Tax Ct at 1343, n 10. "According to the House committee report at the time the 1954 Code was enacted, sec. 1014(c) 'makes explicit the rule of existing law.' See HR No 1337, 83d Cong, 2d Sess, A267 (1954)." *Quick Trust*, 54 Tax Ct at 1343, n 10.

lative history is also cited by the court to support its view that sound tax policy requires unrealized receivables, whether or not subject to section 736(a),<sup>127</sup> to be treated as income in respect of a decedent.<sup>128</sup>

The Tax Court completed its analysis of the three possible dispositions of a partnership interest when it decided a case involving the sale of a partnership interest by the estate of a deceased partner. In *Woodhall*, the court was faced with a cash basis partnership in the lathing and plastering business known as Woodhall Brothers.<sup>129</sup> On the death of W. Lyle Woodhall, his estate sold his interest to the surviving partner, Eldon Woodhall, in accordance with the partnership agreement between the brothers. The court held that payments received by the estate of the deceased partner were income with respect to a decedent to the extent such payments were allocable to unrealized receivables and that the basis of the partnership interest did not equal the amount received on its sale because basis was the fair market value of the interest reduced by IRD amounts locked into the unrealized receivables.<sup>130</sup> The court restated its view that the application of section 691<sup>131</sup> is not limited by the terms of section 691(f),<sup>132</sup> and should be applied under a comprehensive interpretation of the Code.<sup>133</sup> The court

127. IRC § 736(a) (1954).

128. *Quick Trust*, 54 Tax Ct at 1343-44. The court indicated that:

Both the House and Senate committee reports specifically state that income rights relating to unrealized receivables or fees are regarded "as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur." See HR No 1337, 83d Cong, 2d Sess, 71 (1954); S Rep No 1622, 83d Cong, 2d Sess, 99 (1954). And the Senate Committee report adds the following significant language.

*The House bill provides that a decedent partner's share of unrealized receivables are [sic] to be treated as income in respect of a decedent.* Such rights to income are to be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes. \* \* \* *Your committee's bill agrees substantially with the house in the treatment described above but also provides that other income apart from unrealized receivables is to be treated as income in respect of a decedent.* (emphasis in the original).

*Quick Trust*, 54 Tax Ct at 1343-1344.

129. *Woodhall*, Tax Ct Memo (P-H) ¶ 69,278 at 1550-69.

130. *Id* at 1556-69 - 69-1557.

131. IRC § 691 (1954).

132. IRC § 691(f) (1954). Section 691(f) was redesignated as section 691(e) by section (l) of public law 88-570, Sept. 2, 1964.

133. *Woodhall*, Tax Ct Memo (P-H) ¶ 69,279 at 69-1556. The court preliminarily noted "that the application of section 691 is not circumscribed in section 691(f) by the reference to section 753, and through that section to section 736(a). Rather, we view these latter sections as supplementary. Nowhere in part II of Subchapter J (Income in Respect of Decedents) is there language placing restrictions on the application of section 691 to Subchapter

based its opinion on section 61,<sup>134</sup> and found that to the extent payments are allocable to unrealized receivables, those payments are income in respect of a decedent.<sup>135</sup>

Together, the Tax Court opinions in *Quick Trust*<sup>136</sup> and *Woodhall*<sup>137</sup> mark a departure from the statutory framework of the Code and establish judicial parameters for defining partnership income in respect of a decedent.<sup>138</sup> The court's reliance on legislative history may be faulted for its expansion of congressional intent beyond matters actually considered by Congress to the point of ascribing intent to matters Congress should have considered.<sup>139</sup> Nevertheless, the cases were decided more than twenty years ago and have not been refuted by Congress in any way. Pursuant to the so-called "reenactment doctrine,"<sup>140</sup> they may fairly be viewed

K (Partners and Partnerships). Nor is there limiting language in Subchapter K." *Id.* at 69-1556.

134. IRC § 61 (1954) instructs: "[g]ross income means income from whatever source derived." IRC § 61.

135. *Woodhall*, Tax Ct Memo (P-H) ¶ 69,279 at 69-1556, held "section 61 states that "gross income means income from whatever source derived" and, therefore, in computing IRD, no distinction can be made as to whether the payments come from a partnership or from an individual. The only question to be considered is whether in fact there is gross income which may properly be considered as IRD. In the instant case we find and hold that to the extent payments were allocable to unrealized receivables, said payments constitute IRD." 22138

*Id.*

136. *Quick Trust*, 54 Tax Ct at 1336.

137. *Woodhall*, Tax Ct Memo (P-H) ¶ 69-279 at 69-1549.

138. William S. McKee, William F. Nelson, Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 23.03[2][c], at 23-24 (Warren, Gorham and Lamont, 2d ed 1990) ("McKee, *Partnerships*"). The author's overview concluded:

[c] Court-Established Items of Income in Respect of a Decedent

The Tax Court and two circuit courts of appeal have recognized the existence of a third class of partnership IRD [section 736(a) payments and distributive share of partnership interest are the first two classes] items by treating a decedent's interest in zero-basis accounts receivable of a service partnership as IRD.

McKee, *Partnerships* at 23-34.

139. See Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 Tex L Rev 819, 851 (1991) ("Livingston, *Congress*"). Professor Livingston has written an excellent analysis of the application of legislative history in the interpretation of the Code. One interesting point is that the Tax Court will apply legislative history in an attempt to divine what Congress would have done had it considered the question before the Court. That is in distinction from the general use of legislative history to determine what Congress intended on a point which it did consider. Such a broad policy type of analysis may be justified in a triad approach suggested by Professor Livingston at page 872 of his article, and is very helpful in resolving the issues addressed in this article.

140. All of the Code sections at issue in this analysis have been reenacted without substantial change. The reenactment doctrine states that judicial and administrative interpretations of reenacted laws are presumed to have been reviewed by Congress and affirmed

as settled law concerning the sale of a deceased partner's interest and the continuation of such an interest.

### B. *Administrative Interpretation*

The general rule of Treasury Regulation section 1.736-1(a) provides that section 736(a)<sup>141</sup> only applies to payments made to a retiring or deceased partner's successor in interest upon the liquidation of the partnership interest.<sup>142</sup> Moreover the regulation specifically provides that:

Section 736 and this section do not apply if the estate other successor in interest of a deceased partner continues the partnership in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

Accordingly, when the partnership is continued by the successor in interest, there is no liquidating payment under section 736,<sup>143</sup> as interpreted by Treasury Regulation section 1.736-1(a).<sup>144</sup>

The only specific mention of IRD in the regulations under section 736<sup>145</sup> is found in Treasury Regulation section 1.736-1(c),<sup>146</sup> and it is merely a cross reference to section 753.<sup>147</sup> That section refers the reader back to section 736(a)<sup>148</sup> for purposes of defining IRD.<sup>149</sup>

---

as correct. See Eskridge, *Interpreting Legislative Inaction*, 87 Mich L Rev 87, 109 (1988) for a comprehensive explanation of the reenactment doctrine. See also *Lorillard v Pons*, 434 US 575, 580 (1978) which suggested that "Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change." *Lorillard*, 434 US at 580..

141. IRC § 736(a) (1986) (text quoted in note 45).

142. Treas Reg § 1.736-1(a)(1)(i) (1965) explains:

(a) Payments considered as distributive share or guaranteed payment. (1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership.

Treas Reg § 1.736-1(a)(1)(i).

143. IRC § 736 (1986).

144. Treas Reg § 1.736-1(a)(1)(i) (1965) (text quoted in note 142).

145. IRC § 736 (1986).

146. Treas Reg § 1.736-1(c) (1965). Subsection (c) of this regulation also provides a cross reference to section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

Treas Reg § 1.736-1(c).

147. IRC § 753 (1986) (text in note 44).

148. IRC § 736(a) (1986) (text in note 45).

149. IRC § 753 (1986) (text quoted in note 44).

The regulations under section 753<sup>150</sup> expand the concept of liquidating payments to include payments made by a third party in exchange for rights to future payments under section 736(a).<sup>151</sup> To the extent that the sale of a partnership interest by the successor in interest of a deceased partner includes a payment by the purchaser for rights to future payments under section 736(a),<sup>152</sup> Treasury Regulation section 1.753-1(a)<sup>153</sup> requires those payments to be considered IRD. This result is in accord with the *Woodhall* decision.<sup>154</sup> The regulations under section 753<sup>155</sup> do not specifically address the continuation of the partnership by a successor in interest, other than to say that a deceased partner's distributive share will be considered IRD.<sup>156</sup> Unrealized receivables in a cash method partnership are not part of a partner's distributive share, and are therefore beyond the scope of the regulation.

---

150. *Id.*

151. Treas Reg § 1.753-1(a) (1956) provides:

(a) Income in respect of a decedent under section 736(a) - All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

Treas Reg § 1.753-1(a).

152. IRC § 736(a) (1986) (text quoted in note 45).

153. Treas Reg § 1.753-1(a) (1956) (text quoted in note 151).

154. See *Woodhall*, 28 Tax Ct Mem, Dec 1438, aff'd 454 F2d 226 (9th Cir 1972). It should be noted however, that *Woodhall* was decided in 1969, fifteen years after the promulgation of Treas Reg § 1.753-1(a). Yet the court did not even cite the regulation in support of its holding. Instead the court relied on section 741 and the regulations thereunder that address questions concerning the sale of a partnership interest.

155. IRC § 753 (1986) (text quoted in note 44).

156. Treas Reg § 1.753-1(b) (1956) provides:

Other income in respect of a decedent. When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes.

Treas Reg § 1.753-1(b).

Distributive share is defined in Treas Reg 1.704-1 and includes all items of income. However, unrealized receivables of a cash method partnership are not items of income until received, and thus are not distributive shares within the meaning of Treas Reg 1.753-1(b). See also *United States v Bayse*, 410 US 441, 448 (1973), in which the Court said that distributive share refers to proportionate share of income of the partnership. Accounts receivable of a cash method partnership are not income until received. *Bayse*, 410 US at 448.

In our example, the continuation of the A and A accounting partnership by Athene and Arachne's successor in interest would seem to be outside the scope of section 736(a)<sup>157</sup> by operation of Treasury Regulation section 1.736-1(a).<sup>158</sup> Pursuant to the strict statutory analysis, the absence of a liquidating payment under section 736(a)<sup>159</sup> means that there is no IRD under section 691(e).<sup>160</sup> The absence of IRD would permit the application of section 1014(a)<sup>161</sup> without the exception provided in section 1014(c).<sup>162</sup> Arachne's successor would therefore take the partnership interest with a stepped up basis under sections 754<sup>163</sup> and 743(b).<sup>164</sup>

The sale of Arachne's interest would be treated differently under the regulations if the sale included an amount paid for a future right to a liquidating distribution. In that case, Treasury Regulation section 1.753-1(a)<sup>165</sup> would require that payment to be treated as having been received IRD through section 736(a).<sup>166</sup>

### C. Criticism Of Expansive IRD Theories

Some legal scholars have noted that the Code appears to limit the items that can be treated as IRD in the partnership context.<sup>167</sup> This so-called "exclusivity problem" can be succinctly stated as the absence of statutory authority for IRD under any circumstances other than those described in section 736(a).<sup>168</sup> Three members of a Congressional advisory group on partnership taxation have stated their belief that unrealized receivables are not income in respect of a decedent as to a purchaser or a successor to a deceased partner.<sup>169</sup> They argued that the Code contains a "statu-

157. IRC § 736(a) (1986).

158. Treas Reg § 1.736-1(a) (1956).

159. IRC § 736(a) (1986) (text quoted in note 45).

160. IRC § 691(e) (1986) (text quoted in note 43).

161. IRC § 1014(a) (1986) (text quoted in note 58).

162. IRC § 1014(c) (1986) (text quoted in note 60).

163. IRC § 754 (1986) (text quoted in note 97).

164. IRC § 743(b) (1986) (text quoted in note 98).

165. Treas Reg § 1.753-1(a) (1956).

166. IRC § 736(a) (1986).

167. See Willis, *Problems* (cited in note 86) and Ferguson (cited in note 116). But see McKee, *Partnerships* (cited in note 138).

168. IRC § 736(a) (1986) (text quoted in note 45). See Acker at A-36 (cited in note 27).

169. Willis, *Problems* at 1042 (1959) (cited in note 86):

If B and C purchase A's interest, or if A's successor continues as a partner, the values of goodwill and unrealized receivables are not income in respect of a decedent. . . .

Id.

tory oversight."<sup>170</sup> A technical reading of the Code supports that position.<sup>171</sup> Moreover, other commentators have suggested that the explicit nature of the relevant Code sections makes deviation from the Code a "difficult problem of statutory construction".<sup>172</sup>

Notwithstanding this difficulty, the Tax Court, as we have seen, has construed the relevant Code sections to include unrealized receivables in IRD. To the extent that a departure from the four corners of the Code may be justified, there should be a theoretical basis for the result. Accordingly, this analysis must now turn to the two primary partnership theories to aid in explaining the results reached by the Tax Court. Either theory, or both used together, should provide a coherent framework upon which to build the IRD interpretation that catches unrealized receivables when they are included in the assets of a partnership.

#### IV. ENTITY AND AGGREGATE PARTNERSHIP THEORIES

##### A. *Non-Tax Partnership Theory*

Before focusing on tax policy and legislative history it will be helpful to analyze the two theories of entity and aggregate partnership law in a non-tax context. In this way their virtues and vices can be examined without the stress of tax consequences inherent in either system.

At common law the partnership was not recognized as an organization with a separate legal personality.<sup>173</sup> This view is illustrated

170. Id: "This results apparently from a statutory oversight. The Internal Revenue Service may be expected to oppose this result." Id.

171. Carolyn K. Tenen, *Tax Problems of Service Partnerships*, 16 NYU Institute on Federal Taxation 137, 163 (1958) ("Tenen, *Tax Problems*"). This author concluded that "under the existing law, a good technical argument could be made that a sale of a decedent's interest to other partners for its estate tax value will not result in any ordinary income taxation to the estate." Tenen, *Tax Problems* at 163.

172. Id at 164.

173. Alfred F. Conrad, Robert L. Knauss, Stanley Siegel, *Agency Partnership Cases, Statutes and Analysis*, 414 (4th ed 1987) ("Conrad, *Agency Partnership*"). These authors explained the historical understanding of a partnership as follows:

We start with the fact that judges of two hundred years ago did not personify a partnership; it would have been as strange to them to speak of property owned by a partnership as to speak of property owned by a friendship. Later, as merchants came to personify partnerships, they occasionally conveyed real estate to partnership names. Judges were startled; sometimes they found that the conveyance conveyed title to those partners whose names appeared in the firm name; a few thought it might convey to all actual partners, but hardly any thought it could convey to the 'partnership.'

Conrad, *Agency Partnership* at 414.

by the historical treatment of property ownership by partners. Prior to the adoption of The Uniform Partnership Act<sup>174</sup> ("UPA"), judges were reluctant to find a partnership capable of owning property.<sup>175</sup> Under section 8 of the UPA, a partnership is now fully capable of owning property in its own right, like any other legal personality.<sup>176</sup>

Upon the death of a partner, the question of partnership property ownership becomes a little more difficult. In England, courts permitted control and administration of the partnership personal property to remain with the surviving partner.<sup>177</sup> The English doctrine of equitable conversion permitted a similar treatment of partnership realty.<sup>178</sup> Under common law in the United States the doctrine of equitable conversion treated partnership realty like partnership personality, but only to the extent necessary for partnership purposes.<sup>179</sup> The question is now resolved by UPA sections 25(2)(d), 25(2)(e)<sup>180</sup> and 26,<sup>181</sup> which together adopt a hybrid of

174. Uniform Partnership Act § 8 (1969) ("UPA") provides:  
Partnership Property

(1) All property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership, is partnership property.

(2) Unless the contrary intention appears, property acquired with partnership funds is partnership property.

(3) Any estate in real property may be acquired in the partnership name. Title so acquired can be conveyed only in the partnership name.

(4) A conveyance to a partnership in the partnership name, though without words of inheritance, passes the entire estate of the grantor unless a contrary intent appears.

UPA § 8.

175. See note 174 and accompanying text.

176. Uniform Partnership Act § 8 (1969) (text quoted in note 174).

177. Conrad, *Agency Partnership* at 415, 416 (cited in note 173). These authors explained that:

The English courts solved the problem quite painlessly with respect to the partnership personal estate. They promptly recognized that sole control and administration of the partnership goods should remain with the surviving partner. He was not, however, like a joint tenant, who as winner took all. The surviving partner had to account to the decedent's executor, or administrator, who would in turn pay over the proceeds like the proceeds of other personality, to the decedent's next of kin.

Id.

178. Id at 416. In England "the pattern of devolution adopted for partnership real estate was ultimately the same as had been followed for partnership chattels. The rights of use and disposition passed from the decedent to his surviving partners; the proceeds of liquidation were distributed by the administrator to the next of kin." Id.

179. Id at 416. In the United States "many American courts accordingly decided that partnership real estate should be treated like partnership personality only to the extent necessary for partnership purposes." Id.

180. UPA § 25(2)(d) (1969) provides:

the English and American rules that converts real estate into personality for purposes of distribution.<sup>182</sup>

Although the UPA incorporates both entity and aggregate principles in the various contexts of partnership business,<sup>183</sup> the evolution of partnership property law shows a move from an aggregate approach to one more consistent with an entity partnership theory.<sup>184</sup> UPA section 13<sup>185</sup> appears to spring almost exclusively from

#### NATURE OF A PARTNER'S RIGHT IN SPECIFIC PARTNERSHIP PROPERTY

(1) A partner is co-owner with his partners of specific partnership property holding as a remnant in partnership.

(2) The incidents of this tenancy are such that:

\* \* \*

(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

(e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin.

UPA § 25(2)(d).

181. UPA § 26 (1969) provides:

#### NATURE OF A PARTNER'S INTEREST IN THE PARTNERSHIP

A partner's interest in the Partnership is his share of the profits and surplus, and the same is personal property.

UPA § 26.

182. Harold Gill Reuschlein, William A Gregory, *The Law of Agency and Partnership* 64 (West, 2d ed 1990) ("Gill, *Agency*"). These authors noted:

The Uniform Partnership Act does not expressly adopt either the American or the English rule, yet clearly the drafters intended that section 26 should be used to incorporate the English out-and-out conversion theory rather than the American rule of partial conversion. As a result, nearly all of the courts considering section 26 have applied the English rule, that real estate which becomes personal property for the purposes of a partnership remains personal property for the purposes of distribution.

Gill, *Agency* at 64.

183. Weidner, *Perspective* at 7 (cited in note 9). This article concluded that "the extent to which the final product incorporates the entity as opposed to the aggregate theory is very much in the eye of the beholder. The Uniform Act was greeted by the suggestion that it embodied the entity theory much more than its drafters cared to admit. Many still believe that entity notions permeate the Uniform Act, although there is also respected authority that the aggregate theory predominates." *Id.*

184. Gary S. Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law*, 42 Ark L Rev 395, 400 (1989) ("Rosin, *Partnership Law*"). The author noted:

The National Conference of Commissioners on Uniform State Laws (Uniform Law Commissioners) has recently undertaken a comprehensive revision of the UPA. Both the UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Associations of the American Bar Association (ABA Subcommittee) and the Chief Reporter for the Uniform Law Commissioners drafting committee have recommended that the revision "increase" the UPA's emphasis on the entity concept. (citations omitted)

the entity theory, while the omission of a definition of the partnership as a "legal person" comes directly from aggregate partnership theory.<sup>186</sup> Individual provisions can be justified in terms of either theory without invalidating the other. Consistency of theory is not a central requirement of the UPA.<sup>187</sup>

The theoretical support for a diversified statute that employs both entity and aggregate partnership provisions within one statutory scheme can be found in a functional analysis of partnerships.<sup>188</sup> A functional view of partnerships ignores the fiction of partnership personhood, or entity, and instead requires an examination of the underlying rights and obligations of the partnership.<sup>189</sup> Pursuant to this approach, the intent of the partners becomes the primary means of resolving partnership disputes. The intent of the partners to carry on a single business, separate from other matters, with commonly owned property, may require either

---

Rosin, *Partnership Law* at 400.

185. UPA § 13 (1969) provides:

**Partnership Bound by Partner's Wrongful Act**

Where, by any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners, loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefor to the same extent as the partner so acting or omitting to act.

UPA § 13.

186. Weidner, *Perspective* at 9 (cited in note 9). Weidner concluded:

In short, the Uniform Act was still warm from the oven when the debate started over whether it reflected an aggregate or an entity theory. On the one hand, provisions such as the one that states that 'the partnership is liable' for wrongful acts of the partners clearly reflect an entity approach. On the other hand, the Uniform Act scrapped the initial definition of a partnership as 'a legal person' formed by the association of two or more individuals. (citations omitted)

Id.

187. Id. Weidner noted that "many of its [UPA's] provisions can be rationalized in terms of either theory." Id.

188. Rosin, *Conceptualism* at 400 (cited in note 184): Rosin began this article by stating that:

The thesis of this article is that the revision of the UPA should recognize and reinforce the UPS's existing functional approach. Only a functional approach allows direct evaluation of whether, for any given purpose, the partners should be treated collectively (like an entity) or separately (as an Aggregate). Under the functional approach, that determination is not made legalistically on the basis of the metaphysical person-hood of a partnership. Instead, it is made realistically in light of: (1) the relevant rights and obligations of partners under partnership law generally, and (2) the policy considerations relevant to a particular purpose.

Id.

189. Id at 415-16. Rosin found that "simply put, the UPA formally recognizes that the nature of the partnership relationship requires that the rights and obligations arising thereunder be treated differently than rights and obligations that do not. (citations omitted)" Id.

entity or aggregate treatment of specific partnership items depending upon the context of that intent.<sup>190</sup>

One illustration of the functional approach may be seen in the interplay between UPA section 26<sup>191</sup> and UPA section 9(3).<sup>192</sup> Pursuant to those sections, a partner's interest in the partnership is personal property and may be conveyed, but partnership property itself may not be conveyed by the individual partner acting in his own interest.<sup>193</sup> The intent of the parties with respect to ownership of property used in the business is fundamentally different from their intent concerning ownership of an interest in the partnership. Functionally, partnership property is intended to be an asset of the partnership entity. The intent of the partners is to treat the asset as owned by the collective partnership rather than the individual partner. The partner's interest in the partnership, however, is not intended to be an asset of the entity. It is a separate right, unique to each partner, that includes the immediate right to profits and surplus. Accordingly, the entity theory works best to explain the prohibition on assignment of partnership property under UPA section 9,<sup>194</sup> and aggregate theory works best to explain the treatment of a partner's interest in the partnership under UPA section 26.<sup>195</sup> Although there has been considerable debate about

190. *Id.* Rosin further explained:

This separate treatment of partnership-related rights and obligations is not based on the fiction that a partnership is a metaphysical unity, a separate entity or a legal person. Instead, the need for separate treatment derives from the underlying realities of the partnership itself. First, as a matter of fact, the partners are conducting a single business. Second, as a matter of fact, partners tend to segregate business related matters from purely personal matters. Third, when partners acquire common property for business purposes, they do so with the intent of dedicating that property to the business. (citations omitted)

*Id.*

191. UPA § 26 (1969) (text quoted in note 181).

192. UPA § 9(3) (1969) provides:

(3) Unless authorized by the other partners or unless they have abandoned the business, one or more but not less than all the partners have no authority to:

- (a) Assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,
- (b) Dispose of the good-will of the business,
- (c) Do any other act which would make it impossible to carry on the ordinary business of the partnership,
- (d) Confess a judgment,
- (e) Submit a partnership claim or liability to arbitration or reference.

UPA § 9(3).

193. Rosin, *Conceptualism* at 417-19 (cited in note 184).

194. UPA § 9 (1969).

195. UPA § 26 (1969) (text quoted in note 181).

the interface between the two partnership theories, current partnership scholars suggest that the UPA should move away from aggregate theory and toward even greater reliance upon an entity model.<sup>196</sup> Curiously, the only limit upon that model is the effect of the Internal Revenue Code on partnership issues.<sup>197</sup>

The Internal Revenue Code was not created in a vacuum. It is responsive to the same economic forces and must address the same issues as those addressed in the UPA. The distinguishing factor, of course, is that the Code must add a level of analysis that justifies the imposition of tax upon partners based upon partnership income. The next part of this article will therefore address the results of an application of tax policy to the partnership theories developed in connection with the UPA.

## B. *Partnership Tax Theory*

### 1. *Tax Policy and the Primacy of Income Classification*

It may by now be a cliché to note that “the tax tail wags the state organization dog”,<sup>198</sup> but it is nevertheless true that tax considerations may be the ultimate constraint on partnership activity.<sup>199</sup> The pass-through nature of partnerships has been extremely

---

196. Weidner, *Perspective* at 9-10 (cited in note 9). The author observed: Given that the entity theory seems to inhere in the Uniform Act more than its final authors cared to admit, given that the entity theory seems to cut in favor of rather than against simplicity, and given that partnerships of significant size and complexity have become common, including partnerships with corporations and limited partnerships as partners, there is widespread opinion that a revised Uniform Act should more directly adopt an entity model. (citations omitted)

Id.

197. UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, *Should the Uniform Partnership Act be Revised?*, 43 Bus Law 121, 124 (1987). See also Weidner, *Perspective* at 10 (cited in note 9).

198. Weidner, *Perspective* at 36-7. Weidner noted:

Some of the suggested changes to the Uniform Act appear to bear at least indirectly on the tax classification of partnerships. Continuity of life and free transferability of interests appear to be enhanced by provisions such as those requiring registration of partnerships and those redefining dissolution and its consequences. Centralized management might be strengthened by provisions authorizing voting and limiting the agency of certain partners. None of the changes more broadly discussed, however, would restrict the unlimited personal liability of partners. That personal liability has great significance for federal income tax purposes. Indeed, given that the unlimited personal liability of profit sharers is a policy upon which states seem to place little or no value, as indicated by their recent liberalization of limited partnership statutes, one wonders whether the tacit concession of the personal liability of partners is in recognition of the fact that the federal tax tail really wags the state organization dog.

Id.

199. Id at 33: “[T]ax law may be the ultimate constraint on the partnership project.”

attractive to investors interested in tax advantaged investments. The transfer of income or loss to individual partners is not an inherent partnership right. It exists only by legislative grace. Accordingly, investors who wish to benefit from that feature of the organization known to the Internal Revenue Code as a partnership must obey the Code in forming their organization.

The Code employs a pragmatic method for taxing partnership activity.<sup>200</sup> Entity and aggregate treatment of partnership issues are both present in the Code. Taxpayers may, in certain limited circumstances, choose between those theories.<sup>201</sup> Rather than adopt one theory to the exclusion of the other, the Code employs both.<sup>202</sup> In this way the Code can be viewed under the same functional type of analysis that can be used to explain partnership law applications of entity and aggregate theory.

Although primarily pragmatic, subchapter K contains illustrations of both entity and aggregate partnership theories. Neither theory was adopted to the exclusion of the other. Individual problems presented by specific partnership items or transactions are addressed individually. Entity and aggregate partnership theory present alternative methods for resolving partnership issues, but normative tax policy determines which of those solutions sup-

---

Id.

200. Id at 32. "The federal income tax law governing the taxation of partners and partnerships should be considered for two basic reasons. First, the tax law suggests that pragmatism rather than partisanship be brought to the entity/aggregate controversy." Id.

201. Id at 32-33.

Just as there are separate statutes under state law governing corporations and partnerships, there are separate subchapters of the Internal Revenue Code (the Code) governing corporations and partnerships. The tax law of Subchapter K, governing partners and partnerships, is helpful because it indicates a pragmatic approach to the entity/aggregate dichotomy. It suggests that there is no need to adopt one theory as the exclusive theory. It suggests, instead, that some questions are best handled with an entity approach whereas others are best, or at least satisfactorily, handled through an aggregate approach. It also suggests that in other cases, the partners themselves may elect either an entity or an aggregate approach.

Id.

202. See *US v Basye*, 410 US 441, 448, n 8 (1973), which indicated that:

There has been a great deal of discussion in the briefs and in the lower court opinions with respect to whether a partnership is to be viewed as an 'entity' or as a 'conduit.' We find ourselves in agreement with the Solicitor General's remark during oral argument when he suggested that '[i]t seems odd that we should still be discussing such things in 1972.[citation omitted]. The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares.

*Basye*, 410 US at 448, n 8.

ports the imposition of tax. An illustration of this approach can be seen in the Code's treatment of a partnership as a non-taxpayer,<sup>203</sup> while at the same time allowing the partnership its own tax year<sup>204</sup> in which income is computed<sup>205</sup> and audits are conducted at the partnership level.<sup>206</sup> Occasionally the drafters found it necessary to apply both theories to different issues present in a single tax event. Section 743,<sup>207</sup> which addresses the transfer of a partnership interest by sale or upon the death of a partner, is sometimes cited as an example of a provision that gives the taxpayer a choice between aggregate and entity theories.<sup>208</sup> The general rule of section

203. IRC § 701 (1986) (text quoted in note 8).

204. IRC § 706(b)(1)(A) (1986) provides:

(b) TAXABLE YEAR. -

(1) PARTNERSHIP'S TAXABLE YEAR. -

(A) PARTNERSHIP TREATED AS TAXPAYER. - The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

IRC § 706(b)(1)(A).

205. IRC § 703(b) (1986) provides:

(b) ELECTIONS OF THE PARTNERSHIP. - Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership,

IRC § 703(b).

206. IRC §§ 6221 (1986); 6222 (1986); 6223-6231 (1986).

207. IRC § 743 (1986) provides:

(a) GENERAL RULE. - The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY. - 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, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only . . . .

IRC § 743.

208. Weidner, *Perspective* at 34 (cited in note 9). Weidner illustrates this choice with the following example:

Other provisions give partners the choice of an aggregate or an entity model. For example, the general rule is that, when a partner purchases his partnership interest, he will not be given a special basis in each of the partnership's assets to reflect the price he paid for his partnership interest. [IRC § 743(a)] On the other hand, if the

743(a)<sup>209</sup> recognizes the UPA distinction between an interest in a partnership and an interest in partnership property. Transfer of an interest in a partnership will not trigger a change in basis of the partnership property unless the provisions of section 743<sup>210</sup> are met. The Code provides for an election on the part of an acquiring partner to either ignore the individual assets of the partnership and treat it like an entity, or to adjust the basis in individual assets of the partnership under an aggregate partnership theory. Thus, whereas the UPA<sup>211</sup> treats a partnership interest as a property right under an entity approach and forbids a fragmentation of the partnership interest by denying a property interest in partnership property, the Code recognizes a property interest in individual partnership assets to the extent of assigning individual basis to those assets in the hands of an acquiring partner.<sup>212</sup>

The Tax Court has said that the question of income in respect of a decedent goes to the very foundation of partnership taxation theory.<sup>213</sup> The analysis requires a resolution of the tension inherent in treating a partnership interest as a bundle of property rights, of which unrealized receivables is but one such right, and treating such an interest as an entity separate and apart from the individ-

partnership files an election, those who purchase partnership interests may ignore the entity approach and claim they purchased a direct interest in the underlying assets of the partnership. As a result, each partner will be given a special basis in the underlying partnership assets to reflect the price she paid for her partnership interest.[IRC § 743(b)].

Id.

209. IRC § 743(a) (1986) (text quoted in note 207).

210. IRC § 743(a).

211. See UPA §§ 9(3) (text quoted in note 192) and 26 (1969) (text quoted in 181).

212. Section 743 allows a purchaser of a partnership to avoid tax on gain that she has already paid for. On the sale of a partnership asset gain would be reported as income to each partner equal to the difference between the sale price of the asset and the basis of that asset. If the new partner had paid a price for her partnership interest that reflected the fair market value of the asset she would be unfairly taxed on the increase in its value. Ignoring the corresponding increase in basis due to the sale which would ultimately correct the problem, section 743(b) allows the new partner to avoid taxation by adjusting her basis in the sold partnership property for purposes of determining her share of the gain. See Babette Barton, et al, *Cases and Materials Taxation of Business Enterprise 1992-1993*, ¶ 19,115 (CCH, 1991) ("Barton, Cases").

213. *Quick Trust*, 54 Tax Ct at 1344, exemplifies this belief when it observed:

Many of the assertions of the parties have dealt with the superstructure of the partnership provisions - assertions based upon a technical and involuted analysis of those provisions dealing with the various adjustments and the treatment to be accorded to distributions after the basis of the partnership has been determined. But, as we have previously indicated, the question herein involves the foundation, not the superstructure, i.e., what is the basis of petitioner's partnership interest. [citations omitted]

Id.

ual assets of the partnership. Treating the partnership as a bundle of property rights under an aggregate theory would support the Tax Court's application of income in respect of a decedent to unrealized receivables. Treating the partnership as an entity would undermine the Tax Court's position and support a technical reading of the Code to limit income in respect of a decedent to cases in which the entity liquidates the interest of a deceased partner under section 736(a).<sup>214</sup>

The central issue in *Quick Trust*<sup>215</sup> was the basis adjustments sought by a successor in interest under section 743.<sup>216</sup> While other Code sections may be explained by either entity or aggregate principles, section 743<sup>217</sup> seems to require application of both theories. Accordingly, the entity and aggregate theories of partnership taxation, as focused through the lens of section 743,<sup>218</sup> are concentrated on the successor of the interest of a deceased partner. Entity theory of partnership taxation forms the foundation for section 743<sup>219</sup> in that the transfer of an interest in a partnership entity causes a mismatch between the acquiring partner's basis in her interest and the basis the partnership has in its assets which are represented in the acquiring partner's partnership interest. Reconciliation of those bases is consistent with aggregate theory. In the context of the death of a partner, aggregate theory would require an examination of each partnership asset to determine whether it was within the general rule of section 1014<sup>220</sup> or its exception, section 1014(c),<sup>221</sup> and thereby outside the basis adjustment provided by section 743.<sup>222</sup>

The Tax Court has noted that there is no statutory provision dealing with the specific problem of the basis in the partnership interest of a transferee of a deceased partner.<sup>223</sup> Accordingly, it has

---

214. IRC § 736(a) (1986) (text quoted in note 45).

215. *Quick Trust*, 54 Tax Ct at 1340-41.

216. IRC § 743 (1954).

217. IRC § 743 (1986) (text quoted in note 207).

218. IRC § 743.

219. *Id.*

220. IRC § 1014 (1986).

221. IRC § 1014

222. IRC § 743 (1986).

223. See for example, *Quick Trust*, 54 Tax Ct at 1345, where the court noted: Petitioner would have us equate the absence of statutory language specifically dealing with the problem herein and purported inferences from tangential provisions with an intention on the part of Congress entirely to relieve from taxation an item that had previously been held subject to tax.

addressed itself to the fundamental question of the nature of basis in a partnership interest.<sup>224</sup> This inquiry addresses the bedrock principles that support the Code's treatment of partnership basis.

The court employed a pragmatic approach that questioned the entity and aggregate theories for the purpose of determining which theory is better in explaining a result that furthers normative tax policy. The court's analysis was based upon both its reading of the Code and its analysis of legislative history concerning entity and aggregate principles,<sup>225</sup> in the larger context of sound tax policy. Accordingly, the court tested each approach against the yardstick of recognition of income and the corollary of basis adjustment, a standard that controls not just partnership issues but is superimposed over the entire Code. Fidelity to that standard supersedes any question of consistency with entity or aggregate partnership theory, because the principle of income recognition is a normative principle found throughout the Code. Hence, the more basic consideration of the nature of income underlies the analysis of partnership tax theory, notwithstanding any secondary analysis under non-tax partnership entity and aggregate theory. This return to basic income tax principles is pragmatic because it requires an analysis of the substance of the income item in question. It is similar to the functional analysis of partnership law in that both are concerned with entity and aggregate theories as explanations of functional or pragmatic results that are required by superior principles of partnership intent or tax policy respectively. The first inquiry is not which theory to apply; rather it is which theory best explains the result required by a superior principle, namely the preservation of income. After resolution of that first order principle, entity or aggregate theory can be used to resolve ancillary issues such as basis.

## 2. *Implementation Of Tax Policy*

The drafters of the 1954 Code recognized that "[t]he existing tax

---

224. Id at 1344. The court declared that "the question herein involves the foundation, not the superstructure, i.e., what is the basis of petitioner's partnership interest?" Id.

225. Id at 1343. The following passage addresses this analysis:

Thus, to the extent that a "plain meaning" can be distilled from the partnership provisions of the 1954 Code, we think that it is contrary to petitioner's position. In point of fact, however, we hesitate to rest our decision in an area such as is involved herein exclusively on such linguistic clarity and purity. [citation omitted]. However, an examination of the legislative purpose reinforces our reading of the statute.

Id.

treatment of partners and partnerships is among the most confused in the entire income tax field."<sup>226</sup> Accordingly, they took the opportunity to articulate the theoretical, as well as practical, reasons supporting the provisions they drafted.

The troublesome area of transactions between partners and partnerships became a clearly identified battleground between entity and aggregate theory.<sup>227</sup> The House Report specifically adopted an entity foundation upon which it built partnership Code sections to implement that approach.<sup>228</sup> Although the drafters failed to expressly adopt either theory in the context of unrealized receivables as income in respect of a decedent, the legislative history, taken in total, appears to employ aggregate principles in addressing this issue.<sup>229</sup> Nowhere is this more evident than in the portion of the House Report that explains the anti-abuse provisions of the proposed new partnership sections. Here the drafters explain that there ought to be no exception from ordinary income for unrealized receivables based solely upon inclusion of such items in a partnership.<sup>230</sup> Consistent with the first order principle that

---

226. Ways and Means Committee Report on Internal Revenue Code of 1954, HR No 1337, 83d Cong, 2d Sess (1954), in 3 USCANN 4017, 4091 (1954) ("House Report").

227. House Report at 4093:

When a partner sells property to, or performs services for the partnership, the problem arises whether the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership (the "entity" approach). An alternative ("aggregate" approach) is to view the partner as dealing with himself to the extent of his own interest and as dealing with the partnership with respect to the balance of the transaction.

Id.

228. Id at 4093: "Because of its simplicity of operation, the 'entity' rule has been adopted." Id.

229. Id at 4097. The House Report addresses income in respect of a decedent under the general heading of unrealized receivables within the context of section 751. That section treats some assets of a partnership as outside the entity for purposes of determining gain on the disposition of a partnership interest. It treats the partnership as an aggregation of specific property rights for purposes of preventing the conversion of items of ordinary income, locked in the partnership entity, from being transformed into capital gain on the disposition of the partnership interest by a partner. That rationale is applied to unrealized receivables in the partnership on the death of a partner. Hence, the legislative history, taken as a whole, seems to adopt an aggregate approach to IRD in the partnership context.

230. Id at 4097-4098:

The provisions relating to unrealized receivables or fees and appreciated or depreciated inventory are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded

unrealized receivables must generate ordinary income, they must continue to do so even when they are transferred in the form of a component of a partnership interest. The entity is "pierced" and the transfer of an interest in the entity is broken into its constituent parts for determining the taxability of the proceeds from the transfer.<sup>231</sup>

Aggregate partnership theory also supports the House Report's statement that a deceased partner's share of unrealized receivables will be treated as IRD.<sup>232</sup> The partnership entity is fractured in order to serve a higher principle, in this case preserving the fundamental principle of income recognition. The superior mandate that no item of income go untaxed remains intact in the partnership arena only if individual items of income remain so, regardless of their presence in the partnership entity.

The invention of section 751 and its treatment of unrealized receivables as unique partnership assets is perhaps the best example of subjugating partnership theory to the higher principles of income recognition.<sup>233</sup> Pursuant to section 751,<sup>234</sup> the entity theory that is normally applied to an interest in a partnership is ignored

---

an individual entrepreneur.

Id.

231. See IRC §751(a) (1986) (text quoted in note 235).

232. House Report at 4097 (cited in note 226):

A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent. Such rights to income will be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes.

Id.

233. Id at 4096-4097:

Under present decisions the sale of a partnership interest is generally considered to be a sale of a capital asset, and any gain or loss realized is treated as a capital gain or loss. It is not clear whether the sale of an interest whose value is attributable to uncollected rights to income gives rise to capital gain or ordinary income. There is also doubt under present law whether the basis of the assets of the partnership may be adjusted, or is required to be adjusted, to reflect the purchase price paid by a new partner for his interest.

\* \* \*

In order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests, certain rules have been adopted by your committee which will apply to all dispositions of partnership interests. The bill provides that, if in connection with the transfer of a partnership interest, the partner receives any amount attributable to his share of (1) the unrealized receivables and fees of the partnerships or (2) substantially appreciated or depreciated inventory or stock in trade, such amounts are to be treated as ordinary gain or loss. In effect, the partner is treated as though he disposed of such items independently of the rest of his partnership interest.

Id.

234. IRC § 751 (1986).

for all cases in which the partnership interest includes unrealized receivables or inventory items.<sup>235</sup> These components of the partnership interest, which would otherwise generate ordinary income if earned outside the partnership context, are segregated from the partnership interest and treated as items of ordinary income upon sale or exchange of an interest, notwithstanding that the sale is treated as a sale of a capital asset for all other purposes.<sup>236</sup> In other words, the transfer of a property interest in the partnership carries with it the transfer in the individual partnership assets. The assets that generate ordinary income on sale continue to do so for purposes of determining the gain on the transaction to the selling partner.

As we have seen, the strictly statutory approach of sections 753,<sup>237</sup> 736(a),<sup>238</sup> and 691<sup>239</sup> requires the segregation of unrealized receivables from the rest of the partnership interest when there is a payment in liquidation of an interest of a deceased partner. The Tax Court has found support in legislative history for the same treatment in the contexts of continuation of the partnership interest or sale of that interest.<sup>240</sup> The House Report supports that position and states that “[a] decedent partner’s share of unrealized receivables and fees will be treated as income in respect of a decedent.”<sup>241</sup> Although the report does not articulate a theoretical basis for that position, it is consistent with the aggregate approach used with respect to unrealized receivables under section 751(a).<sup>242</sup> Moreover, it confirms the theory that normative tax principles supersede entity or aggregate theory and, specifically, that the normative principle of income recognition supersedes entity theory in

---

235. IRC § 751(a) (1986) provides:

(a) SALE OR EXCHANGE OF INTEREST IN PARTNERSHIP. - The amount of any 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

(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.

IRC § 751(a).

236. *Id.*

237. IRC § 753 (1986) (text quoted in note 44).

238. IRC § 736(a) (1986) (text quoted in note 45).

239. IRC § 691 (1986).

240. *George Edward Quick Trust v Commissioner*, 54 Tax Ct 1336, aff'd 444 F2d 90 (8th Cir 1972); *Chrissie H. Woodhall v Commissioner*, 28 Tax Ct Mem Ced 1438, aff'd 454 F2d 226 (9th Cir 1972).

241. House Report at 4097 (cited in note 226).

242. IRC § 751(a) (1986) (text quoted in note 235).

matters concerning IRD.<sup>243</sup>

Entity theory cannot justify a fragmentation of the partnership interest. Aggregate partnership theory, on the other hand, requires it. Unrealized receivables are therefore the exception to the entity approach to partnerships initially expressed by the drafters of the Code. Maintaining the higher principle of income recognition requires an exception to entity theory for partnerships when income items such as unrealized receivables are included in the partnership entity. At such times the entity must be ignored, and the income items split out for purposes of recognizing income on the sale or exchange of those items. Furthermore, consistent with the treatment of unrealized receivables under section 751,<sup>244</sup> there must also be an exception to the partnership entity for IRD, not only in the event of termination of the partnership interest, but also in the case of a transfer of that interest to a successor or the sale of that interest to a third party.

### C. *Reconciliation Of Tax And Non-Tax Partnership Theories*

Commentators have recognized that it is possible, even desirable, to use both entity and aggregate theories in crafting the UPA and the Code.<sup>245</sup> That does not mean, however, that both theories should be used in the resolution of a single partnership issue. If we focus on the issue of determining the basis of a partnership interest and the underlying partnership assets upon the death of a partner, we can apply normative tax principles and then analyze the result in terms of entity and aggregate partnership theory.

Entity theory applied generally, in other words, not limited to the case of a deceased partner, appears to work best when the partnership interest contains no unrealized receivables or appreciated inventory. Section 751(a)<sup>246</sup> would not come into play, and an interest in the partnership entity would be treated like an interest in any other sort of entity, for example, a corporation. In other words, it would be a capital asset. No further inquiry would be made into its constituent parts and the basis of the interest in the hands of a successor would be its fair market value as obtained

---

243. Weidner, *Primer* at 33 (cited in note 7). The author observed: "The terribly complex rules of section 751 are basically designed to require the recognition of ordinary income on the sale of an interest in a partnership that holds 751 assets and on certain distributions from such a partnership." (citations omitted). *Id.*

244. IRC § 751 (1986) (text quoted in note 234).

245. Weidner, *Perspective* at 32-33 (cited in note 9).

246. IRC § 751(a) (1986).

either through sale or through the application of section 1014.<sup>247</sup> Once the partnership interest is examined for purposes of detecting the presence of hot assets, however, the aggregate theory has been triggered. There can be no turning back, no return to entity principles. The entity, having once been partitioned, cannot be reconstituted. Only by fragmenting the partnership interest into its constituent parts can an asset-by-asset analysis be performed. That fragmentation is itself an application of aggregate partnership theory. Accordingly, partnership interests are not thereafter regarded as interests in an entity. The most that can be said is that after an examination of the aggregate components of the partnership interest, no reason can be found to fragment the group into individual and differing subgroups.

Some commentators have concluded that the possibility of the absence of hot assets, and the corresponding treatment of the partnership interest as an entity, means that there is really a "modified entity approach" at work.<sup>248</sup> It seems, however, that the initial examination of a partnership interest extinguishes the entity theory. The Code requires an examination of each asset for the purposes of classifying it under section 751.<sup>249</sup> It then prescribes specific, and differing, treatment for those assets based upon the initial classification. The fact that after such a procedure the interest may be treated as containing some or none of the hot assets described in section 751<sup>250</sup> does not change the theory which requires the initial examination. The mere resemblance of the final product to an entity does not alter the process which generated that product. It is the process, the approach, the analysis, that we are attempting to define, not the product.

The foundation of the aggregate approach to partnership theory is the splitting of the partnership into discrete bundles of rights and obligations. The partnership interest is composed of many such rights and responsibilities.<sup>251</sup> By examining those rights individually pursuant to the superior normative principle of income recognition, we employ an aggregate theoretical framework that ignores the partnership entity. Even if there were no unrealized receivables present in the partnership interest and it were therefore disposed of, or valued, as if it were a share of an entity, the exami-

---

247. IRC § 1014 (1986).

248. Lind, *Fundamentals* at 213 (cited in note 34).

249. IRC § 751 (1986).

250. IRC § 751.

251. UPA §§ 13, 14, 15, 18, 24, 25, 26 (1969).

nation of the interest for the purpose of deciding whether it contains partnership property defined as unrealized receivables is aggregate in nature.

There is no real mix of aggregate and entity theory to the disposition of the partnership interest, either upon the death of the partner or upon an inter vivos disposition of the interest: there is only aggregate theory. The fact that after the application of the aggregate inquiry it is determined that there is no reason to fragment the interest into its constituent parts, and the interest is treated as a single unit, does not change the nature of the original inquiry. The initial aggregate inquiry having been accomplished and the higher-order principle of income recognition having been served, the partnership interest can now be transferred or valued with the benefit of a comprehensive analysis of each of its constituent parts.

## V. HOT ASSETS: THE SCOPE OF UNREALIZED RECEIVABLES

### A. *The Nature Of Hot Assets*

Armed with an aggregate partnership theory, that is, treatment of the partnership interest as an aggregation of rights and responsibilities, we now require a refinement of the definition of those constituent parts. In other words, we need a definition of unrealized receivables.

The Code defines unrealized receivables in section 751(c)<sup>252</sup> to include a wide array of items in addition to earned but not yet received income. Included in the definition are assets that generate ordinary income to the partnership. Assets such as mining property, farm land, and franchises are illustrative of the type of asset which, as partnership property, will trigger the recognition of ordinary income on the disposition of a partnership interest under section 751(a).<sup>253</sup> It is the presence in the partnership of these so-called "hot assets" that requires the aggregate approach to resolving questions concerning the proper tax treatment of income from the disposition of a partnership interest. Each of the assets in the partnership is examined and classified prior to resolution of the ultimate question of recognition of income.

The scope of section 751(c),<sup>254</sup> unrealized receivables, far exceeds those items that would be so classified for purposes of income in

---

252. IRC § 751(c) (1986) (text quoted in note 37).

253. IRC § 751(a) (1986) (text quoted in note 235).

254. IRC § 751(c) (1986) (text quoted in note 37).

respect of a decedent in the non-partnership context. If this were the end of the analysis of the partnership interest under section 751(c),<sup>255</sup> then all of the items contained therein could be considered IRD in the partnership context.<sup>256</sup> However, having once established an aggregate theoretical analysis of IRD at the partnership level, it is theoretically sound to continue that analysis throughout the components of the partnership interest. In other words, section 751(c)<sup>257</sup> should not only be viewed as creating a sub-entity within the partnership but should also be viewed as a bundle of items that should be considered individually.

### B. *Proper Treatment Of Hot Assets As Income In Respect Of A Decedent ("IRD")*

If aggregate partnership theory explains IRD as applied to partnerships upon the death of a partner, it follows that each component of the partnership interest should be examined to determine its individual proper treatment. The partnership, when viewed as an aggregation of individual discrete items, is open to individual, item-by-item scrutiny.<sup>258</sup> The proper question to ask in resolving such treatment concerns the nature of the income item under normative principles of income in respect of a decedent generally, in other words, outside the partnership context, because it is the application of those principles to unrealized receivables that initially required the segregation of unrealized receivables from other partnership assets under sections 691(e),<sup>259</sup> 753,<sup>260</sup> and 736.<sup>261</sup>

The touchstone of our analysis has consistently been the normative principle of income recognition. All of the items listed in sec-

---

255. *Id.*

256. McKee, *Partnerships* at 23-25 (cited in note 138). The author concluded: The rationale of *Quick Trust* and *Woodhall* strongly suggest that partnership items other than zero-basis accounts receivable may be IRD. Under this analysis, IRD includes any partnership item that would be IRD if held by the decedent in his individual capacity. On the other hand, partnership items (such as potential depreciation recapture) that would not be IRD, if held individually, should not be IRD simply because they fall within the §751(c) definition of 'unrealized receivables'. (citations omitted).

*Id.*

257. IRC § 751(c) (1986) (text quoted in note 37).

258. An entity theory would not permit an item by item analysis. As discussed above, that theory is premised upon the integrity of the entity to the exclusion of investigation of the constituent parts of the organization.

259. IRC § 691(e) (1986) (text quoted in note 43).

260. IRC § 753 (1986) (text quoted in note 44).

261. IRC § 736 (1986).

tion 751(c)<sup>262</sup> would require ordinary income recognition by the partner disposing of her interest in a partnership which contained such items. Pursuant to section 751(a),<sup>263</sup> sale of a partnership interest containing items described in section 751(c),<sup>264</sup> so called hot assets, would generate ordinary income. That does not mean, however, that all of those items are properly treated as IRD.

There is a further refinement in our bedrock principle of recognition of income that must be addressed upon the death of a taxpayer. As explained above, IRD provides a mechanism for taxing income earned by a decedent before her death, but paid after her death.<sup>265</sup> It does not apply to all items of income, just to those earned but not yet received by the taxpayer. As mentioned above, the first characteristic of IRD is that section 691<sup>266</sup> properly applies to items that would have been realized by the decedent in gross income without further effort. The ordinary unrealized receivables fall into this category. Their payment will occur in time and will not be due to any further effort on the part of the decedent. The unrealized receivables that are defined in section 751(c)<sup>267</sup> as other than those ordinary unrealized receivables are different in that they all require further action before they would have been realized by the decedent. That further action would either be disposition of the partnership interest, thereby triggering section 751(a),<sup>268</sup> or disposition of the property itself by the partnership.

The legislative history provides some specific guidance and support for that analysis in the partnership area. The House Report explains the nature of unrealized receivables contained in the partnership interest.<sup>269</sup> It also describes a distinction between section 751(a)<sup>270</sup> unrealized receivables, and IRD unrealized receivables.

---

262. IRC §751(c) (1986) (text quoted in note 37).

263. IRC § 751(a) (1986) (text quoted in note 235).

264. IRC § 751(c) (1986) (text quoted in note 37).

265. *Helvering v Enright*, 312 US 636 (1941).

266. IRC § 691 (1986) (text quoted in note 23).

267. IRC § 751(c) (1986) (text quoted in note 37).

268. IRC § 751(a) (1986) (text quoted in note 235).

269. House Report at 4097 (cited in note 226):

A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent. Such rights to income will be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes. However, a decedent's share of appreciated or depreciated inventory or stock in trade is not treated as income in respect of a decedent.

Id.

270. IRC § 751(a) (1986) (text quoted in note 235).

Section 751(a)<sup>271</sup> addresses itself to either unrealized receivables or appreciated inventory. The House Report clearly excludes appreciated inventory from income in respect of a decedent.<sup>272</sup> Furthermore, the House Report defines unrealized receivables or fees much differently from than the section 751(c)<sup>273</sup> definition.<sup>274</sup> Accordingly, the House Report supports the view that IRD includes only unrealized receivables in the general sense of unpaid but previously earned income. In this connection, the distinction is between amounts that would have been realized by the deceased taxpayer if she had been on an accrual basis prior to her death and amounts unrecognized by reason of a cash method of accounting. The fact that she was on a cash basis is what led to those amounts not being realized prior to her death and what requires their inclusion in IRD.

In our example, the A and A partnership uses the cash method of accounting for income. Amounts which were earned by the firm would have been taken into income by the deceased under an accrual method. The use of a cash method should not isolate amounts earned but not yet paid from income taxation. And as we have seen IRD is the statutory device that ensures the income taxation of the amounts received by the cash method taxpayer that were earned prior to death but received after death.

If, as I have argued, aggregate partnership theory underlies income in respect of a decedent in the partnership context, it follows that aggregate theory should be applied throughout the analysis. Each component of the partnership interest, including unrealized

---

271. IRC § 751(a).

272. House Report at 4097 (cited in note 226):

[A] decedent's share of appreciated or depreciated inventory or stock in trade is not treated as income in respect of a decedent. The decedent's interest in such inventory or stock in trade will be increased or decreased in basis in the same manner as other property held by the decedent. The change in basis as the time of death will not be reflected in the basis of partnership assets but will be used by the estate or heir as an adjustment to the income received on the disposition of such property. The estate or heir is thus treated in the same manner as a purchaser with respect to the decedent's interest in appreciated or depreciated inventory or stock in trade.

Id.

273. IRC § 751(c) (1986) (text quoted in note 37).

274. House Report at 4097 (cited in note 226):

The term "unrealized receivables or fees" is used to apply to any rights to income which have not been included in gross income under the method of accounting employed by the partnership. The provision is applicable mainly to cash basis partnerships which have acquired a contractual or other legal right to income for goods or services.

Id.

receivables, should be examined to determine whether it is IRD. The first characteristic of IRD is that earned but not realized items of income may not be avoided by virtue of their inclusion in a partnership. We should now examine individual section 751(c)<sup>275</sup> unrealized receivables to determine which ones constitute earned but not received items of income.

The regulations seem to ignore any distinctions among section 751(c)<sup>276</sup> hot assets in the IRD context. Regulation section 1.736-1(b)(2)<sup>277</sup> provides that, for purposes of section 736(a),<sup>278</sup> the term unrealized receivables is defined by section 751(c).<sup>279</sup> As described above, that definition encompasses a panoply of unrelated items including stock of a DISC<sup>280</sup> or former DISC, section 1245<sup>281</sup> and 1250<sup>282</sup> recapture, stock in foreign corporations, trademarks, etc. The possibility that those and other section 751(c)<sup>283</sup> items might be afforded the same treatment as the simple unrealized receivables in *Woodhall* and *Quick Trust* has caused commentators to express concern.<sup>284</sup> The application of aggregate partnership theory in the presence of IRD principles, however, should put that concern to rest.

Only section 751(c) items that represent earned but not yet realized income may be IRD. Employing the item-by-item analysis required by aggregate partnership theory, none of the items listed in the flush language of section 751(c)<sup>285</sup> qualifies for IRD treatment, because none is earned but not yet realized. They are all potential future ordinary income items, not items of income that have been earned but not realized at death.

---

275. IRC § 751(c) (1986) (text quoted in note 37).

276. IRC § 751(c).

277. Treas Reg § 1.736-1(b)(2) (1965) explains:

Payments made to a retiring partner or to the successor in interest of a deceased partner for the interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in the partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

Treas Reg § 1.736-1(b)(2).

278. IRC § 736(a) (1986) (text quoted in note 45).

279. IRC § 751 (1986) (text quoted in note 234).

280. IRC § 992(a) (1986).

281. IRC § 1245 (1986).

282. IRC § 1250 (1986).

283. IRC § 751(c) (1986) (text quoted in note 37).

284. McKee, *Partnerships* at 23-25 (cited in note 138).

285. IRC § 751(c) (1986) (text quoted in note 37).

The clearest examples of this analysis are the recapture items. Depreciated or depleted property such as section 1245<sup>286</sup> property, or mines, or oil and gas property, may generate ordinary income upon their disposition. The time of receipt of that income at a date later than the death of the partner precludes it from IRD treatment. The root IRD principle of income earned but not realized cannot apply to income not yet earned. Consequently, because all of the items listed in the flush language of section 751(c)<sup>287</sup> are unearned at the time of death, none of the items can be IRD.<sup>288</sup> In the context of the A and A partnership, farm land is not IRD because it does not represent income that has been earned but not yet paid on the death of Arachne. Accordingly, there can be no IRD to Arachne's successor in interest.

## VI. CONCLUSION

The functional approach to non-tax partnership theory advanced by scholars such as Professor Weidner has a corollary in the tax arena as well. Just as each state must decide whether entity or aggregate theory best describes and supports a desirable partnership result, so too the Code must choose between those two theories based upon which theory best serves the function of the partnership. In other words, the chief question to be asked in both tax and non-tax partnership circumstances concerns the purpose of the partnership vis-a-vis a particular partnership transaction. Resolution of that question in the tax context is governed by a set of principles that supersedes the foundational issues of entity and aggregate partnership theory.

The death of a partner requires an analysis of the individual assets of a partnership if the overarching principles of income recognition and its analogue, basis preservation, are to be preserved in the partnership context. Although a partnership interest may for many other purposes be viewed as an entity, the death of a partner requires an aggregate analysis of the partnership interest in order to determine whether individual assets of the partnership reflect the four characteristics of IRD that trigger recognition of income upon the death of a partner. Pursuant to a functional approach to partnerships, entity theory can be seen to simply give way to supe-

---

286. IRC § 1245 (1986).

287. IRC § 751(c) (1986) (text quoted in note 37).

288. The flush language of section 751(c) contains items that ought to generate ordinary income in the context of section 751(a) but not as IRD under section 691.

rior and more useful principles in this circumstance. The need to identify and preserve IRD upon the death of an individual supersedes the need to treat a partnership interest as an entity. Treatment of the partnership as a conduit under aggregate theory permits a splitting of the interest into its constituent parts. After that splitting, each part can be examined on its own merits without concern for any effect on the partnership entity itself.

Upon the death of a partner, the two principal theories of partnership law are applied in subservience to the higher order normative principle that income, earned but not recognized by any taxpayer, may not escape taxation upon the death of the taxpayer. In other words, income in respect of a decedent is recognized by Congress, the courts and the Service as operational upon the death of an individual, even if the amount earned by the individual must first pass through the business association known as a partnership.

The implementation of IRD principles to unrealized receivables in every possible partnership context has required the Tax Court to fill in some of the gaps left by Congress.<sup>289</sup> In so doing the court rejected entity theory in favor of viewing the partnership as an aggregation of partnership rights and duties, one of which is the right to unrealized receivables. Although the court did not define unrealized receivables, its application of aggregate partnership theory to resolve the IRD question means that aggregate theory should apply throughout the analysis. Consequently, each asset susceptible of being classified as an unrealized receivable must be examined to see if it fits the superior category of unrealized receivable under IRD principles. In other words, one must determine whether a specific item was earned by the decedent in her lifetime, but not yet realized prior to her death. Upon application of that approach, it becomes clear that the flush language of section 751(c)<sup>290</sup> contains no such items of earned income. Consequently, none of those items is income in respect of a decedent.

---

289. *Quick Trust*, 54 Tax Ct at 1345; *Woodhall*, Tax Ct Mem Dec (P-H) ¶ 69,279 at 69-1557.

290. IRC § 751(c) (1986) (text quoted in note 37).